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Unit 1: Accounting & Finance 101: The Foundation (Part I – Why and What of Accounting & Finance)

Learning Objectives

1. Understand the purpose and scope of accounting and finance in business.
2. Recognize the role of accounting in decision-making and control.
3. Identify the key users of financial information and their needs.
4. Explain the importance of financial literacy for managers and entrepreneurs.
5. Differentiate between accounting and finance as disciplines.
6. Appreciate the role of accounting & finance in business sustainability and growth.
7. Develop a foundational mindset for applying accounting principles in real-world contexts.

Content

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1.1 Introduction to Accounting & Finance

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1.0 Introductory caselet

Anita, a young entrepreneur who has just stepped into the Indian apparel industry with TrendEdge. The venture soon began to get good orders through the social media promotions and word-of-mouth. As sales soared, Anita discovered that she often found it difficult to reconcile cash income, payments made to suppliers or monthly expenses.

At the outset, she kept track of all this on a simple spreadsheet, but as transactions piled up, errors and missed payments were routine. She already saw that while her store was making sales, she had no idea if it was profitable or what she owes and would need to generate in the future.

Then one day, when a supplier refused to send in fabric until her old dues were cleared, Anita was struck by the cash crunch. It left her wondering — was the business truly expanding, or merely running around in circles without a respectable financial hand at the helm?

Anita – After attending a brief course on some of the Accounting & Financial Basics, Learned that maintaining records in order and then analyzing them was pretty important. She learned that accounting is not just logging transactions, but generating information useful for decision-making, and finance is about managing money for future growth.

Prepared with this knowledge, Anita determined to start using accounting software, keep financial accounts and talk to a finance adviser. In a few months, TrendEdge not only managed to rationalise payments and collections but also received a small investor since they could produce transparent financials.

Critical Thinking Question:

(ii) Why is it important for Anita to adopt standard procedures in accounting and finances?) What will the risks be if she keeps doing things the same way?

1.1 The Nature of Accounting and Finance

1.1 MEANING AND DEFINITION OF ACCOUNTING

Accounting Accounting is the organized way in which a business records its financial transactions including purchases of inventory, sales and refunds to customers. It offers an organized format for recording income, expenses, assets, liabilities and equity. The main goal of accounting is to give a clear picture of the financial condition, or position, of a firm and to provide an accurate representation of the financial results (earnings) for a particular period of time.

Definitions:

• The American Institute of Certified Public Accountants (AICPA) has described accounting as "the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the results thereof."

Accounting is essentially the "language of business" that is used to communicate financial information to people for making decisions.

1.1.2 Meaning, Definition, and Importance of Finance in Business

Finance, on the other hand, is defined as the scope of management of money and credit so that an individual or a company can conduct their business more profitably. Such activities include budgeting, saving, borrowing or lending money and investing of these funds in financial assets. Finance is frequently described by academics as an art as well as a science: art, due to the requirement for judgment, creativity and experience to deal with uncertain situations; and science because it has disticnt theories, principles anaualitative techniques on which it relies. Finance itself can be divided into three sub-categories: personal finance, corporate finance, and public finance, which serve the needs of an individual, company or government.

Especially in business environment finance is excessively important to ensure that funds are well utilized and mobilized to achieve organizational goals. Closely related to finance is accounting, the methodical recording, classification and reporting of financial transactions. Accounting is the language of business and communicates pertinent information through transactional record keeping, asset valuation, liability tracking, and profitability. And finance, in turn, leverages such data to assess performance, steer risks, predict upcoming requirements and take strategic decisions like investment into a new market growth market or concentrate cost.

The role of accounting and finance in business is paramount. They are fundamental building blocks for decision-making at the firm level and allow management to estimate budgets, allocate resources, and analyze profitability in a sound manner. They also create the confidence of investors or creditors and other stakeholders through transparency and accountability. Furthermore, strong financial management helps achieve long-term viability: it balances short-term operational needs with long term growth plans. In the absence of proper accounting and financial management firms are vulnerable to inefficiency, mismanagement, and losses that might cost them their number one position in business. Hence, finance and accounting integration has positive effects on firms' performance by ensuring sustainability in a volatile environment.

1.2 Role and Importance of Accounting and Finance in Business

Accountancy and finance act as the spinal cord of any corporation. They're more than "the guys who keep the books" — they are the analytical and strategic cornerstone behind

everything that happens in operations, from measuring performance to planning for expansion; from ensuring compliance to driving innovation. Their functions are interrelated but distinct:

• Accounting: The process of recording, classifying, summarizing and reporting financial transactions.

• Finance involves the translation of this data to decide how resources are allocated, invested, risk-managed and value-created.

Combined, they allow businesses to operate effectively, meet stakeholder demands and negotiate challenging economic conditions.

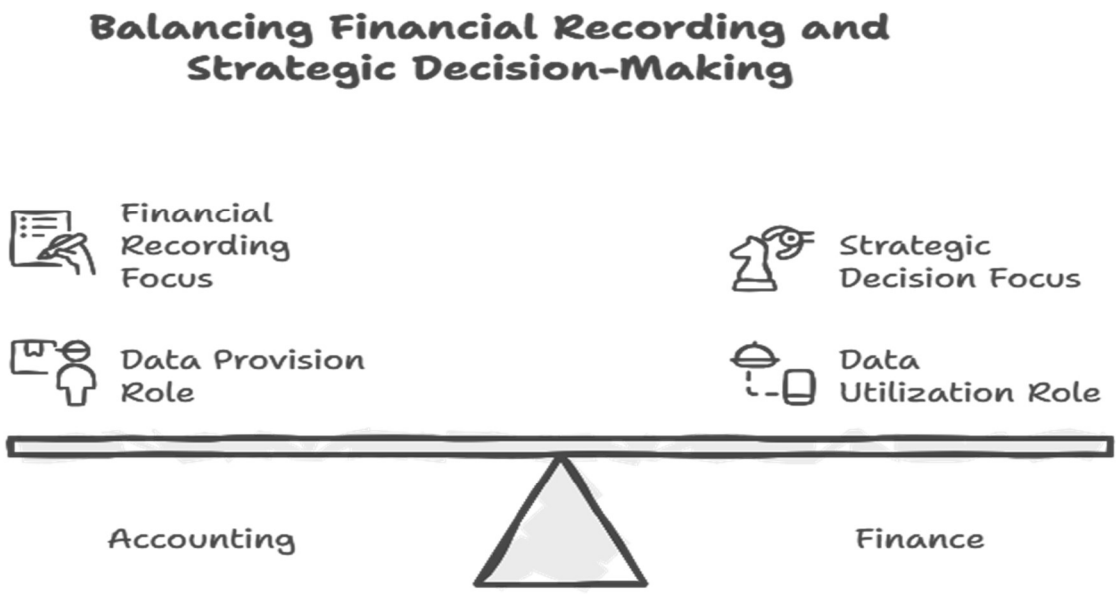

Figure **1.1**

1.2.1 Performance Measurement and Financial Analysis

Why It Matters:

Measurement is the cornerstone of business performance There are three things no one in business can ever know enough about: Whether their goals are being achieved, whether or not they're making money and how well off financially they are now as well as in the future.

Accounting's Role:

Accounting produces core financial statements:

• Income Statement: (Profit and Loss Account):Shows revenues, expenses and profit for a particular period.

• Balance Sheet: Reflects the financial position at a point in time — liabilities, assets and equity.

• Cash Flow Statement: Illustrated how cash flows into and out of the business — operations, investing, financing.

Example:

A manager examining a decrease in quarterly profits might turn to the income statement to pinpoint cost overruns and then read the balance sheet to see if he has been managing or wasting his assets.

Insight: Without solid accounting, we won't manage performance well and the strategic decisions we make will be guesswork.

1.2.2 Managerial Decision-Making and Strategic Planning

Why It Matters:

Managers make decisions every day, in the short term and the long term, that shape the future of a business — what to produce, how much money to invest, whether to enter a new market and so on. These decisions need to be data-driven.

Finance's Role:

Accounting interprets the data generated in it for its use through: 1.

• Budgeting and forecasting

• Pricing decisions

• Make-or-buy decisions

• Investment appraisal (eg NPV, IRR) • Capital investment appraisals such as NPV and / or IRR.

Example:

A manufacturing company choosing between automating production and employing more labor would factor in cost-benefit analysis, break-even points and ROI projections — all financial objects.

Insightful Report: Knowledge based financial decisions add value by enhancing resource optimisation, preventing expensive errors and assisting sustainable business planning.

1.2.3 Legal Compliance and Regulatory Reporting

Why It Matters:

Businesses are subject to different laws and regulations like tax, corporate reporting and auditing requirements. Those who fail to comply face fines, penalties or criminal charges.

Accounting's Role:

Accounting ensures compliance with:

• Legal and taxation laws (e.g. income tax, GST/VAT)

• Statutory audits and financial disclosures

• Corporate laws and regulatory requirements (e.g.,SEBI in India,SEC in USA)

Enterprises also need to comply with established accounting standards:

• GAAP (Generally Accepted Accounting Principles)

• IFRS (International Financial Reporting Standards)

Example:

There are public companies that report their financials quarterly. Those need to be audited by external accountants, and must be accurate and meet legal criteria.

Big Idea No. 1: As a discipline, accounting helps keep businesses within the bounds of what is legal and rewards stakeholders (investors, creditors and the public).

1.2.4 Building Investor Confidence and Raising Capital

Why It Matters:

Next up, a business can only garner investors or loans or be floated on public markets to the extent that it looks bijou and earnest in its financial conduct.

Finance and Accounting's Role:

• Providing clear, audited financial statements

• Compiling investment reports, earnings estimates and disclosures

• Strong internal controls and governance practices

Example:

For startups seeking venture capital, this means showing very specific five-year financial projections; for public companies, it requires gaining the confidence of investors by providing regular and honest reports.

Investors invest in businesses that are fiscally responsible, open and strategic.

1.2.5 Cash Flow Management and Liquidity Planning

Why It Matters:

Even the most successful companies fail if they run out of cash. More often than not, the availability of money required to meet commitments is more important than profit.

Finance's Role:

• Forecasting inflows and outflows

• Then how are we going to manage credit terms, inventory and payment cycles?

• Key tool to evaluate: cash budgets, liquidity ratios and working capital analysis.

Example:

Such a retailer may need to time its cash reserve accumulation prior to the holiday shopping season, when accounts payable (due to suppliers) have been due while sales revenue from customers peaks.

Insight: Withdrawing money from the business to pay expenses is very important and helps you avoid bankruptcy by paying employees, suppliers, lenders etc.

1.2.6 Risk Management and Financial Control

Why It Matters:

Businesses are subject to different types of risk: market risk, credit risk, operational and strategic risk. The accountants and the financial systems are essential for us in terms of linking them up together and working out how to measure them.

Finance's Role:

• Performing risk and sensitivity analyses

• Hedging with tools (e.g., futures, options)

• Keeping track of debt levels, the interest rate and currency calculation.

Example:

For example, an exporter can protect itself from currency risk by fixing exchange rates with the use of forward contracts.

Big Idea: Risk management promotes financial stability, guards against shocks and supports long-term existence.

1.2.7 Supporting Strategic Growth and Innovation

Why It Matters:

Growth can be high investment and low yield—whether in expansion, acquisitions or innovation.

Accounting and Finance's Role:

• Evaluating new projects' financial feasibility

• ROI, Payback EstimationsAssessment of return on investment (ROI) and pay back period

• Cost structures R&D-intensive industries

• Helping to evaluate debt versus equity financing decisions

Example:

A tech company introducing a new product line needs to be able to assess development costs, potential market size, pricing strategy and competitive positioning — all with the help of financial modeling.

Key Insight: Accounting and finance enable innovation to be strategically feasible and financially viable.

"Activity"

Form small groups and list five everyday business transactions (e.g., purchasing goods, paying rent, receiving customer payments). Classify each as either accounting (recording and reporting) or finance (funding and managing money). Discuss how both functions complement each other in ensuring business success.

1.2 Why Accounting?

1.2.1 Role of Accounting in Business Decision-Making

Accounting is fundamental for helping business leaders make decisions by providing them with financial information in an explicit and systematic manner. It's commonly referred to as the "nervous system" of a business, because decisions can' t be any better than their data. B2B decisions are everywhere We make multiple choices every day in business whether that be launch new product, expand into a market, outsource operations or invest in a piece of technology. And in the absence of credible accounting, these decisions would be based on speculation, not facts.

• Measuring profitability: Accounting enables managers to determine what products, services or branches of the business are profitable and which ones eat up resources. This is useful for product portfolio optimization.

• Cost accounting: By breaking down fixed and variable costs, companies can analyze where they need to get more efficient. If overheads are spiraling, the accounting information may pick up on that trend before you do.

• Investment decisions: When considering whether to purchase new machinery, open a branch or add a service they use information provided from accounting such as forecasted cash flows, return on investment and break-even assessments.

• Pricing decisions: The cost, demand and competitive parameters of prices are managed with the help of accounting ensuring that the price is not set at random striving for profitability and market competitiveness.

• Performance measurement: This is another aspect of accounting where it helps in the form periodic performance reports that indicate whether a business is actually moving towards its goals and to take action if not.

Figure **1.2.1**

Recording and Reporting Transactions

Accounting is based on recording of each transaction consistently. This will ensure that no transaction, however small and quantifiable in currency terms, passes the books.

The steps to solve the challenge are as follows:

• Recording

Each event when money is coming into or going out of a business — like sales, purchases, wages, rent and utility payments — are recorded in the books.

• These facts are initially recorded in books of original entry (journals or daybooks).

• They are then recorded in ledgers, which group transactions under the right account heads.

• An interim trial balance is calculated periodically to check that the sum of all debits equals the sum of all credits, thus representing a true ratio.

• Reporting

Transactions are entered and categorised then summarised into financial statements. These include:

• Revenue Statement (Profit and Loss Account):

Shows income and expenditure for the reporting period. It gives you a sense of whether the business has been profitable or not.

• Balance Sheet:

Reports the trial balance of the business at a particular date. It lists:

o Assets (e.g., cash, inventory, equipment)

o Liabilities (e.g., loans, accounts payable)

o Equity of owners (capital, earnings retained)

• Cash Flow Statement:

It tracks real money inflows and outflows under three key sections:

o Operational activities (c) (Cash from main business operations)

o Investment activities (cash used in or provided by investment assets)

o Financing activities (cash from loans, equity and dividends)

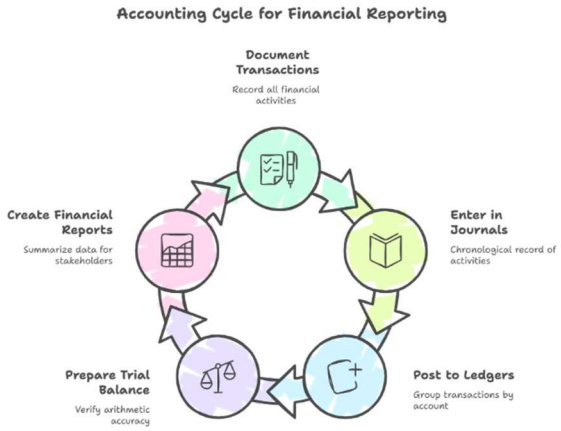

Figure **1.2.2**

1.2.3 Ensuring Transparency and Accountability

Financial reporting Transparency of disclosure is considered a component that contributes to the credibility and long-term potential performance of an organization (Lopes, 2006). When the activities of an entity are documented in a systematic manner and the information provided to users is reliable, all interest groups (owners, shareholders, creditors, employees or supervisory authorities) can take decisions for actions on the ground.

• Transparency

Accounting : keeping your books clear and accessible: Accounting makes sure financial records are available to managers in a consistent way. A company that honors transparency is more likely to earn the trust of outside parties, garner investment and obtain favorable terms from financial institutions.

• Accountability

Accounting is a detailed and auditable history of financial choices. Management is responsible for the resources in its charge. And how will inefficient uses of funds or underutilisation of owned assets be discovered other than in the accounting records?

• Truthfulness

Accurate accounting promotes a fair or transparent representation of the financial performance and position of an organization. It makes sure that account balances—resulting from batches of transactions—are accurate and reflect “what really happened” and not merely what was expected or intended, in accordance with established accounting rules.

• Fraud Prevention

Well-organized, open accounting systems are less susceptible to shenanigans. By establishing and maintaining checks and balances, accounting insures against unauthorized disbursements, misuse of assets or fabrication of records.

1.2.4 Supporting Regulatory Compliance

Firms are subject to rules and requirements of governments, professional accounting bodies and international standards. Accounting is considered the formal means to assure requirements are consistently met.

• Tax compliance: There are laws that require businesses to calculate, file and pay taxes when due. Correct bookkeeping is necessary to properly calculate your taxable income and will keep you from inadvertently making mistakes that will get you sanctioned.

• An ability to pass an audit: External auditors or regulatory bodies typically review companies. Perfect and uniform accounts facilitate this service smoother and also genuine.

• Standards compliance: Accounting helps to adhere with the GAAP, IFRS, or other specific national standards.

• Corporate governance: Public companies must submit annual reports, share financial information with shareholders and comply with strict reporting standards.

• Preventing penalties and protecting reputation: Misreporting or underreporting might lead to fines, litigation or reputational harm. Getting those risks accounted for keeps the company from being perceived as a less reliable place to do business.

1.2.5 Providing Financial Insights for Planning

But accounting is not only importance to record history, it also gives look ahead ideas that are important in planning and decision making. It turns arbitrary numbers into actionable information that allows an organization to predict the potentialities and risks.

• Budgeting: Companies create budgets that project revenues and costs over a certain amount of time. Accounting is the benchmark information that we need to set appropriate goals.

• Prediction: Businesses can predict future sales, profits and cash flows using historical financials. Projections also help anticipate potential shortages or surpluses.

• Resource allocation: Financial intelligence illuminates which business units or projects should be allocated more investment, and which may need to get cut.

• Risk analysis: Using accounting a manager is able to identify risks like rising costs or reduced sales, and prepare contingency plans.

• Business growth decisions: Whether expanding into a new market, launching a new product or looking at the possibility of a merger, accounting gives you financial justification and feasibility analysis for such moves.

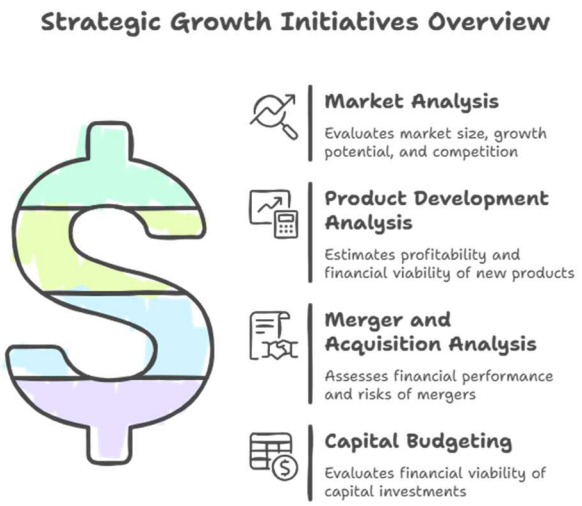

Figure **1.2.5**

1.3 Accounting vs Finance

1.3.1 Key Differences in Purpose

Accounting and finance work together in the same principle, but they have clearly defined goals that one should not be mistaken for the other.

Accounting: Accounting has a basic function to maintain an organized, accurate record of the financial transactions that have already occurred.Dictionary – View Original – Index Adjaye, Nii ayi-AcquahkwesibeaCount down Count down_Counting on You. It is a historical function and aims to process transactions impartially, secure that the operations of this organisation are clearly reflected in the books of account. In this regard, accounting offers transparency, factualness and compliance with laws and professional standards. For example, if a business receives cash for products it sells to its customers, accounting ensures that the sales revenue and associated costs of good sold along with other incurred costs are recorded in proper books of accounts.

• Finance: Finance is also more forward-looking. It encompasses planning, managing and controlling money to accomplish the mission" and that "Financial management includes the

responsibility of managing the funds so that the organization's goals are achieved in a fair manner as cost-effectively as possible". Finance involves determining the methods in which money is acquired (loans, equity, retained profits) and how it is used (investments, expansion plans and maintenance). As an example, once the company makes revenue on a sale (accounting), finance must determine what to do with this money, pay dividends, invest in new projects (if any), pay for corporate activities as savings or reserves etc.

Because it does, accounting serves to answer the question "What happened to the company's money?", and finance asks, "What do we do with the money that we have?"

1.3.2 Scope and Focus Areas

The breadth of accounting and finance is terms that are used to describe what activities both departments do within an organisation. Accounting v/s Finance Though closely related, there are some important differences between the two domains and how they help with organizational targets.

Scope of Accounting

Accounting at its core is about the orderly management of monetary records to enable decent recording, organizing, and comprehending of all transactions.

• Recording Transactions

Recording each financial transaction in the order of its occurrence based on source documents (e.g. invoices and receipts).

• Classifying and Summarizing Data

Classifying recorded transactions, into revenue, expenses, assets or liabilities and summarizing the classification in a useful reports.

• Preparing Financial Statements

official reports such as Income Statement, Balance Sheet and Cash Flow Report – to reflect the state of affairs and predict the business performance.

• Auditing

Testing and evaluating financial statements and internal controls to determine if they are accurate, complete and not materially mis-stated.

• Compliance

Making sure the firm meets accounting standards and tax requirements, as well as statutory reporting. Proper accounting also helps to simplify the auditing services and compliance with financial laws.

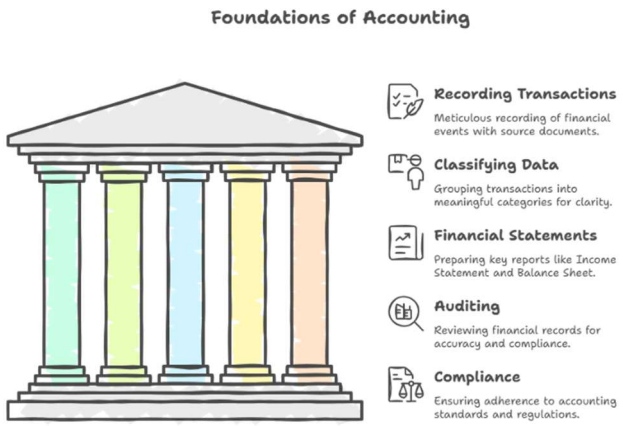

Figure **Scope of Accounting**

Scope of Finance

Financial management involves the planning, controlling and utilisation of financial resources. It allows a business to establish better decisions that create value and promote sustainability.

• Raising Capital

Determining the optimal structure of a financing package (e.g. debt, equity, or retained earnings) to satisfy financial requirements.

• Investment Decisions

Anticipating the return that can be expected from a new project, asset or financial instrument (e.g. bond, share), before investing money in it.

• Working Capital Management

Control of current assets and liabilities, such as inventory, accounts receivable (A/R) and accounts payable management for adequate liquidity and running the business optimally.

• Risk Management

Minimize your company's risk of exposure to variables like interest rates, exchange rates or market fluctuations with financial tools and strategies.

• Capital Structuring and Dividend Policy

Finding the right debt-to-equity ratio; deciding how much profit should be returned to shareholders as dividends and how much should help grow the company.

Focus Areas

• Accounting is defined as the process of recording and reporting financial transactions. It's focus is creating accurate, consistent data that drives compliance, allows for audit and assures financial transparency.

• Management of funds is emphasized in finance. It is about looking forward, both in terms of assessing financial risks and opportunities and capital investment to attract a return on investment (ROI) and develop the business itself.

Did You Know?

"Accounting focuses mainly on recording, compliance, and reporting past financial transactions, while finance emphasizes future planning, investment, and growth strategies. Interestingly, many business leaders rise from finance roles rather than accounting because strategic financial management directly drives expansion, risk management, and shareholder value creation."

Figure **Scope of Finance**

1.3.3 Interdependence between Accounting & Finance

Despite their unique objectives, accounting and finance are not distinct entities; they complement each other as two sides of the same coin in every business.

• Accounting as foundation: Financial executives base their decisions on accounting transactions. Financial plans and investment studies could never be made if we didn't have proper accounting data. For example, a financial manager cannot decide how much to borrow without knowing the company's accounting-reported current liabilities and profitability.

• Accounting becoming influenced by finance: Financial tactics tend to influence the design of accounting systems. For instance, if an organization decides to do business overseas (a finance decision), then accounting must be adjusted to cope with many different currencies, and international reporting standards.

• Integrated decision-making:

o Accounting o Tells about past performance, history of cash flows and liabilities.

o Finance — Analyzes this data to make funding, investment, or expanding decisions.

• Both with similar objective: They both want to protect company's resources and make sure the company is stable while maximizing shareholder's value. Credibility starts with accounting accuracy and that information is leveraged in a longer-term focus when the emphasis shifts to finance.

1.3.4 Practical Examples in Organizations

The contrast and relation between accounting and finance can be seen in the operations of a business.

• Example 1: Producing Reports vs Consuming Them

o Accounting function: It formulates the income statement reflecting profit and expenses in a particular year.

o Finance function: Utilises this report to determine whether surplus can be reinvested for growth or should be returned to shareholders as dividends.

• Example 2: Cash Management

o Accounting function: These are entered in the cash book posting both inflows (sale receipts, loans) and outflows (payments to suppliers, workers).

o Finance: Assess cash flow trends to identify whether there is a need for more money;if this the case, will additional needs be offset by an excess.

• Example 3: Capital Investment

o Accounting: Treats the acquisition of new machinery as a fixed asset, subsequently depreciating it each year.

o Financial role: Analyses the costs related to purchase, and decides whether it is economically feasible in comparison of leasing.

• Example 4: Loan Management

o Accounting function: Proper principal paydowns and correct Interest Expense on FI, KEPT books.

o Finance role: Determines whether to raise new equity, pay off existing debt as interest rates fall or re-finance.

• Example 5: Risk and Compliance

o Accounting function: Compliance to GAAP/IFRS reporting standards and tax rules for all financial reports.

o Finance aspect: Hedg es, insurance or diversification therewith against market and credit risks.

• Example 6: Strategic Expansion

o Role of accounting: Ensures that the latest profitability and capitalposition reports are accurate.

o Finance: The team uses that data to determine if the company can grow into a new market or buy another business.

1.4 Basic Accounting Terms

1.4.1 Transaction

Meaning: A transaction is the transfer of money between two accounts, can be linked to business operations(i.e. sales, purchases etc.) and are reported on a company's financial statement. The transactions are the basis for accounting records.

• Spot: Payments or receipts that are settled and made immediately, either by cash.

o Example: A store purchases goods with cash at the time of purchase.

• Credit Deals: Receipts or payments received on a later date (credit – you), paid/received).

o Example: A wholesaler supplies goods to one of its customer on credit, payment will be made after 30 days.

• Business Examples:

o Buying of inventory from a supplier.

o Selling of finished products to end-consumers.

o Rent, wages, or utilities.

1.4.2 Capital & Drawings

• Capital: The owner's initial investment in the business to start and operate it. It represents the owner's equity.

o Eg: Let's say an individual invest ₹5,00,000 to start a Café.

• Drawings: The amount of cash or other assets taken out of the business by the owner for personal use. Drawings reduce the owner's capital.

o For example: The owner of a café takes ₹ 20,000 from the business account for personal expenses at home.

1.4.3 Assets

Definition:

Assets are items of value owned by a company, property that can be converted into cash, or establishments and goods available for sale.

The SCOPE OF ASSETS Assets are one of the basic building blocks of a balance sheet; they can be distinguished by time, physical form, and work use.

Types of Assets

Current Assets

Items with the value that you think will get converted in to cash or will be consumed/sold within a year or operational cycle of company, which ever is longer\) 2.

• Examples:

o Cash and cash equalets (bank, petty cash) 27.

o Trade receivables (receivables from customers)

o Inventory (raw materials, finished goods)

o Prepaid expenses (advanced rent, insurance)

Fixed Assets (Non-Current Assets)

Long-term assets not for sale from which businesses operate. These resources give service or are employed on production over more than one accounting period.

• Examples:

o Land

o Buildings

o Machinery and Equipment

o Vehicles

Tangible Assets

Things that have physical shape, and can be seen or touched. These can be either liquid assets or fixed ones.

• Examples:

o Furniture

o Computer systems

o Tools and instruments

o Fixtures

Intangible Assets

Nonphysical resources that provide long- term values to the firm. These rights are usually legal rights or intellectual property.

• Examples:

o Goodwill (eg brand name, customer loyalty obtained through acquisitions)

o Patents (exclusive rights over inventions)

o Trademarks (brand names, logos)

o Copyrights (protection for creative works)

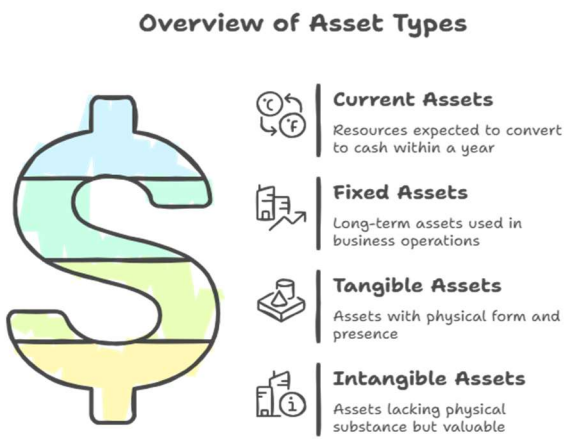

Figure **Types of Assets**

1.4.4 Liabilities

Definition:

Liabilities refer to the financial obligations (debtedness) of an enterprise, such as money owed to suppliers, wages payable and taxes owed to government. Such liabilities are related to past events or transactions, and shall be settled through the transfer of (typically) assets (cash) or delivery of services in due course.

Liabilities are also a fundamental part of the accounting equation: Assets = Liabilities + Owners\' Equity. They are divided into two main types based on the time required to settle them off:

Current Liabilities

Current liabilities are obligations expected to be satisfied by the company in its normal operating cycle or within twelve months of the close of business on the day of preparation. These are usually paid off using the entity's current assets or by establishing other current liabilities. Current liabilities are important numbers to look at when analyzing a company from a short term liquidity standpoint and working capital management.

Common examples include:

&bull Accounts Payable: Money owed to suppliers by purchasing an organisation either from goods or services received or from other expenses.

• Wages/Salaries Payable: Money an employer owes its workers for work recently done, but not yet paid.

• Taxes Payable: Any taxes owed to the government (whether it be income, sales, or other.

• Short-Term Financing: Indebtedness or credit which is payable in 1 year.

• Cost: Money that has been spent but not yet paid.

Long-Term Liabilities / Non-Current Liabilities

Long term liabilities (non-current liabilities) are any financial obligations which aren't due for at least 1 year from the balance sheet date. These obligations are necessary for long-term financing of projects, purchasing capital equipment or making key investments. The separation between these debts provides interested parties with a clear picture of the long-range financial health and stability of the company.

Common examples include:

• Bank Loans (LT): Funds borrowed from banks with a term of more than 1 year.

• Debentures: Instruments of long-term debt that companies issue in order to raise money, typically with a fixed interest rate.

• Debt Obligations: Notes payable and long-term debt.

• Lease liabilities: Liabilities under long-term leases that are recognized as such in accounting standards, as for example IFRS 16.

• Pension Obligations: Money that is due in the future to workers for retirement related benefits.

Figure **1.4.4**

1.4.5 Suppliers & Customers

In the context of business accounting and financial reporting, **suppliers** and **customers** are two key external stakeholders who directly influence a company's working capital and credit cycle. Their relationships with the firm are typically based on **credit transactions**, which give rise to specific accounting terms and classifications on the balance sheet.

1. Suppliers (Creditors – Accounts Payable)

Suppliers are individuals or business entities that provide goods or services to a company, typically on credit terms. When a company procures materials or services without making immediate payment, it incurs a liability known as **accounts payable**, making the supplier a **creditor**.

These amounts are recorded as **current liabilities** on the balance sheet, as they are usually payable within a short-term period (e.g., 30–90 days).

Example:
A garment manufacturer purchases fabric from a textile supplier on 60-day credit terms. The amount owed to the supplier is classified as **accounts payable**.

2. Customers (Debtors – Accounts Receivable)

Customers are individuals or organizations that purchase goods or services from a company, often on credit. When a company allows its customers to delay payment, it creates an asset called **accounts receivable**, and the customer becomes a **debtor**.

Accounts receivable represent amounts that the company expects to collect in the near future and are classified as **current assets** on the balance sheet.

Example:
A retail clothing store sells products on credit to loyal customers who agree to settle their bills at the end of each month. The unpaid amounts are recorded as **accounts receivable**.

1.4.6 Income

Definition: Income refers to the money earned by a business from its normal operations, such as sales, services, or other activities.

- **Business Examples:**
  - Revenue from selling products.
  - Service fees earned by consultants.
  - Interest earned on business bank deposits.
  - Rental income from property owned by the business.

1.4.7 Expenses

Definition: Expenses are the costs incurred by a business to generate revenue and operate its activities. They reduce the company's profit.

- **Business Examples:**
  - Salaries and wages paid to employees.
  - Rent and utilities for office or factory premises.

- Raw material purchases for production.
- Advertising and marketing costs.

1.4.8 Profits & Losses

- **Profits:** The financial gain realized when total income exceeds total expenses. Profit is the reward for successful business operations.
  - *Example:* A bookstore sells books worth ₹1,00,000 in a month, while expenses total ₹80,000 → Profit = ₹20,000.
- **Losses:** The financial shortfall when total expenses exceed total income. Loss reduces the owner's equity.
  - *Example:* The same bookstore incurs ₹1,20,000 in expenses but only generates ₹1,00,000 in sales → Loss = ₹20,000.

Knowledge Check 1

Choose the correct option:

1. A purchase of goods on credit is an example of which type of transaction?
   a) Cash
   b) Credit
   c) Capital
   d) Expense
2. The money withdrawn by the owner for personal use is called:
   a) Capital
   b) Drawings
   c) Income
   d) Liability
3. Which of the following is an intangible asset?
   a) Furniture
   b) Patents
   c) Inventory
   d) Cash
4. Accounts payable is classified under:
   a) Current Assets
   b) Fixed Assets

c) Current Liabilities
d) Long-Term Liabilities

1.5 Summary

ϖ Business Operations and Decision-Making is built around Accounting and Finance.

Accounting: Accounting is the technique of recording, classifying and summarizing financial transactions.

ϖ Finance is the science of managing, planning and allocating money to business investments in future.

ACCOUNT:ϖ Transparency and accountability are the chief functions of account in company's business.

ϖ Finance is about optimization of returns, risk management and sustainability.

ϖ Transactio ns are cash- or credit-dated and comprise the source for all accounting records.

ϖ VOCABULARY Capital, assets, liabilities, income and expense are some of the key terms used in describing financial structure.

ϖ The ultimate results of business activity are the profits and losses that result from such activity.

ϖ Accounting information is used for budgets, forecasts and strategic planning.

How finance uses accounting information in making investments decisions and financing is:
ϖ Finance: draws on the data provided by accounting to develop investment and financing polices.

Accountancy and finance combine to help companies develop responsibly and on a competitive basis.

1.6 Key Terms

Transaction: An economic event which can be measured in money and which is entered into the books of account.

Capital: Money the owner puts into the business for operations.

Drawings: Money or assets taken by the owner for private use.

Assets: Anything owned by a business that has value and provides future economic benefits.

Liabilities: Debt of a business that it owes to others.

Income: The amount of money that a business receives from sales, services or other purposes.

Outgoings: Expenditures on the running of the business and earning revenue.

Profit: Excess of the results of operations over expenses for a period.

Loss: Excess of costs over income during a period.

Debtors: People or other entities that owe the business money for goods or services which have been sold on credit.

1.7 Descriptive Questions

Define accounting and describe the role accounting plays in contemporary society.

What is finance? Comment on your role to manage resources.

Distinguish between finance and accounting with appropriate examples.

Discuss the role of accounting in business decisions.

What is the role of accounting to achieve transparency and accountability?

What are the significant differences between a cash sale and credit sales? Give examples.

Define capital and drawings. What is their effect on owner's equity?

Describe and give examples of the various types of assets.

Differentiate between current liabilities and long-term liabilities, giving examples.

Describe Creditors and Debtors with appropriate business examples.

Define income and expenses. Whom do they know whether they are profited or loser?

Describe how accounting information aids in financial planning and forecasting.

1.8 References

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Answers to Knowledge Check

Knowledge Check 1

1. b) Credit
2. b) Drawings
3. b) Patents
4. c) Current Liabilities

1.9 Case Study

Introduction

Operating a small business is more than selling a product or service, it's managing your numbers. Day-to-day sales are top of mind for many entrepreneurs but systematic accounting and financial planning is not. It causes a lot of disorder, cash crunch and inability to determine the exact profitability. This case examines the significant role that accounting and finance can play in helping a business grow sustainably.

Background

Ravi set up an electronic goods shop, ElectroMart from where he started selling in a local market. At first he was thrilled, because sales were booming. But everything had been managed informally by Ravi, who kept records of sales in a diary and expenses on loose sheets. A few months later, despite strong sales, he was unable to pay suppliers and wasn't sure he was going to be profitable either. It left him with increasing debts.

Ravi found that despite sales were growing, weak financial control was resulting in losses. A friend had told him the right thing to do was keep proper accounts and get financial help. Having learnt basic accounting software, Ravi began entering all transactions, drawing up financial statements, and monitoring income, expenses, assets and liabilities. And before he knew it, he was able to pinpoint profitable products, manage cash flow more effectively and even approach a bank for a small business loan.

Problem (a) Absence of Systematic Information Protocol

Ravi's dependence on notes made in an informal manner was found to have caused confusion about the exact revenues, expenses and dues.

Solution: Having structured accounting practices and carrying your financial statements (profit and loss statements, balance sheets) prepared will give Ravi clarity on his real financial status.

MCQ:

What is the disadvantage of not keeping systematic accounting records?

a) Higher sales

b) Confusion and poor decision-making

c) Increased supplier trust

d) Lower compliance costs

Answer: b) Disorder and Poor Decision-Making

Problem 2: Mismanagement of Cash Flow Some companies operate on the idea of 'cash is king'.

Ravi was having good sales but due to lack of monitoring on inflows and outflows he had liquidity problems.

Solution: Ravi was able to forecast shortages and ensure that he had enough liquidity through financial management practices such as preparing cash flow statements and budgeting.

MCQ:

Which statement keeps track of money coming in and going out?

a) Balance Sheet

b) Cash Flow Statement

c) Income Statement

d) Trial Balance

Answer: b) Cash Flow Statement

Problem 3: Problem in Business Planning

Lacking those financial insights, Ravi couldn't easily determine what products to expand or which expenses to cut.

Solution: By the use of accounting and financial analysis, datum was delivered which allowed for better planning so that Ravi dealt with profitable items and avoid unnecessary expenses.

MCQ:

What are the ways in which accounting aids in business planning?

a) By increasing competition

b) By recording sales alone

c) Through the delivery of timely financial information

d) By reducing employee workload

Answer: c) By offering precise financial information

Conclusion

Things like this serve as a stark reminder that small companies frequently don't pay enough attention to accounting and finance. Because of good record keeping, cash-flow management and financial planning, Electro-Mart was able to pull out of difficult times and begin a period of sustainable growth. Accounting provides clarity transparency, and finance is the road map to the future. Both are the basic underpinning of any great business.

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Unit 2: Accounting & Finance 101: The Mechanics (Part II – The Language of Accounts)

Learning Objectives

1. Understand the concept of accounting as the "language of business."
2. Identify and explain the basic accounting terms and concepts used in practice.
3. Learn the rules of debit and credit in double-entry bookkeeping.
4. Distinguish between different types of accounts: personal, real, and nominal.
5. Record simple business transactions using journal entries.
6. Explain the role of ledgers and trial balance in summarizing financial data.
7. Develop the ability to interpret accounting records for decision-making.

Content

2.0 Introductory Caselet

2.1 Introduction to the Language of Accounts

2.2 Types of Accounts

2.3 Basics of Debit and Credit

2.4 Accounting Concepts and Conventions

2.5 Practical Problems in Accounting

2.6 Summary

2.7 Key Terms

2.8 Descriptive Questions

2.9 References

2.10 Case Study

2.0 Introductory Caselet

Ledgeria is a small business family town and handmade furniture is a popular product. A pair of enterprising young entrepreneurs, Rina and Kabir opened a workshop named WoodCraft Studio. Their goods were selling well and customers raved about the quality of their products. At first, they simply recorded sales and expenses in a notebook, assuming that would be sufficient.

But soon, problems arose. Other times, sales were recognized and expenses weren't. They couldn't even determine true nature of how much money they made, or whether they were making any profit. Rina reasoned that the business was a success, given high sales, while Kabir fretted as cash appeared to evaporate. Disagreements grew, and confusion increased.

To resolve this, they sought the advice of a local accountant who taught them the language of accounts. They studied debits and credits, journals, ledgers and trial balances. By using double-entry bookkeeping, each transaction was recorded accurately and documented descriptions of both where the money came from and where it went.

WoodCraft Studio had clarity within months. They were able to see which products were profitable, what they owed in payments from customers and what they owed their suppliers. More importantly, Rina and Kabir ended their arguments because the records spoke for themselves.

Critical Thinking Question

Why did Rina and Kabir need to understand the nuts and bolts of accounting, and what dangers might their business have encountered if they were to proceed with an incomplete or incorrect set of records?

2.1 Introduction to the Language of Accounts

2.1.1 Importance of Accounting as a Business Language

Accounting is commonly referred to as the language of business because it communicates the financial health of an organization in a standardized and easily accessible way. Like human language enables individuals to convey their ideas and experiences to others, accounting allows a business to deliver its monetary transactions in the company.

• Universal Communication Among Stakeholders: All the economic events/initiatives of an enterprise including buying and selling, payment of salaries etc., are communicated in terms of money using the vehicle called as accounting. However, by applying common rules and structure to accounting practices, this language becomes standardized and understood by all parties — owners, managers, investors, creditors and regulators.

• Decision Making Instrument: Good decision making in business relies on sound financial information. Managers use accounting to measure revenues, costs and profits, understand

performance, and determine whether to grow the business or initiate other changes. So without that language, you have a lot of guesswork.

• Comparability and Standardization: Generally accepted accounting principles such as GAAP or the IFRS, help to ensure that companies from different industries and countries report financials in a consistent manner. This normalization enables a comparison of companies. For instance, an investor can analyze the performance of two companies located in separate parts of the world by studying their financial statements.

• Trust and credibility: Investors, creditors, and regulators depend on clear accounting records when considering putting down money or investing in company. Disclosing through accounting of a firm that spills the beans, building credibility and trust again and hence better relationship in long run with its stakeholders.

• Worldly Perception: In an increasingly globalized world, accounting expands beyond local practice.!."\!$/33 International standards like the IFRS have enabled some corporations to secure foreign investment, speaking as they do a financial language that can be comprehended by anyone on the planet. This universal approach also highlights the importance of accounting when it comes to international transactions, takeovers and overseas investments.

Simply put, accounting is the grammar, language and framework of financial communication, without it no organization can exist irrespective if its size.

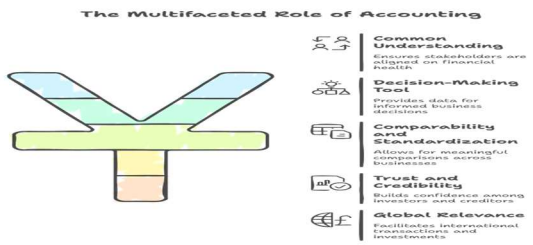

Figure 2.1.1

2.1.2 Role of Accounts in Financial Communication

Accounts represent the main means by which firms articulate to a variety of users their financial results and position. They're not just numbers but a story about how the organization earns, spends, saves and grows.

• Internal Financial Communication:

o Managers: Accounts are needed to monitor costs, revenues and the performance of departments. A production manager, for instance, can review how the materials add up with regards to budgets.

o Owners/Entrepreneur: Book of accounts gives information to them to know that their business fattens enough and it can be sustainable or not.

o Staff/Departments: the use of budget and spending reports enable coordination between departments eliminating waste and arguments over how much $ will go where.

• External Financial Communication:

o Capital Providers: By using of accounts, they come to know the profitability, dividends and long run prospects. This allows investors to determine if they want to purchase, hold or sell shares.

o Lenders and Creditors: Financial statements are analysed by banks and creditors to check the ability of repayment before lending funds or providing credit.

o Regulators and Governments: Accounts convey information as to whether an entity had been in compliance with tax laws, corporate reporting requirements and other statutory duties.

o Customers and Suppliers -- A company that has a solid financial position, which shows in its financial statements, is a source of safety to the customers as well as suppliers.

• Transparency, medium: Accounts make misrepresentation difficult because transactions are verifiable and auditable. For example, audited financial statements reassure third parties that the numbers they're seeing from the company can be relied upon.

• Linking Past with Future: As a record, an account narrates historical financial events; but as information used by decision-makers it is required to predict future expansion. For instance, a continuous rising trend in the reporting of profits on the accounts can indicate that you're looking at some potential growth.

Therefore, accounts are not just a source of record keeping but the language itself through which business communicates with all interested parties – both within and outside the business – in order to obtain clarity, accountability and trust.

"More tham 90 % of corporations around the world employ one or more of the standardized accounting set of guidelines, whether that is in GAAP or IFRS for financial reporting purposes. This makes it possible for investors, lenders and regulators to compare reports from different countries. "Without that kind of financial communication, they wouldn't be able to obtain capital, establish confidence and meet legal obligations."

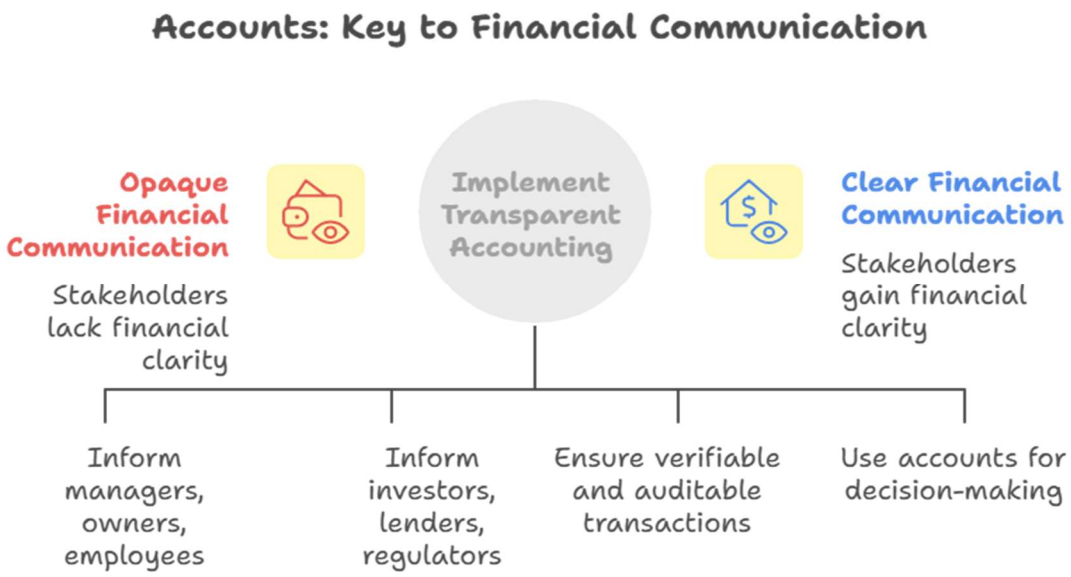

Figure 2.1.2

2.2 Types of Accounts

2.2.1 Personal Accounts

Definition:

Personal accounts are those consumers, organizations, or other businesses with whom the business has a direct monetary relationship. These accounts are posted with details of all the transactions the business has with individuals and companies that it either owes money to (creditors) or is owed by (debtors).

Examples of Personal Accounts:

- Clients (Customers/Debtors) – individuals who incur debts to the company
- Vendors (Creditors) – individuals or businesses that the company owes money.
- Employees – for salary-related transactions
- Banks – for financial dealings and going overdrawn
- Stockholders – for share capital and dividend transactions.

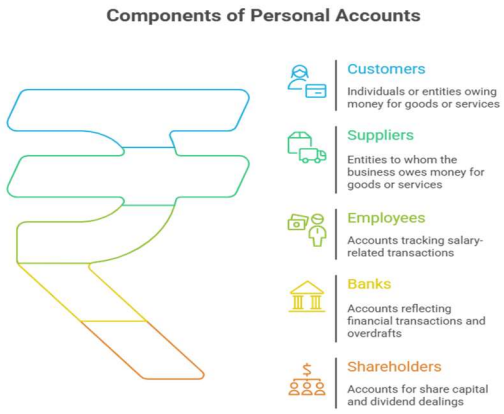

Figure 2.2

2.2.2 Real Accounts

Definition:

Real accounts represent the business assets— both tangible and intangible - of a firm. They show the ownership of assets in the company and are be permanent accounts – on a balance sheet, these accounts balances will be brought into next accounting period.

Real accounts are a key component of the balance sheet and do not zero themselves out at the end of the fiscal year.

Classification of Real Accounts:

Assets – Assets are things of value that can be seen, touched or measured.

o Examples ♣ Machinery, building, furniture, vehicles, land.

Intangible Asset – A non-physical asset that has value due to rights or economic benefit.

o Examples: Patents, goodwill, trademarks, copyrights.

2.2.3 Nominal Accounts

Definition:

All expenses, losses, incomes and gains and so forth incurred or earned by the business during an accounting period are recorded in nominal accounts. These are nominal accounts and there is no balance to be carry forward. At the end of the period, balances are transferred to Profit and Loss Account to ascertain net result (profit or loss) of business.

Classification of Nominal Accounts:

Expenses and Losses – Expenditures or sacrifices made by the enterprise in the eaning of revenue.

o Examples: Rent, salaries (wages), electricity rates, advertising, depreciation.

Incomes and Gains – The amounts coming into the business.

o Examples: Commission received, rent received, interest earned, profit on sale of asset.

Knowledge Check 1

Choose the correct option:

1. Which account records dealings with persons or firms?
   a) Real
   b) Personal
   c) Nominal
   d) Capital
2. Furniture Account belongs to which category?
   a) Nominal
   b) Real
   c) Personal
   d) Expense
3. Salary paid is recorded under:
   a) Income
   b) Asset
   c) Expense
   d) Liability
4. "Debit what comes in, Credit what goes out" applies to:
   a) Real Accounts
   b) Nominal Accounts
   c) Personal Accounts
   d) Capital Accounts

2.3 Basics of Debit and Credit

2.3.1 Meaning of Debit and Credit

In accountancy, debit (Dr.) and credit (Cr.) constitute the two extremes of all transactions. They are the basis of the double entry system used in recording business transactions, which

forces every break between accounts to have offsetting debits and credits. This idea comes from the accounting equation:

Assets = Liabilities + Capital

• Debit (Dr.):

o It represents the left side of an account.

o Normally debited to increase an asset or expense.

o Can alternatively manifest as a reduction in liabilities or capital.

o Example:The company buys machinery for cash.The Machinery Account is debited, as the business has gained an asset.

• Credit (Cr.):

o Shorthand for the right side of an account.

o Usually reveals a gain in liabilities, equity or revenue.

o Can also demonstrate a decline in resources.

o For instance, Rent Income Account is credited on receipt of rent as it increases the income.

Clarification:

Debit is not always the same as “add” and credit is also not always the same as “subtract.” They only work according to the type of account its being used: asset, liability, capital, expense or income.

2.3.2 Application of Debit and Credit in Transactions

Just like in any other business transaction, there is a debited account and another credited to ensure the double-entry system tallies up5. The application can be approached from two main angles:

A. Concept (Classification of Accounts)

Transactions are captured by noting the classification of an account as it pertains to one of three general categories (Personal, Real, or Nominal) and using these rules: Debit Credit 24 according to Journal.

Golden Rules of Accounting

The Golden Rules of accounting are essentially those rules that determine when an account should be debited or credited so that the basic accounting equation always remains balanced.

Classes of Accounts & Their Regulation

(a) Personal Account

- Definition: Involves individuals, companies or institutions.
- Rule: Debit Receiver, Credit the Giver.
- Business Illustration:

If a company borrows $10,000 from Bank of America:

o Bank of America (money giver) → Credit

o (Company → recipient of money) Cash account → Debit

(b) Real Account

- Definition: Anything of monetary value, including but not limited to cash, buildings, patents and goodwill.
- Rule: Debit What Comes In, Credit What Goes Out.
- Business Illustration:

If the business buys furniture for $5,000 cash:

o Furniture (asset enters) → Debit

o Cash (asset decreases) → Credit

(c) Nominal Account

- Definition: Connected with receipts, disbursements, and profits.
- Rule: DR – All Expenses & Losses CR – All Incomes & Gains.
- Business Illustration:

If the firm spends $2,000 in staff salary:

o Salary (expense) → Debit

o Cash (out ◊ Payment/Asset) → Credit.,exports are thus recorded as a credit.

B. Contemporary Perspective(The Accounting Equation Structure)

Based on the equation:

- Assets & Expenses → Debit = More and Credit = Less
- ACID (All Credit Increases, Debit Decreases) = Increase = Credit, Decrease = Debit

Example Applications:

Purchase of machinery for cash ₹50,000 →

o Debit: Machinery (Asset ↑)

o Credit: Cash (Asset ↓)

Payment of salaries ₹20,000 →

o Debit: Salaries (Expense ↑)

o Credit: Cash (Asset ↓)

Commission received ₹5,000 →

o Debit: Cash (Asset ↑)

o Credit: Commission Income (Income ↑)

This is an approach that is well suited to computerized systems because it ties directly into the balance sheet and income statement.

C. Practical Illustrations (Debit–Credit Applications)

Under Traditional Approach:

Goods sold to Mr. Sharma for credit ₹10,000 →

o Debit: Mr. Sharma (Receiver)

o Credit: Sales (Income)

Payment for office furniture costing ₹20,000 →

o Debit: Furniture (Asset in)

o Credit: Cash (Asset out)

Salary paid ₹15,000 →

o Debit: Salary (Expense)

o Credit: Cash (Asset out)

Under Modern Approach:

Case No. Transaction Debit Account Credit Account

1–Paying rent of ₹ 8,000 in cash…Rent (Expense ↑)……Cash (Asset ↓)

2 Received interest ₹2,000 from bank Cash (Asset ↑) Interest Income (Income ↑)

3 To Customer (Debtor/Receiver ↑) ₹30,000 of goods sold on credit Customer (Debtor/Receiver ↑) Sales (Income ↑)

2.4 Accounting Concepts and Conventions

2.4.1 Basic Accounting Concepts

Business Entity Concept

o This principle views the business as distinct from its master(s). The owners personal hat needs not to mingle with the business and transaction records.

o Example: If the owner takes some cash out for personal purposes, this will be included in a line called “Drawings” and not as an expense of the business.

Money Measurement Concept

o Everything recorded in accounting books is externalized, quantifiable and of a monetary nature. Well, it is that non-finance factors such as employee skills or brand reputation are not kept tabs on even though they could be impacting business value.

o E.g., purchase of raw material worth ₹50,000 is recorded but not the staff efficiency.

Going Concern Concept

o Assumes that the business will remain operational for a reasonable period of time and not be absconded with. Assets are recorded at actual use not liquidation value.

o Example: A factory is shown in books of accounts at cost after charging depreciation while the same value will be different based on market prices.

Dual Aspect Concept

o Each transaction impacts -2- accounts; one receives the Debit entry, and the other is Credited, maintaining the balance of Accounts Equation (Assets =Liabilities + Capital) at all times.

o Example: Machinery account will be debited and Loan Account will be credited when machinery worth ₹1,00,000 is purchased in loan.

Accrual Concept

o Revenue and expenses are recorded when received or paid, not necessarily when earned or incurred.

o Example: If a corporation ships goods in March but the payment is not received until April, the revenue is reported in March.

Historical Cost Concept

Under this concept, all assets and liabilities are recorded in the books of accounts at original cost. This creates neutrality and confirmability in the financial statements.

Example:

For example, if land was bought 10 years ago for ₹10,00,000, then this asset should still be disclosed in the balance sheet at its purchase cost and not at current market price of ₹50,00,000.

Realisation Concept

This principle assumes that income should be reported in time when it is actually earned rather than when the cash payment is received. A sale is regarded as consummated — and both the (revenue) and (cost of goods sold) recognized — when title passes from the seller to the buyer.

Example:

Even if sales of goods worth ₹1,00,000 is done on a credit basis in the month of March but it is received after one month i.e., April then also we shall recognize revenue in the same period when goods have been sold out.

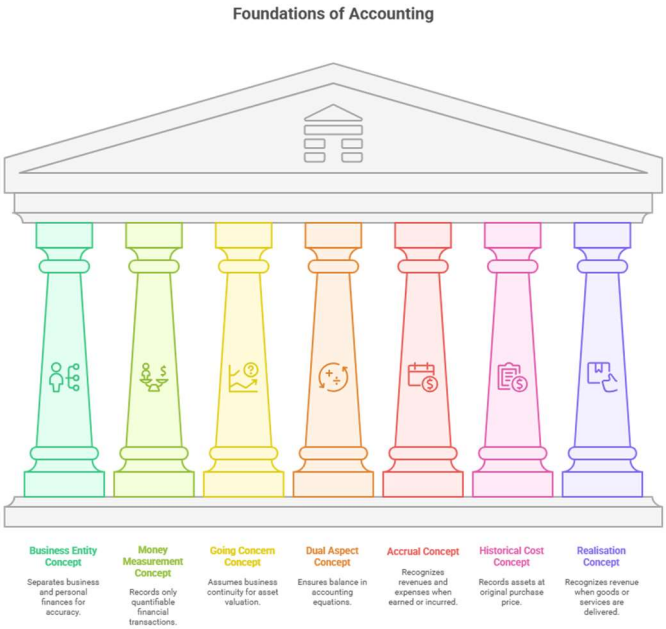

Figure 2.4.1

2.4.2 Accounting Conventions

Conventions in Accounting Conventions are guidelines adopted by accountants when preparing financial statements. Such conventions add to the relevance, reliability and comparability of accounting information and ensure consistency in its disclosure.

Convention of Consistency

Whenever a specific accounting method or practice is chosen (e.g. depreciation method), it should be followed uniformly from one period to the next. This allows for meaningful comparisons of financial results between periods.

Example:

Once a company has adopted one method for depreciation (e.g. straight line basis) they should not change their methods, from year-to-year even if a better method is found or more appropriate because this will distort profit figures and make it more difficult for the company to be compared with others.

Convention of Conservatism (Prudence)

Read more Recognition Convention: It is an accounting convention through which all expected losses are noted, as they become known and all gains only when actually realized. The idea is to prevent overestimating assets or income.

Example:

A provision for bad debts is established not only where there has been a material default in payment, but also if the risk of default on specific customers exists.

Convention of Materiality

Information that is irrelevant or immaterial to the decision process of users should not be reported (CICA 5.6.tc2). Unimportant or irrelevant details can be left out or presented in a different way.

Example:

A ₹200 calculator purchased by a large company may directly be recorded as an expense without being capitalized, since it does not make a material difference to the operations.

Convention of Full Disclosure

All material financial information will be disclosed completely and fairly in the financial statements of the beneficiary and notes thereto. This promotes informed decision making.

Example:

If there is a company that's in litigation, the information has to be reported in the notes to accounts," whether or not "the outcome is uncertain," and "unless it appears probable that a loss will not occur."

Form a team and give five examples of accounts (do not give ledger for form five) (e.g. Purchasing machinery on hire purchase, Making provision for doubtful debts, Paying annual rent, Owner withdrawing cash, Recording staff goodwill). General 24For each of the following, indicate which accounting concept or convention is involved and why it is crucial for reliable financial information.

2.5 Practical Problems in Accounting

2.5.1 Journal Entries (Beginner Level)

Definition:

Journal is the first book of accounting entry in which transactions are entered according to double-entry system, chronologically. Every transaction impinges on a minimum of two accounts, and one account is debited while the other is credited equal to this amount.

Structure of a Journal Entry:

COMMON JOURNAL ENTRY FIELDS A normal journal entry has the following columns:

Date Particulars L.F. Debit (₹) Credit (₹)

(1) (2) (3) (4) (5)

• Date: The date of the deal

• Details: The titles of the debited and credited accounts and a short narration

• L.F. (Ledger Folio): Page number of the ledger (Necessary during posting)

• Debit: The amount debited

• Credit: The amount credited

Format of a Journal Entry:

1 Date Particulars L.F. Debit (₹) Credit (₹)

yyyy-mm-dd Name of Debit Account Dr. Amount

To Name of Credit Account Amount

(Narration: Brief explanation)

Examples of Simple Transactions:

Business started with cash ₹1,00,000

Date Particulars L.F. Debit (₹) Credit (₹)

2 2025-09-01 Cash A/c Dr. 1,00,000

To Capital A/c 1,00,000

(Being capital introduced in business)

Purchased goods for cash ₹20,000

Date Particulars L.F. Debit (₹) Credit (₹)

2025-09-02 Purchases A/c Dr. 20,000

To Cash A/c 20,000

(Being goods purchased for cash)

Paid rent ₹5,000

Date Particulars L.F. Debit (₹) Credit (₹)

2025-09-03 Rent A/c Dr. 5,000

To Cash A/c 5,000

(Being rent paid in cash)

Sold goods for cash ₹15,000

Date Particulars L.F. Debit (₹) Credit (₹)

2025-09-04 Cash A/c Dr. 15,000

To Sales A/c 15,000

(Being goods sold for cash)

"Journal entries" is a dated term, harking back to the 15th century when Luca Pacioli, an Italian mathematician also known as the "Father of Accounting," debuted double-entry accounting. "This procedure guarantees in every entry there were an equal debit and credit, laying the foundation for modern accounting precision and international financial reporting."

2.5.2 Ledger Posting

Definition:

A ledger is a book of accounts in which similar transactions recorded in the journal are brought together and classified under suitable account headings. It reflects the running total all those past transactions pertaining to an account at a certain point in time and are used to prepare financial statements.

Steps in Ledger Posting:

Extract the debit and credit factors from the journal entry.

Debit the debit side of appropriate ledger account for the amount to be debited.

Post the credit amount to the credit side of related ledger account.

Repeat the above for all journal entries so that you have a complete transaction history in each account.

Balancing of Ledger Accounts:

After each period, all ledger accounts are balanced:

• If Debit total Debit total, the account has a Credit Balance.

• The balances are written down on the side, which has a lower total as "Balance c/d" (carried down) and brought forward (b/f), in next period.

Ledger Account Format (T-Format):

There are two sides to every ledger account:

Account Name

Debit Side (Dr.) Credit Side (Cr.)

Date Particulars Amount (₹)

---------- ----------

• Date: Date of transaction

• Specifics: Name of the account from other side of journal entry

• Amnt: The amount debited or credited

Illustration:

Journal Entry:
Date: 2025-09-01 **Entry:**
• Cash A/c Dr. ₹1,00,000
• To Capital A/c ₹1,00,000
• (Being capital introduced by the owner)

Ledger Accounts:

Cash Account

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
2025-09-01	Capital A/c	1,00,000			

Capital Account

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
			2025-09-01	Cash A/c	1,00,000

This example shows how the journal entry is reflected in the respective ledger accounts:

- **Cash A/c** is **debited**, so the entry is on the **left side** (Dr.) with **Capital A/c** in particulars.
- **Capital A/c** is **credited**, so the entry is on the **right side** (Cr.) with **Cash A/c** in particulars.

2.5.3 Trial Balance Preparation

Meaning: A trial balance is a statement showing the debit & credit balances of all accounts in the ledger extracted at a given date to test the arithmetical accuracy.

• Purpose of Trial Balance:

o To maintain 1_ correspondence between total debits and total credits (arithmetic of double-entry).

o Assist in the discovery of errors (posting, excluding.).

o To provide the foundation for the preparation of final accounts (Trading, Profit & Loss A/c and Balance Sheet).

1 • Format of Trial Balance:

Particulars (Account)	Debit (₹)	Credit (₹)
Cash A/c	1,00,000	–
Capital A/c	–	1,00,000
Purchases A/c	20,000	–
Rent A/c	5,000	–
Sales A/c	–	15,000

Totals: debit ₹ 1,25,000 = credit ₹ 1,25,000

This only goes to show that postings of the journal to the ledger are mathematical, but does not prove all types of errors (e.g., error of principle, compensating errors).

2.6 Summary

ϖ Because it expresses itself in a very recognized financial language, accounting is known as the language of business.

ϖ Accounts are the language of business and a means of communication between the organizations and interested parties.

ϖ Types of Accounts: Three types of accounts exist – Personal, Real and Nominal.

ϖ We have the Golden rules of Accounting are prepared which guide the treatment to be given for Debit and Credits for each type of account.

ϖ Debit = increase in asset or expense and Credit = Increase in liability, equity or revenue.

ϖ Principles of Accountancy such as Business Entity, Money Measurement, Going Concern, Dual Aspect and Accrual Concept leads to fair presentation.

ϖ Accounting conventions such asConsistency, Conservatism, Materiality and Full Disclosure maintain uniformity and consistency.

ϖ Journal is the first all -entry in a scientific accounting records.

ϖ Journalling ensures account classification and balance is clear.

ϖ Trial balance ascertains that the sum of all debit and credit balances are equal, thus ensuring accuracy in books.

2.7 Key Terms

Journal: Book of original entry posting all transactions in a chronological order.

Ledger: Main book of accounts under which transactions are categorized under heads.

Trial Balance: A statement of debit and credit balances of all ledger accounts, used to test the equality of books.

Debit (Dr.) - Left side of an account, representing an increase in assets or a decrease in liabilities.

Credit (Cr.): Right side of an account, indicating either an increase and decrease on liabilities,capital or income.

Personal Account An account associated with an individual, business, or other organization (e.g., creditor, debtor).

Real Account : Account as related to property of the business, whether tangible or intangible.

Nominal Account: An account which is related to incomes, expenses, gains or losses.

Consistancy (Convention) Principle that a company should use the same accounting methods from period to period.

2.8 Descriptive Questions

Describe why accounting is called the "language of business."

Explain the use of accounts in communicating with owners and interested parties within and outside an organisation.

Explain the distinctions among Real, Personal and Nominal accounts by giving examples.

State and describe the Golden Rules of Accounting with examples.

Explain the significance of debit and credit in the double-entry system. Give suitable examples.

Explain the concepts of Business Entity and Going Concern with real life examples.

a)Describe the Conventions of Conservatism and Full Disclosure. Why are they important?

Define Trial Balance. What do they aim to achieve and how can such an instrument fall short?

Prepare journal entries for:

o (a) Goods on credit purchased by Ram ₹10,000

o (b) Cash has been received from Mohan ₹5,000

o (c) Rent paid ₹2,000

2.9 References

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Answers to Knowledge Check

Knowledge Check 1

1. b) Personal
2. b) Real
3. c) Expense
4. a) Real Accounts

2.10 Case Study

Introduction

Accounting is the very foundation of financial transparency in business. The principles of accounts—the journal, the ledger and the trial balance—have been designed to enable businesses remain transparent, as well as, keeping an accurate record. If your business is new, the processes of recording, categorising and reconciling transactions can be difficult without a proper framework. This scenario involves ensuring financial discipline through judicious use of debit and credit.

Background

Start Up by Ananya was about her start up GreenBrew Café. The café became popular, but the books were carelessly kept. Entries were recorded in a ledger, but no double-entry rules were used. Suppliers were sometimes paid late; sales income was recorded incorrectly and cash flow became erratic.

On the advice of an accountant, Ananya adopted the journal–ledger–trial balance system. She used the debit to post and debit and credit posting rules correctly in order to easily follow through the transaction mapping, determine any remaining balances due, and generate a trial balance with all debits and credits accounted for. This provided her with profit clarity and allowed her to confidently apply for a bank loan.

First Issue: Unable to Record Transactions

Ananya fought to keep track of their transactions accurately, the confusion and computation errors adding up.

Solution: The adoption of journal entry that uses debit equally to credit was the means through which each transaction was completely captured.

MCQ:

What is the first step in writing down a financial transaction?

a) Ledger posting

b) Trial balance

c) Journal entry

d) Final accounts

Answer: c) Journal entry

Problem 2: Accounts are Being Mistakenly Classified

She couldn’t keep track of which accounts to debit or credit for various transactions.

Answer: By using the Golden Rules of Accounting (Personal, Real & Nominal Accounts) it can be understood how each and every transaction is treated.

MCQ:

Cash is paid for rent, which account is debited?

a) Rent Account

b) Cash Account

c) Capital Account

d) Sales Account

Answer: a) Rent Account

Problem 3: Verifying the Accuracy of Account Balances by Use of a Trial Balance

Mistakes continued to be made until a trial balance ("balance") was struck in which the total of the debit side equaled that of the credit side.

Solution: Preparation of trial balance facilitated the verification of postings and checked arithmetical accuracy.

MCQ:

What is the trial balance for?

a) To show net profit

b) To record cash only

c) To verify arithmetical accuracy

d) To prepare tax returns

Answer: c) To test the correctness of arithmetic

Conclusion

GreenBrew Café is a clear demonstration that journals, ledgers and trial balances are much more than mere formalities; they are indispensable props for financial clarity. Understanding and applying the principles of debits and operating with arguably more discipline can avoid errors, gain investor trust, draw potential customers to their company in a smart informed system of decision-making based on sound financial data.

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Unit 3: Accounting & Finance 101: Understanding Financial Statements (Part III- Schedule III Format of Financial Statements)

Learning Objectives

1. Understand the purpose and scope of Schedule III under the Companies Act, 2013.
2. Identify the key components and structure of the Schedule III balance sheet.
3. Classify assets and liabilities as per Schedule III requirements.
4. Interpret the format and presentation of the Statement of Profit and Loss under Schedule III.
5. Differentiate between Division I, II, and III of Schedule III based on the type of company.
6. Apply Schedule III disclosure norms to enhance transparency and compliance.
7. Analyze how Schedule III improves comparability and standardization of financial reports.

Content

3.0 Introductory Caselet

3.1 Capital and Revenue Concepts

3.2 Overview of Financial Statements

3.3 Balance Sheet

3.4 Profit & Loss Account (Income Statement)

3.5 Schedule III Format of Financial Statements

3.6 Practical Problems

3.7 Summary

3.8 Key Terms

3.9 Descriptive Questions

3.10 References

3.11 Case Study

3.0 Introductory Caselet

Case 05-8 Team-Based Incentive Compensation, which discussed financial reporting by a medium-size manufacturing business that issued public securities to obtain a loan and to finance plant expansion. But when they applied for a loan from the bank to scale up their operations, the branch manager told them that audited financial statements in line with Schedule III of Companies Act, 2013 was required.

The finance team was taken by surprise. They did not present their current reports in the standardized format prescribed by Schedule III as also did not classify the assets, liabilties and make contingencies disclosures wherever applicable and notes to account. They had just hired a new accountant, Mr. Rajiv when they stumbled upon Aatrix and learned that while their financials were technically sound, they weren't being accommodated in terms of presentation or ease of compare-ability or reproduction to meet regulatory expectations.

To correct the mistake, Mr. Rajiv then contacted a Chartered Accountant who detailed for him organization under Schedule III such as Vertical format of BALANCE SHEET, splitting up of Current & Non-Current stuffs and mandatory dosclosure requirements. The updated guidance were not only within the legal structure of information given to a lender, they gave more detailed direction into the company's financial well being.

Impressed with the standard format, management chose to use Schedule III when all future reporting would be completed – even for internal purposes, as it was thought that it would create better financial literacy across departments.

Critical Thinking Question

Why is it necessary for companies to adopt Schedule III for financial statements and what would be the consequences of non-statutory presentation formats presented to external stakeholders?

3.1 Capital and Revenue Concepts

3.1.1 Capital Expenditure – Meaning and Examples

Capital Expenditure, posted by Daytrader999Money spent on purchasing or upgrading physical assets such as buildings, machinery, land etc., technology. These are generally not recurring in nature and are incurred to increase the business's long-term earning potential or life. Capital expenditures are not deducted from profits, so while they are part of a cash flow calculation (since it is an outflow of cash), the cost is accounted for as an investment and not as an expense in the income statement.

Capital investment is too important to be made on the short term. It is often a decision that needs to be made with much financial analysis and budgeting since it involves several dollars, for long into the future, and how it will effect the finances of a company.

Key Characteristics of Capital Expenditure:

• Spreads benefits over several accounting periods

• Includes the purchase or major improvement of fixed assets

• Recognized on the balance sheet as an asset

• Subject to depreciation or amortization

• Not amortised through current profits of the period

Examples:

• Land and Building Purchase: Taking real estate on purchase basis to establish a factory/office.

• Purchase of machines: Buy a new machinery in order to expand the production.

• Construction Projects: New plants or warehouses.

• Innovation: Expenditure on technology and innovation, including the investment in enterprise resource planning (ERP) systems.

• Purchase of Vehicles: Purchasing vehicles for carriage of goods.

3.1.2 Revenue Expenditure – Meaning and Examples

Examples 3.1.2.1 Definition: – Revenue expenditure is defined as the consumption of goods and services for the purpose of generating revenue during normal business processes which ranges from purchase a Car to wear and tear on equipment., constructing machinery, Rent incurred, wages paid etc. 3.1.2.2 Examples: (i).

Revenue Expenditure: Revenue expenditure includes amounts spent by the entity in the normal course of business to maintain its earning capacity. These are short-term, and repeat costs that you need in order to keep your business running smooth. Revenue Expenditure versus Capital Expenditure Unlike the capital expenditure, the revenue expenditure is all charged to Profit and Loss Account for the accounting period in which it was incurred.

They do not result in the acquisition of a long-term asset or improve the life and/or value of an existing one. How to do this, not by maintaining the status quo; but by sustaining and allowing current operations to function.

Key Characteristics of Revenue Expenditure:

• Expenses for preserving the capabilities of these existing assets and the on-going operations of a business

• Recurs at regular intervals (monthly, quarterly_ or annually).

• Fully drawn down in the period under review

• Shown in the Profit and Loss Statement

• Not created assets or expanded capacity

Examples:

• Salaries and Wages: Compensation paid to staff in return for work performed.

• Rent and Utilities: Expenses for leasing the location to operate the business, and any electricity, water or gas needed.

• Raw Materials: Costs associated with the products used in production.

• Predictable Repairs: Small repairs that are needed to maintain machinery or buildings.

• Advertising: Promotional and marketing activities to keep the brand in the public eye.

• Insurance: The annual or monthly payments made to an insurance policy in exchange for coverage.

3.1.3 Capital Receipts and Revenue Receipts

Capital Receipts vs Revenue Receipts Capital Receipts and Revenue Receipts are inflow of funds in the hands of the company which have different characteristics, purpose to serve and treatment in the financial statements.

Capital Receipts

Capital receipts are the proceeds of non-recurring transactions, which either creates a liability or reduces an asset. These are not part of the normal course of business. They're generally used to finance capital expenditure and appear on the balance sheet, not in the profit and loss account.

Characteristics of Capital Receipts:

• Non-operational and irregular in nature

• May incur a liability (loan) or decrease an asset (sale of equipment)

• Not available for dissemination as profit / dividend

• Appear in the balance sheet

• Typically seen in connection with financing or investment activities

Examples:

• Debt and borrowing: Capital raised by taking up loans from financial institutions or through bond issuance.

• Disposal of Fixed Assets: Proceeds from the sale of obsolete plant and equipment.

•EQUITY: Capital contributions representing ownership interest in a business.

• Public Capital Grants: Government grants for capital items or for R&D.

Revenue Receipts

Revenue receipts are money received from the core activities of an organisation. They are part of the historical profit and are transferred to the Profit and Loss Appropriation Account.

Characteristics of Revenue Receipts:

• Recurring and operational in nature

• Do not increase liabilities or decrease assets

• Directly impact income or loss from operations

• Collected from sales or services

• Appear in the income statement

Examples:

•Sales Revenue: The amount generated through sales of goods and services.

• Interest income: Money earned from bank deposits or investments.

• Royalty or Commission: Income from intermediacy and licencing.

• Rent Received: In the event that the property is an income generating asset.

Comparison Summary:

Criteria	**Capital Receipts**	**Revenue Receipts**
Nature	Non-recurring	Recurring
Source	Financing or investing activities	Operational activities
Accounting Treatment	Shown in balance sheet	Shown in profit & loss account
Impact on Profit	No direct impact	Affects current profit/loss
Examples	Loans, sale of fixed assets	Sales revenue, interest income

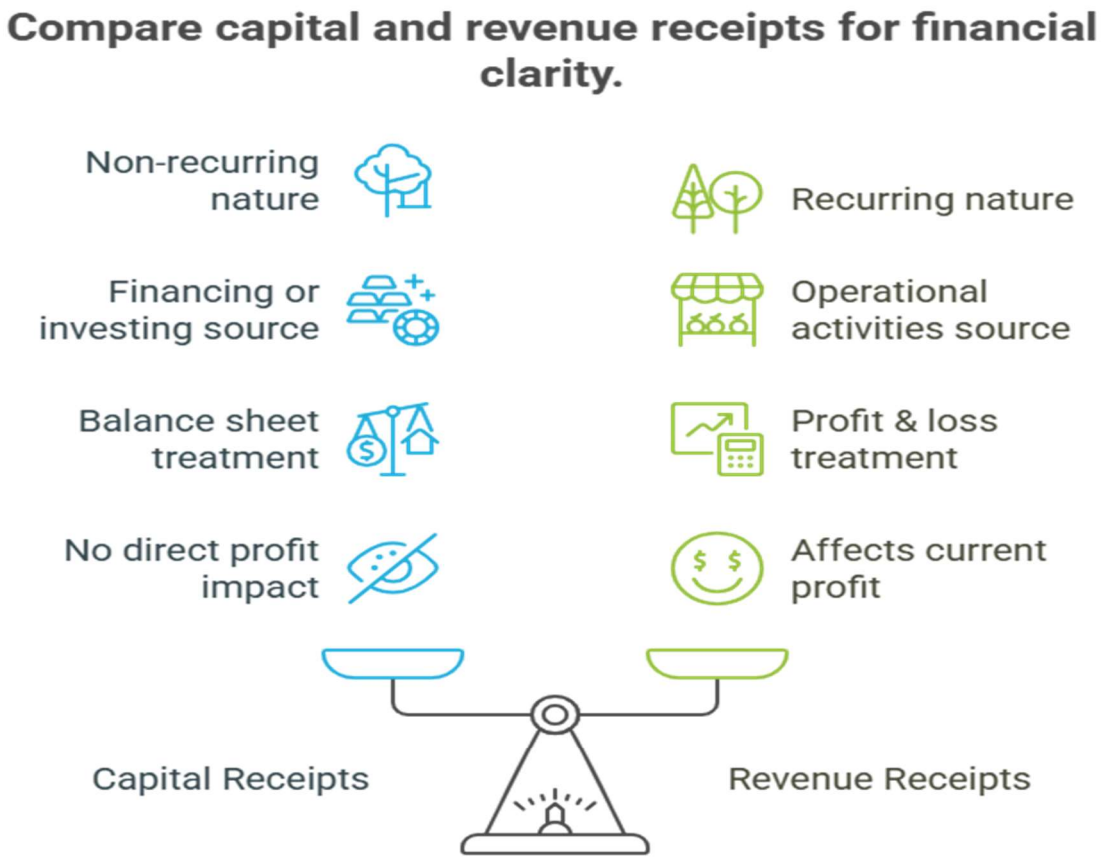

Figure **Comparison Summary:**

3.1.4 Importance of Correct Classification

Proper distinction between capital and revenue items is the very basis of accounting. It also provides veracity, reliability and comparability of financial statements. Incorrect categorization may result in lack of clarity and/or representativeness under financial statements, regulation disqualification as well as unstruct red decision support to internal and external stakeholders.

Why Classification is Important:

True and Fair Financial Reporting

Understating profit by characterising a capital expense as revenue, or vice versa, also deceives stakeholders about how well the company is performing.

Compliance With Generally Accepted Accounting Principles and Legal Requirements

Blurred distinction between capital and revenue for audit and disclosure purposes: The statutory requirements, such as Schedule III to the Companies Act and accounting standards (Ind AS under IFRS), emphasizes on a clear cut differences parameters of items recorded in financial statements only in terms of their materiality.

Proper Asset Valuation and Depreciation

Investing in capex increases the value of an asset, and its value is depreciated over time. Misclassifications can lead to inaccurate depreciation expense and asset values.

Impact on Tax Calculation

The funds boats spend are tax-deductible in the current year whereas the boats purchase must be depreciated. Misclassification may also have tax implications and bring about unwanted scrutiny or penalties.

Financial Decision-Making and Ratio Analysis

Financial ratios, such as ROA, net profit margin, and asset turnover are based on proper classification. Misclassification can distort important signals to those investors, creditors and managers.

Audit Accuracy and Transparency

The appropriate classification is important during audits for audit trails, internal controls and regulatory compliance. Inaccuracies could lead to audit qualifications or disclaimers of opinion.

Budgeting and Financial Planning

Budgeting for capital and revenue expenses is different between organisations. Misclassification can have an impact on planning, funding and allocation of resources.

Correct classification is not only an accounting necessity, it is essential for financial honesty and responsibility.

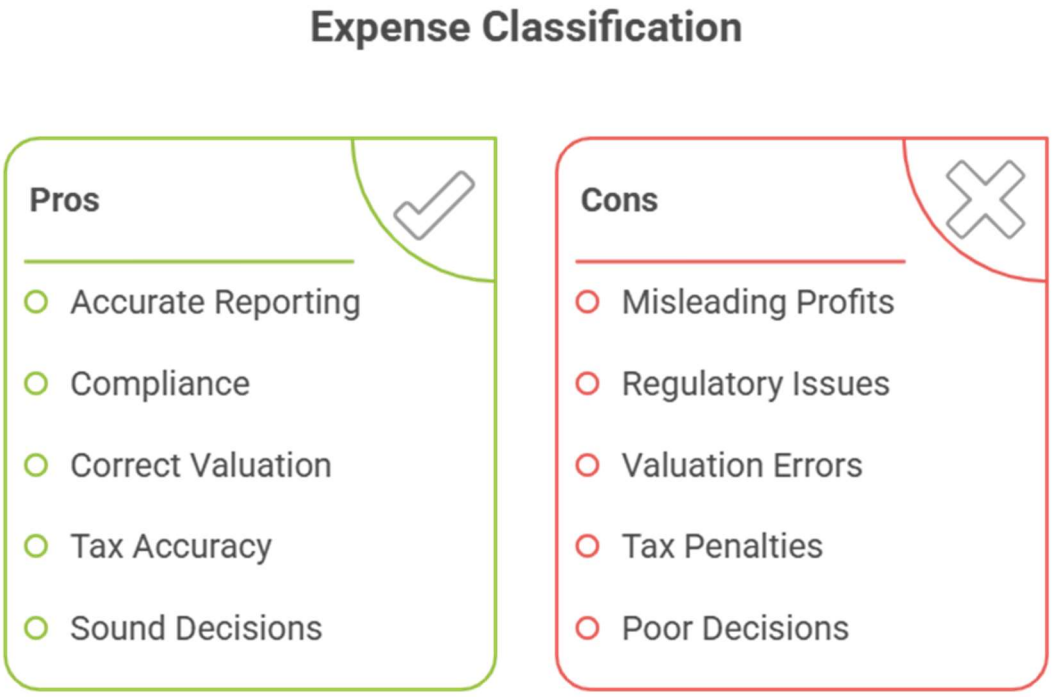

Figure **3.1.4**

3.2 Overview of Financial Statements

3.2.1 Purpose and Objectives

Financial Statement Financial statements are structured records of the activities and position of an individual, institution, or company. They are produced at the end of a reporting period, and explain how well (or poorly) an entity has performed financially; its financial position; and what caused changes in its cash.

Purpose:

• To portrait true and fair picture of the company's financial position.

• To save for tax, accounting and financial preparation.

• To have transparency and accountability in corporate functioning.

? As a vehicle for decision making, planning and control.

Objectives:

Performance Measurement: To understand how well ýthe company has performed during a certain period by analyzing its proýtprofit, revenue, and expenses.

Statemenent of financial position analysis: To analyse the assets, liabilities and equity at a particular date.

Cash Flow Analysis: To illustrate cash movement from operations, investing and financing.

Compliance: For statute compliance, as per legal frameworks like Companies Act and accounting standards (Ind AS, IFRS etc.).

Investor and Creditor Confidence: To help prospective and current investors, lenders, and creditors compare the risk and return prospects of involvement in the entity.

1)Management Control: For use by managers to monitor performance and take corrective action where necessary.

3.2.2 Users of Financial Statements

Financial statements are intended for a wide-band of users having varied interests and needs.

Internal Users:

• Administrative: For planning, decision making, and monitoring of performance.

• Workers: To gauge the stability and profitability of the company — which affect job security and promotions, as well as wages.

• BOD: To assess governance at the firm as a whole, and approve major business transactions.

External Users:

• Investors/Stock Holders: To take decisions to buy or hold or sell share, depends on Profitability and returns.

• Creditors and Lenders: To assess the company as a credit risk, ability to repay loans (interest) ratio.

• Government and Regulators: In order to comply with the law, work out taxes and record economic contributions.

• Financial Analysis and Economic Research, Analysts: For financial analysis economic research and market forecasting.

• Customers: To assess the supplier's financial soundness for long-term supply chain dependence.

• Suppliers: In order that suppliers can decide whether to extend credit or enter into long-term contracts.

• The Public: For knowledge of the company's role in the economy, ecology and society.

Every user group looks at financial statements in a different way depending on their needs and connection with the organization.

3.2.3 Limitations of Financial Statements

Financial statements are not unlimited tools by which to measure the performance of a business and make informed decisions.

Historical Nature

Historical financial statements don’t predict future intrinsic value or earnings power. For instance, fixed assets appear at the historical cost minus depreciation, rather than their present values.

Limited Scope

They concentrate mostly on financial numbers while ignoring qualitative features like customer loyalty, brand strength, employee satisfaction and environmental impact.

Use of Estimates and Judgments

Some items such as depreciation, provisions and valuation of assets are based on management's estimates and assumptions that could differ from actuals thus affecting comparability and reliability.

Not Inflation-Adjusted

Financial statements are presented at historical cost and do not take into account the dilution value of money over time, thus they are misleading comparators across times of inflation.

Subject to Manipulation

Cherry picking or taking certain items under the consideration are the reasons companies have often manipulated these techniques to show superior financial conditions than they actually were.

Non-Uniform Accounting Policies

False If one company uses depreciation method X and another uses Y, they will not be very comparable unless that is adjusted.

Lack of Timeliness

Financial statements are not available at the end of an accounting period, and there is frequently a lapse between them.

Incomplete View of Risk

And financial statements do not describe all of a company's business risks (e.g., how would they account for market volatility, legal threats, cyber-threats or competitive disruption?)

Financial statements are important, but they should also be read with awareness of these weaknesses and in conjunction with other information when used to make decisions.

3.3 Balance Sheet

3.3.1 Meaning and Structure

Meaning

The Balance Sheet is a major financial statement that indicates the financial position of business at a particular point in time, usually at the end of an accounting period. It provides a concise summary of what an organization owns (assets), what is owes (liabilities) and the residual interest of owners, covering also who would receive the entities assets if they were liquidated.

Key characteristics include:

• The balance sheet – also called the Statement of Financial Position.

•It follows the basic accounting equation:

Assets = Liabilities + Equity

• It shows the balance remaining in the accounts and is a part of final accounts prepared at the end of a given accounting period (financial year end).

Structure

The balance sheet is divided into three main components:

Assets – Economic resources owned by the business.

Personnel Recessions (2 of 3) Liabilities – Obligations to Entities outside your company.

Stockholders' Equity – The residual interest of the owners in the assets of the enterprise after deducting liabilities.

In fact, Assets are presented on one side (or at top in the vertical form) and Liabilities plus Equity combined on other side (in P/L a/c. below) representing "the sources of funds" and 'obligations".

3.5 Schedule III Format of Financial Statements

3.5.1 Introduction to Schedule III (Companies Act, 2013 – India)

Schedule III to the Companies Act, 2013 prescribes a general format for the preparation and presentation of financial statements of companies incorporated in India. It promotes consistency, comparability and transparency in reporting financial numbers between companies and across time.

This is extensible to all companies, other than the ones involved in banking,insurance and electricity business if not expressly so provided. (i) Schedule III requires balance sheet and statement of profit and loss to be prepared vertically. It also establishes a 'distinct line' between assets/liabilities that are current and those which are non-current, thereby promoting consistent classification clarity.

To ensure consistency of accounting treatment over time, the pattern so prescribed under schedule III should be followed in each subsequent accounting periods. If items are reclassified or presented differently, the company must fully describe the nature of any such change and its effects in addition to explaining why it was necessary.

The function of Schedule III is to bring IGAAP in line with internationally accepted standards such as the International Financial Reporting Standards (IFRS). It consists of three Divisions:

• Division I: Applicable for entities as per the AS="""God is a concept, by which we measure our pain""".GF.

• Second Schedule: This applies to companies that are applying Indian Accounting Standards (Ind AS)

• Division III: Applicable to NBFCs that are required to prepare financial statements under Ind AS

This form allows for flexibility, yet better follows the same format standardizing financial information making reports more intercomparable.

Did You Know?

“Schedule III of the Companies Act, 2013 replaced the old Schedule VI and introduced a uniform structure for financial statements in India. It mandates a vertical format and categorization of assets and liabilities into current and non-current, improving transparency, comparability, and compliance with global financial reporting standards.”

3.5.2 General Instructions for Preparation

III SCHEDULE These are the general principles as may be followed in preparing financials:

True and Fair View: Financial statements should give a true and fair view of the state of affairs of the enterprise and its profits or loss, or property.

Disclosure Requirements:

o Each asset must be disclosed individually.

o Figures to be rounded off as per the turnover limit (i.e. nearest hundred, thousand,lakh or crore)as applicable.

Comparative Information: Previously reported amounts for the current period must also be included with accumulated totals of the preceding period.

Unit of measurement: The unit (e.g. ₹ in lakhs or crores) shall be indicated prominently in the financial statements.

Current vs Non-Current Classification:

o Assets and liabilities that are expected to be settled within 12 months of the reporting date are classified as current.

o Provided for those anticipated to be settled after twelve months as non-current.

Repetition of Format-Prescribed format under Schedule III has to be repeated on periodical basis for all the accounting periods. This guarantees the comparability of financial statements. Disclosure should be made to reflect changes in classification or format and the reasons for such changes and their financial effect. This requirement is be press home in the financial reporting consistency, as mentioned on Page 13.

Notes to Accounts: The notes annexed are an integral part of the financial statements and include detailed information on certain figures.

Grouping and Sub-Grouping Line items shall be logically grouped together. Schedule's breakdown should be shared in case of further clarification.

Rounding: According to the total receipts. For instance, where turnover is below ₹100 crore, amounts can be rounded off to the nearest lakh while in the case of turnover exceeding ₹100 crore, rounding off could be done to the nearest crore.

3.5.3 Format of Balance Sheet (Schedule III)

-(i) The balance sheet shall be prepared in the form set out in Part I of Schedule III and may, subject to the provisions of that part, or as any other form as may be laid by.parliament by law or prescribed under section 133, comply with a standard approved for such class of companies: Provided that nothing in this sub-rule shall apply to any insurance company [the preparation and presentation whereof is regulated by regulations made by Insurance Regulatory,Development Authority].

Balance Sheet as per Schedule III (Part I or II) is prepared vertically and in two parts, Assets and Equity & Liabilities.

A. Assets

• Non-Current Assets:

o Property, Plant and Equipment

o Capital Work-in-Progress

o Intangible Assets

o Non-Current Investments

o Deferred Tax Assets

o Long-Term Loans and Advances

• Current Assets:

o Current Investments

o Inventories

o Trade Receivables

o Cash and Cash Equivalents

o Short-Term Loans and Advances

o Other Current Assets

B. Equity and Liabilities

1 • Shareholders' Funds:

o Share Capital

o Other Equity

o Money Received Against Share Warrants

• Share Application Money Pending Allotment

• Non-Current Liabilities:

o Long-Term Borrowings

o Deferred Tax Liabilities

o Long-Term Provisions

o Other Non-Current Liabilities

• Current Liabilities:

o Short-Term Borrowings

o Trade Payables

o Other Current Liabilities

o Short-Term Provisions

3.3.2 Assets Side

Assets are the things that belong to the company which it expects will provide future positive cash flows. Assets are categorized into:

Non-Current Assets

These are the assets which will not be converted into cash or consumed within a period of one year. They are those investments the company has made for years to support and expand their activities.

Examples:

• PPE: Property, Plant and Equipment – Buildings, machinery, land, vehicles

• intangible assets, including patents, copyrights, trademarks and goodwill

• Long-Term Investing: Shares in other companies, bonds, property

• Deferred Tax Assets: Benefits for taxes in the future

• Capital WIP: Work in progress in the form of constructing / developing asset

Objective: Non-current assets generate revenue over various financial periods.

Current Assets

These are assets that an entity expects to realise, sell or consume and liabilities that it intends to settle within its normal operating cycle or twelve months after the end of period when then longer.

Examples:

*Cash & Cash Equivalents: Cash, bank deposits, marketable securities

• Trade Receivables: Amounts owed by clients

• Stock: Raw material, Work in process and Finished goods

• Temporary investments: Liquid investments for short-term benefit

• Prepaid expenses; Definitions Payments in advance for services, goods

Objectives: Working capital is vital for the management of ongoing operations and solvency.

3.3.3 Liabilities Side

Liabilities are the debts to outsiders which are paid off by the transfer of money, goods and services. They are classified as:

3.3.4 Shareholders' Equity

Shareholders' equity is the remaining interest in the assets of an entity after deducting all liabilities. It represents the owners' claim on the business, and comprises of capital originally invested together with profits kept in the business.

Components of Shareholders' Equity:

Share Capital:

¬ Equity Share Capital: Money brought in by owners subscribing for shares.

 Preference Share Capital: Capital from which preference for payment of dividend as well as recovery of capital is given.

Other Equity:

¬ General Reserves: Funds kept away from profits for future use.

Retained Earnings: The sum of all profits and losses the company has incurred since it started, minus dividends distributed.

♣ Securities Premium: Amount collected on shares over their face value during issue of shares.

Other Comprehensive Income:

o Unrealised gains and losses not yet taken to profit and loss account (e.g., revaluation surplus, foreign currency translation).

Money Received Against Share Warrants:

¬ Advance money against Share Allotment under some Agreements.

Role in Financial Analysis:

• Reflects the company's net worth.

• Facilitates calculations of important ratios such as:

o Return on Equity (ROE)

o Debt-to-Equity Ratio

o Book Value per Share

• Equity is also an important measure of the firm's financial health and its capacity to raise money without borrowing.

Non-Current Liabilities

Long-term debts payable after one year, or beyond the normal operating cycle.

Examples:

• Long term Borrowings: Debentures, Bonds, Term loans

• Deferred Tax Liabilities: Taxes to be paid in the future on account of differences in timing

• LeaseLiabilities: Long term lease payment liabilities

• For pensions, warranties or other legal obligations.

Non-cumbersome liabilities reflect long-term solvency and upcoming financial obligations.

Current Liabilities

Liabilities that are expected to be settled in the ordinary course of business or within one year of the financial statement date.

Examples:

• Creditors: Trade balances with suppliers

• Short-Term borrowings: This refers to the loans that needs to be repaid within an year.

• Payments Outstanding: Wages, rent and interest due

• Customers' Advances: The payments received in advance on account of giving goods/services.

• Current Portion of Long-Term Debt: The portion of long-term debts due within one year

Significance: Current Liabilities are used to evaluate a company's financial stability and liquidity.

Knowledge Check 1

Choose the correct option:

1. **Which of the following is a non-current asset?**
   a) Cash
   b) Inventory

c) Machinery
d) Trade receivables

2. **What does the balance sheet primarily show?**
   a) Profit or loss
   b) Income and expenses
   c) Financial position
   d) Cash inflows

3. **Which of the following is classified as a current liability?**
   a) Debentures
   b) Trade payables
   c) Lease obligations
   d) Preference shares

4. **Shareholders' equity includes which of the following?**
   a) Trade receivables
   b) Bank overdraft
   c) Retained earnings
   d) Inventory

3.5.4 Format of Statement of Profit & Loss (Schedule III)

The Profit & Loss Account of Schedule III also has a vertical presentation as below:

Revenue from Operations:

o Sale of Products or Services

o Other Operating Income

Other Income:

o Interest Income, Dividend, Profit on Disposal of Assets

Total Revenue (1 + 2)

Expenses:

o Cost of Materials Consumed

o Purchase of Stock-in-Trade

o Changes in Inventories

o Employee Benefit Expenses

o Finance Costs

o Depreciation and Amortization

o Other Expenses

Profit before Exceptional and Extraordinary Items and Tax

Exceptional Items (if any)

Profit Before Tax

Tax Expense:

o Current Tax

o Deferred Tax

Profit or Loss for the Period

Other Comprehensive Income (for Ind AS schedule III compliant companies)

Total Comprehensive Income

Earnings Per Share:

• Basic and Diluted EPS

3.4 Profit & Loss Account (Income Statement)

3.4.1 Purpose and Structure

The Profit & Loss Account (Income Statement) is one of the primary financial statements used by a company to report its performance over a specific accounting period. To distill revenues, costs, gains, and losses for the net income or net loss for the period.

Purpose:

• To demonstrate how much money the company made or lost over a period of time.

• To expose for improved operational efficiency.

•In other words, "to offer something that would help in performance and decision making.

• To meet statutory and regulatory obligations.

3.4.2 Revenue Section

The Income Section covers all the company's sources of income accrued in that period.

Key Components:

Revenue from Operations:

o Operating income: Derived from core business activities such as sale of goods and services.

o The dominating means of earnings that show how business has performed.

Other Income:

o Non operation income as such as:

♣ Interest income

♣ Dividend income

♣ Gain on disposal of investments or assets

♣ Rental income

o This part refers to secondary of back up income.

Total Revenue:

o Revenue from operations + other income.

o Forms the basis for comparison with expenses.

3.4.3 Expenses Section

In the Expenses Section, all of a company's operating expenses during an accounting period have been tabulated. Costs apply these expenses against revenues to compute the net income (or loss) for the period. The expenses are categorized to show the structure of the cost and it's effect on business.

Key Categories:

Cost of Materials Consumed

o For manufacturing organizations and this is the cost of materials used to manufacture or produce goods.

o Formula:

Cost of Materials Consumed = Opening stock of raw materials + Purchases of Raw material – Closing Stock Of Raw Material

Purchase of Stock-in-Trade

o For trade; goods purchased, including specifically for resale as they stand after introduction across national boundaries.

Fluctuations of the Stock and Work-in-Progress in progress 25.

o Represents the net movement in the inventory of finished goods and work-in-progress for the period.

o Formula:

Change in Stock = Opening Stock of (Finished + Work-in-Progress) – Closing Stock of (Finished + Work-in-Progress)

Employee Benefit Expenses

o Covers all costs relating to employees including wages, bonus, contributing provident fund and gratuity as well as other staff welfare expenses.

Depreciation and Amortization

o Describes the spreading of the cost of tangible and intangible resources over their useful lives through a system.

Finance Costs

o Includes interest expenses on funds borrowed, bank charges and other financial costs related to financing activities.

Other Expenses

o Encompasses overhead expenses like, rent or legal and professional fees; utilities, repairs, maintenance; advertising.

Exceptional Items (if any)

o Refers to gains or losses, which are unusual and non-recurring and not a part of normal business operations. This could be write-downs, restructuring charges or earnings from continuing operations.

3.4.4 Profit / Loss and its Analysis

A net result is obtained after deducting expenses from total revenue:

Profit Before Tax (PBT)

o Income before tax – all operating income plus nonoperating income and losses.

Tax Expense

o Comprising current tax and deferred tax.

PAT / Net Profit

o The company's net income after taxes are deducted.

o This gets added to the equity portion of the balance sheet in retained earnings.

Other Comprehensive Income (OCI)

o Unrealised gains/losses out of P&L Like:

♣ Revaluation of assets

♣ Foreign exchange differences

♣ Actuarial gains / losses in respect of defined benefit plans

Total Comprehensive Income

o Net income or loss plus other comprehensive income.

Interpretation:

• It would suggest that the company was in good financial and operating health if it were making a net profit.

• Net losses reflect inefficiency or an extraordinary event that has impacted earnings.

• Trends in profit margins over time indicate whether a company's growth, efficiency and cost-management trends are showing improvement or decline year after year.

• The contributors utilize the profitability ratios like Net Profit Margin, Gross Profit Margin, and Return on Sales in order to judge company performance.

3.5.5 Key Disclosure Requirements

Schedule III prescribes various disclosures to enable stakeholders evaluate its financial position and performance. They are generally part of the Notes to Accounts, which give details for the major financial statements.

Key Disclosure Areas (to be read in conjunction with note to accounts):

Share Capital:

o Number and class of shares

o Rights attached to each class

o Reconciliation of shares outstanding

o Promoter shareholding and its Changes during the year

Other Equity:

o Specific movement and composition of each reserve and retained earnings

Property, Plant and Equipment:

o Gross and net book values

o Accumulated depreciation

o Additions to and disposals of the hedge accounting reserve for the period under review

Contingent Liabilities and Commitments:

o Guarantees given

o Claims not acknowledged as debts

Borrowings:

o Nature of borrowings

o Terms of repayment

o Security details

Aging of Trade Receivables and Payables:

o Strata by age categories (i.e.6mo)

Note: The following items which were earlier presented in Notes to Accounts are now a part of the ManagemD ent D iscussion & A nalysis (MD&A) section pursuant to the best practices in Indian corporate reporting.

• Related Party Disclosures

• Segment Reporting

• Corporate Social Responsibility (CSR) Expenditure

This differentiation facilitates a better fit with the narrative and analytical frameworks necessary for MD&A, while promoting clarity and usefulness in financial reporting.

3.6 Practical Problems

3.6 Categorisation of Payments & Receipts (In Practice Examples)

This section is centred around case-study type examples to assist students in differentiating between capital vs revenue expenditure and capital vs revenue receipts.

Practice Example 1:

Identify the following as capital or revenue expenditure:

• New delivery van bought

• Repair of old machinery

• Salaries paid to office staff

• Legal fees for acquiring land

Answers:

• Capital

• Revenue

• Revenue

• Capital

Practice Example 2:

Distinguish between capital and revenue receipts with reference to the following:

• Loan from a bank

• Income from sale of goods

• Sale of old furniture

• Rent received from tenants

Answers:

• Capital

• Revenue

• Capital

• Revenue

These exercises develop the ability to classify accurately a prerequisite to making correct financial statements.

3.6.2 Preparation of a Simple Balance Sheet (Illustrative Problem)

Illustrative Problem:

Prepare a balance sheet using the following information:

Particulars	**Amount (₹)**
Plant and Machinery	1,50,000
Furniture	50,000
Cash in Hand	20,000
Debtors	40,000
Creditors	30,000

Loan from Bank (long-term)	70,000
Capital Introduced by Owner	1,60,000

Solution:

Balance Sheet as on 31st March, 20XX

A. Equity and Liabilities

1. **Shareholder's Funds / Capital**
   - Capital: ₹1,60,000
2. **Non-Current Liabilities**
   - Loan from Bank: ₹70,000
3. **Current Liabilities**
   - Creditors: ₹30,000

Total Liabilities: ₹2,60,000

B. Assets

1. **Non-Current Assets**
   - Plant and Machinery: ₹1,50,000
   - Furniture: ₹50,000
2. **Current Assets**
   - Debtors: ₹40,000
   - Cash in Hand: ₹20,000

Total Assets: ₹2,60,000

3.6.3 Preparation of a Simple Profit & Loss A/c (Illustrative Problem)

Illustrative Problem:
Prepare a simple Profit & Loss Account using the following details for the year ended 31st March, 20XX:

Particulars	**Amount (₹)**
Sales Revenue	3,00,000
Cost of Goods Sold	1,80,000

Salaries	30,000
Rent	10,000
Advertising	5,000
Interest Income	2,000

Solution:

Profit & Loss Account for the Year Ended 31st March, 20XX

Income:

- Revenue from Operations (Sales): ₹3,00,000
- Other Income (Interest): ₹2,000
  Total Income: ₹3,02,000

Expenses:

- Cost of Goods Sold: ₹1,80,000
- Salaries: ₹30,000
- Rent: ₹10,000
- Advertising: ₹5,000
  Total Expenses: ₹2,25,000

Net Profit = ₹3,02,000 – ₹2,25,000 = ₹77,000

This profit will be added to retained earnings in the balance sheet under shareholders' equity.

Did You Know?

"The Profit & Loss Account not only reveals a firm's net profit or loss but also helps assess operational efficiency. Including "Other Income" like interest or rental earnings offers a broader view of performance, and even small amounts can significantly impact profitability when core margins are low."

3.7 Summary

v Financial statements are the summaries of the financial transactions of a company.

v Capital and revenue provision must be categorized correctly for the purpose of reporting.

v Capital expenditure produces a long-term asset, whereas revenue expenditure is for day-to-day operations.

v Capital receipts are non-revenue inflows; revenue receipts flow from core operations.

v) Temporary Fixtures : refers to fixtures which are of temporary and portable nature such as water cooler, painting etc.

v Financial statements consists of Balance Sheet and Profit & Loss Account.

v The Balance Sheet reveals what the company owns (including cash, where you'll find it in this case), owes and the equity of shareholders at a moment in time.

v Assets and liabilities are categorized in current and non-current elements.

v The Profit & Loss Account reflects the income and expenditure over a particular period.

v) Schedule III sets out a uniform structure of financial statements in India.

v It brings in the consistency, comparability and legal requirement of financial reporting.

v Key disclosures in financial reports enhance transparency for readers.

v Application problems build comprehension of classification and financial statement preparation.

3.8 Key Terms

Capital Expenditure : Spending made on acquiring or upgrading productive capacity that will benefit the firm for several years.

Revenue Expenditure: Costs for daily operation of the business in the same financial year.

Capital Receipt: A one-off inflow which would either create a liability or reduce an asset.

Revenue Receipts: Routine earnings from operations of the business.

Deferred Revenue Expenditure: The revenue expenditure, which is supposed to be beneficial over more than one accounting period.

Balance Sheet: A report that provides an overview of a corporation's financial status at a fixed point in time.

Profit & Loss Account: A summary of income and costs over a period.

Schedule III: A schedule in which to prepare financial statements, as required under the Companies Act 2013.

3.9 Descriptive Questions

Differentiate between Capital Expenditure and Revenue Expenditure with Examples.

Define deferred revenue expenditure and discuss its accounting treatment.

Explain the difference between capital receipts and revenue receipts with examples.

Why is a balance sheet prepared? Describe its structure.

Describe the presentation of assets and liabilities schedule III format.

Explain the major elements of a Profit & Loss Account.

Explain the significant disclosures requirements prescribed under Schedule III of the Companies Act, 2013.

Construct an intro balance sheet with imaginary numbers, and correctly get classification on items.

Explain to me how to construct a simple Profit & Loss Account with some imaginary figures.

3.10 References

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Answers to Knowledge Check

Knowledge Check 1

1. c) Machinery
2. c) Financial position
3. b) Trade payables
4. c) Retained earnings

3.11 Case Study

Introduction

Financial statements are the "life-information" of an enterprise which must be sufficiently communicated to it's purposed users. The below is the summarised Balance Sheet of Kavya Enterprises 'Schedule III' company not in words was attaced to this form. The company has had a profitable operating history, but finance struggles to deliver information in a consistent, compliant and investor-friendly manner.

This case study explain you how Kavya Enterprises decoded and revised their financial writings (Balance Sheet & Profit & Loss Account) as per the amended Schedule III. Emphasis is placed on the classification of outlays and receipts, the interpretation of profitability and solvency indicators, as well as key disclosures and compliance practices.

Background

Kavya Enterprises had been operating for many years by maintaining account books and financial interned statements prepared internally but without proper segregation of current /non-current. Since it was getting funds from investors, the management decided to follow a formal financial schedule III format of reporting.

After examining its historical data, the finance team found a number of categorization issues:

• The school district misclassified as capital outlay repairs to machinery.

• Sale of assets were categorized as revenue receipts.

• Amortization of deferred revenue expenditure was not uniform.

Share capital and reserves were not appropriately segregated within equity disclosures.

These problems hurt the way ratios, profit reporting and stakeholder clarity that make it difficult to judge a company's actual performance and risk.

Problem 1: Failure to Discrimination between Capital and Revenue Expenditure

The group miscategorized some ordinary expenses like repairs, advertising and so forth as capital expenditure, artificially inflating the company's asset base and minimizing costs for the year.

Solution:

A review of the definitions used for the measures was carried out by the finance team:

• Capital expenditure should lead to an asset or increase in earning capacity.

• The surplus is for revenue expenditure while the deficit on 'other capital' account will finance capital outlay.

So they reclassified that, because it was a matter of compliance and how you were going to compute your profit.

MCQ 1:

Which one of the following is a capital expenditure?

A) Repairs to equipment

B) Salaries to staff

C) Purchase of machinery

D) Advertising expenses

Answer: C) Purchase of machinery

Principle 2: Misreporting of Receipts.

The company accounted for sales proceeds of the old equipments in the operating income, overstating its operating profits.

Solution:

The crew had invoked Schedule III and brought into capital receipts the proceeds of sums so received from outside the business on that aegis.

MCQ 2:

Which of the following is a revenue receipt.

A) Sale of old equipment

B) Interest on bank deposits

C) Loan from bank

D) Issue of debentures

Solution: B) Interest on deposits in banks

Problem Statement 3: The Sleeping and Waking Up of Formats

The original balance sheets were not prepared in a columnar style with current and non-current assets listed separately. This fact made it difficult to assess the liquidity and working capital status.

Solution:

The finance is the first to take in the vertical schedule III that provides appropriate separation for:

• Working with current vs non-current assets and liabilities

• Shareholders' equity, borrowings, and reserves

This enhanced both communication and the stakeholder perception.

MCQ 3:

How does Schedule III specify the format of financial statements?

A) Horizontal

B) T-format

C) Vertical

D) Tabular

Answer: C) Vertical

Problem Statement 4: Missing Disclosures

There were no notes attached on the contingent liabilities,shareholding pattern and transactions with related parties,a breach of disclosure regulations_fkend09pi.

Solution:

In some accounts, messages were including by the squad such as:

• Details of share capital

• Related party transactions

• Ageing of trade receivables

• Contingent liabilities

This was transparent and made in compliance with regulation.

MCQ 4:

Where in the financials I can find related party transaction disclosure?

A) Trial balance

B) Journal entries

C) Notes to accounts

D) Cash flow statement

Answer: C) Notes to accounts

Conclusion

Schedule III transition results Kavya Enterprises was able to improve accuracy, compliance, and readability of the financial statements by transitioning to Schedule III reporting. The business was then able to convey a true and fair view to investors and financial institutions by fixing incorrect classifications, utilising the correct formats and providing important disclosures that trusted businesses typically make.

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Unit 4: Banking – Part I: Foundations of Banking

Learning Objectives

1. Understand the basic concept and role of banking in the financial system.
2. Identify different types of banks and their key functions.
3. Explain the structure of the Indian banking system.
4. Describe the process of financial intermediation by banks.
5. Understand the concept of money creation and credit expansion.
6. Analyze the role of banks in economic development and financial inclusion.
7. Recognize the regulatory framework governing banking operations in India.

Content

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4.0 Introductory Caselet

Meera, a commerce graduate joined in as the head of a small company in Pune, and received her first salary. Unsure what to do with her money, she decided to open a savings account at a nearby bank branch. While speaking to the bank officer, she

learned about various banking services—current accounts, savings accounts, fixed deposits, loans, net banking and mobile banking apps.

The interaction sparked Meera's curiosity. She'd thought all along that banks were just a place to keep money from being lost or stolen. But now she found that banks are important for economic growth, lend to businesses, take deposits from the public and aid in monetary control. She learnt about commercial banks, cooperative banks and the role of the Reserve Bank of India in regulating them.

Over the years, Meera did not just start saving systematically but also make help her father move on to digital payments. Her personal experience was a case in point of the role banks play as financial intermediaries and as the building blocks for both individual and national development.

Critical Thinking Question

Why is it important for someone like Meera to know how simple banking works, and how does financial literacy help them make better decisions?

4.1 History and Evolution of Banking

4.1.1 Origins of Banking Systems (Ancient to Medieval)

Banking had its origins with the early civilisations of mankind, who started a primitive system of lending to borrowers, and depositing with lenders.

Ancient Banking:

• In Mesopotamia (2000 B.C.E.), the temples and palaces served as financial hubs, providing grain loans to farmers and traders.

• In ancient Greece and Rome, moneylenders and moneychangers made currency exchanges and granted loans. Temples were among the earliest "banks," where wealth and valuables were kept.

• The financial system in ancient India was complex and well-documented. Arthashastra (4th century BCE) prescribes controls in matters of trade and describes the role of a class of bankers, it calls nagarajanaka or yakshas.Other early evidence of such institutions are in the works of Pāṇini.

• Banking type of activities were conducted through indigenous institutions like shrenis (guilds), which served as collective financial bodies offering credit and managing trade finance.

Medieval Banking:

•Banking work in the Middle Ages was done by Jewish and Italian money changers, including the Medici family of Italy.

• Bills of exchange, early cheques, and promissory notes were all used in time to formalise the underlying arrangements.

• In abrahamic religions financial institutions came up with concepts like interest, under Sharia occurred the most well developed ideas of banking based on personality of a law (Islamic canonical law), mutually distributed profit loss mechanism other than an exposure to interest usury.

• In medieval India, merchant castes like the Marwaris, Chettiars and Multanis were instrumental in banking and trade finance. Indigenous banking arrangements like hundis (Bills of Exchange or credit instruments) came to be developed and so were widely accepted by all communities.

These were the precursory models of the interest based banking system that now dominates the world.

4.1.2 Evolution of Modern Banking

Military bankers, along with modern banking practices, appeared in the early period of Renaissance or even earlier.

Key Developments:

• First bank to be established and the world's oldest existing bank: Banca Monte dei Paschi di Siena, Italy (1472).

• The Bank of England was founded in 1694 as a central bank to finance government debt.

• Commercial banking, central banking and stock exchanges emerged in Europe's 17th and 18th centuries.

• Industrial Revolution (18th–19th century) accelerated demand for capital and established banking giants to facilitate infrastructure, railroad, and global trade projects.

• The evolution of usance instruments such as cheques, banknotes and bills of exchange further modernised money handling.

Evolution in India:

• The banking system in India has its Origin, from the Britisher, during colonial period.

• The Bank of Hindustan (est. 1770) in Calcutta, was the first bank of British India and has since stopped functioning.

• The Presidency Banks: Bank of Calcutta (1806), Bank of Bombay (1840), and bank of Madras (1843) were each founded in the 19th century merged to form Imperial Bank of India, the predecessor State Bank of India which was established in 1955.

• Central bank –N Reserve Bank of India (1935): currency issuing and monetary authority.

• Post-independence, India registered several events like nationalisation of banks in 1969 and 1980, liberalisation of economy during the 1990s and digital banking/financial inclusion initiatives in this century.

The use of banking industry has come a long way and now becomes one regulated and a most important corner stone of economic growth by providing various services like deposits, remittances loans & investments. In India, this transformation also reflected international developments and local socio-economic and political conditions thereby providing a fertile ground for the growth of diverse banking system.

4.1.3 Development of Banking in India

India's banking system has witnessed a phenomenal growth and innovation over time, moving from traditional to modern banking through indigenously evolved instruments in line with the changing needs and conditions of the Indian economy. This development is the product of a combination of elements and influences, such as traditional western banking institutions, colonial legacy and post-independence adaptation to social economic requirements peculiar to the country.

Early Indian Banking

Banking services were also responsible for a traditional financial intermediaries in ancient and medieval India included money lenders, Shroffs, SETHS and Chettiars who did indigenous banking including deposits and loans and remittance services. These native bankers were central to the trade and credit markets, functioning on trust, family connections and local systems of finance. Nor were they lacking in system—all these apparatuses, however informal the shape of them, could produce regional viability.

Western banking was introduced during the colonial era. The Bank of Hindustan, established in 1770 at Calcutta (now Kolkata), is the oldest functioning bank; it closed down in 1832. Later, the Presidency Banks were so formed under British India to serve regional interest in 1806 for the Bank of Bengal, in 1840 for the Bank of Bombay and 1843 for the Bank of Madras. They were essentially wholesale banks with a focus on servicing the requirements of British businesses and government transactions, and established the precedent for institutional banking in India.

Modern Indian Banking Milestones

In 1921, the three Presidency banks were amalgamated to form the Imperial Bank of India, a bank that was semi government-owned and had some central bank functions. But due to the rising necessity of a central monetary authority, RBI (Reserve Bank of India) was formed in 1935. Originally established as a private bank, the RBI was

nationalized in 1949 and took over all currency issuance, monetary market regulation and banking supervision.

The decision for nationalization came after India had gained political independence in 1947, and its government recognized the need for the country to make financial reforms so that more people could access banking and credit. In a drastic policy move, 14 of the major commercial banks were nationalized in 1969 including 6 more in 1980. The objective was to widen banking's reach in rural areas, boost agricultural and priority sector lending and limit the dominance of some private entities in the sector.

Liberalization in 1991 brought Indian banking into a new era. The government also permitted private sector banks (ICICI Bank, HDFC Bank and UTI Bank) to exist but within strict regulations. It was also a time of consolidation, both in regulation and the focus on financial stability.

Towards the 21st century, India also experienced a tremendous advancement in digital banking and financial inclusion. UPI (Unified Payments Interface) has revolutionized real-time digital transactions, and programmes such as the Pradhan Mantri Jan Dhan Yojana have made the inclusion of millions of unbanked people into formal financial systems a reality. The penetration of banking services in rural and unbanked areas was further extended by measures such as deployment of banking correspondents, mobile banking and payment banks.

So while today, India has a developing banking system which includes PSU banks, private banks, foreign banks and the cooperative bank sector and RRBs operating under the watchful eye of RBI. The sector will keep changing in the face of more digitalisation, financial innovation and a firm commitment to inclusive and sustainable growth.

Timeline: Key Milestones in the Development of Indian Banking

Year	Event
1770	Establishment of the Bank of Hindustan in Calcutta
1806–1843	Formation of Presidency Banks: Bengal (1806), Bombay (1840), Madras (1843)
1921	Merger of Presidency Banks into the Imperial Bank of India
1935	Establishment of the Reserve Bank of India (RBI)
1949	Nationalization of the RBI

Year	Event
1955	Imperial Bank transformed into State Bank of India (SBI)
1969	Nationalization of 14 major commercial banks
1980	Nationalization of 6 more commercial banks
1991	Liberalization and entry of private and foreign banks
2009–2016	Growth of digital banking, mobile payments, and new banking models
2014	Launch of Pradhan Mantri Jan Dhan Yojana
2016	Introduction of Unified Payments Interface (UPI)
2020s	Expansion of fintech, neobanks, and increased financial inclusion

4.1.4 Milestones in Global Banking Evolution

Banking around the world has shifted substantially over the centuries, influenced by economic crises, regulatory changes, new technology and the inexorable march of globalization. Every stage in the evolution of global banking is a response to and solution for new financial markets and customer needs.

One of the first and most important was the founding of the Bank of England in 1694, which signaled the advent of modern central banking. It was to administer public borrowing and the issuance of bank notes, and set the relinquishment for central banking structures world-wide. More than 100 years later, in the United States, the New York Stock Exchange was formed in 1817, shifting capital markets and banking even closer and enabling funding to be raised on a wide scale.

The 1930s Great Depression was a time of extreme financial instability that led to the birth of new regulations. In the United States, the Glass-Steagall Act of 1933 was enacted to barrier commercial and investment banking from each other with the intention of restoring confidence in banking and preventing hazardous speculation using depositors' funds.

A new international monetary order was created after World War II. The World Bank and the International Monetary Fund (IMF) were established during a conference at

Bretton Woods in 1944. Their purpose was to encourage international economic cooperation, development, and stability among countries.

The 1970s and 1980s experienced an explosion of financial innovation. ATMs, credit cards and home banking systems became part of the everyday banking language. It was the birth of 24/7 banking and increased dependence on digital systems.

The growth of online banking in the 1990s, had seen online banks provide traditionally remote access to a service that was once exclusively available from a local bank albeit with higher levels of security and hence increased appeal to customers. From then on, internet banking became a common service provided by banks in both advanced and emerging countries.

Since the global financial crisis of 2008, when major US financial institutions failed and subprime mortgage markets imploded, the international banking industry has not confronted a more serious threat. This crisis revealed systemic failures in risk management and regulation. This elicited tougher scrutiny by international regulators most prominently, Basel III regulations, which have toughened up the monitoring on banks by introducing standards for capital adequacy ratio, liquidity standards and stress testing.

In the 21st century, technology has come to dominate banking like never before. No, the rise of FinTech in last five years or so is really about the quick appearance of bank-like businesses that replace traditional banks with a faster more user friendly often cheaper financial service through digital delivery. Decentralized technologies like blockchain have established safe means for recording transactions, and cryptocurrencies such as Bitcoin and Ethereum are the direct result. Neo-banks — purely digital banks like Revolut and N26 — provide stripped-down, app-based services with no physical branches aimed at consumers who are comfortable with technology.

One exemplar instantiated innovation of today, is India's Unified Payments Interface (UPI), which went live in 2016. UPI revolutionized the digital payments landscape by allowing real-time bank-to-bank transfers via mobile apps. By 2024, UPI had crossed the 10 billion monthly transaction milestones highlighting how scalable and effective a digitally facilitated banking-backed infrastructure was. Another example is China's WeChat Pay and Alipay, whose platforms are deeply integrated with digital financial services that people can use to carry out all kinds of banking and payment operations over social media — texting on their phones.

In addition, AI enabled banking services are gaining traction, where banks apply machine learning techniques to fraud detection, credit risk assessment and personalized financial advisory service. Chatbots and virtual assistants are now a fixture in customer service, helping to expedite resolution times.

These global landmarks illustrate the continuously transforming face of banking – a sector that is always adapting to cyclic market conditions, surrounding regulations or the needs of a new digital-first generation.

4.2 Types of Banks

4.2.1 Commercial Banks

Commercial banks are the backbone of financial markets, and their principal activity is to accept deposits from the public in return for credits granted to individuals, businesses, and different entities. The essence of this business is financial intermediation: savings from depositors have been mobilized and put to productive use through lending. These banks provide the basis for liquidity in the economy, payments and investment to enable growth in the broader economy.

Acceptance of deposits in different forms (such as savings accounts, current accounts and fixed deposits) being the most reliable function of a commercial bank, is also the oldest. Savings accounts inspire saving on a regular basis while current accounts are run for routine transactions by businesses. Fixed deposits are those that provide better interest rates but have a locked time period.

On the borrowing side, commercial banks extend a variety of credit options such as personal loans, home loans, car loans, business loans and overdrafts. They also finance working-capital requirement through short-term facilities such as cash credit, bill discounting as well as term loans. Besides providing fund-based facilities, banks provide non-fund based facilities in the form of bank guarantee and letter of credit, facilitating trade and business operations.

Commercial banks today have advanced to offer digital means for payments and transactions such as through internet banking, mobile apps, debit cards, cheques and Unified Payments Interface (UPI). These are online transactions enabling DSK Bank customers to make fast, secure and real-time payments of bills and fund transfers.

In India, the commercial banks are categorized in to public sector banks, private sector banks and foreign banks and they have their own importance in the financial system.

Public Sector Banks

PSBs are banks where the Government of India (GOI) is a majority stakeholder. These banks were nationalized with a view to ensure financial inclusion and to extend credit facilities to the underprivileged domains like agriculture, small industries, villages. PSBs function under social obligations other than profitability. Key examples are the State Bank of India (SBI), which is the largest public sector bank as well as other a few others such as Bank of Baroda, Punjab National Bank and Canara Bank. These banks have a wide reach in the country, especially in semi-urban and rural areas, and cater to implementation of Ministries departments of GOI for PMJDY.

Private Sector Banks

The private sector banks are managed and owned by the private shareholders and stakeholders while they are also regulated by RBI (Reserve Bank of India) under 1949 Banking regulation act. These banks generally emphasize technology-enabled banking services, customer experience and urban markets. They tend to be more efficient and innovative than their public sector partners. Top private sector banks of India are HDFC Bank, ICICI Bank and Axis Bank. These banks have played a large role in the expansion of digital banking services provided in India including, mobile wallets, on-the-spot loan approvals, AI-driven customer service and tailor-made financial planning solutions.

Foreign Banks

Foreign banks (transnational banks) which have opened their branches in India. These banks offer superior global experience, cutting edge technology and products, and low cost international financial services to the Indian customers. They usually serve multinational corporations, high-net-worth individuals and large Indian businesses that are involved in international commerce. These include banks like: HSBC, Deutsche Bank, CitiBank and Standard Chartered bank. Foreign banks in India are regulated and licensed only under the regulatory jurisdiction of Reserve Bank of India (RBI) and are not subjected to Bank regulation norm that is applicable to local banks. Although they have quite few branches in comparison to the domestic banks, they provide specialized services including forex trading, global wealth management and cross-border banking.

Public sector, private sector and foreign commercial banks constitute the foundation for India's formal banking system. Reserve Bank of India (RBI) is the apex banking institution under whose regulation these banks fall, including provisions of the Banking Regulation Act, 1949, which ensure so much integrity and sound business practices among the Indian Commercial banks in general.

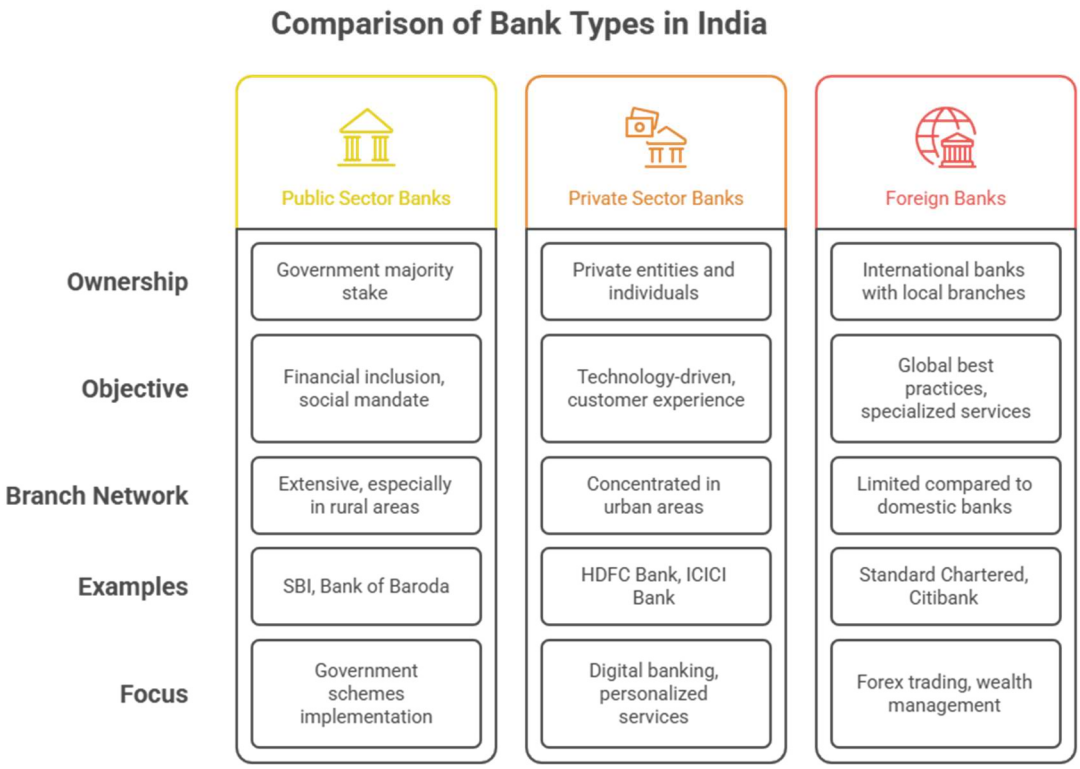

Figure 4.2

4.2.2 Cooperative Banks

Cooperative banks are institutons based on mutuality, democracy and member ownership. While commercial banks operate with the profit motive predominating, cooperative banks are established for the purpose of furthering financial inclusions particularly of rural and semi urban populations. Credit unions are businesses established to meet the needs of their members – often co-workers or members of the same community – by offering accessible credit and simple banking services.

These banks are covered by Cooperative Societies Act; they may be a state level or central bank. They operate with a rare dual regulatory framework: the Reserve Bank of India (RBI) regulates their banking operations while the management and administrative functions are subject to supervision by state governments or the Ministry of Cooperation. This double control is necessary for monitoring activity, but it can face coordination problems.

Cooperative banks provide the same variety of financial services as commercial banks. These services include the receipt of deposits, extension of agricultural, small business and housing loans, as well as other financial services like remittances and insurance

products. What is notable about them, however, is that they reach out to sections of the population that are generally excluded by commercial banks—small and marginal farmers, artisans, weavers, and low-income households—who are in need of easy credit.

Types of Cooperative Banks

Urban Cooperative Banks (UCBs)

Urban Cooperative Banks - These banks are located and operate in urban and semi-urban areas, thus serving the banking needs of city people. They offer deposits and loan products very similar to that of commercial banks, though a vast majority of their loans are given out to small business owners, salaried employees and self-employed individuals. Their size can range from small, single branch entities to large multiple branch banks across cities. In the same meeting, it further indicated to bring them fully within RBI's scanner so that transparency and governance standards can be improved.

Rural Cooperative Banks

3

Tiered structure The Rural Cooperative Banks have a three-tier structure:

• Primary Agricultural Credit Societies (PACS): At the village level

• District Central Cooperative Banks (DCCBs) or District Bank at the district level

• State Cooperative Banks (SCBs) at State level

These banks are primarily focused in providing credit facilities to the agricultural sector such as seasonal crop loans, equipment and working capital loans to farmers and short term trade credits (loans) to rural artisans and traders. Their strong ground-level presence makes them indispensable in the execution of government projects concerning rural development and agricultural subsidies.

Multi-State Cooperative Banks

(8) Multi-State Cooperative Banks cover states and are registered under the Multi-State Cooperative Societies Act, 2002. These banks are generally larger, better capitalized compared to single-state banks, and are subjected directly to the control of Central Registrar of Cooperative Societies and Reserve Bank of India (RBI). Diverse operational base enables them to cater to a broader membership ranging from Co-operative Housing Societies, Factory workers, Agriculturists etc in a variety of geographies.

A live instance is Saraswat Co-operative Bank in the Indian state of Maharashtra, In India 6 states are primary banking co-opegoverning banks. It is a retail bank that provides various banking products and services to individuals, small and medium enterprises (SMEs) with an GDP-weighted average capital adequacy ratio of 19.2%. A case in point is the The Punjab and Maharashtra Cooperative (PMC) Bank, which despite

having regulatory problems over the past few years, underscored both how essential strong governance and monitoring from RBI are for cooperative banking.

Role in Financial Inclusion

Cooperative banks are important in the financial sector in India, particularly to serve underbanked and unbanked people. They are intermediaries in the distribution of government subsidies, crop loans waivers and other welfare programmes. Their local rootedness, member-based business model and capacity to tap small savings make them important tools for inclusive and community-centric banking.

But the cooperative bank suffers problems of capital adequacy, professionalism and tech-upgradation as well. Recent regulatory changes are intended to improve their governance and operational transparency, making them an important part of India's changing financial system.

4.2.3 Regional Rural Banks (RRBs)

Regional Rural Banks (RRBs) are Government of India owned scheduled commercial banks, which were established after the recommendation of the Narasimham Committee to provide credit and banking facilities to rural areas. Established by the RRD Act, 1976, the first existed RRBs were set running on October 2, 1975 with a view of providing socio-economic development to Indian rural sector. Banking in these banks focuses mainly on extending need based and client responsive credit to small and marginal farmers, landless labourers, artisans and rural entrepreneurs; most of whom are deprived from access to mainstream commercial banking channels.

The owner structure of RRBS is template based, consisting of three different types of owners:

• 50% Holding of the Central Government

• 15% by the concerned State Government.

35% by the Sponsor Bank (a public sector bank whose duty is to support of RRB)

This three-dimensional design allows the RRBs to gain from support of government, local governance and technical help Managerial advice of sponsor banks. RRBs are governed by the Reserve Bank of India (RBI) and receive the developmental policy related to banking and for expansion and PCBs from NABARD(National Bank for Agriculture and Rural Development).

5 The main objective of RRBs is to mobilize the financial resources from rural / semi-urban areas and grant loans and advances mostly to small and marginal farmers, agricultural labourers and rural artisans. They provide a range of financial services such as savings accounts, current accounts, crop loans, agriculture term loans,

microfinance and government scheme payments like MNREGA wages and PM-KISAN payments.

Examples of RRBs

Prathama UP Gramin Bank

Prathama UP Gramin Bank is a leading RRB in Uttar Pradesh which came into effect after the combination of two separate RRBs Prathama Bank and Sarva UP Gramin Bank in 2019. It has a network in multiple areas such as Moradabad, Rampur, Amroha, Sambhal and so on. The Bank is backed by Punjab National Bank (PNB). Bank falls in the straight line of ownership under typical RRB model, that is 50% owned by Central Government and 35% jointly by State Government Uttar Pradesh and Punjab National Bank. Prathama UP Gramin Bank is dedicated to offer financial help to village homes, small farmers and SHGs.The bank actively participate in the government sponsored financial inclusion scheme.

Kerala Gramin Bank

Kerala Gramin Bank is one of the RRB's in Kerala, formed as per GO (P) No 30/2013/dated 16.01.2013, by amalgamating 2 RRBs namely South Malabar Gramin Bank and North Malabar Gramin Bank through a Notification of Government of India, Ministry of Finance with an equity participation from Govt. It runs through all fourteen districts of the state, and therefore is classified as a state-wide rural bank. The bank is directly sponsored by Canara Bank and also its shareholding pattern as per RRB model is Government of India: fifty percent, the Government of Kerala: fifteen percent Canara Bank : thirty five percent. Kerala Gramin Bank provides its customers with an extensive range of rural banking products, and is rated high for prompt to serve performance in digital banking, microcredit and financial inclusion activities in the region.

Such banks have played a key role in taking formal banking to distant rural pockets/underserved areas and also often served as the first point of contact between the common man and the formal banking system. Their branch presence, local knowledge of rural credit demands and the capacity to operate government welfare/subsidy schemes effectively have made them an indispensable part of India's rural development policy.

More recently, both the government and RBI have begun to take measures to consolidate RRBs towards making them more operationally efficient, financial viable as well as effective in their service delivery. Several of the smaller RRBs have been consolidated to create large, regionally wide reaching entities capable of adapting technology and outreach.

4.2.4 Development Banks

Development banks are dedicated financial institutions which have an important role in financing long-term economic development. Unlike commercial banks, which cater to short-term credit and profit-led antics, development banks are meant for funding big projects with a longer gestation period—especially in areas like infrastructure, industry, agriculture and micro, small and medium enterprises (MSMEs). These banks mostly do not receive their deposits from the general public, they are funded by a government guarantee, bonds and/or refinancing done by apex institutions.

Developmental functions of a development bank Development banks perform many developmental functions like providing term loans, project financing, taking equity participation, giving technical & managerial assistance and promoting Entrepreneurial activity. They typically operate at concessional interest rates and are important for supporting planned and inclusive development, especially in areas where they cannot attract a large amount of private capital because the risk is high or payment horizons are long.

The following are Examples of Development Banks in India : 1.

Industrial Development Bank of India (IDBI) 22.

10

9.Industrial Development Bank of India Industrial Development Bank of India (IDBI) was established in 1964 as a wholly owned subsidiary of RBI. Its main function was to supply long-term capital to economic industries, and control the activities of other development finance institutions. IDBI has played a vital role in the development of Indian industry as a key player operating in both small-scale and large-scale industrial segments across the economic value chain, supporting infrastructure development through focused sectors of the economy – including such industries as steel, power, chemicals and engineering – by extending assistance for investment in project finance & underwriting.

"With liberalization of Indian economy and widening of financial system, the focus and role of IDBI underwent a change. It became a commercial bank in 2004, and carries a universal banking license that provides retail banking services as well as its original developmental mandate. Even after this shift, IDBI continues to occupy a high position in the financial architecture of India; particularly as a father figure to development finance.

1

Small Industries Development Bank of India dequeueReusableCellWithIdentifier

Small Industries Development Bank of India (SIDBI) was set up in 1990 through an Act of Parliament as the principal financial institution for the promotion, financing and development of the micro, small and medium enterprise (MSME) sector. SIDBI directly finances, refinance and microfinance to small and startups industries and

entrepreneurs. It has also provides capacity building, innovation and modernisation of the MSME ecosystem through several schemes and partnerships.

Aiding what could be called as funding's last mile, SIDBI has played a crucial role in helping products such as CGTMSE (Credit Guarantee Fund Trust for Micro and Small Enterprises), MUDRA initiative create the right kind of impetus and also channeling venture capital support to startups. In the past few years, SIDBI has also been a driving force for encouraging green finance, women entrepreneurship and digital lending platforms for inclusive growth.

8 NATIONAL BANK FOR AGRICULTURE AND RURAL DEVELOPMENT (NABARD)

The National Bank for Agriculture and Rural Development (NABARD) was established in 1982 as an apex development bank, an institution that provides credit for the promotion of agriculture, small scale industries, cottage, and village industries, handicrafts and other rural crafts. It was formed by the merger of the functions of the RBI and the Agricultural Refinance and Development Corporation (ARDC). NABARD's mandate is to promote rural infrastructure, farm and non-farm sector activities and generate employment opportunities in rural India.

NABARD extends refinance to cooperative banks, RRBs and other rural financial institutions like PACS for lending to farmers and rural artisans. It also oversees many government sponsored programs like the Rural Infrastructure Development Fund (RIDF) and the Producer Organizations Development Fund (PODF). NABARD is the catalyst for transforming social and rural economy and climate resilient agriculture to bring about Socio-economic prosperity in Indian villages.

4.2.5 Central Banks

A central bank is the top financial institution in a nation and is responsible for regulating the country's monetary and financial system. It is a key player in defining and enforcing monetary policy, supervising the operations of the banking sector, managing national currency and foreign exchange reserves and sustaining financial as well as economic stability. Central banks are not like commercial banks in the sense that they do not chase profits, and neither would they engage directly with the public. Instead, the banks function as the government's banker and serve as a backstop to financial institutions in times of trouble.

In India, the Central Banking authority is the Reserve Bank of India (RBI). 1935 The RBI was set up in 1935 through and by a legislation called "The Reserve Bank of India Act, 1934". It originally was a private entity until was nationalized in 1949, following independence. The RBI's mandate is extensive: it is the issuer and manager of the country's currency; manages the cost of credit using monetary policy tools such as bank rates and repo rates; supervises, licenses banks and non-banking financial

companies (NBFCs), besides being custodian to India Inc's foreign exchange under the Foreign Exchange Management Act (FEMA). It also handles the government's borrowing programme as well as payment and settlement systems to protect price stability and sustainable economic growth.

In other countries too, and apart from India's where the central bank has been vested with such roles (which however are narrowly defined) most have a central bank but don't specifically perform the role of the MPC.

6 The Federal Reserve (USA)

The Federal Reserve System (also known as "the Fed") is the central banking system of the United States, created in 1913 with the enactment of the Federal Reserve Act. It is one of the world's most powerful financial firms, thanks to the fact that the dollar is the world's reserve currency. The core of the Fed's mandate is maximum employment, stable prices and moderate long-term interest rates. It consists of a Board of Governors in Washington, D.C., and 12 regional Federal Reserve Banks. Exchange rate and monetary policies are consumerism one uses to accomplish this takes a huge scale of activities.

European Central Bank (ECB)

1998 The ECB is the central bank for Europe's single currency, the euro (€). Based in Frankfurt, Germany, the ECB aims to ensure price stability and set monetary policy for the euro area - plotted by 19 EU members - as well as overseeing systemically important banks via its Single Supervisory Mechanism (SSM). It acts autonomously of its member governments and is central to keeping the economic integration of the eurozone on track.

Bank of Japan (BoJ)

The Bank of Japan (BoJ) is the central bank of Japan and was established in 1882 and is one of the oldest Central banks in the world. It has helped guide Japan through a range of economic cycles, from the deflation that plagued the country in the 1990s to more recent struggles with stagnant growth and an aging population. The issuing authority of the yen is the Bank of Japan (BoJ) and, as with any major currency in the world, it sets interest rates. It implements tools such as quantitative easing and negative interest rates to increase economic activity. Because Japan is itself so important in global trade and finance, its policies are closely monitored around the world.

4.2.6 Specialized Banks

Development banks are those financial institutions set up to cater for the needs of particular economic sectors or functions that need specialized financial aid, policy backing and technical know-how. Unlike universal banks that cater to a variety of business, specialty banks concentrate on niche segments such as international trade,

agriculture and rural development or housing finance. These banks are instrumental in promoting the national policy goals by accessing sectors, which normally don't have access to banking facilities.

7 EXIM Bank: Export-Import Bank of India

EXPORT-IMPORT BANK OF INDIA The Export-Import Bank of India (EXIM Bank) was set up in 1982 by an Act of the Parliament to support the internationalization of Indian business as one-stop shop forconsumption data, market research and opportunities. As the principal export credit agency, EXIM Bank offers variety of products including buyer's credit, supplier's credit and lines of credit to overseas financial institutions. And it provides risk mitigation tools such as guarantees and insurance. The bank boosts Indian exports in manufacturing, infrastructure and engineering services with its long-term finance and access to international markets. The bank also plays a leading role in establishing new government sponsored schemes like Make in India, Project Exports and Lines of Credit (LoC) under the foreign policy of India.

11 National Bank for Agriculture and Rural Development(NABARD)

The National Bank for Agriculture and Rural Development (NABARD), was established on 12 July 1982 on the recommendations made by Shivaraman Committee in setting up the NABARD through an act of Parliament, i.e. ENACT NO -61 OF 1981 as the central unit from state finance or directly related any branch of the Reserve Bank of India. NABARD is the apex development bank for agriculture and rural development in India. It offers refinance to institutions like RRBs, cooperative banks and microfinance institutions to lend it onward to farmers, rural artisans and agricultural activities through SHGs. NABARD also provides direct funding to individuals under the SHG program and to entrepreneurs under the 'Scheme of backward Linkage' – a bank with NABARD subsidiary scheme, and indirectly in the form of refinance under SHG-Bank Credit Programme (SIDBI) for various activities such as handicrafts development support via world bank or national collateral management services limited. Its initiatives have helped in bringing financial inclusion, increasing agricultural productivity and reducing poverty in rural India.

4 National Housing Bank (NHB)

The National Housing Bank (NHB), a subsidiary of the Reserve Bank of India, was set up on 9 July 1988 under the NHB Act of 1987. NHB is the biggest institution dealing with housing finance in India and also acts as the principal agency to promote housing mortgage market in the country. It does so by regulating and supervising housing finance companies (HFCs), it also provides refinance to the banks and other institutions involved in giving house loans. NHB also operates Pradhan Mantri Awas Yojana, a Government of India initiative to facilitate affordable housing for weaker sections and low income groups. It facilitates and widens the spread of housing finance

markets, provides liquidity to the housing / home-financing market, and promotes innovation in housing development products and processes.

“Activity”

Students will prepare a comparative chart highlighting key features, functions, and examples of six types of banks: Commercial, Cooperative, RRBs, Development, Central, and Specialized banks. Each group will present one type with real-world examples and explain its role in financial inclusion and economic development through a short presentation.

4.3 Functions of Banks

4.3.1 Accepting Deposits

Accepting of Deposits: The banker is to receive deposits from the general public. This not only affords the public and businesses a safe place to keep money, it also allows banks to use that money as sources of credit and funding for investment opportunities or other financial products. Deposits play an important role in the banking system as they are principal of financial intermediation and credit creation which leads to economic growth and liquidity of the economy.

Types of Deposits

Savings Account

Individuals typically park their surplus funds in the form of savings bank deposits; it's a very popular type of deposit product. These are meant to inculcate saving habits and also to be able to have easy access through ATM, cheque and other digital mode of transactions.

Real-life example:

Ravi, a teacher, holds savings account with HDFC Bank. His company pays his monthly salary into this account which he uses for all day-to-day expenses, like paying bills in the form of utility payments/online shopping & UPI transfers. The account nets him a small amount of interest, and he also has access to ATMs and mobile banking.

Current Account

A current account is usually maintained by firms, business houses and the professionals to make a large number of transactions. Current accounts, unlike savings

accounts, generally do not pay interest but have functions including overdraft facilities and no limit on the number of transactions.

Real-life example:

A Surat-based textile trader operates a current account with ICICI Bank. Explanation: being supplier and recieving payment from customers on daily basis,and also their deposits are not stable,so he wants current account to do more transaction with restrictions 100%. He doesn't receive interest, but the convenience as well as overdraft benefits him in managing his working capital.

Fixed Deposit (FD)

FD is when you invest a lump sum amount with the bank for a certain period of time and will receive higher interest rate compared to that in a regular saving account. It locks up the funds, and early withdrawals may trigger penalties.

Real-life example:

Meera Meera is a retired government servant who wants to invest ₹5 lakhs for 3 years, to generate interest income which is secured and regular. As she doesn't need this sum immediately, the FD provides her both financial security and higher interest than a savings account.

Recurring Deposit (RD)

1) For regular saving A recurring deposit (RD) is the best option for those individuals who want to save money regularly. It provides a facility to the depositor that he/she can invest fixed amount every month for a decided period, and will get an interest as of FD. It's especially helpful for people who work on fixed salary or students.

Real-life example:

Anita is a young software engineer and she starts an RD with Axis Bank of ₹3,000 per month for 2 years. She wants to save up for an international holiday. The RD offers her a disciplined way to save with guaranteed returns, making it easier and possible for her to reach out/goal of travelling.

4.3.2 Providing Loans and Advances

Dispensing loans and advances with the funds raised by banks in the form of deposits among people is one of their prime functions. Not only does this generate fees — banks make money by charging interest on the loan — it is also key to keeping the wheels of commerce turning, as it allows businesses to expand; people to afford homes and cars and credit cards; and governments to invest in infrastructure. Banks, by lending to various sectors of the economy, facilitate employment creation, consumption, entrepreneurship and development.

Varieties of loans and how they apply to you

Term Loans

Term loans are those loans that are issued for some fixed period say 1, 2, and 3, or may up to more than10 years. They tend to be repaid in default monthly or quarterly chunks, and are typically employed for things like expanding businesses, buying machinery or -- in the case of local government funding vehicles -- financing infrastructure projects.

Real-life example:

ISBPL Pune: A small manufacturing unit in Pune borrows a ₹50 lakh term-loan from Bank of Baroda for installing a new production line. The repayment will be made in 5 years. This credit allows the company to grow operations, produce more output, and bring on new workers.

Cash Credit

The cash credit facility is offered to business entities as short-term credit. The first permits them to take out a loan against stock, raw materials or receivables that have been pledged and is usually provided with an up-to-a-limit provision for the company to borrow as necessary. The amount hired is the only one with interest tolling.

Real-life example:

A wholesale grocery trader in Delhi gets sanctioned a cash credit limit of ₹20 lakhs by Punjab National Bank on the security of his stock. In seasonal peak of festival season, he purchases an additional stock using ₹10 lakhs from the limit. Now, he pays interest on only ₹10 lakhs utilized (and not the full sanctioned limit) and can manage his working capital smartly.

Overdraft Facility

An OD is used by current account holders — usually businesses or professionals — to withdraw more money than is available from their accounts, ideally within a pre-agreed limit. It offers short-term liquidity for emergencies and is handy when cash flows are temporarily restricted.

Real-life example:

For example, Ramesh, who runs a printing press in Chennai has an overdraft of ₹2 lakhs available with HDFC Bank. What he does is overdrafts ₹1.5 lakhs every time I have to buy in bulk by paying online for the material before taking supply and recovers it from payment, once the work gets complete which takes around 2 weeks approximately till we get paid.

Personal Loans and Home Loans

Personal loans: It is an unsecured loan provided to individuals for meeting their personal needs, such as an emergency medical requirement, higher education expenses, wedding expenditure or travel. Home loans, meanwhile, are long-term loans extended to the purchase of residential property, construction or renovation. These are however, repaid in EMIs (equated monthly instalments) for long durations.

Real-life example:

Software engineer Neha borrows a home loan to buy an apartment in Bengaluru To fund the purchase of her new abode worth ₹40 lakh, she takes help from ICICI Bank. Her EMI is debited from her salary account every month. In a different scenario, friend Raj avails a ₹3 lakh personal loan from Axis Bank to meet the wedding expenses and he repays it in 24 months.

Agricultural Loans

Agriculture loans are provided to farmers and rural business owners for the purchase of seeds, fertilizers, irrigation equipment or livestock; crop cultavation or land improvement. These can be short or long term and are frequently made available at cheap interest rates under various government plans.

Real-life example:

A Nashik based farmer takes a Kisan Credit Card (KCC) loan of ₹1.5 lakh extend to him by NABARD assisted Maharashtra Gramin Bank. He invests that money to purchase premium grape saplings and drip irrigation gear. Flexible loan terms will enable him repay post-harvest and free up any stress of the loans.

4.3.3 Agency Functions

In addition to their primary duties of accepting deposits and granting loans for the general public, banks offer many other services for customer, institutions and government. They are called non fund based functions because the bank has not to undertake any financial liability or using its own funds in those services. While there's no interest income for the agency function per se, bringing services near customers is essential from a customer service perspective, and promoting a cashless economy by reducing reliance on physical currency handling improves overall operational efficiency.

Fund Transfers

Transfer of money from one account to another whether within the same bank or in to other banks is one of the major services rendered by banks as agents; 3. Technological advancements like the NEFT (National Electronic Funds Transfer), RTGS (Real-Time Gross Settlement) IMPS (Immediate Payment Service), and UPI (Unified Payments Interface) services have changed the face of fund transfer. Banks also offer normal

paper-based payment options like demand drafts for non-electronic/written transactions.

Real-life example:

Priya, who works in Mumbai, sends ₹10,000 to her parents in Kerala via UPI through the mobile banking app. No paperwork The process is instant. Another businessman, for example, sends ₹5 lakhs to a supplier via RTGS in high-value payment but with same-day settlement.

Collection of Cheques and Bills

Banks also make a collection of cheques and bills of exchange for depositors. In case of a cheque issued by one bank and deposited in another, the receiving bank pays the issuing bank and credits it to the account of depositor. This is a must have service for people and businesses that receive payments in the form of cheque.

Real-life example:

Rahul, a freelance graphic designer, receives a cheque from the client worth Rs 25,000 and issued by another bank. He banks it at his branch of the SBI. The bank clears the cheque in couple of days, and Rahul's account is credited with the fund.

Order of Payment on Bills and Other Claims

Banks also provide the facility of paying the repeated bills and charges via standing instruction or through ECS (Auto-debit). This may include the utility bills (such as electricity, gas, water), insurance premiums, EMIs of loans, credit card dues and taxes. The bank then debits the amount on the due date automatically as per instructions given by the customer at the time of setting up CHI and gives an assurance for timely payments without being attended personally.

Real-life example:

Shalini, who is a salaried employee sets-up standing instructions with HDFC Bank to pay her monthly electricity and internet bills. Her home loan EMI, too, is an auto debit every month. These automatic services save her time and make sure she never misses a due date, which can result in late fees or service cancellations.

4.3.4 General Utility Functions

Banks The bank, besides the deposit accepting (borrowing) and lending functions, also renders a number of general utility services by adding to customer convenience and satisfying diverse financial needs. Ultimately, these services — which don't produce profit directly in the same way that a loan or investment does but instead support customer retention, banking reach and banks as comprehensive financial service providers — are about cultivating big-picture value. Where utility functions really get

interesting is in the provision of safety, ease and financial services to traditional banking consumers today.

Locker Facilities

Safe Deposit Locker – Service Provided By Banks That You Can Trust The most trusted service provided by banks is the provision to keep in safe custody items of high value - Jewellery, property documents, wills, and certificates. They are situated inside secure bank vault and offered in differing sizes dependent on individual needs of customers. For the locker, banks charge an annual fee as well access is restricted in order to ensure security of the contents kept.

Real-life example:

Mr. and Mrs. Verma, a retired couple in Lucknow, said they kept family jewellery and legal property papers in a medium-sized locker that they rent at their local Punjab National Bank branch. “The fact that I’ve got all my valuables in a high-security vault means at least those are secure, especially as our family travels quite a bit.”

Issuance of Drafts and Cheques

Banks also provide instruments such as demand drafts (DDs) and banker’s cheques for carrying out secure financial transactions. They are always prepaid checked as against a personal cheque and they are also guaranteed by the bank that is beneficial wherever trust and proof of payment are important (for example, in the case of government transactions, educational institutions ´ fees or property).

Real-life example:

Arjun, a student in Kolkata, had to fork out ₹30,000 in admission fees for securing a place at a university outside his home state. Its a security measure that the college has in place. So he goes to his SBI branch, deposits the cash and gets a DD issued in favour of the institute which has to be sent with his filled app form.

Debit and Credit Card Services

And customers of banks are provided by them with debit cards to withdraw money from ATMs, buy in stores or make purchases online directly from their comparator savings and current accounts. Credit cards, in contrast, allow customers to make a purchase or cash withdrawal using a line of credit with the expectation they will pay it back later (or not at all), generally within an interest-free grace period. WalletsEnjoy rewards, cashback and EMI facility with these cards that are widely used as a financial tool.

Real-life example:

Ritika, a marketing professional in Delhi, relies on her HDFC Bank debit card to pick up daily essentials like groceries and cover fuel expenses, even as she uses her ICICI Bank

credit card for handling larger ticket spends — such as booking travel tickets and buying electronics. She pays off the credit card balance each month, so she does not rack up interest charges but earns a cashback on all transactions.

Did You Know?

"Agency functions of banks go beyond deposits and loans—over 70% of utility bill payments in urban India are now handled through bank auto-debit services. With digital banking growth, fund transfers and cheque collections are increasingly automated, making banks crucial facilitators of everyday financial transactions for millions."

4.4 Types of Banking Operations

2

4.4.1 Retail Banking

Retail banking (also known as consumer banking) is the provision of services by a bank to individual consumers, rather than to companies, corporations or other banks. It is the most photographed and photographed set of banks that seeks to meet the financial needs of ordinary people. The Retail Banking aims to offer banking services to individuals for managing personal finance, daily transaction and credit facilities.

Retail banking Retail banks offer various deposit accounts, including savings accounts, current accounts and term deposits – also known as certificates of deposit in the U.S.A. or fixed deposits in India. These include products that allow customers to safely store their money, earn interest and address general day-to-day financial requirements. Apart from deposit services, the retail banks offer variety of loan productssuch as personal loans, housing loans, vehicle loans and educationloans (with relatively easier repayment options and interest rates) etc.

They do so via bank branches, automated teller machines (ATMs), the internet and mobile apps to make banking seamless. Increased digital penetration means aspects such as net banking, UPI transfers, e-wallet linking and real-time alerts have made retail banking more convenient and customer-friendly.

Real-life example:

Anita, a school teacher in Jaipur, has a salary account with Axis Bank where her monthly salary gets credited. She also employs mobile banking for money transfers, paying bills and checking her account balance while on the run. When she needed to consolidate debt and renovate her house, she applied for a personal loan online and

had been approved by the following morning. She also has a credit card from her bank for online shopping, which earns her reward points and cashback.

As mentioned earlier, retail banking products target the mass market and are known for their low complexity, user-friendly service delivery, fast turnaround time, and high accessibility. The target customers for these products include mass people of all age groups and income levels. For instance, a fixed deposit product is best suited for a retiree seeking low-risk financial investments, whereas mobile banking applications are tailored for young customers seeking 24/7 accessible services. On the positive side, retail banking is highly successful in promoting financial inclusion in developing economies like India. It allows millions of people from different demographic segments such as salaried employees, pensioners, student, and small traders to access the formal banking sector. Additionally, retail banking played a critical role in helping the government implement its financial inclusion schemes, such as the Jan Dhan Yojana, which granted bank accounts to many previously unbanked individuals in Indian rural areas. Corporate banking or business banking refers to a bank's finance product suite to business entities such as corporates, companies, and large-scale businesses. In contrast, retail banking caters to individual people; corporate banking addresses business entities' higher complexity and scale. These services are essential to helping medium and large businesses in every field operate smoothly, expand and innovate strategically. Corporate banks provide several tailored finance services, including working capital or project finance, trade finance and cash flow. Working capital finance helps companies meet their short-term financing needs for operations including raw material purchases or wage payments. On the other hand, project finance aids mega-infrastructure or industrial projects with long time spans and extensive capital needs. Trade finance like letters of credit and bank guarantees hedged import-exporters involved in ensuring both parties get secure payment arrangements.

Another key of corporate banking is cash management, which allows companies to manage their receivables, payables, liquidity and day-to-day transactions in an efficient manner. Most corporate banks offer treasury services to manage interest rates, foreign exchange exposures and investment portfolios. Furthermore, banks may provide advice on corporate mergers and acquisitions, capital restructurings and strategic investments to assist businesses with making financial decisions.

Real-life example:

A company like Tata Motors, which is a multinational company, requires multiple corporate banking facilities for its operation across the globe. For example, it could borrow a long-term loan from the State Bank of India to finance a new manufacturing plant in Gujarat. If it imports machinery from Germany, the bank opens a letter of credit in order to have timely payment to its supplier. At the same time, the company's treasury staff members rely on corporate banking platforms to hedge forex exposures

related to cross-border transactions. Tata Motors also depends on cash management services to manage collections from its wide network of dealerships throughout India.

Corporate banking clients generally have long-term and strategic relationships with corporate banks, as relationship managers are closely attuned to the developing needs of business clients. Large firms have complex financial needs, as well as regulatory responsibilities; they need personalized services and risk analysis with more intricate financial planning than personal banking provides.

These services are contributing significantly to industrial progress, world trade and economic growth. It allows these businesses to grow, deploy capital effectively, and compete for customers in the world and thereby contribute to national economic activity inside the US as well as abroad.

4.4.3 Investment Banking

Investment banking is a highly specialized segment of the banking industry that primarily serves entities such as corporate companies, governments and other large institutions by helping them to raise capital (amounts in excess of one million dollars).,which in turn help them structure major financial transactions and those requiring detailed valuations. Investment banks are not the same as retail or commercial banks, in that they don't take deposits., and do not make loans.Investment banking is a branch of economics which seeks to gain money through investing businesses' capital—for example equity or debt—or advising them on their transactions.

Investment banks play a significant role in underwriting new securities. This includes assisting firms in raising funds through the issuance of securities, be it equity or debt instruments, like hep in initial public offerings (IPOs), follow-on public offering (FPO). Investment banks, which act as intermediaries between the issuing company and the investing public may also purchase securities directly from companies in a fixed-price offering and resell them to other investors. they will at times buy directly from the issuer. this adds the under writing risk on one's own balance sheet although it is considered offset by receiving due diligence and legal comfort.

Another primary role is to accommodate acquisitions and mergers. Investment banks counsel clients about buying, selling or combining with other companies — and help them negotiate value and terms, navigate regulations, and structure the deals. These services are especially popular in transactions with a lot at stake such as cross-border deals, leveraged buyouts, or consolidation in resource-hungry industries.

Asset management is also provided by investment banks, including managing assets for large investments institutions or high-net-worth individuals. They also trade securities and derivatives, currencies, fixed income instruments and other types of

financial products—sometimes as part of their client offerings (for example in risk management) sometimes on their own behalf or even on behalf of a group they operate.

Real-life example:

In India in 2021 the food delivery company Zomato went public through an initial public offering to raise money for its expansion. A number of investment banks, including Kotak Mahindra Capital, Morgan Stanley India and Credit Suisse underwrote and managed the IPO. These investment banks not only assisted Zomato in determining the share price and timing of the offering, but also marketed the issue to investors and ensured that it complied with regulations. MCNs like Goldman Sachs and JP Morgan have also recommended domestic companies such as Reliance Industries and Tata Group in multi-billion dollar mergers, acquisitions, and overseas listings.

Typical clients for investment banks are big companies, government and institutions - not the retail trade. They often perform high dollar and risk financial transactions, which involve the application of capital markets, regulations, international finance and strategic planning concepts.

Serving as an intermediary for companies in need of capital and investors with shortages is one out of many functions investment banking serves in the financial markets, capital allocation, strategic corporate development. Its impact is especially pronounced in high-growth economies and global financial hubs that are experiencing rapid growth and often consolidation.

4.4.4 International Banking

What is need of International Banking Banking business that cross the national boundaries and, therefore, facilitate international flow Of Funds Goods And Services And financial transactions. It is a major factor in the advancement of international trade, foreign investment and economic integration. International banking enables companies, governments and individuals who engage in commerce on the world stage to transact everything from lending and foreign exchange (FX) to trade services, all while ensuring that that money flows securely or legally across borders.

One of the core business activities of international banking is forex services which involves, among others, trading foreign currencies and selling currency receipts at premium. Banks quote and deliver forex rates for travelers, importers, exporters and multinational corporations. And this is a necessary service for commerce, investment and travel between countries.

More broadly, international trade finance is a significant role served by banks in which letters of credit (LCs) and bills of exchange are provided. Such instruments guarantee that an exporter will get paid and an importer will receive the goods under pre-determined terms, lowering the risk of cross-border deals. Trade finance allows for the

efficient operation of global supply chains, even when buyers and sellers are thousands of miles apart or operating under differing legal systems.

Another form of international banking is offshore banking. That means providing financial services to clients located outside the bank's home country, usually in jurisdictions with beneficial tax or regulatory environments. Corporations and high-net-worth individuals frequently use offshore accounts to handle income, investments or operations in several countries simultaneously.

International banks also process overseas remittances, which allow people and companies to send money abroad. Whether it is a migrant worker sending money home or a company paying an overseas supplier, banks ensure cross-border funds move smoothly and safely through networks such as SWIFT, wire transfers and digital payment systems.

Real-life example:

A software export company in Bengaluru clinches a deal with an American client to import a tech solution for $100,000. Payment is sent in U.S. dollars to the Indian firm via its current account in ICICI Bank that has international banking facilities. Exchange Rate ICICI Bank provides for currency conversion and settles the equivalent amount in INR to the company, along with forex risk mitigation using derivative contracts. And if the company must import some specially tooled equipment from Japan, the bank sends a letter of credit to the Japanese supplier, guaranteeing that it will be paid when shipped. This no-edge worldwide banking assistance permits the Indian industry to deal with foreign transactions with complete security.

Key players in the global banking ecosystem comprise of Multinational Banks (Ex: HSBC, Citi, JPMorgan Chase), Foreign Branches of Domestic Banks (like SBI's branches across UK or Canada) and International Financial Institutions (the World Bank or Asian Development Bank for example). These institutions are multilateral organizations that serve the states through constructive policies in trade, projects of development or financial stability between countries worldwide.

In a massively globalized world, international banking is a major force behind the policies that promote globalization, facilitate capital movement, and contribute to the efficient functioning of businesses and individuals in concentrate.

4.4.5 Digital / Online Banking

Digital Banking is as the provision of banking services through electronic and online channels which eliminates the traditional physical branches enabling customers to transact remotely. It includes services through websites, mobile banking apps, ATMs internet banking portals and AI-based chat bots. The rise of digital banking is due to a

combination of technological advancement and customer need for faster, easier and paperless financial services.

CharactersNo matter what the type, digital banking is famed for being available 24/7. Transactions may be conducted at any time of the day, even on weekends and holidays which is not possible with branch banking. Products like instant UPI fund transfers, NEFT (National Electronic Funds Transfer), RTGS, IMPS (Immediate Payment Service) have revolutionized the flow of money in the economy ensuring easy and fast settlements of transactions.

Digital no longer restricts users to performing basic transactions — it's now possible for bank customers to perform complex tasks that previously required a visit to the bank branch, such as opening a bank account, taking out a loan or making an investment. "Electronic Know Your Customer verification allows any customer to open an account or apply for credit 100% digitally and in minutes. Moreover, bill payments, insurance premium renewals, mutual fund tracking and tax payment are also weaved into the banking apps to confer holistic financial management solutions at one stop.

There are many advantages to digital banking. It is speed, convenience and accessibility for customers, particularly in remote areas with a few branches but the high penetration of mobile. For the banks, digital platforms help reduce operating expenses by cutting down on paperwork, staff and physical infrastructure. Additionally, it has been argued that digital transactions will have more secure and auditable records which could lead to a higher level of transparency in the financial system.

Real-life example:

BENGALURU: Ravi, a young professional based in Bengaluru, transacts for almost all his financial needs using the SBI YONO mobile banking app. His salary is directly deposited into his bank account, and he pays his electricity and internet bills through auto-debit instructions. When he wants to send money back home to his parents, who were living in their hometown, he uses UPI for instant transfers. More recently, Ravi also placed a request for a personal loan on the app; the application got approved and money disbursed to his account in 48 hours flat — without visiting a branch or paperwork. Dealing with all of those matters digitally makes his life easier and simpler, and he can manage every last dollar in his bank account.

Technology (FinTech) though which they enhance digital banking with AI based chat boy (~ customer service, biometric authentication for security and data analytics - personalized product offerings etc. It has not just changed the way people bank but it has completely redefine the banking as we know of by providing hassle free and simplified services, making banking easier for common people.

Knowledge Check 1

Choose the correct option:

1. **Which banking type deals primarily with individual customers?**
   a) Corporate banking
   b) Retail banking
   c) Investment banking
   d) International banking

2. **What is the main focus of investment banking?**
   a) Personal loans
   b) Foreign remittance
   c) Capital raising
   d) ATM services

3. **Which banking service handles cross-border transactions?**
   a) Retail banking
   b) Corporate banking
   c) International banking
   d) Mobile banking

4. **Which of the following is a feature of digital banking?**
   a) Manual cheques
   b) Face-to-face service
   c) Paper-based forms
   d) 24x7 access

4.5 Products and Services Offered by Banks

4.5.1 Deposit Products

The banks offer different deposit products for customers to save, protect and grow their money. They are the basis of anyone's relationship with a bank and they provide key liquidity to the banking system. Deposit products meet various types of needs – for everyday transactions and long-term savings – as well as the needs of individuals and businesses.

Savings Account

The most highly established deposit product provided by banks is a savings account. It's for people who want to save small or moderate sums of money on a regular basis and get a low rate of interest in return. Savings account(s) are very liquid and can be accessed using common forms of money such as banknotes and checks unlike other types of accounts (like a certificate of deposit).

Real-life example:

Priya, 39, is a college lecturer in Hyderabad who holds a savings account with HDFC Bank. Her pay is paid into this account...elementGuidId Her salary is deposited directly into this account. She does internet banking to pay her bills, UPI for grocery shopping and also avails of ATM services when she needs cash. She even begins to earn interest income over time, which makes her want to continue saving.

Current Account

Regular account- Regular is best suited for business people, traders, and professionals who have to deal with many transactions. Current accounts often do not provide interest for customers and have rather high transaction limits, provide overdraft to clients as well as some business-oriented services. These accounts are necessary to manage the money flow, paying suppliers and receiving customer amounts quickly.

Real-life example:

A cloth merchant from Surat has a current account in ICICI Bank. He uses it to make supplier payments every day, deposit customer cheques and handle payroll for his employees. The basic savings account doesn't yield interest, but Ike loves it because he can swipe up to 50 times per month with the option to overdraw.

Fixed Deposit (FD)

Customers can deposit a lump sum with the bank for a specified period (ranging anywhere from few months to several years). In exchange, the bank offers a better interest rate than on savings. FDs are long-term saving instruments and cannot be withdrawn as and when needed, unlike a savings account.

Real-life example:

Rajesh, a retired government servant from Kochi invests ₹10 lakhs in SBI 5 year Fixed deposit to get regular interest income. As he does not need ready access to the money, it earns him better returns than in his savings bank account and helps him plan for his post-retirement financial requirements.

Recurring Deposit (RD)

Recurring deposit (RD) is best suited for those who want to save a small sum every month for some period. This product is aimed at promoting thrift and provides fixed

deposit like returns. This is especially the case for individuals with a salary, who wish to systematically accumulate wealth over a period of time.

Real-life example:

Anita, a young software engineer from Pune begins an RD with Axis Bank at ₹3,000 per month for two years. She wants to earn enough savings to purchase a new scooter. She ends the tenor with her intended savings and even more return on the money.

4.5.2 Credit Products

Banks issue a wide range of credit products to meet the lending requirements of consumers, businesses and industries. They are so by lending money and extending lines of credit to individuals for personal consumption, business creation and asset formation. Besides earning income for banks in the form of interest and fees, credits are essential in promoting economic markets by allowing individuals and companies to obtain funds outside their current budget.

Personal Loans

Personal loans are unsecured loans given to individuals for personal consumption The interest rates, though not as high as for payday loans, are higher than traditional secured loans and the amount one can borrow depends on proof of income, credit score and repayment capacity.

Real-life example:

For example, Ritika, a marketing executive in Delhi, avails ₹3 lakh as a personal loan from HDFC Bank to finance her wedding expenses. It takes her very little documentation to get loan approval, and she pays it back in three years through monthly installments. That way, she can meet short-term financial needs without having to dip into her savings.

Business Loans

The business loans are available to a wide range of companies including the micro, small and medium enterprises (MSMEs) as well as large corporates. You can apply for any of these loans to manage working capital, buy equipment or expand business. As deemed necessary, the banks provide term loans/ Overdraft facility/ Cash credit limit etc to support business in managing its operations and expansion.

Real-life example:

Let us say an MSME owner in Coimbatore avails a ₹50 lakh business loan from Indian Bank to expand his textile unit. The money is spent on new looms and hiring more workers. The higher production number is enabling it to cater for the growing export requirement, and thus improving its profitability.

Housing Loans

What are housing loans: Housing loans or popularly known as home loan is a long-term loan that helps an individual in acquiring the property of his choice. Loans like these can have terms of 20 or even 30 years and are some of the most prevalent types of secured lending. Housing loans also form an important source of asset creation and is tax-deductible under the Indian law.

Real-life example:

Sunil, an IT professional based in Bengaluru, takes a ₹60 lakh home loan from ICICI Bank to purchase an apartment. The payment has to be made by way of EMIs payable every month for 20 years. It would have been a very distant proposition for Sunil to afford his dream home outright, without this loan. The bank's backing helps create wealth over the long term in the shape of real-estate ownership.

Credit Cards

Credit cards offer consumers a line of revolving credit that can be used for both online and offline purchases. User can pay by monthly due date or user can convert it high value transactions in to EMIs (equated monthly installments). Credit cards offer reward points, cashbacks, travel benefits all these make it attractive. The amount of credit is dependent on income, spending habits and the customer's credit profile.

Real-life example:

Ananya: She is a prolific traveler and uses Axis Bank credit card for booking flights and hotels. By paying her dues on time, she doesn't get hit by interest charges and also collects reward points, which she uses each year for a free domestic flight. She does this during festivals --- she turns a big electronics' purchase into an EMI and convinces herself that the repayment will be manageable and budget friendly.

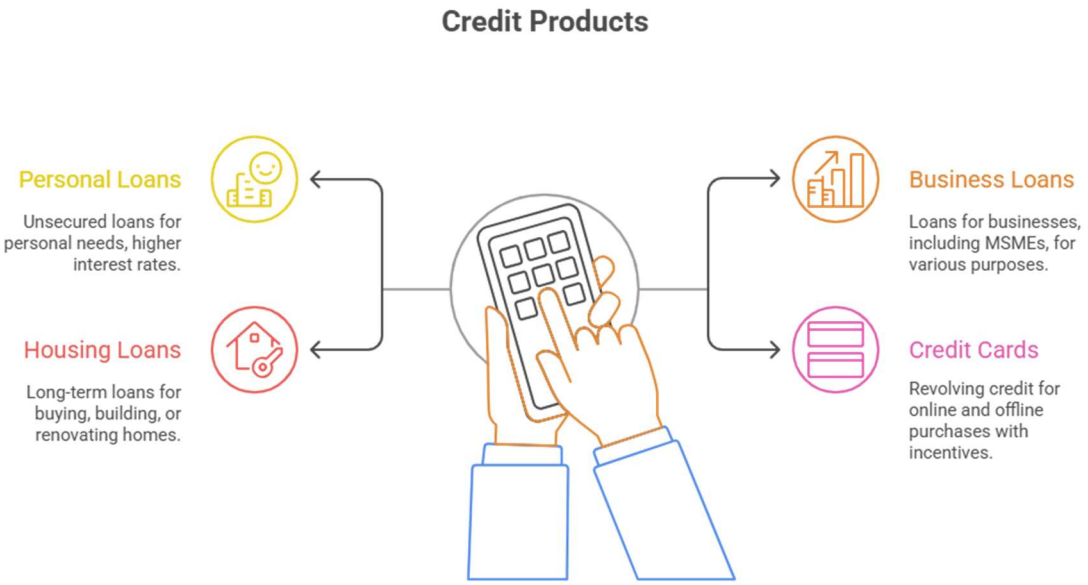

Figure **4.5.2**

4.5.3 Investment and Asset Management Services

Today, banks have a more expanded role of advising than ever before, as they continue to accept funds on deposit and lend that out while providing financial advice to individuals and institutions along with many other services designed to help grow, protect, and preserve wealth. All of these services would be considered sub-categories under the over-arching area of investment and wealth management, which encompasses things like asset allocation, portfolio diversification, retirement planning and tax-efficiency. It is widely considered a service of high-net-worth individuals and entities, though the term does not have a formal or universally accepted definition and its meaning can vary between individual wealth managers.

Mutual Fund Distribution

No shortage of banks sell mutual funds and provide their customers with a source for getting into well-managed investment programs. Customers can select instruments according to their risk profile — equity funds for higher returns and debt funds for stability. Banks usually offer advice, which assists clients in choosing the correct funds according to their financial objectives.

Real-life example:

Ramesh is a salaried person living in Mumbai, and he invests ₹5,000 every month in an equity mutual fund via his HDFC Bank account using the Systematic Investment Plan (SIP) mode. This disciplined investment strategy over time enables him to create wealth toward his daughter's higher education.

Demat and Trading Accounts

Banks offer Demat accounts and trading accounts where shares can be traded in electronic form. For those investors who want to play in stocks, this service is a must. By combining Demat services with internet banking, Banks has simplified the process of trading.

Real-life example:

Anjali, a young IT professional based in Bengaluru applies for a Demat and trading account with ICICI Bank. She uses it to buy shares in companies like Infosys and Tata Motors directly from her bank's online portal, bypassing the need for a separate brokerage service.

Portfolio Management Services (PMS)

Banks and their corporate bodies provide specialized Portfolio Management Services (PMS) to high net worth clients. Under PMS, professional managers manage the investment portfolio of a client aiming at maximum returns but taking risks by investing in equities, debt and also through alternative investment.

Real-life example:

A senior executive, Mr. Kapoor assigns ₹50 lakhs in the PMS division of Kotak Mahindra Bank. His investments are actively managed and rebalanced by the bank's portfolio managers, who provide him detailed reports on performance and help ensure his portfolio is in line with his long-term wealth-building goals.

Retirement and Pension Planning

We also help our customers plan for their financial security after retirement by offering pension products, annuity plans and retirement focused investment plain or schemes. This will guarantee a regular source of income post retirement and eliminate dependancy on money.

Real-life example:

Government school teacher Seema is close to retirement and seeks pension advice from her SBI relationship manager. She is an NPS investor through bank and with the savings invests 30% of it in the National Pension System (NPS) to ensure a regular income at her after retirement.

Tax-Saving Investments

Banks also advise customers for routing the funds into tax saving instruments like Equity Linked Savings Schemes (ELSS), banks FDs and insurance-based products. While these products assist people in cutting taxes under Section 80C of the Income Tax Act, they also inculcate long-term financial discipline.

Real-life example:

Arun is a software engineer, who puts ₹1.5 lakhs in ELSS mutual funds using the investment services offered by Axis Bank. This does not only lower his taxable income but also allows for potentially higher long-term gains as against the conventional tax saving options.

4.5.4 Insurance and Bancassurance Services

Bancassurance involves a bank and an insurance company forming an alliance where the assured products are sold by the bank through its branch locations as well as through ATM's (automated teller machines), as alternate channel, such internet-banking and in some cases mobile banking or apps. This model uses the banking network to provide wide coverage of insurance and build consumer trust, offering banks an opportunity to diversify their product offerings and receive commission. For consumers, it is a one-stop shop for financial protection products alongside their existing purchasing behavior.

With bancassurance, banks provide a variety of insurance products. These consist of life insurance policies, which offer a sum benefit to dependents on the policyholder's death and health insurance through which patients' medical bills are paid. Banks also sell general insurance products like motor, travel, and home insurance that provide their customers with protection against backyward risks faced everyday.

Customer benefits – the convenience of bancassurance One of the key advantages of bancassurance for customers is this convenience. They can buy or renew insurance policies right at the bank, either in-person or on their computers and other devices. Banks also offer packaged products like loan protection insurance, where a policy is bundled with the home (or personal) loan, and becomes payable in event of the occupant's death or disability to settle outstanding dues. Beyond customer trust and credibility, additional revenue from commission for the bank.

Real-life example:

Rohit, a working professional in Delhi, applies a home loan from ICICI Bank. A loan protection insurance policy from the bank's tie-up with ICICI Prudential Life Insurance is offered as part of the loan package. This secures that the insurance company will pay back the remaining loan amount in case of an unfortunate event and Rohit's family won't have to repay it. Likewise, Priya often travels for work and buys a travel insurance

plan from HDFC Bank mobile app (powered by HDFC ERGO), which covers her for medical as well as baggage loss during trips.

4.5.5 Digital Banking Products

Thanks to technological development, banks have a wide range of digital banking products that take financial services faster, safer and more convenient. These have revolutionised the manner in which people and businesses engage with banks, increasing financial access by decreasing reliance on brick-and-mortar branches and encouraging cashless operations. As convenient as they are efficient, digital banking products give customers round-the-clock access to fundamental banking services via secure channels.

Mobile Banking Apps

Banking applications are one of the most frequently used digital products. They give customers the ability to check balances, make transfers, pay bills, buy and sell mutual funds -- even initiate a loan application all from their handheld devices. Frequently, mobile apps come with functionality such as biometric login, push notifications and built-in customer support.

Real-life example:

Anita is a young working professional in Pune who has the SBI YONO app to take care of her financial needs. She pays her electricity bill, invests in a systematic investment plan (SIP), and gives money to her parents—all on the mobile phone without visiting a bank branch.

Internet Banking Portals

Internet banking sites enable customers to conduct the entire range of banking transactions, through its website. In addition to fund transfer they also support services like payment of tax/insurance payments, repayment of loans/fixed deposits and so on. Internet banking has been a boon particularly for corporates, business people and also salaried individuals as it aids them save on valuable time.

Real-life example:

Rajesh, a 40-year-old small businessman from Jaipur, relies on HDFC Bank's net banking for payment of GST and salary to his employees and managing vendor payments. And by using the online platform, he spares himself the time and hassle of having to visit the bank branch on several occasions.

Unified Payments Interface (UPI)

India's digital payment landscape has been redefined by the Unified Payments Interface (UPI), which was introduced by the National Payments Corporation of India

(NPCI). It enables instant bank-to-bank money transfers using mobile numbers, UPI IDs or QR code, without bank details. The ease of UPI and its interoperability among banks have made it one of the most favoured digital payment mode.

Real-life example:

Ravi, a student in Bengaluru clears his college canteen bill of ₹120 and pays through UPI by scanning QR code using Google Pay. It's done, and within seconds, Ravi and the seller both get confirmation messages.

Digital Wallets

Digital wallets are an online service that enables a user to store and control their money, as well as complete fast transactions on purchasing or paying bills / recharge etc. Wallets such as Paytm, PhonePe and Google Pay can also be connected to users' bank accounts for ease in transferring money and making mobile payments. But they work best for small-value, high-frequency transactions and have become a key part of India's movement toward being less dependent on cash.

Real-life example:

Priya, a homemaker in Delhi, has ₹2,000 in her Paytm wallet that she uses for buying groceries, metro recharges and online shopping. And because her wallet is connected to her bank account, she can load it up on the fly, for easy daily transactions.

Did You Know?

"India's UPI system processed over 10 billion transactions in a single month, making it one of the world's fastest-growing digital payment platforms. Digital banking products like mobile apps, internet banking, and wallets have revolutionized how customers access financial services—24x7, paperless, and without visiting a bank branch."

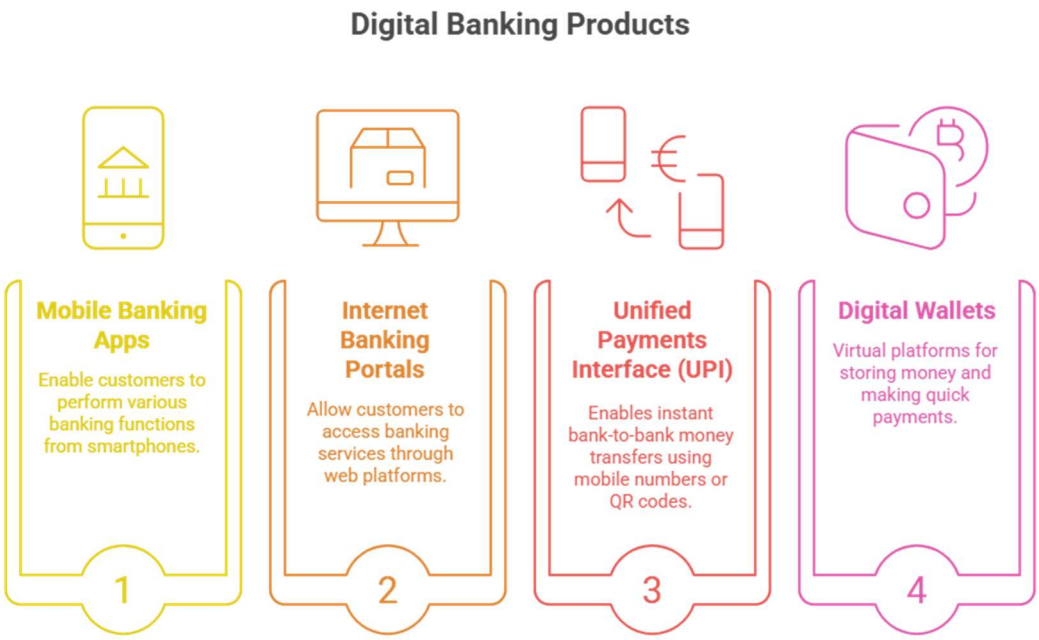

Figure **4.5.5**

4.6 Summary

ϖ Banking has gone from old time money lending to new age digital banking.

ϖ The centrality and importance of banks in financial intermediation incubationally and economic development.

ϖ India has a mixed banking system, with public, private, cooperative, rural and development banks.

ϖ India's central banking authority is the Reserve Bank of India.

ϖ Banks provide basic services such as accepting deposits and lending.

⎫ Agency functions -comprising of cheque cashing, money transfer and bill payment.

ϖ General Utility Services offer lockers, drafts, cards and internet banking.

ϖ Retail banking — individual, corporate banking — firm.

ϖ Capital markets and cross border finance If 16 There is investment and international banking.

ϖ Benefits of digital banking at UPIs, apps and wallets for services.

ϖ Besides, Banks also provide investment, insurance and wealth management options.

ϖ Advances in technology have made banking quicker, safer and more accessible.

4.7 Key Terms

Retail banking: The business of noninvestment banks, offering services to individual customers.

Corporate Banking: Financial products built for companies and huge businesses.

Investment Banking: The business sector of banking which facilitates the raising of capital for companies and provides financial advisory services.

Central Bank: The central authority controlling the banking system and monetary policy.

Deposit Products: Accounts where clients stash money like savings and fixed deposits.

Credit Products: Lending and credit facilities to consumers and businesses.

Bancassurance: Selling of insurance products in bank branches and over the bank's proprietary channels.

Digital Banking: The provision of banking services through electronic channels such as mobile apps and websites.

UPI (Unified Payments Interface): A real time digital payment system for transferring funds instantly between two bank accounts.

Wealth Management: Advice about how to manage and grow private wealth or investment for individuals or institutions.

4.8 Descriptive Questions

Discuss the development of the banking system from ancient times to present.

Distinguish between commercial banks, cooperative banks and development banks giving suitable examples.

Explain in detail what are main functions of banks, also state primary, agency and utility function.

What are the types of banking operations? Play up their characters and the customers they target.

Explain different types of bank deposits and their features.

Discuss the function of banks in extending credit and advancing economic development.

What is digital banking? 2 Mention to its product or trade established and, benefits to the customers.

Explain the concept of bancassurance and its benefits for both banks as well as their customers.

What is the value of wealth management and investment banking services for bank customers?

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Answers to Knowledge Check

Knowledge Check 1

1. b) Retail banking
2. c) Capital raising
3. c) International banking
4. d) 24x7 access

4.10 Case Study

Introduction

Suraksha Bank, a medium-sized Indian private sector bank used to largely practice branch-based banking and had developed an offering of less risky financial products. The management nevertheless had to confront the stark reality that changed digital-first competition and customer behavior were demanding a refresh of its portfolio.

The bank has digitally transformed by replacing its existing app with a new one to upgrade the mobile and online banking experience, introduce UPI as a mode of payment, cybersecurity measures and cross-sell products such as digital insurance, mutual funds and electronic wallets. The Journey offered its own set of hurdles, however- technological infrastructure, staffing and on boarding customers all had to be fit for purpose while compliance with existing (and new) regulation would need to be met.

This case study examines how a new bank in India (Suraksha Bank) managed the change and translates what it may mean for product innovation, digital banking service delivery and customer centricity in competing-bank world similar to India.

Background

Until 2020, Suraksha Bank's clients were highly reliant on physical branches and basic ATM facilities. With emergence of FinTech players and government-backed platforms, such as UPI and Jan Dhan Yojana, the customers started expecting faster, paperless and branchless banking services.

Acknowledging the transformation, the bank began to combine digital channels and traditional services. A cross-functional team was built to re-engineer customer journeys, digitize loan and account opening processes as well as forge partnerships for insurance and wealth services – offered through a single digital platform.

The bank also spent on data analytics to provide more personalized product recommendations, and it trained staff to help customers who are unfamiliar with digital banking.

Problem 1: Low Adoption of Digital Products From the inception of the internet, the possibility for exchanging virgin digital information such as audio, video and text has been ever increasing.

Even though it introduced a new mobile banking app, customer usage was low in the first quarter. Many customers would visit branches for services readily available online.

Solution:

The bank launched digital literacy camps, demo vids and SMS campaigns to sensitize all customers about using UPI, mobile banking & internet banking. Branches staff were rewarded for encouraging customers to download the app.

MCQ 1:

What was the most successful approach for increasing customer engagement on digital banking?

A) Reduced branch hours

B) Increased ATM deployment

C) Digital awareness initiatives

D) Free cheque books

Answer: C) Digital awareness initiatives

Problem Situation 2: Very Restrained Product Variety

The portfolio of products of Suraksha Bank was devoid of investment or insurance in a contemporary way, since fintechs bundled services on the mobile app.

Solution:

It introduced bancassurance, besides launching investment services through tie-ups with insurance companies and mutual fund houses. So those were all plugged into the app and we built some really nice, user-friendly dashboards to track portfolios.

MCQ 2:

How product strategy was the reason for Suraksha Bank being able to diversify?

A) Adding more branches

B) Launching paper cheques

C) Providing bancassurance..and mutual funds

D) Providing lockers at discount

Answer : C) Bancassurance and mutual funds

3 Issue on Security in Digital Channels

Some of our customers also wouldn't use digital banking because they were worried about being a victim of fraud and ID theft.

Solution:

It introduced two-factor authentication, live fraud monitoring and AI-powered alerts for unusual activity. Customers were also sensitised on secure banking through webinars and SMS alerts.

MCQ 3:

One way to tackle cyber security issues was?

A) Reducing online features

B) Two-factor authentication

C) Sending monthly passbooks

D) Disabling UPI access

Answer: B) Two-factor authentication

Conclusion

How Suraksha Bank transformed from a traditional bank to a digitally-enabled ecosystem is indicative of the increasing role played by innovation that keeps the customer at its centre. By expanding its product-base, promoting digital skills and prioritising security measures, the bank has not only boosted customer service but also established itself as a competitive player in India's rapidly changing banking sector.

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Unit 5: Banking – Part II: The Central Bank & The Indian Banking Landscape

Learning objectives

1. Understand the role and functions of a central bank, with a focus on the Reserve Bank of India (RBI).
2. Explain the monetary policy tools used by the central bank to regulate the economy.
3. Describe the structure and classification of the Indian banking system.
4. Identify the regulatory and supervisory powers of the RBI over commercial banks.
5. Analyze the role of the central bank in maintaining financial stability and controlling inflation.
6. Understand key developments and reforms in the Indian banking landscape.
7. Examine the challenges and future outlook of India's banking sector in a globalized economy.

Content

5.0 Introductory Caselet

5.1 Role of the Reserve Bank of India (RBI)

5.2 Leading Banks in India

5.3 Financial Statements of Banks – Overview

5.4 Summary

5.5 Key Terms

5.6 Descriptive Questions

5.7 References

5.8 Case Study

5.0 Introductory Caselet

India experienced a significant economic slowdown due to a global pandemic in 2020. Businesses closed their doors, jobs disappeared and the financial system was under siege. Center-stage among the crisis was seized by the Reserve Bank of India (RBI).

Arun, a final-year student of finance, followed the news closely. He also observed that the RBI reduced the repo rate, declared moratoriums on loan repayments and extended liquidity support to banks and financial institutions. Intrigued, he started to probe how a central bank can affect the level of interest rates, control inflation and maintain financial stability.

He learnt that RBI was much more than a currency- issuing authority; it is a regulator, policy maker and guardian of the economy. It managed the money supply, kept an eye on banks and shielded depositors — particularly when things became uncertain.

Arun began to broaden his knowledge about India's banking system while he learnt about the different tasks public sector banks, private banks and cooperative banks perform under the watch of central bank.

Critical Thinking Question

Why is the central bank called the lender of last resort in a country's financial system?How this function becomes even more significant during an economic crisis?

5.1 Role of the Reserve Bank of India (RBI)

5.1.1 RBI as Bank of Issue in India

Established in 1935 under the RBI Act of 1934, it is the country's central bank and a monetary authority. Founded as a private bank, in 1949 it was nationalised and since then it is a government-owned entity; however it does not comes under the prompt corrective action plan of Reserve Bank of India. The RBI is instrumental in ensuring financial stability, driving economic growth and maintaining price stability. It undertakes a wide range of activities as the top institution in India's financial system that go well beyond traditional banking and help keep the economy ticking over — and robust enough to withstand shocks.

Issuer of Currency

The RBI is the sole authority to issue currency notes in India, other than 1-rupee notes and coins, which are issued by the Ministry of Finance. This single-source control helps in standardization of the currency design, prevents counterfeiting and creates confidence in the money system. The RBI controls the supply of money to meet the needs of trade, commerce and to prevent inflation.

Real-life example:

After India's surprising demonetisation of ₹500 and ₹1,000 notes in November 2016, the RBI was tasked with supervising the withdrawal of old notes and minting a new denomination: ₹500 and ₹2,000. This signalled its importance in foreign exchange management.

Banker to the Government

The RBI is the banker of the Central and State Governments. It operates government accounts, helps raise borrowing by issuing bonds and treasury bills and processes the repayment of debt. It also undertakes the issuance of new government securities and is involved in deficit financing.

Real-life example:

During the COVID-19 pandemic, the Government of India borrowed by issuing special securities to finance an increase in expenditure on healthcare and welfare. The RBI made borrowing easy for such states, by providing liquidity and ensuring smooth debt servicing.

Banker's Bank

Anurag Joshi The Sure Banker has a system to find undervalued small cap others like me use some form of fundamental analysis, and the combination of consensus analyst expectations for valuation from Yahoo Finance return on investor capital is below 10. It supplies emergency liquidity through loan of last resort, disciplines the banking system and guarantees financial stability. Banks also have to hold some of their deposits with the RBI as reserves.

Real-life example:

In March 2020, the RBI had put Yes Bank under moratorium after it faced a serious liquidity crunch and reconstituted its board while coordinating with State Bank of India and other lenders to infuse money. This prevented a collapse that might have roiled India's banking system.

Custodian of Foreign Exchange

India's foreign exchange reserves are managed by the RBI and it controls forex transactions in the country under FEMA, 1999. It provides stability to the exchange rates which are primarily dominated by the forces of demand and supply.

Real-life example:

In 2018, when the rupee depreciated sharply because of high global crude oil prices, the RBI stepped into help too by selling U.S. dollars from its forex reserves. This was designed to stabilise the rupee and limit volatility in currency markets.

Equivalent to credit and monetary policy controller

The most important function of the RBI is arguably control and influence on the monetary policy and credit credits. It controls inflation and liquidity in the system by making changes to

policy rates such as repo rate, reverse repo rate, among others. This way, the RBI maintains equilibrium between economic development and price stability.

Real-life example:

In 2022, reignited global supply chain disruptions saw inflation climbing and the RBI hiked repo rates multiple times to combat the price surge. This made borrowing more expensive, curbed excess demand in the economy and helped tame inflation within the RBI's target range.

5.1.2 Regulatory and Supervisory Functions

Role of Reserve Bank as regulator and supervisor The Reserve Bank of India (RBI) is the main regulatory body in the Indian banking and financial sector, which ensures that banks function in a safe, sound and efficient manner. The basis of its operating rules is to ensure the safety and solvency of banks, safeguard depositors' interests and maintain public confidence in the financial system. The RBI, by virtue of its statutory power under the Banking Regulation Act, 1949 and the RBI Act, 1934 establishes a framework to accommodate innovation and maintain stability.

Issuing Banking Licenses

Only the RBI has the power to issue bank licenses in India. These look at an applicant's financial resources, business plan, and standards of governance and long-term sustainability. The RBI also frames the rules for issuing new bank licenses to private banks and foreign entities.

Real-life example:

Bandhan Bank and IDFC First Bank were given permits by the RBI in 2015, making them the first two new private banks to enter Indian banking sector since a decade. This spurred competition and financial inclusivity by taking services to underprivileged areas.

Establishing Prudential Standards and Capital Levels

This is because the RBI prudential norms lay down strictures on how much a bank should set aside for bad loans, based on aged debts. These norms guard against overcommmitment in risk taking by banks and financial system stability. The RBI also implements global regulations like Basel III to make banks stronger.

Real-life example:

Amid the NPA crisis in the 2010s, the RBI had tightened provisioning norms, requiring banks to create higher reserves for bad loans. This stopped the erosion of their balance sheets and protected depositor funds.

Conducting Inspections and Audits

The RBI keeps track of the financial health of banks and other non-banking entities through regular checks, audits and on-site inspections/scrutiny. The CAMELS format (capital adequacy, asset quality, management control, earnings prospects, liquidity position and sensitivity to market conditions) of an inspection provides scope for RBI to pick out weaknesses at the early stage.

Real-life example:

When cooperative banks such a Punjab and Maharashtra Cooperative (PMC) Bank were hit by anomalies in 2019, RBI's audit had found massive underreporting of bad loans. The RBI, in turn, imposed restrictions on withdrawals to safeguard depositors and launched resolution proceedings.

Regulation of NBFCs, Cooperative Banks and Payment Systems

Its responsibilities are not just confined to commercial banks, but also extends to NBFCs, cooperative banks and even payment systems. By controlling such bodies, the RBI safeguards financial stability in the wider system. It prescribes guidelines for NBFC lending, liquidity management, and governance to avoid systemic risks.

Real-life example:

ALSO READ: How accountants are fighting NBFC crisis Virus only latest culprit: NBFCs have been under the spotlight ever since the busting of infra developer major IL&FS in 2018 that led to a liquidity crisis in financial markets. The RBI has since tightened up NBFC regulations and kept a closer eye on the flow of liquidity to ensure such hazards do not happen again.

Tracking M&As and Branch Expansion

The RBI also monitors bank mergers, acquisitions and branch expansion plans to ensure that consolidation does not weaken but strengthen banks and does not introduce risks. It assesses whether these changes are consistent with the objectives of financial inclusion, market contestability and systemic stability.

Real-life example:

The RBI had closely watched the consolidation of 10 public sector banks into four larger sized ones in 2020. It established direction around integration, IT systems and risk management – key objectives that ensured uninterrupted service to millions of customers throughout India.

5.1.3 Monetary Policy Implementation

The Reserve Bank of India (RBI) formulates monetary policies with two main goals- to ensure price stability and economic development. For this purpose, RBI use a bunch of important tools which are essentials in controlling liquidity, inflation and overall financial stability of the economy.

The Repo Rate (5.50% as of August 2025) is the rate at which RBI lends short-term money to the banks. A decrease in the repo rate generally translates into a lower cost of borrowing for banks, who can avail themselves at cheaper rates and, in turn, extend credit more affordable to businesses and consumers. For example, following the RBI's 50 bps cut in the repo rate in June 2025, a number of leading banks –including Punjab National Bank and Bank of India - lowered their Marginal Cost of Funds Based Lending Rate (MCLR), making personal, home and business loans cheaper.

On the other hand, Reverse Repo Rate is that the rate at which RBI borrows money from commercial banks; it is currently at 3.35%. Its purpose is mainly to soak up surplus money in the banks. In times of high inflation or excess liquidity in the system, the RBI hikes reverse repo rate making it more attractive for banks to park funds with it and also suck out excess money from the system.

Another prominent weapon of the RBI is Cash Reserve Ratio (CRR), which is the proportion of a bank's total deposits that have to be kept with the RBI in cash. The CRR is currently 4.0% but was temporarily slashed to 3.0% in June, 2025 to inject some liquidity into the system. With the reduction in CRR, banks have more money to lend and this promotes economic growth.

The Statutory Liquidity Ratio (SLR) that currently stands at 18.0% forces banks to hold a fraction of their net demand and time liabilities in liquid assets like government bonds. This serves to preserve the financial stability of the banks and also creates a captive market for government securities.

The RBI also conducts Open Market Operations (OMOs) to inject liquidity directly by purchasing or selling from government securities in an open market. For instance, in July 2025 RBI undertook OMOs to suck out excess liquidity from system which had risen over ₹5.5 lakh crore. The RBI, by selling the government bonds, opted to withdraw money supply from the banking system that in turn pushed up interest rates and helped rein in inflation.

Lastly, an MPC (which is a six-member committee led by the RBI Governor) decides the policy repo rate after taking into account inflation and growth prospects. In its meeting in August 2025, the MPC voted to keep the repo rate unchanged at 5.50%, indicating that a balance was struck between all considerations. Though inflation has softened to 3.1% – well within the RBI's target band – the committee, worried by global economic headwinds, "decided to continue with an accommodative stance while remaining watchful for a durable reduction in inflation to use available space to support domestic growth."

Through thesestruments, the RBI controls aggregate money supply, interest rates structirecredit availability and inflation. For instance, lower interest rates prompt more consumer borrowing and spending, lifting demand in the economy. Similarly, tightening supports the containing of inflation and financial stability.

5.1.4 Control of Inflation and Price Stability

Price stability in the economy is maintained by Reserve Bank of India (RBI). These are functions that must be performed to promote sustainable economic growth and preserve the value of a currency. This task is pursued under a flexible consumer price index (CPI) inflation-targeting regime by the RBI. According to an agreement with the Government of India, (GoI), RBI has set ±2% band for 4% inflation target which is in line with global standards.

To tame inflation, the RBI uses the policy repo rate to radiate out effects on cost of borrowing and supply of money in economy. When the inflation starts to rise and goes near or towards the upper limit of the target band, RBI then uses this weapon to control it. This dampens the appetite to borrow, and in turn restricts consumer spending and investment, helping contain inflationary pressures. Conversely, at times of disinflation or economic slowdown, the RBI could reduce the repo rate so as to make borrowing more attractiveand stimulate demand and investment.

Besides change in repo rate, the RBI uses various other monetary policy tools like reverse repo rate, CRR (Cash Reserve Ratio), SLR (Statutory Liquidity Ratio), OMOs (Open Market Operations) to maintain proper liquidity and inflation trend. These tools act in concert to balance inflation control and economic expansion.

In India inflation has been widely fluctuating across different periods. “In 2019, inflation was subdued slightly at around an average of 3.7%,” he said. But in the year 2020, the year of COVID-19, inflation spiked to some 6.6%. Inflation averaged about 5.1 % in 2021, declining somewhat from the prior year. In 2022, inflation increased once more to approximately 6.7% because of global commodity price shocks and domestic supply bottlenecks. A slight letup was felt in 2023, with inflation averaging approximately 5.7%. Inflation continued to cool in 2024 to around 5.1%. There was a significant fall in the level of inflation by mid-2025 when CPI inflation fell to 2.82 percent in May and a low of 1.55 percent in July, which was clearly below the lower bound value range of the target rate implemented by RBI.

As a result of the sharp drop in inflation in 2025, the RBI took accommodative actions, cutting the repo rate by 50 basis points and CRR by 100 basis points. These policy measures were designed to stimulate growth as prices continued to decline. But policymakers are wary, understanding that base effects and evolving global circumstances could reignite inflation in the future.

5.1.5 Management of Currency and Foreign Exchange

Currency notes issued by the Reserve Bank of India (RBI) are legal tender in India without any limit; however, the RBI mints and circulates coins except ₹1 coin which is minted and circulated by Government of India. So long as RBI is the manager of nation’s currency, it is its duty that the extra supply of currency is ensured and it should be able to reach every nook and corner in the country. This also includes supply of notes to the public through currency

chests, bank branches etc. and their withdrawal from circulation such that only good quality notes are available in supply. The RBI also makes persistent efforts to keep the currency safe and secure against counterfeiting by enhancing security features, besides fostering public confidence in the legal tender.

The RBI performs not only a currency management function but also an intrinsic part in the administration of India's foreign exchange market. It manages and utilizes Pakistan's foreign exchange reserves long term in such a manner that the planned external financing requirements can be met without resorting to short-term credit from international creditors. It further supervises all foreign exchange transactions under the Foreign Exchange Management Act (FEMA), 1999 to ensure that they are in adherence with the national economic interests and legal regimes.

It intervenes in the forex market to check excess volatility and bring about stability in the rupee's value against other currencies. The RBI influences supply and demand by trading in foreign currencies to prevent disorderly movements. It is necessary in order to maintain investor confidence, helps ensure trouble-free cross-border trade and serves as a tool for managing capital movements. RBI's management of currency and forex markets eventually help build faith in Indian rupee and also to foster macro financial stability and external.

5.1.6 RBI and Other Financial Inclusion

The Reserve Bank of India (RBI) has long been active in its efforts to drive financial inclusion, aimed at making formal banking and financial services accessible to the underserved, unbanked as well as rural populace. Recognizing that growth could not be equitable without involving the underprivileged in it, RBI has taken some of the following steps to narrow down the gap dividing between formal financial sector and unorganised segment.

One of the initial steps made in this direction is the issue of guidelines on opening of BSBDAs. These are zero-balance accounts which enable people, especially poor, to access the banking system without any requirement to maintain a minimum balance. It has allowed millions of people to open bank accounts for the first time.

To reach out even more, the RBI has now provided licenses for Small Finance Banks (SFBs) and Payments Banks — entities created to address the banking requirements of small borrowers, marginalized, unorganized sector and migrant laborers. The banks work on simple models and use technology to provide basic banking to the remote areas.

One other import fusion has been the encouragement of the Banking Correspondent model, with individuals or organizations acting as agents/representatives of banks to enable bank transactions in such physical distant areas where a brick and mortar or full branch is not feasible. BCs have handheld devices or micro ATMs and provide services such as depositing cash, withdrawing cash, account opening and settling payments.

The RBI has also promoted and dovetailed its agenda with major government programmes like the Pradhan Mantri Jan Dhan Yojana (PMJDY), which resulted in over 500 million bank accounts being opened, and the Pradhan Mantri Mudra Yojana (PMMY) that extends microloans to small entrepreneurs. It has also paved the way for Direct Benefit Transfer (DBT) through bank accounts, which ensure efficient and transparent payment of subsidies and welfare benefits to the intended people.

To promote financial literacy, RBI has opened Financial Literacy Centres (FLC) in the country. To achieve the above targets, these centres organise workshops on familiarisation with banking products, credit discipline, saving habits and consumer rights (with a special focus on rural folks, SHGs and students in schools).

An example on the ground of RBI's financial inclusion success is visible in villages such like that of Malkangiri in Odisha, where physical bank branches were hardly there. Rural households in those areas can now withdraw government subsidies and make digital payments, even take microloans without having to travel long distances, thanks to banking correspondents and digital micro-ATM services. It has not only given a boost to the local economy, but also helped in empowering women and daily wage earners so that they can engage in financial decision making.

"Activity"

Students will select one key function of the Reserve Bank of India—such as monetary policy, currency management, or financial inclusion—and prepare a short infographic or poster explaining its purpose, tools, and real-life impact. They will then present how this function supports economic stability and public trust in the banking system.

5.2 Leading Banks in India

5.2.1 Public Sector Banks (e.g., SBI, PNB, BOB)

These institutions are known as Public Sector Banks (PSBs), those in which a majority stake (i.e more than 50%) is held by the Government of India. These banks are backbone of Indian banking system and have been in the forefront of supplying financial services to the entire country, particularly rural and semi-urban areas. Being owned by the government, PSBs have institutional support and become vehicles for social policy objectives.

One of the hallmarks of PSBs is their deep penetration in both regions (rural and urban) where they also serve as critical mechanisms through which credit extends, savings are mobilized

and financial inclusion achieved. Their activities are in tune with national development objectives and are governed by PSL norms. These directives bind them to lend a minimum share of their deposits towards sectors such as agriculture, micro and small enterprises, education, housing and the weaker sections of society—activities which private-sector banks typically overlook.

They play an active role in the implementation of government-run programmes." For example, as part of the Pradhan Mantri Jan Dhan Yojana (PMJDY), PSBs played a significant role in opening no-frill accounts for millions of unbanked, especially in remote and rural areas. They are also involved in initiatives such as Pradhan Mantri Awas Yojana (PMAY) and extend housing loans to lower income groups.

Among the PSBs, the most recognizable is State Bank of India (SBI), which is also one of India's oldest and largest banks. SBI not only has a dominant presence in India, but also has offices in many other countries as well – being the banking institution chosen for representing the country. Another major player is Punjab National Bank(PNB), which has a large network of branches and long head offices position for FARM and small business financing. Bank of Baroda (BOB) differentiated by its international presence combined with the dynamics of modern value added banking and services.

The effect of PSBs in reality is evident during the COVID-19 crisis. Public sector banks such as SBI and PNB also managed disbursing emergency funds and welfare payments under the government relief packages during nationwide lockdown. Using their large network and strong IT backbone, they ensured that direct benefit transfers (DBTs) went to millions of beneficiaries with speed. In rural Bihar, for instance, SBI's banking correspondents allowed villagers in an area without a brick-and-mortar branch to draw money and verify account balances, which wage laborers or farmers were able to use at time of crisis.

PSBs are authorised to act as RBI agents, allowing them to undertake several banking activities PSBs additionally have specific functions such as the handling of pension payments for Military and Central/State Govt. They are also financially sustainable institutions with both the commercial viability and developmental role, which forms an important part of India's public financial architecture.

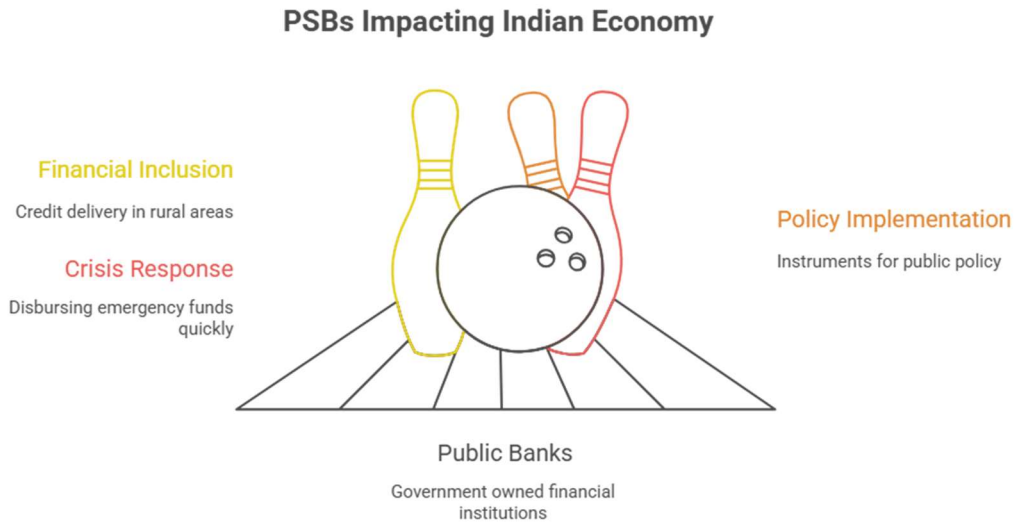

Figure **5.2**

5.2.2 Private Sector Banks (HDFC Bank, ICICI Bank and Axis Bank)

Private sector banks are commercial institutions owned by private people or company rather than the government. These are dynamic players in the Indian banking industry and have been recognized for customer centricity, technology adoption and agile operations. They have revolutionized the banking ecosystem in India over the last twenty years with innovative digital offerings and high touch-standards of customer service.

Early adoption of digital banking technology is one critical factor that sets private sector banks apart. From mobile banking applications and net-banking facilities, to AI-enabled chatbots and paperless account openings, these banks have been at the forefront of the move towards convenient, self-service banking. Their emphasis on operational excellence and product innovation enables them to provide the best possible interest rates, customized loan products and investment options as well as processing efficiency at par with international success stories.

HDFC Bank is India's one of the largest private sector bank known for delivering best-in-class retail banking, as well as digital services in the Indian financial space. It was one of the first to introduce 10-second personal loans, contactless credit cards and fully digital savings account openings. ICICI Bank is another prominent player, whose service offerings span not just traditional banking services but insurance and investment management as well as corporate banking. Axis Bank has the special advantage of these two worlds – retail and corporate, and strong digital platform" Wittyfeed said on 16 July.

An example of how private banks enhance innovation can be seen from ICICI Bank's iMobile Pay, where even non-customers can now avail of UPI payments, bill payments, investments or

even open a fixed deposit without visiting a branch. In its bid to serve customers best during COVID-19 lockdown, HDFC Bank had also started the "Shaurya KGC Card," which is an exclusive credit product for defence personnel configured with attractive rates and flexible terms. Moreover, Axis Bank's video KYC-based account opening process allowed customers to open savings accounts from the convenience of their home, not only helping in time reduction for onboarding but also ensuring customer safety.

The private sector banks are still driving the banking universe of India by making technology and financial services to merge well. Their agile transformation, digital ecosystems and above all the provision of personalised financial journeys make them among the key movers in the modern Indian banking place.

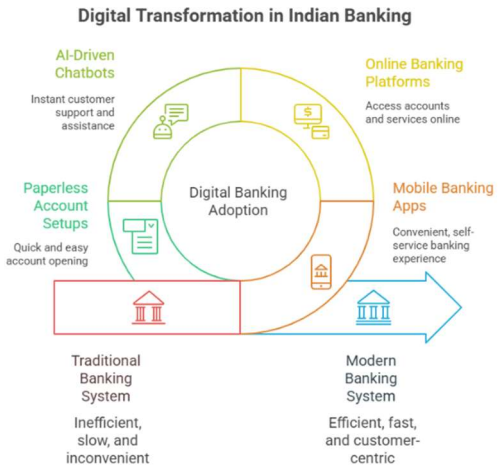

Figure **5.2.2**

5.2.3 Foreign Banks Operating in India

Foreign banks are banking companies incorporated outside India and having a place of business in India, to which the BR Act is made applicable. Their introduction in the Indian banking industry brings global standards of banking, latest technology and access to international markets. Although they operate under regulations issued by the Reserve Bank of India (RBI), foreign banks also bring expertise in crossborder domains such as trade finance, treasury services and investment banking.

They are usually banks serving a limited clientele, such as HNWIs (High Net Worth Individuals) and MNCs (multinational corporations), and may open offices in financial centers for simple services. Their products are typically centred around the requirements of international-exposure clients, such as foreign exchange trading, offshore investment vehicles, global fund transfers and structured financial plans. Most foreign banks in India have limited branch coverage, as regulatory and operational restrictions inhibit their ability to operate branches in numbers comparable to Indian public & private sector banks. But they make up for that

with better tech integration, more personal relationship management and specialized financial services.

For instance, Citibank has been synonymous with premium credit cards, NRI banking and wealth management for long. HSBC is known for its leadership in corporate banking and cross-border trade services to multinational companies with solutions delivered from end-to-end. Standard Chartered, the oldest foreign bank in India has a wide range of products and services, including retail, small business and commercial banking products to its customers (partly due to larger branch network than most other foreign banks).

An illustration of foreign bank operations can be found in the manner Standard Chartered assisted Indian exporters when global trade was hit by a disruption. By offering Rs one trillion in foreign currency as working capital to textile exporters from Gujarat, the bank offered cross-border trade finance solutions and helped them tackle issues of fluctuating exchange rates and an extended payment cycle. At the same time, HSBC's international presence has meant that Indian start-ups with foreign backers have been able to easily set up multi-currency accounts as well make cross-border transactions via digital platforms that are directly connected with their global banking networks.

Foreign banks are the lifeline for India's financial integration with world which enables international capital, supports inflow of foreign investment and brings in best banking practices & risk management to Indian shores. Though not as tangible, they concern themselves with the likes of forex trading, investment banking and global remittances.

Figure **5.2.3**

5.2.4Regional Rural Banks (RRBs) and Cooperative Banks

Regional Rural Banks (RRBs) and Cooperative Banks, as part of India's rural banking eco-system are instrumental in the financial inclusion of agriculture based and small business dependent population. These institutions are meant for grassroots access because the mainstream commercial banks have only nominal penetration there.

Regional Rural Banks (RRBs) are a category of financial institution in India.All RRBs are Government Scheduled Commercial Banks and they hold 51% of share capital by the government? Governments owned the stakes in these bank.Three entities -Central Government, concerned State Government and Sponsor Bank contribute to RRB(Rural Regional banks) in formulating their share capital. Their main objective was to extend credit and banking facilities to small and marginal farmers, agricultural labourers, artisans and rural entrepreneurs. RRBs are regulated and supervised by the Reserve Bank of India (RBI) and they are also monitored by the National Bank for Agriculture and Rural Development (NABARD).

The Kerala Gramin Bank is a notable RRB which operates in the Indian state of Kerala. It is a sponsored bank of Canara Bank and has 927 branches, spread over half the districts of Kerala. The bank was established on 2013 after the merging under amalgamation north malabar gramin bank amd south malabar gramin bank. It (Bank) is playing a vital role in the development of rural sector through offering both farm loan, SHG financing and other government welfare-linked schemes. Likewise, the Andhra Pradesh Grameena Vikas Bank (APGVB), which is sponsored by State Bank of India, has a good presence in Andhra Pradesh and some parts of Telangana districts. It extends critical credit support to farmers, micro-enterprises and SHGs in rural and semi-urban areas which has a significant bearing on State-level agricultural productivity.

On the other side, Co-operative Banks are banks which work on co-operative basis (that is based on concept of cooperation, Self-help and mutual help). These banks are registered under Cooperative Societies Act of the states concerned or under MSCSA (Multi-state co-operative societies Acts). They operate at urban, semi-urban and rural levels; many are structured as primary agricultural credit societies, district cooperative banks, or urban cooperative banks. Unlike in the case of RRBs, for cooperative banks the regulatory control is bifurcated where regulation of banking business lies with RBI while management and governance matters are controlled by State Governments.

One such example is Saraswat Cooperative Bank, headquartered in Mumbai, which is one of the major urban co-operative banks in India. The bank has a presence in multiple Indian states including Maharashtra, Gujarat, Delhi, Madhya Pradesh and Karnataka providing retail banking, corporate banking and NRI banking. It is owned by as well as operates for its customer-owners under the one-member-one-vote principle with shareholding being strictly limited to customers. The Cosmos Bank, situated in the same state but operating across seven states is another tribute. Popular for its early embrace of core banking technology, Cosmos

Bank offers services typical of contemporary banking such as mobile and internet banking among others to micro borrowers, self-employed persons and cooperative housing societies.

Both RRBs and Cooperative Banks are important in rural credit delivery and small-scale economic development at the grassroots level. They empower people in distant, unbanked and unserved parts of the country.Any new licence holder will have an opportunity to bring about a significant change: banking for local communities, agriculture, rural entrepreneurship and assisting inclusive growth of the Indian economy.

5.2.5 Emerging Trends: Small Finance Banks & Payments Banks

To increase the penetration of formal financial services and to deepen financial inclusion, India's central bank, namely the Reserve Bank of India (RBI), created two new types of banks: Small Finance Banks (SFBs) and Payments Banks. These organisations cater to particular sections of the population that are conventionally not served by mainstream banks, including low-income households, small vendors, migrant labourers and people in far-flung rural areas. They are governed by RBI and they operate on the basis of distinct licensing regulations specific for their purpose.

Small Finance Banks (SFBs) are a type of universal banks that were created with the objective of furthering financial inclusion by primarily undertaking basic banking activities to un-served and underserved sections including small business units, small and marginal farmers, micro and small industries and unorganized sector entities. While these banks can accept all kinds of deposits and give loans, their priority sector lending (PSL) mandates are more stringent – a minimum 75% of the adjusted net bank credit must flow to sectors such as agriculture, micro-enterprises, education and housing for the poor.

A few examples of well-performing SFBs would be AU Small Finance Bank, that began its journey as a vehicle-finance company offers banking services to millions of customers especially from semi-urban and rural Rajasthan. For example, Chennai-based Equitas Small Finance Bank has expanded into urban slums as well as the hinterland with micro-loans, savings accounts and insurance solutions for informal workers. Ujjivan Small Finance Bank, as a microfinance institution, has presence in several states and is strong in tier-2 and tier-3 cities where it give small-ticket loans to street vendors, shopkeepers and women entrepreneurs.

On the contrastingly end Payments Banks are envisaged to give a technology-led, low cost model of banking. The focus of these banks are on digital transactions, remittances and small savings. Although they can accept deposits up to ₹2 lakh per customer (according to the new RBI guidelines) but cannot lend or issue credit cards. Low-Value, High Volume Transactions Their business model is that they do high-volume transactions at low values through mobile apps, digital wallets and agent networks.

The India Post Payments Bank (IPPB) uses this sprawling postal network and employees to provide banking services at its rural and remote outlets. A real-life example can be witnessed in rural Bihar wherein IPPB facilitates pensioners/welfare beneficiaries to receive money in their bank account and withdraw cash through Aadhaar enabled Biometric system at post office counters. 6) Paytm Payments Bank: Yet another popular brand, they have been able to redefine the way payments are done digitally using instant mobile wallets & UPI services into a savings bank account at an app. Airtel Payments Bank leverages the telco's telecom infrastructure to offer banking services, particularly in areas without a substantial branch network, and facilitating mobile-based payments even where bank business correspondents are unavailable.

"Small Finance Banks and Payments Banks are a signal to the tectonic changes in the Indian banking landscape - of technology-enabled, low-cost financial inclusion that transcends bank branches," Sinha added. They are rewriting the script for how banking is delivered to the last mile, with a razor-sharp focus on simplicity, access and affordability.

Did You Know?

"Foreign banks like Citibank, HSBC, and Standard Chartered have been operating in India for decades, bringing global expertise in trade finance and wealth management. While they hold only about 6% market share, they account for a significant portion of India's international banking transactions and corporate lending portfolios."

5.3 Financial Reporting of Banks- An Overview

5.3.1 Unique Features of Bank Financial Statements

Bank balance sheets are radically different from the non-bank companies because of specialized nature of banking activities, regulatory environment and financial risk. The statements are organized to present a bank's liquidity, credit risk, capital and overall risk management information. Interpreted as per Indian Accounting Standards (Ind AS) and Reserve Bank of India (RBI) guidelines, the banking financials give you a complete picture of how the institution has not just performed but utilized its funds.

Among the most notable characteristics of bank's financial statements are the extensive regulatory disclosures found in such companies¿ 10-K and call reports. Unlike the normal balance sheets of corporates, banks have to disclose separate data for provisioning norms,

exposure limits, risk weighted assets and sector-wise credit distribution. Another important aspect is the relevance of interest income that represents the largest earnings source for banks. NII & NIM among the key profitability parameter, which holds key underlying in banks' income statement.

Banks are very sensitive to interest rates and liquidity. Minor shifts in market interest rates may have a major impact on bank earnings and asset-liability management. Accordingly, the liquidity ratio and maturity analysis of assets and liabilities are monitored and disclosed. Banks are also required to classify their loan assets according to the making of repayments and aging concept such as performing and non-performing assets (NPAs). This categorisation impacts capital requirements and is a measure of the bank's credit risk rating.

Bank statements also contain disclosures relating to capital adequacy, as per the Basel III guidelines that require banks to have an adequate buffer of capital to absorb risks. These disclosures contain information on Tier 1 and Tier 2 capital, CRAR (capital to risk weighted asset ratio) and leverage ratios.

In general, a bank's financial statements constitute not only a yardstick of authorities and market participants for sound financial performance but also an instrument to ensure regulatory compliance of its own business as well as of the overall system. Analysts, investors and regulators rely heavily on them to assess the health, strength and compliance with prudential standards of the institution.

5.3.2 Balance Sheet of Banks

The chart of income account is a simple summation of the credits. It provides a profile of where the bank gets money from (liabilities and capital) and how it uses that money (assets) in different types of financial instruments and activities. Bank balance sheets, unlike those of non-bank firms, are designed to provide information about the bank's position with respect to its liquidity, solvency, asset quality and compliance with regulation particularly as it pertains to risk management and adequacy of capital.

On the assets side, a banks holdings usually start with cash and balances with Reserve Bank of India (RBI), which all banks are required to keep to fulfill their CRR or SLR requirements. Next are investments which consist of mainly government securities, treasury bills and bonds; low risk, highly liquid instruments. Largest asset is loans and advances which produce the most of interest income for a bank. These samples are personal loans, business loans, mortgages and working capital financing. Other assets are such as bank branches, office services infrastructure and computer systems (i.e. fixed assets) to other miscellaneous things like accrued interest, tax credits and receivables and fixed deposits with other banks .

The other side of the balance sheet shows what the bank owes. Largest part of it is comprised of customer deposits, savings accounts, current account and fixed deposit. These deposits are the lifeblood of most banks. Banks also borrow from the RBI, other banks and

intersbanks loans are additional sources of funds. Furthermore, interest payable; outstanding claims or commitments; and set asides for non-performing assets or contingencies are considered when determining other liabilities and provisions.

One of the most important regulatory ratio on the balance sheet of a bank is Capital Adequacy Ratio (CAR), which indicates the capacity of the bank to bear losses. The CAR is determined by comparing a bank's capital to its risk-weighted assets. Indian banks are also required to meet the 11.5% minimum CAR, including a capital conservation buffer, under Basel III norms. This is so banks will be well-capitalized and can withstand the stress of financial downturns without threatening either depositors' money or the stability of the broader financial system.

The functioning of these principles is evident in the SBI's financial statement. As on March 2023, SBI declared deposits in excess of ₹40 lakh crore, which was majority of its liabilities. Its loans book, on the asset side, had exceeded ₹30 lakh crore broken into corporate advances (large assets), agriculture and personal credit. The bank also held a significant investment in the portfolio of government securities to comply with SLR provisions. With an 8% CAR in SBI's case, which was based above the regulatory minimum (of around 13.8% back then), epitomizing its strong capital base and sufficient hygiene to instil confidence among all stakeholders including investors, depositors, or regulators.

5.3.3 Profit & Loss Account of Bank's

P&L Account of a bank gives an overall picture of the bank revenue and loss over an accounting period such as Financial Year. It is a source and applications statement which records the cash in-flows (funds sources), out-flows (uses of funds) and surplus or deficit of the bank, enabling an assessment to be made of operational efficiency, profitability and financial soundness. In contrast to manufacturing units or trading companies, a bank P&L is centred heavily around intangibles like interest income and expenses; non-interest intervention streams (like fee from forex etc.) and credit risk provisioning.

Interest Income This is the primary income source for a bank, which comes from loans and advances made to customers, as well as investments in government securities, bonds and interbank placements. This is the bread and butter of income for banks. On the cost side, banks have to pay interest on deposits of various types such as savings bank deposits, current accounts and term deposits and also for borrowing money from RBI or for some other financial institutions. The spread between total interest income and total interest expense is called Net Interest Income (NII), a key measure of a bank's profitability.

In addition to interest income, banks derive non-interest income from a range of fee services and activities. This includes fees and charges for services such as ATM transactions, debit and credit card use, account maintenance charges, rent on lockers or issuing demand drafts. Banks also make money from foreign exchange transactions, treasury trading and the sale of

third-party financial products like insurance and mutual funds. That income stream diversifies the bank's revenue sources and curbs reliance on old-fashioned lending.

Banks also have large operating costs such as teller salaries, rent, utility bills and marketing. A significant part of costs-at least in credit-driven organizations-relate to provisions for NPAs. Banks are also required to allocate a certain percentage of their earnings to develop a reserve for potential losses on bad loans, putting further strain on their profitability.

Last figurer in the P&L statement is the net profit or loss derived after subtractions of any expense outlay (including provisions and taxes) from total income. Ideally, a good bottom line reflects as much skill for handling income as handling risk.

As a token example of this, consider the HDFC Bank`s annual report for the completing March 2023. The bank has around ₹80,000 crore in net interest income with retail loans such as home loan, auto loan and credit cards representing a large part of the total interest income up till now. It also posted strong non-interest income from fee-based services and cross-sell of financial products. Even after accounting for the provisions that it made on bad loans and its operating expenses, the bank reported healthy net profit in an indication of a balanced income strategy and robust operational control.

5.3.4 Key Ratios in Banking

Financial ratios are critical tools used to evaluate a bank's performance in terms of **profitability, efficiency, asset quality, and risk management**. These ratios allow regulators, investors, analysts, and internal management to assess how well a bank is managing its resources, handling credit risk, and generating returns.

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1. Gross NPA Ratio

Formula:

$$\text{Gross NPA Ratio} = \left(\frac{\text{Gross NPAs}}{\text{Gross Advances}}\right) \times 100$$

- **Gross NPAs (Non-Performing Assets)**: Total value of loans that are classified as non-performing. A loan is considered NPA when interest or principal payments are overdue for more than 90 days.
- **Gross Advances**: The total amount of loans and advances extended by the bank, including performing and non-performing loans.

This ratio measures the **proportion of a bank's loan book that is at risk of default**. A higher Gross NPA Ratio indicates poor asset quality.

2. Net NPA Ratio

Formula:

$$\text{Net NPA Ratio} = \left(\frac{\text{Net NPAs}}{\text{Net Advances}}\right) \times 100$$

- **Net NPAs**: Gross NPAs minus provisions (funds set aside by the bank to cover potential losses).
- **Net Advances**: Gross Advances minus provisions.

This ratio reflects the **actual loss exposure after provisioning**. A lower Net NPA Ratio suggests that the bank is adequately protected against loan defaults.

3. Capital Adequacy Ratio (CAR)

Formula:

$$\text{CAR} = \left(\frac{\text{Capital}}{\text{Risk-Weighted Assets}}\right) \times 100$$

- **Capital**: Includes Tier 1 (core) and Tier 2 (supplementary) capital of the bank.
- **Risk-Weighted Assets (RWA)**: Assets adjusted for risk based on asset class. For example, loans to the government have lower risk weights than unsecured personal loans.

CAR indicates the **bank's capacity to absorb losses** while meeting its obligations. As per Basel III norms, Indian banks must maintain a **minimum CAR of 11.5%** (including capital conservation buffer).

4. Return on Assets (ROA)

Formula:

$$\text{ROA} = \left(\frac{\text{Net Profit}}{\text{Average Total Assets}}\right) \times 100$$

- **Net Profit**: Profit after tax for the financial year.
- **Average Total Assets**: Average of total assets at the beginning and end of the period.

ROA shows how **efficiently the bank is using its assets to generate profit**. A higher ROA indicates better asset utilization.

5. Return on Equity (ROE)

Formula:

$$\text{ROE} = \left(\frac{\text{Net Profit}}{\text{Shareholders' Equity}}\right) \times 100$$

- **Shareholders' Equity**: Capital contributed by shareholders plus retained earnings.

ROE measures **how much profit the bank generates for each unit of shareholder investment**. It's a key indicator of profitability from the investor's perspective.

6. Cost-to-Income Ratio

Formula:

$$\text{Cost-to-Income Ratio} = \left(\frac{\text{Operating Expenses}}{\text{Operating Income}}\right) \times 100$$

- **Operating Expenses**: Expenses related to running the bank (salaries, rent, IT, etc.).
- **Operating Income**: Includes both interest income and non-interest income.

A **lower Cost-to-Income Ratio** indicates higher efficiency, as it shows that a smaller portion of income is being consumed by operating expenses.

Knowledge Check 1

Choose the correct option:

1. **What is the main source of income for banks?**
   a) Rent
   b) Interest

c) Donations
d) Taxes

2. **What does CAR measure?**
a) Loan recovery speed
b) Profit margin
c) Capital strength
d) Market share

3. **What are NPAs?**
a) Non-paid accounts
b) Non-profitable areas
c) Non-performing assets
d) Non-prime accounts

4. **Which ratio shows profit earned on total assets?**
a) ROE
b) ROA
c) NPA
d) CRR

5.4 Summary

ϖ The Reserve Bank of India (RBI) is the central bank and bankers' bank of India.

ϖ RBI is responsible for issuing currencies as well as monitoring foreign exchange and monetary policy.

ϖ It controls and inspect all business and cooperative banks in India.

ϖ RBI uses tools such as repo rate, CRR, and SLR to reign in inflation.

ϖ The Indian bank system consists of public sector, private sector, foreign banks and cooperative banks.

ϖ Public sector banks are government owned and more reachable to the people.

ϖ Tech-savvy private banks Private banks are using technology for creating customer experiences.

ϖ There are number of overseas banks doing business in India providing such facilities to the people of India from their specialized international services.

ϖ Rural Credit is an important element of RRBs and CCBs.

ϖ Several new-age establishments – the Small Finance and Payments Banks deepen penetration.

ϖ There are special disclosures of capital and asset quality in bank financial statements.

ϖ Important banking ratios used to gauge profitability, asset quality and risk.

ϖ RBI also works for spreading out financial literacy and inclusion in the country.

5.5 Key Terms

Reserve Bank of India (RBI): India's monetary policy and banking regulator.

Repo Rate: This is the rate at which RBI lends short-term money to commercial banks.

CRR (Cash Reserve Ratio): It is the proportion of a bank's deposits which has to be kept with RBI in cash.

Capital Adequacy Ratio (CAR): It is a ratio of bank's capital to its risk weighted assets.

NPA (Non-Performing Asset): Loan / advance on which interest or part of the principal remains overdue for a period not less than 90 days.

Public Sector Bank: A bank that is owned by the government.

Private sector bank: A bank owned and controlled by private individual shareholders.

Small Finance Bank: A bank catering to marginal and small depositors.

5.6 Descriptive Questions

Describe the role and responsibilities of the Central Bank, Reserve bank of India.

What are the primary instruments of monetary policies used by RBI?

Explain the organisation of the Indian banking system with examples.

Differentiate between the public sector banks and the private sector banks.

What is CAR (Capital Adequacy Ratio)? Why does it matter for banks?

Describe the elements of a bank's Profit & Loss account.

Define NPAs. What impact do they have on a bank's finance performance?

What are Small Finance Banks and Payments Banks? Note to Editors - Their contribution to financial inclusion.

5.7 References

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Answers to Knowledge Check

Knowledge Check 1

1. b) Interest
2. c) Capital strength
3. c) Non-performing assets
4. b) ROA

5.8 Case Study

Introduction

After economic disruptions due to the deadly pandemic, Covid-19 in India, the banking sector came under acute pressure in terms of liquidity crunch, increasing NPAs and low credit growth. Reserve Bank of India (RBI) turned out to be the lynchpin for bring in stability and confidence back into the financial system.

This caselet enables a discussion on how the RBI leveraged its regulatory, supervisory and monetary powers to protect the Indian banking system. It reflects the dynamic relationship between RBI actions and the behaviour of commercial banks, particularly in issues such as monetary easing, moratorium practices, financial inclusion and forex management.

Background

Some banks started reporting early this year that bad loans and liquidity were soaring as business shutdowns and declines in consumer spending tore a hole in the U.S. economy. The RBI quickly responded by slashing the repo rates, announcing a loan moratorium and raising the Cash Reserve Ratio exemption for banks to ensure liquidity.

In addition, RBI ascertained uninterrupted digital payments, extended financial literacy, and provided support to the MSMEs through special refinance facilities. The central bank's interventions offered a window into how a central bank can act as both regulator and crisis manager.

Problem Statement 1: Increase in NPAs Among the banking institutions, NPAs continue to increase.

A number of both public and private sector banks had also witnessed a rise in NPAs on account of overburdening debt being borne by common people who were finding it hard to repay loans leading to their financial position weakening.

Solution:

The RBI announced a moratorium on interest and principal repayment for stressed accounts and asked banks to increase provisioning. It espoused enhanced asset classification norms and early warning systems as well.

MCQ 1:

What was an RBI resolution for NPA increase after the pandemic?

a) Lower credit scores

b) Allow unchecked borrowing

c) Loan Recast for stressed assets

d) Ban all new loans

Answer: c) Restructuring of loans in case of stressed assets

Problem Statement 2: Slowdown in lending and Low credit growth

Uncertainty and subdued demand made banks reluctant to lend, and that has been a drag on the recovery.

Solution:

While RBI cut the repo rate and unveiled targeted long-term repo operations (TLTRO) for injecting liquidity in segments such as agriculture, small-scale industry and infrastructure.

MCQ 2:

Through which tool, RBI enhanced liquidity in sectoral specific manner?

a) Increased SLR

b) Repo hike

c) TLTRO operations

d) Foreign borrowing

Answer: c) TLTRO operations

Problem 3: Inequality of Access to Banking

Rural and low-income communities could not avail themselves of formal banks during lockdowns.

Solution:

RBI has been pitching for Payments Banks, Banking Correspondents and digital platforms such as UPI to raise financial inclusion even in remote areas. Jan Dhan accounts and DBTs provided strong support in reaching relief to the government's intended beneficiaries.

MCQ 3:

What did RBI do to boost financial inclusion during the pandemic?

a) Closed rural branches

b) Removed UPI services

c) Enabling Digital Payments and Banking Correspondents

d) Encouraged only urban lending

Answer: c) Facilitated digital payments and banking correspondents

Conclusion

This case lessson demonstrates the multi faceted role of RBI in sustaining stability, liquidity and inclusiveness in the indian banking sector. The central bank had taken such proactive measures and also provided its innovative regulatory support to steer the economy and financial sector across an uncharted crisis.

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Unit 6 Insurance – Part I: Fundamentals of Insurance

Learning Objectives

1. Understand the basic concept, purpose, and significance of insurance in financial planning.
2. Identify the fundamental principles on which insurance operates.
3. Differentiate between various types of insurance such as life and general insurance.
4. Explain the roles of insurers, insured, agents, and regulatory bodies.
5. Analyze the concept of risk and how insurance helps in risk transfer.
6. Understand the structure of the insurance industry in India.
7. Recognize the importance of insurance in personal and business risk management.

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6.3 Need and Significance of Insurance

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6.6 Summary

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6.10 Case Study

6.0 Introductory Caselet

Insurance had never been part of Ravi's financial planning: at 28, the marketing executive had no dependents or spouse who would need his protection. He thought he had enough savings in fixed deposits and mutual funds for his future. One Monday, on his way back from a work trip, he had a little accident. While he survived, his two-wheeler was damaged and inflicted heavy expenses.

Surprised at the sudden expense, Ravi began to look into how he could shield himself from such financial shocks. He discovered that insurance could have paid both his medical bills and the cost of repair on his truck if he had taken out a comprehensive health and motor insurance.

His new found meaning peaked his interest in how insurance was essentially all about risk sharing, and how small premiums could mean salvation for you from financial ruin. That experience broadened Ravi's perspective on the greater significance of insurance - not just a protection but an essential part of financial responsibility.

Critical Thinking Question

What would an early education about insurance do for someone like Ravi, and what are the hazards that could be averted through sound insurance planning?

6.1 Introduction to Insurance

6.1.1 Concept and Meaning of Insurance

The insurance is a contract between the insurer and the insured in which an individual seeking insurance protection makes a payment, called a premium, to an insurance company. It is more or less an arrangement between the insurer (the company issuing insurance) and the insured (the person/entity purchasing insurance), whereby insurer undertakes to indemnify the insured against certain possible future losses for consideration in the form of periodical payments.

Key elements of the concept:

Risk Transfer

Definition:

Risk transfer is the process of offloading financial responsibility for a loss/scenario from the policyholder (person or business) to the insurance company.

Explanation:

When you purchase an insurance policy, you are effectively paying a premium in order to transfer the risk of a particular type of loss — fire, theft, illness, liability — to an insurer. The

insurance company, in exchange, agrees to pay for the financial cost of such loss, if any (subject to the conditions set forth in the insurance policy).

Example:

If you had a $20,000 car. It can always been damaged in an accident. You're willing to pay a car insurance company $800 a year in return for not being out of pocket in the event of an accident; because if you didn't have that coverage and had an accident, you'd be down about $20,000. You crash your car, the insurer covers the cost to repair or replace it, up to a certain limit in your policy.

You've shifted the risk of loss to the insurance company by paying a relatively small premium.

Risk Pooling

Definition:

Risk pooling is the mechanism through which insurance combines the payments made by many people into a common fund from which to compensate a few, larger losers.

Explanation:

Some people who purchase insurance will have no claims. Insurers depend on the law of large numbers; the more policies they sell, the more predictable overall losses are. This predictability enables them to charge equitable premiums and make sure there's enough money in the pool to meet claims.

Example:

Take, for example, an insurance company that underwrites 10,000 homeowners policies at $1,000 a piece. This creates a premium pool of $10 million. So even after 100 houses are fire damaged in a year, meaning typical losses of $50,000 each, all claims only add up to $5 million. The balance pays for administrative overhead and profit.

Everybody pays into the pool and only those who incur losses submit claims, thus diffusing risk across many.

Indemnification

Definition:

Indemnity is the idea that insurance returns a person to the same financial position they were in before a loss occurred, without providing them with excess.

Explanation:

The purpose of insurance is not to make you financially better off after a loss—it exists only to make you whole for the value that's actually lost. This deters fraud and it ensures that insurance remains a safety net, not an easy-money scam.

Example:

Say your insured laptop is stolen. And let's say it was worth $1,200. Your insurance will pay you the actual cash value or the replacement cost, depending on your policy — and nothing more. You can't take $2,000 because that's what the newer model costs.

Insurance pays you fairly but doesn't allow you to profit from misfortune.

6.1.2 Characteristics of Insurance

Insurance has special features that make it separate from other types of financial arrangements or risk management:

Risk Sharing and Pooling: Insurance operates on the concept of risk pooling. premiums are paid to a common fund in which they share losses.

Contractual Agreement: It's a legal agreement between the insured and the insurer. Terms and conditions, amount of premium payable and the procedure for claiming etc. are specified in a formal contract.

Premium Payment: The insured has to pay periodic or a one-time premium in order to avail of the coverage.

Utmost Good Faith (Uberrimae Fidei): There is a requirement on both the insurer and insured to act in utmost good faith by providing information for each other, fully and accurately. The insurer can deny the claim if the insured does not disclose a material information.

2560 -There must be insurable interest-Theinsured must be related to the subject of insurance with a financial or other legal interest. For instance, one can insure ones own house, but not a stranger's house.

Principle of Indemnity: The purpose with insurance is to bring the policyholder back to his or her pre-loss financial condition rather than gain from it.

(2) Principle of contribution: Where the insured has effected several policies from different insurance offices on the same risk, each is bound to contribute rate-ably to all loss covered by such policies.

SUBROGATION – A principle insuring that a person who claims compensation from the company retains rights and remedies against another party for his loss or injury; also, a right reserved by most policies to permit the insurance company, after it has paid the insured for an accident (for which some other person must pay), to recover that amount from the other

party. Otherwise, the insured would be receiving a double recovery—in one instance from the insurance company and in another from the wrongdoer.

So if the other driver is at fault in an accident with your car, and the repairs are covered by your insurance company, your insurer would then sue the other driver for that amount. It's a principle which prevents what would be unfair, allowing insurers to recoup losses where they can.

Number of Insureds: Insurance companies require a greater number of insured individuals to estimate their losses and manage risk effectively.

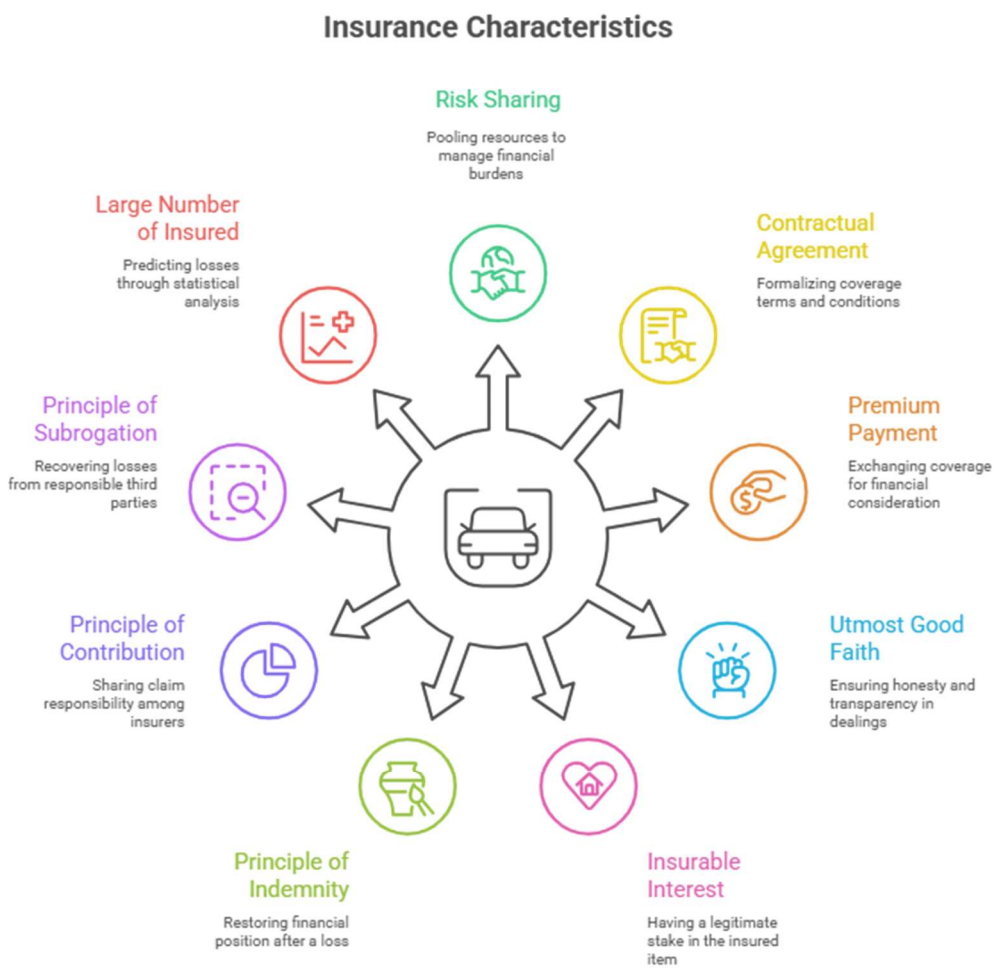


Figure **6.1.2**

6.1.3 Functions of Insurance

There are several economic, financial and social functions of insurance:

Provides Protection Against Risk

• Insurance covers the risk of loss due to fire, theft, accident or natural disaster.

Opacity is a way to make it easier for adverse shocks not to become financial stability problems,"Mr. Goodfriend says."

Promotes Financial Stability

• Insurance helps smooth cash flows and maintain economic steadiness by covering potential losses to prevent an interruption in the flow of money.

• It is supposed to let businesses invest with confidence, knowing that their most fundamental risks are paid by other people.

Encourages Savings and Investment

• Some other products beyond life insurance provide investment and savings benefits as well as risk coverage.

• Encourages long-term financial planning.

Helps in Capital Formation

• Insurance firms are to invest the premiums collected in infrastructure, stock markets and government bonds.

• This helps in the national economy growth and establishment of capital.

Generates Employment

• The indirect and direct suspense in millions of employees all over the world since they have agents, congestion surveyors, underwriters, claim managers etc.

Facilitates Credit

• Insurance spreads risk and thus boosts the creditworthiness of individuals and businesses, which in turn makes it easier for them to obtain loans.

Reduces Burden on Government

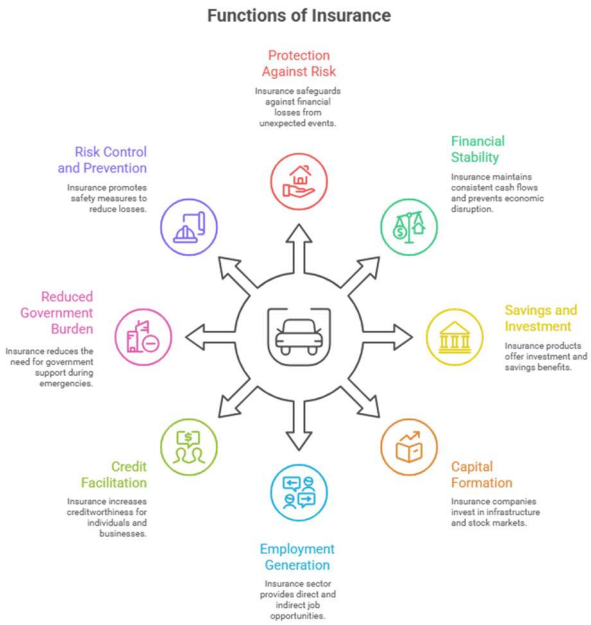
• Insurance allows people to manage such risks themselves, reducing the demand for government aid during natural disasters or other emergencies.

Risk Control and Loss Prevention

• There are numerous insurers that offer advise and rewards for clients who take risk-reducing steps, responding to the fact that some areas of risk are under their direct control.

Did You Know?

"Insurance doesn't just protect individuals from loss—it also fuels the economy. By pooling premiums, insurers invest in infrastructure, promote savings, and support business growth. Insurance coverage even enhances credit access and reduces government financial burdens during disasters, making it a silent engine of national development."



6.2 Principles of Insurance

6.2.1 Principle of Utmost Good Faith

This duty demands from both parties to the contract—i.e. insurer and insured—the full disclosure of all material facts at the time of and during negotiation of any insurance policy.

Key Features:

• Facts Must Be Material: Specifically, all facts that would impact an insurer's coverage or pricing position. If, for instance, someone buying life insurance conceals a history of heart disease, that would run afoul of this principle.

• Utmost Good Faith: The underwriter has to present policy exclusions, claims procedure and clauses in detail and the insured must not hide or misrepresent fact.

Consequences of Violation:

• The policy could be invalidated.

• Claims may be denied.

- If fraud or deliberate non-disclosure is discovered, you can take legal action.

6.2.2 Principle of Insurable Interest

This principle provides that the purchaser of insurance must have insurable interest in the subject matter of the insurance. This is to keep people from betting on someone else's life or property.

Requirements:

- The insured must be in a worse financial position if the insurable event takes place.
- The interest must exist at:

o Inception of the policy (on life insurance).

o At the time of loss (for property, fire and marine insurance).

Examples:

- You can insure your own house, but not your neighbor's.
- There is insurable interest between husband and wife.
- A firm has insurable interest in its factory and machinery.

Did You Know?

"The principle of insurable interest ensures that you can only insure something or someone if their loss would cause you a financial setback. This rule prevents people from taking out insurance on strangers or unrelated property, making insurance contracts ethical, legal, and based on genuine financial relationships."

6.2.3 Principle of Indemnity

This is the very concept which guarantees that insurance works as indemnification against loss, and is not meant to turn a profit. It is mostly applicable in general insurance such as fire, marine and property etc.

Objectives:

Re-establish the insured to its pre loss economic situation.

- Avoid unjust enrichment.

Valuation:

- On the basis of actual cash value, replacement cost or market value at time of loss.

Example:

For instance, if a warehouse that has been insured for ₹10 lakhs is damaged, and the actual loss to the owner is only of ₹3 lakhs, the claim settled by insurance company will be ₹3 lakhs only even if one holds a cover of higher amount.

6.2.4 Principle of Contribution

In the case of dual insurance covering the same subject matter, and there being a liability, this principle prevents insured from making profit at the expense of insurer(s) by claiming more than actual loss.

Application:

• They should all be written on the same interest and subject, but must be evidencing the same risk.

• In fire and marine insurance.

Example:

If a house of 10 lakhs is subjected to double insurance under companies A and B, to the extent of ₹6 lakhs with A and ₹4 lakhs with B respectively, and loss caused is of ₹5 lakhas then the contribution would be:

• Company A: ₹3 lakhs

• Company B: ₹2 lakhs

This maintains equity among insurers.

6.2.5 Principle of Subrogation

Subrogation gives the insurer the right to stand in for insured after payment of a claim, and sue or collect from the third-party which is responsible for damages.

Purpose:

• Forbids to the insured the double compensation of being compensated by both the insurer and the wrongdoer.

• Transfers liability to the guilty party.

Conditions:

• Only applies after the claim is paid.

• To the amount of claim paid.

Example:

Since your insured vehicle was damaged by another driver's negligence, and the insurance company paid you ₹50,000 for repairs to your car, the insurer may sue that negligent driver to recover ₹50,000.

6.2.6 Principle of Proximate Cause (Causa Proxima)

Under this doctrine, it is found out whether a loss falls within coverage by analyzing the nearest or most direct cause of that loss rather than remote or unrelated causes.

Key Points:

• Not all events are insured—only those named in the policy.

• The Dominant Cause • If contributing causes lead to loss, just the proximate and efficient cause is regarded.

Example:

If cargo is damaged in a fire from lightning (a covered peril), the cause of loss proximately caused would be lightning. If damage happens because poor packaging (not covered), claim is denied.

6.3 Need and Significance of Insurance

6.3.1 Risk Coverage and Protection

Although insurance is one of the oldest risk management tools, it primarily serves as a form of risk management. It offers protection against uncertainties, which can cause financial loss.

Key Aspects:

• Security against uncertainties: There is always an uncertainty that what will happen in future. Life is associated with risk of death, accident, loss due to fire, natural calamities etc. Uncertainty can be reduced by insurance helping insured parties to recover from losses faced by them as a consequence of risks.

• Peace of mind: If you know you will be covered in case of loss, individuals and companies can operate without the constant specter that a setback could wipe them out.

• Business continuity: For businesses, insurance is a way of keeping working even after an incident like fire, liability claims or equipment breakdown.

Example:

Hospitalization fees are covered by health insurances, and property is insured against fire and explosion.

6.3.2 Financial Stability and Security

Insurance helps to promote individual and institutional financial stability by providing a cushion12 against financially traumatic events.

Contributions:

• Predictable financial planning: It allows individuals and businesses to plan for large or predictable unknown major expenditures (e.g. having a surgery or buying a house) for circumstances such as sudden cost of surgeries, road accidents, and lawsuits.

• Limiting personal risk: Life and disability insurance enable families to sustain a pre-existing standard of living in the event of death or being unable to work.

• Enables to long-term goals: People can feel more comfortable making plans for education, home ownership or retirement with financial protection.

Impact:

• Decreases reliance on personal savings or loans in times of crisis.

• Increase the economy's resilience by limiting the number of bankruptcies due to exogenous events.

6.3.3 Encouragement of Savings and Investment

Some insurance products, particularly life insurance and endowment policies, offer coverage against risk as well as saving and investment options.

Dual Benefit:

• Risk cover: In the event of premature death or disability, the nominee receives a lump sum.

• Savings option: Over many years, some policies accumulate cash value that you can withdraw or borrow against.

Long-Term Discipline:

• Making regular structured premium payments inculcate financial discipline.

• Life goals like education, marriage and/or retirement, insurance products can be matched.

Investment in National Economy:

• The collected premiums are invested into government bonds, infrastructure and capital markets and thus being used for nation building.

6.3.4 Economic Growth and Development

Insurance in macroeconomics Insurance has an essential role in the operation of a country’s economy that contains factors, impacting development and stability.

How It Supports Growth:

• Mobilisation of funds: ”Premiumis” are collected, and this will determine if the company has capital to re-invest in economic activities like infrastructure.

• Employment: The industry provides millions of jobs—agents, underwriters, actuaries, claims adjusters, customer service and IT support.

• Startups benefit: Through the coverage of business risks, insurance drives innovation and growth for both startups and small to medium-sized enterprises (SMEs).

Social Impact:

• Lightens the load on governments in disasters and emergencies.

• Makes microinsurance available to low-income persons by fostering inclusive growth.

“Activity”

Ask students to list five real-life scenarios where insurance could provide protection (e.g., car accident, house fire, medical emergency). Then, have them explain how insurance would help in each case. This will help them understand the practical importance of insurance in offering financial stability, risk coverage, and economic support.

6.4 Is Insurance an investment?

6.4.1 Insurance as Risk Protection vs. Investment

There are two, different yet crucial aspects to insurance as part of personal finance: risk protection and investment. Knowing the difference between these two aspects can lead people to make an informed decision about the policy they will get.

Insurance as Risk Protection

Insurance is, at its heart, a transfer of risk device. The policyholder makes fixed payments, known as the premiums, to the insurance company in exchange for the latter’s promise to indemnify them against financial loss if the insured event takes place in their life (e.g. death or accident) or their lives (e.g. an illness). The real intention here is to protect against unexpected risks for which you would otherwise be financially responsible. For instance, term policy pays sum assured to nominee in case of death of the insured only during the term and health covers expenses against medical and hospitalization. One of the salient aspects of pure protection plans is that it provides no returns if the insured event does not happen; it's what you purchase for peace of mind and financial safety, not wealth building.

Insurance as Investment

Some insurance products have evolved to incorporate an investment product as well as the protective element component. These policies are sometimes called hybrids. Part of the premium is allocated to mortality charges, also known as the mortality premium which provides life cover, and rest of it goes into investments that can be chosen by the policyholder. For example, with endowment plans one gets the benefit of lumpsum payment at maturity irrespective of whether a claim arises which gives you both protection and savings. In the same manner, Unit Linked Insurance Plans (ULIPs) segregate the premium amount between secured insurance cover and related investments in market. The mortality premium is used to purchase the life cover in this product and the remaining amount is invested in equity, debt or a hybrid fund based on what you choose. This two-in-one nature makes ULIPs an attractive investment option for someone looking long term wealth creation as well as financial protection by way of accruing assets and providing cover against life's uncertainties.

6.4.2 Pure Risk Exposure versus Investment-Linked Coverages

Knowing how the products differ in design can help consumers select the best policy to meet their objectives.

A. Pure Risk Coverage

These policies are concerned exclusively with protection and not returns.

• Term Life Insurance:

o Provides high amounts of sum assured at low premiums.

o No money back unless such an insured event (for example, death) were to occur.

o Great for budget-conscious people that need all-over coverage.

Benefits:

• Simple structure.

• High coverage for low cost.

• Best suited for risk-only needs.

B. Investment-Linked Insurance

These integrate the features of protection and investment.

• Endowment Policies:

o Providing profit at the time of expiry.

o Ideal for those who are not risk takers.

• ULIPs:

o An amount is invested in the mutual funds (either equity or debt) and the rest is an insurance component.

o Returns depend on market performance.

o Offer flexibility in fund switching.

Benefits:

• Wealth creation + protection.

• Long-term savings discipline.

6.4.3 Pros and Cons of Considering Insurance as an Investment

Analysing insurance as an investment: With advantages and the downsides.

Pros:

Double Benefit: Insurance + Investment in a single product avoids the hassle of maintaining two separate schemes.

Financial Discipline: Compulsory payment of premium leads to regular savings.

Tax Advantages: Premium paid by you is eligible for tax deductions (as per Sections 80C and 10(10D) of the Income Tax Act in India).

Maturity Value: You get a lump sum at the term end if no claim is made.

Cons:

Not As Good Returns As Pure Investments: ULIPs and endowment plans may not offer returns as high as mutual funds or PPF.

High Charges:ILPs have charges such as Mortality Charges, fund management fee, policy admin charges etc.

Lock-in Period: You are not allowed to take out funds before the due date with steep charges (probably in ULIPs).

Rigidity: there is no flexibility: once on a path, it is difficult to swerve without loss.

Real-Life Example:

• Assume a 30-year-old is purchasing ₹1 crore term plan for ₹10,000/year (pure risk).

• Or, instead, a ULIP (₹1 crore cover + investment) would cost ₹50,000/year.

• The term plan is pure protection, while the ULIP is a cover + investment option but at an increased expense & complexity.

Knowledge Check 1

Choose the correct option:

1. **What is the primary purpose of traditional insurance?**
   A. Wealth creation
   B. Risk protection
   C. Tax saving
   D. Fund transfer

2. **Which of the following is a pure risk coverage policy?**
   A. ULIP
   B. Endowment plan
   C. Term insurance
   D. Money-back policy

3. **In ULIP, a part of the premium is:**
   A. Donated
   B. Given back
   C. Invested in markets
   D. Held as reserve

4. **What is a major drawback of investment-linked insurance?**
   A. No protection
   B. High returns
   C. Complex structure
   D. Easy withdrawal

6.5 Important Terms in Insurance

6.5.1 Policyholder and Insurer

Policyholder

The policyholder is the individual or organization that a insurance poliicy. They are the ones who:

• Enter into the contract with the insurer.

• Pay the premiums.

• Retain the right to adjust both the schedule for making contributions and other policy features (such as adding riders or replacing beneficiaries).

The policyholder can be:

•An insured (For example, a person whose own life is covered by a policy of insurance).

• Other than the insured (e.g., parent purchasing policy on child).

Example: If Ms. Meena takes out a health insurance cover for her son, she is the policyholder and her son is the insured person.

Insurer

The insurer may be the following insurance provider:

Covers according to the Terms and Conditions in the policy.

• Takes on the uncertainty for the policy holder.

• Pays the risk-holder upon making a claim and having them accepted.

Example: LIC, SBI Life, New India Assurance and ICICI Lombard are insurers.

6.5.2 Premium

A premium is what you pay for insurance. It is the money that needs to be paid by you periodically (monthly/quarterly/yearly) to the insurer in order to stay insured.

Characteristics:

•Payment - may be sent in monthly, quarterly, annual or single payments (single premiums).

• In all pure risk policies unless the contrary is stated it's not refundable.

Factors Affecting Premium:

• Type of policy (life, health, vehicle and so on)

• The insured’s age and health status

• Lifestyle (smoking, hazardous job, etc.)

• Coverage amount and policy duration

• Add-ons or riders attached

Like all types of life insurance, premiums are lower when purchased at a younger age.

6.5.3 Sum Assured / Coverage

This is the largest sum of money that an insurance company will pay in respect of a valid claim.

Sum Assured (Life Insurance):

• A sum of money paid to the nominee if the insured individual dies during the policy term.

• Can also be paid out at maturity, depending on the product.

Coverage (General Insurance):

• The maximum amount to which the insurer will pay the costs or damages.

• In relation to health, automobile, travel and property insurances.

Example: A health insurance plan has a cover of ₹5 lakh and the insured's medical emergences bills are ₹3 lakh, the insurer will pay ₹3 lakh. If the bill is ₹6 lakh, then insurer pays out ₹5 lakh from pocket and the remaining ₹1 lakh has to be paid by you.

6.5.4 Claim and Settlement

A claim is the application submitted by the policyholder or beneficiary to an insurance company, regarding their intention to move forward with coverage based on the terms of the contract.

Claim Process:

Notification: Reporting the event (accident, hospitalization, death, etc.) to the insurer.

Documents required: Proofs in the form of medical report, FIR, death certificate etc.

Assessment: Insurance provider reviews if event falls under cover and documents are genuine.

Compromise: In the event of a compromise settlement, the insurer pays claim amount.

Settlement Types:

• Cashless Settlement : Frequent in health and motor insurance; the cost is directly disbursed to the service provider (hospital or garage, etc).

• Reimbursement Settlement:Policyholder pays first and then submits for reimbursement.

Quick and effortless claims settlement leads to trust being built in an insurance company and is a performance indicator for the industry.

6.5.5 Surrender Value

The surrender value is the payment a policyholder receives when they cancel their policy before it reaches maturity. It primarily applies to life insurance policies that include a savings or investment feature, such as:

• Endowment plans

• Whole life policies

• ULIPs

Important Points:

• Not applicable for the first few premiums (generally 2–3 years) paid.

• It has a surrender value less than the total premiums paid, particularly in the policy's early years.

• Amount ($) includes the applied percentage of bonuses or investment gains (if any) less charges.

To do so could mean a substantial monetary loss and loss of policy benefits.

6.5.6 Riders and Add-ons

Riders (for life insurance) and add-ons (for general insurance) are optional covers that can be appended to a base insurance policy for an additional premium. They assist in tailoring the policy in line with the requirements of the insured.

Life Insurance Riders:

• Accidental Death Benefit Rider: Provides an extra amount if death is as a result of an accident.

• Critical Illness Rider: Provides a lump sum upon testing positive for certain illnesses (such as cancer, heart attack).

• Waiver of Premium Rider: Gests you will future premiums if the insured experienced disablement or serious illness.

General Insurance Add-ons:

• Zero Depreciation Cover: In a motor policy it enables full settlement without account for depreciation.

• Room Rent Waiver: In health insurance, does away with the limit on hospital room rent charges.

• Consumables Cover: This takes care of consumable charges that include gloves, masks, and syringes during hospitalisation.

Riders and add-ons enhance policy coverage however they also increase the premium hence should be availed as per real risk requirements.

6.6 Summary

ϖ Insurance is a risk management and financial tool.

It is based on concepts such as the principle of uberrima fides, insurable interest and indemnity.

ϖ Insurance is a guarantee that provides financial support in time of emergency.

ϖ It is a vehicle for economic growth and encourages long-term saving.

ϖ The insurance can be pure risk based or investment linked.

ϖ Term insurance does not provide any Maturity Benefit.

¬ ULIPs and endowment plans offer the benefit of insurance + investment.

ϖ Investment-linked insurance tends to have higher premiums and a lower flexibility.

ϖ Frequent terms are policyholder, insurer, premium and sum assured.

ϖ Claims are requests for compensation made to the insurer formally.

ϖ There is a surrender value upon premature termination of the policy.

– (freerider.com) and the optional extras it offers to custom fit your coverage.

ϖ Knowing these ideas is helpful in selecting the right insurance plan.

6.7 Key Terms

policyholder The owner and payer of the insurance policy.

Insurer: The company that offers insurance and accepts the risk.

Premium: The sum paid by the insured to the insurance company in return for protection.

Sum Assured: The uppermost limit of the claim which an insurer will pay in an eventuality.

Claim: A demand to the insurer for payment of the benefits provided by a policy.

Indemnification: The act of settling the approved amount of a claim.

Wærwerte: The money to be paid upon discontinuance of a policy.

Riders: Optional enhancements to a base policy for added coverage.

Coverage: The hazards and limit protected by the insurance.

6.8 Descriptive Questions

What is insurance?Explain the concept and significance of insurance with examples.

Describe the basic features of an insurance contract.

Explain the principle uses of insurance for individuals and society.

Explain the principle of uberrimae fidei. Why does it matter in insurance agreements?

Distinguish between Pure Risk cover and investment-linked insurance plans.

What is the advantage and disadvantage of insurance as investment?

Define premium and sum assured. What is the relationship between them in a policy?

Describe the claim-settlement procedure in life, and general insurance.

What is Life Insurance Surrender Value and When Do You Get it?

Explain the significance of riders and add-ons in insurance policies.

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Answers to Knowledge Check

Knowledge Check 1

1. B. Risk protection
2. C. Term insurance
3. C. Invested in markets
4. C. Complex structure

Introduction

Insurance is not just a financial product; it’s a shield against the unpredictable moments in life and the ruin they can bring. Whether it's life-threatening illness, the death of a loved

one or property loss, insurance allows you to keep functioning and prospering. In this caselet, we discuss how a health insurance product was at the center of helping one middle-class family to navigate through a significant health crisis and thus help us to appreciate that insurance is more than just a theory.

Background

The Sharmas, an average middle income family based out of Pune were a couple who thought twice and weighed options thrice, especially when it came to finances. Mr. Sharma, who is 42-year-old marketing executive, had bought a family floater policy insuring himself, wife and two children. Coverage was ₹10 lac, including cashless hospitalisation and critical-illness cover.

One day, Mr. Sharma developed acute chest pain and was diagnosed with heart trouble which demanded an immediate surgery. The total expenditure for the surgery, post-operative care and medications were somewhere around ₹ 6.5 lakhs which would have literally destabilized a middle class family if not covered in health insurance.

Problem 1: Responding to Unanticipated Financial Stress

Had they not been insured, the Sharma family would likely have had to use their savings or borrow money. This might have delayed plans for their children's educations or increased long-term debt.

Solution

With the benefit of right planning and sound health policy, insurance took care of all hospital bills on cashless claim basis, so that family didn't have to worry about the expense and could devote 100% attention towards recovery.

Problem 2: Puzzling Over Policy Language and Coverage

At the beginning, the family was not aware of what terms did the critical illness rider become applicable which resulted to confusion during claims.

Solution

They came to know through a claims manager and the insurer's customer service support how the rider of ₹2 lakh lump sum payout for post-operative was available. The point was: One should read policy T&Cs properly while buying insurance.

Problem 3: Long-Range Financial Planning AFTER Recovery

The family took some time to recover, then re-evaluated its financial and insurance situation. They understood that they needed life insurance and a term policy on top of everything.

Solution

Term plan Mr. Sharma bought a term life insurance policy to secure his family's future. They also chose super top-up health insurance to raise their coverage without breaking the bank, should they have more medical needs down the road.

MCQ Sample Questions

What saved the Sharma family from a financial catastrophe during their medical crisis?

A) Personal loan

B) Family savings

C) Policy with cashless claim option

D) Employer reimbursement

Answer: C) Currency note which does not have reversal query companion.

What was the family's lesson about riders in insurance?

A) Riders increase premiums

B) Riders are not useful

C) Riders require detailed understanding

D) Riders are automatically applied

Answer: C) Riders need detailed comprehension

Conclusion

And the case shows that insurance is not only a legal or financial obligation but also a potentially live-saving support. Flexing with health insurance and knowing what to do, the Sharma family came through a crisis poised and prescient. The case is a reminder that it pays to know what your coverage covers, take long-term risks into account and align insurance with one's goals in life.

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Unit 7: Insurance – Part II: Operations & Industry Landscape

Learning Objectives

1. Understand the operational framework of insurance companies, including underwriting, claims processing, and policy servicing.
2. Explain the role of regulators like IRDAI in governing the insurance industry in India.
3. Identify the key participants in the insurance ecosystem, such as insurers, agents, brokers, and TPAs.
4. Analyze the insurance value chain, from product design to customer service and renewal management.
5. Differentiate between various distribution channels, including bancassurance, online platforms, and agency networks.
6. Evaluate the impact of technology and digital transformation on insurance operations and customer experience.
7. Assess market trends and challenges shaping the insurance industry landscape in India and globally.

Content

7.0 Introductory Caselet

7.1 Operations of Insurance Companies

7.2 Types of Insurance

7.3 Insurance Products

7.4 Regulation by IRDAI

7.5 Leading Insurance Companies in India

7.6 Summary

7.7 Key Terms

7.8 Descriptive Questions

7.9 References

7.10 Case Study

7.0 Introductory Caselet

A rising player in the life and health insurance provider realm, LifeSure Insurance Ltd. had started emerging as a favored alternative amongst tier-2 and tier-3 cities, premised on its unparallel low-cost health insurance plans. In order to gain market share, the firm offered loose underwriting guidelines and streamlined claim procedures, resulting in thousands of policyholders within a matter of months.

Initially, the strategy worked. Policies sold tripled in one year and premium collections skyrocketed. The management toasted what looked like a successful expansion. Nevertheless, by the second quarter LifeSure was struggling financially. Payouts on claims had risen sharply, and the company's claims ratio — the share of claims it paid out as a percentage of the premiums it collected — was well above industry averages.

A closer review found that lax underwriting was failing to accurately screen for the risk of illness in many applicants. Therefore, many high-risk people had been able to obtain coverage at low rates. Moreover, lax verification had led to some false claims being overlooked.

The Chief Risk Officer has questioned the sustainability of this approach. In reply, the company brought out a new underwriting model which included data analytics and medical scoring. They also have been tightening the claims adjudication process with pre-authorization controls and post-claim reviews. Even as the pace of new policies slackened, its loss ratios improved and the solvency margin was restored.

LifeSure's management now confronted a classic trade-off: aggressive growth vs. prudent risk management. The trick was to balance out being able to keeping it financially viable with maintaining that trust of your customers.

Critical Thinking Question:

How do insurance companies reconcile their thirst for fast expansion into the market with the necessity of good underwriting and claim management?

7.1 Operations of Insurance Companies

7.1.1 Underwriting Process

Definition:

Underwriting is the method by which an insurance company considers, classifies and rates a risk to decide either to insure it or not, and then identifies the terms (rating) of that acceptance.

Purpose:

- To make certain the insurer is taking on risks in a measured way.

• To strike the profitable relationship between claims and premiums.

Steps in the Underwriting Process:

Application Review - This is the collection of information about an applicant's personality, background or lifestyle (in life/health), property (in general) and business practices (commercial).

Risk Assessment – Evaluates the level of risk by employing actuarial data and underwriting standards.

Risk groups: Applicants are classified into their appropriate risk classification – preferred, standard, and substandard.

Decision Making: The underwriter decides whether to reject the risk outright, accept it as is or make adjustments (such as charging a higher premium or restricting coverage).

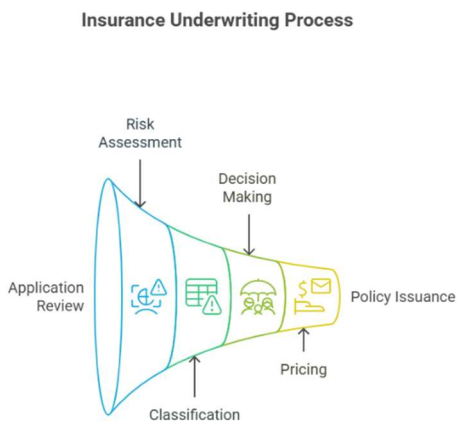
Pricing: The ultimate price is based on the risk; taxed or premium charged.

Types of Underwriting:

• Medical Underwriting: Life and Health insurance underwritten on the basis of health risk.

• Value: Financial Underwriting value to be established.

• Moral Underwriting: Evaluates the character of insured.



7.1.2 Policy Issuance and Administration

Policy Issuance:

This includes the legal act of issuing the contract once a decision to underwrite has been made and a premium paid.

Key Activities in Policy Issuance:

Issuance of Documentation: 1) Policy document, schedule and endorsements are prepared.

Formation of contract: A binding contract is formed between the insurer and insured.

Delivery: The policy is sent (usually with certification) to the insured.

Policy Administration:

This is the like management for a policy's life cycle.

Core Functions of Policy Administration:

• Endorsements: Processing endorsements (e.g. a change on the policy).

• Renewals-: Handling the policy continuation when it reaches at the end.

• Management of Lapse: Monitoring the non-payment of premiums, and processing through grace periods or reinstatement.

• Customer Care: Responding to questions from policyholders and providing guidance.

Technology in Administration:

Most insurance companies use core policy administration systems (PAS) to automate and modernize operations, so they can process transactions with precision, comply with regulations and respond fast.

7.1.3 Premium Collection and Fund Management

ArrayCollection and funds management

Premium Collection:

The process of policyholders paying money for coverage.

Collection Methods:

• Direct debit or bank transfers

• Credit/debit cards

• Cash or cheque payments

• Online payment portals

Premium Billing Cycles:

• Annual

• Semi-annual

• Quarterly

• Monthly

Grace Period:

A stipulated period of time after the premium due date where the policyholder can still pay his or her past due premium and have no lapse in coverage.

Fund Management:

After receiving the premiums, insurance companies aggregate them and invest the money to make profits in order to remain financially stable.

Key Areas of Fund Management:

Asset Allocation: The manner in which money is divided among various classes of assets (stocks, bonds, real estate.

Liquidity Management Making certain that enough cash and near-cash assets exist to pay claims and meet other operational needs.

Regulatory Guidelines: Investment guidelines should comply with regulations of regulators like IRDAI in India.

Overage and Profit Distribution: Excess earnings can be as bonuses (in participating policies), retention or re-investment.

Actuarial Oversight:

Fund managers depend on so-called actuaries to predict liabilities and make sure reserves are enough.

7.1.4 Claims Management and Settlement

Claims Management:

This is the full end-to-end procedure in processing and settling of claims being submitted by policyholders.

Stages of Claims Management:

Notice of Claim: Reporting incident or loss by policyholder or assignee to the insurance company.

Submission of Documents: The requisite documents (death certificate, medical papers, FIR) are submitted.

Claim Review: Review of claim to ascertain its legitimacy and whether it falls within the policy coverage.

Determination, Findings and Decision: Claim is either accepted or denied on basis of conditions and circumstances.

Settlement: If accepted, payment is issued to the policy owner or beneficiary.

Types of Claims:

• Cashless Claims: Routine in health and motor insurance; the insurer pays bills directly to service providers.

• Reimbursement Claims: In this the policy holders are required to bear the expense at first and then reimbursement from insurer.

Fraud Detection and Prevention:

Leveraging analytics and investigation units to identify false claims and uphold integrity.

Turnaround Time (TAT):

Regulators say insurers must pay up claims within a certain time.

7.1.5 Risk Management and Reinsurance

Risk Management:

The practice of measuring , analyzing and managing the types of loss exposure in your insurance portfolio.

Roles of Risk Management Department in Insurance Firms:

• Setting underwriting limits

• Managing claim ratios

• Controlling exposure to high-risk areas

• Diversification between regions, sectors or policy type

Tools Used:

• Risk-based capital models

• Predictive analytics

• Catastrophe modeling

Reinsurance:

Reinsurance is the practice by which an insurance company (the ceding company) transfers portions of its risk to another insurance company, reinsurer. This assists the primary insurer in its risk management, financial stability and protection against extraordinary losses. It is, essentially, “insurance for insurance companies.”

Purpose of Reinsurance

Spreading Risk and Preventing Insolvency:

That's because if an insurance company underwrites lots of policies and then a significant number of claims come all at once — as in the case of a natural disaster — it might not have the funds to cover those claims. Reinsurance serves to spread that risk, so no one company is left bearing the full brunt of a catastrophic event.

Increasing Underwriting Capacity:

Reinsurance enables insurers to underwrite bigger or more coverages than they would have had capacity for on their own. By transferring at least some of the risk off their books, insurers can release capital to write more business.

Stabilizing Financial Results:

Claims are subject to blips from year to year in any event. Reinsurers help damp out these spikes, leading to more predictable financial performance.

Protection Against Catastrophic Losses:

Natural disasters like earthquakes or floods or enormous industrial accidents can lead to huge claims. This is where reinsurance comes in as a financial backstop.

Types of Reinsurance

Facultative Reinsurance:

Here, the reinsurer reviews and approves or denies specific risks presented to it by the ceding company. When an insurance company underwrites a policy of ₹500 crore for a skyscraper, it may choose to purchase facultative reinsurance cover because its exposure in a single location is very high.

Treaty Reinsurance:

Under treaty reinsurance, a ceding company and a reinsurer enter into contract that automatically covers a class or type of risk, such as all automobile policies or all fire insurance policies. This makes life easy, and ensures continuous protection, without having to negotiate each risk.

Types of Reinsurance Contracts

Proportional Reinsurance:

Under this arrangement, a reinsurer participates I net premiums and losses at a constant percentage. There are two main forms:

o Quota Share: The reinsurer receives a fixed percentage on each policy. For instance, if a company has a 40% quota share agreement and it insures a factory for ₹1 crore, the reinsurer assumes ₹40 lakh of the risk and gets 40% of the premium.

o Excess of Loss : Here, the insurer covers the full damage up to a certain level and from there on it's reinsurer reimbursement. For example, if the insurer keeps ₹10 lakh on each policy and writes a ₹50 lakh policy, then only ₹40 lakh is covered by the reinsurer.

Non-Proportional Reinsurance (Excess of Loss):

In this kind of arrangement, the reinsurer pays out only if losses surpass a certain limit. For instance, an insurer with a retention of ₹1 crore but incurring a loss of ₹3 crore would have the excess band covered by the reinsurer. This approach is popular for disaster recovery.

Global Reinsurers

Reinsurance is a very specialised global business. A few of the largest and most well known reinsurers are:

• Swiss Re (Switzerland)

• Munich Re (Germany)

• Hannover Re (Germany)

• SCOR SE (France)

• Lloyd's of London (UK, is a market for reinsurance

These companies also help keep global insurance afloat by absorbing large risks that could potentially swamp national insurers.

Example in Practice

Suppose an Indian insurance firm underwrites a ₹500 crore policy on a big airport. It can't take all of the risk upon itself. The insurer may retain ₹50 crore and cede the balance of ₹450 crore to several reinsurers. If a large accident for example cost ₹ 300 crore the insurer pays ₹ 50 crore and the re-insurers pay balance of ₹ 250 crore. This shields the ceding insurer from ruinous financial exposure.

"Activity: Understanding Risk Transfer through Reinsurance"

Form small groups and select an example of a natural disaster (e.g., flood, earthquake). Discuss how an insurance company might manage its risk exposure using reinsurance. Identify which type of reinsurance (facultative or treaty) would be more suitable and justify your choice with reasoning based on potential losses.

7.2 Types of Insurance

7.2.1 Life Insurance

A life insurance policy is a legally binding contract between a policy owner and the insurance company, in which the insurer agrees to pay an established amount to the designated benefici- ary when the insured dies or at another agreed upon time. Life insurance is also used as a saving/investment and tax planning tool.

Term Life Insurance

Explanation:

The most basic and cheapest type of life insurance is term life insurance. It offers economic safeguard for a predetermined duration or "term" (such as 10, 20, or 30 years). If the insured died during the term, the policyholder receives a death benefit from the insurer. If the policyholder survives the term then no benefit is paid out unless it was a return of premium policy.

Advantages:

- High coverage for low premiums
- Easy to understand and manage
- Temporary needs (such as covering a home loan)

Limitations:

- No maturity benefit
- Life insurance stops when the policy term ends, unless it’s renewed

Whole Life Insurance

Explanation:

The coverage of a whole life insurance policy extends until the death of the insured person or a defined age (typically 100 years). In case of demise, the ‘sum assured’ is given to the nominee. And it builds a cash value over time, against which you can borrow, or make partial withdrawals.

Key Features:

- Payout guaranteed for life or to age 90
- Fixed or level premiums
- Builds cash value (savings component)

Use Case:

Good for estate planning, or securing the financial future of the dependents after your lifetime.

Endowment Plans

Explanation:

Endowment policy is a combination of investment and life cover. It disburses the death benefit during the policy term or a maturity benefit if the policyholder survives.

Highlights:

• Encourages disciplined savings

• Participating plans offer bonuses

• Can be put to use for investment purposes such as education, marriage etc.

Caveats:

• Premiums are substantially more than term insurance for the same amount of cover

• Returns are relatively conservative

Unit Linked Insurance Plans (ULIPs)

Explanation:

ULIPs are market-linked insurance products that offer the combination of life cover and investment. Part of the premium is used to provide for life cover and the balance is invested in equity, debt or balanced mutual fund-like instruments.

Salient Features:

• Freedom to select or switch funds depending on risk appetite

• Clarity of fees and fund performance

• Lock-in period of 5 years

• Build and Protect Assets with One Policy

Risks:

Returns are influenced by the stock market

Complicated fee structure for more traditional plans

7.2.2 Non-Life Insurance (General Insurance)

Non-life insurance consists of a variety of policies that offers protection for anything other than life. These are some of the health, motor, property, marine and liability risks.

Health Insurance

Explanation:

Health insurance covers treatment for the costs of one's health care from a state of illness or injury, including hospitalization. One of the most important classes of general insurance for a person and his household.

Key Benefits:

• Covers inpatient and outpatient treatment

• Daycare treatments*, ambulance charges, pre- and post-hospitalization

• Cashless treatment at network hospitals

• Tax deduction available under Section 80D on the Income tax act

Special Plans:

• Critical illness cover

• Senior citizen plans

• Maternity benefits

Challenges:

• Waiting periods for certain diseases

• Co-payments and sub-limits that are built into some policies

Motor Insurance

Explanation:

Motor Insurance It is a coverage against financial loss as a result of damages to the vehicle, or if it causes harm to some other person's property in an accident caused by you.

Categories:

Third-Party cover: Insures against third party injuries/properties; required by law.

Full Coverage: This is when your insurance plan covers both deductibles and your personal property on a third-party claims.

Add-ons:

• Zero depreciation

• Engine protection

• Roadside assistance

Legal Requirement:

Compulsory - for all vehicle owners to have insurance or the like is required at least third party coverage.

Property and Fire Insurance

Explanation:

Property insurance protects physical assets — homes, offices, factories — from destruction or damage caused by fire, theft and elements like floods, earthquakes or riots.

Coverages Offered:

• Structural damage

• Furniture and fixtures

• Equipment and inventory

• Business interruption (optional)

Policy Types:

• Standard Fire and Special Perils

• Home Insurance

• Industrial All-Risks Policy

Additional Riders:

Cover for Earthquake, Cover for flood, Cover for terrorism

Marine Insurance

Explanation:

Marine insurance provides financial protection to goods, cargo and ships during transit by sea, air, rail or road.

Types of Marine Insurance:

• Marine Cargo Insurance: On the cargo such as commodity transported

• Hull insurance: For the vessel proper

• Freight Insurance : Insures the documents for protecting income of shipping company (freights).

Risks Covered:

Berry, fire, stranding, piracies, jettison and others

Importance:

A must have for and companies doing import/export or supply chain management

Crop Insurance

Explanation:

Crop insurance is a type of insurance that offers protection to farmers against the damage caused by natural disasters, insects and diseases on their crops. It provides security through stable income and helps to maintain the sustainability of agriculture.

Major Coverages:

- Loss originating from droughts, floods, hailstorms etc.,
- Pest attacks and diseases
- Pre-sowing and post-harvest losses

Popular Schemes (India):

- PMFBY: It refers to Pradhan Mantri Fasal Bima Yojana.
- Weather-Based Crop Insurance Scheme (WBCIS)

Implementation:

Typically government-sponsored and administered by insurance companies in cooperation with the agricultural department.

Liability Insurance

Explanation:

Liability insurance under a D&O policy shields the director or officer against legal responsibility for damages, financial losses, or other money damage claimed to have been sustained by others as the result of some action or actions taken by the individual in his official business capacity that resulted in injury.

Major Types:

Public Liability Insurance – providing cover for injury or damage to the public

Product Liability: For manufacturers of products that contribute to injury

Professional Indemnity: Professional service providers such as doctors, lawyers, architects etc

Employer's Liability for law suits from employees against employers

Coverage Includes:

• Legal defense costs

• Compensation to affected third parties

• Settlements and judgments

Industries that Rely on It:

Healthcare, manufacturing (automobiles), IT services, real estate and logistics

Accidental Insurance

Accidental insurance is a cover, which provides financial security in case of the death, disability, or injury resulting from an accident. It's purposed to help when tragic events occur in your life that could lead to medical expenses, loss of income or disability.

Key points:

• What's covered: Provides benefits in the event of accidental death, permanent total disability, partial disability and occasional temporary loss of income resulting from accidents.

• Medical bills: Many policies include hospitalization, surgery and rehabilitation costs for accidental injuries.

• Loss of Income: Compensates to the family members in the event of permanent disability or death because of an accident.

• Lower Premiums: When compared with health or life insurance, accidental insurance is usually very cheap to buy.

• Add-on Feature: It is commonly provided as a rider or add-on to the current life or health insurance policy.

• Benefit: Protects your family from financial troubles in case of an accidental death, the cost of which could be serious consequences when you are a part of risky professions or have frequent travel.

Knowledge Check 1

Choose the correct option:

1. **Which type of insurance provides coverage for a specific period and pays only on death during the term?**
   a) Whole Life Insurance
   b) ULIP

c) Term Insurance
d) Endowment Plan

2. **What does health insurance typically cover?**
   a) Vehicle damage
   b) Medical expenses
   c) Fire accidents
   d) Legal liabilities

3. **Which insurance combines life cover with market-linked investments?**
   a) Term Plan
   b) Whole Life Plan
   c) ULIP
   d) Endowment

4. **What is the main purpose of marine insurance?**
   a) Vehicle repairs
   b) Cargo protection
   c) Health safety
   d) Tax savings

7.3 Insurance Products

7.3.1 Individual vs Group Insurance Products

For an insurance product there are manydesign choices, the most important of which is whether it will available for individual or group purchase.centextAlignment-652013 Dec(1972)13–205.

Individual Insurance Products

Definition:

Processes One Person Policy Where policy, premium and benefits are tailor-made depending on the profile of insured.

Features:

• Customized coverage

• Personal premiums according to risk factors(age, condition, way of living)

• Flexibility to choose sum assured and add-ons

• For life, health, motor and/or property insurance

Example:

A personal health insurance policy that provides a reimbursement of the insured person's medical costs with possibilities to add coverage for serious illness and maternity.

Group Insurance Products

Definition:

Onn one policy for several people - normally of an organisation's or business' employees, society members.

Features:

• Comprehensive coverage for all participants under one agreement

• Risk pooling to lower the cost of premiums

• Frequently available as a workplace perk

• Typically renewable annually

Example:

Corporate group health insurance offered to employees, and occasionally their dependents.

Key Differences:

Criteria	**Individual Insurance**	**Group Insurance**
Policyholder	Individual	Organization/Group Admin
Premium	Based on personal profile	Based on group demographics
Customization	High	Limited
Continuity	Long-term	Generally one-year renewable

Did You Know?

"Group insurance policies often offer lower premiums compared to individual plans due to risk pooling across members. However, coverage under group insurance usually ends when the member leaves the organization, whereas individual policies remain in force as long as premiums are paid, offering more long-term security and flexibility."

7.3.2 Micro-Insurance and Rural Insurance Products

Micro-Insurance Products

Definition:

Basic insurance products provided for the poor and/orand"- -orthe informal sector, with low premiums and lower benefits.

Features:

• Simplified documentation and processes

• Small sum assured

• Affordable premium

• Life, health, accident or asset protection cocciakukan

Purpose:

For providing access to financial services and protecting the economically vulnerable.

Example:

Life micro-insurance products for daily wage earners with premiums starting at ₹50 a year.

Rural Insurance Products

Definition:

Insurance policies designed to suit local conditions in the rural context, frequently covering agricultural and livestock risks or rural health.

Features:

• Meant For farmers, craftsmen and petty traders

• Protection for farm assets, crops, weather risks

• Support government schemes like PMFBY

Types of Coverage:

• Cattle insurance

• Tractor insurance

• Rural health insurance

• Gramin personal accident cover

Challenges Addressed:

Low penetration of insurance, financial awareness and access to infrastructure in rural regions.

7.3.3 Specialized Insurance Products

These are types of insurance that cover less common or new types of risks that would not generally be covered under standard policies.

Travel Insurance

Definition:

Defends your against unexpected accidents, loss and damage while traveling in the country or abroad.

Common Inclusions:

• Trip cancellations or delays

• Lost baggage or passports

• Medical emergencies

• Accidental death or disability abroad

Variants:

• Single-trip or multi-trip plans

• Student travel insurance

• Corporate travel insurance

Use Case:

A must-have for men and women who travel out of the country on a leisure, business or study trip.

Crop Insurance

Definition:

Features remuneration to farmers for losses or damages resulting from natural disasters, pests and diseases.

Key Features:

• Covers pre-sowing to post-harvest stages

• Government subsidized premiums (in India)

• Yield-based or weather-based loss assessment

Popular Scheme:

Pradhan Mantri Fasal Bima Yojana (PMFBY) 36.

Importance:

Protects farmer revenue and enhances agriculture sustainability.

Cyber Insurance

Definition:

Covers financial loss and liability if you're hacked, your data is breached or a digital threat occurs.

Key Coverages:

• Data loss or theft

• Business interruption due to cyberattack

• Lawsuit costs for data privacy violations

• Extortion or ransomware attacks

Target Users:

Corporates, banks, IT firms and now even individuals

Growing Relevance:

As the process of digitalization advances, the danger of cyber threats also rises and cyber insurance becomes a key component towards minimizing these risks.

Keyman Insurance

Keyman 'Keyman' means an employee who possess the key to operational success of the business and his loss due to death or disability would result in financial loss for the business. The "keyman" is typically someone whose talent, expertise or leadership is crucial to the firm's prosperity.

Key Features

• Policy Ownership: The Corporation buys and retains ownership of the policy.

• Key Person: Insured _ The employee whose efforts are critical to the operation of the business.

• Beneficiary Who Gets the Insurance: The insurance goes to the company, not an employee's family.

• Premium Payment: Paid by the corporation as a business expense.

Purpose

• Money: Supplies money to offset lost profit and/or cover known debts.

• Continuity: To keep up the day by day functioning till substitute is on board place.

• Creditworthiness: Makes the company seem more credible to banks and investors; it demonstrates risk management.

• Retention: Demonstration of value to the organization.

Benefits

• Pays the cost of recruiting and training a replacement.

• Assists in retaining investor and customer confidence following the passing of a key figure.

• Provides financial support to maintain profitability and business stability.

• Can roll out money to pay back loans that were predicated on the insured employee's presence.

7.4 Regulation by IRDAI

7.4.1 Duties, Powers & Functions of IRDAI

Legal Background:

Constituted under the IRDA Act, 1999, IRDAI is an autonomous statutory body which works under the Government of India and Ministry of Finance.

Duties of IRDAI:

Regulation and Development of Insurance Sector: To safeguard the interest of policyholders, promote orderly growth of insurance industry life and general segment.

Safeguard Policy holders : Ensure fair treatment and settlement of the policyholders.

Support Market Integrity: Encourages fair competition and a well-functioning financial system among players.

Key Powers of IRDAI:

• Issuing and cancelling licenses of insurance companies and intermediaries

• Posing rules and recommendations for operational fulfillment

• Conducting inspections, audits, and investigations

• Levying penalties for non-compliance

• Approving mergers, acquisitions, and transfers of insurance businesses

• Approving insurance premiums and products

Major Functions:

• Standards: Regarding solvency margin, administration of assets, investment of funds and agent education.

• Watching the Solvency Ratio: The state makes sure your insurers have enough capital to pay claims.

• Product Approval: Review and approve new insurance product prior to market launch.

• Monitoring Distribution Channels : Monitors of agents, brokers, corporate agents and web aggregators as well as bancassurance.

• Consumer Awareness: Educates the public as part of the Insurance Awareness Campaign.

Regulatory Ecosystem:

IRDAI works in tandem with other financial regulators viz., SEBI, RBI and PFRDA particularly relating to hybrid products and the supplemental jurisdiction.

7.4.2 Protection of the Interest of the Policy Holders

Objective:

To guarantee that policyholders receive fair and equitable treatment and that their interests are safeguarded during the entire life cycle of a contract — from purchase to claim settlement.

IRDAI's Key Measures for Protection:

Standardization of Policy Documents:

Make certain that policy terms are clear, plain and easy to read.

Mandated Disclosures:

At the point of sale, insurers will have to reveal in writing all costs, benefits, exclusions and "lock-in" periods.

Free Look Period:

15-day free-look period for cancellation and refund of premium subject to some nominal deductions from the date of receipt of policy.

Grievance Redressal Mechanism:

• Insurers must have an identified officer of grievance redressal.

• IRDAI's Integrated Grievance Management System (IGMS) provides a facility of registering and monitoring the complaints.

• Recourse can be given to the Insurance Ombudsman at no cost of litigation.

Claim Settlement Guidelines:

• Time-bound processing of claims (30 days for non-investigated claim and 120 days in case of investigated claims).

• Interest payable on delayed settlements.

Mis-selling Prevention:

• Agents subject to strict licensing and training

• IRDAI's Guidelines on POS - Products to make things easier for low-risk customers.

• Ban on misleading advertisements

Data Privacy and Confidentiality:

Insurers have to comply with standards for safe handling of customer data and obtain informed consent before sharing details.

Oversight on Service Quality:

The insurers are regularly inspected and audited by IRDAI for service standards and policyholders experience.

"Activity: Exploring IRDAI's Role"

Students will visit the official IRDAI website and identify one recent regulation or circular related to policyholder protection or insurance company conduct. They will briefly present how this regulation impacts either customers or insurers, emphasizing IRDAI's role in maintaining transparency, fairness, and trust in the insurance industry.

7.5 Leading Insurance Companies in India

7.5.1 Public Sector Insurers

Public sector insurers being PSU(i.e. Public Sector Undertakings) are wholly owned by the Government ICICI Lombard is 30% owned by Copperagemuller Braun & Schell Inc, an American firm It is a non-governmental organisation, Det Norske Veritas holding remaining 16%.These Insurance companies intially came under purview of Controller of Capital Issues

but now IRDAI i.e. Regulatory authority now called as Insurance Regulatory and Development Authority has these companies under its purview. They have good credibility, are well-spread-out in terms of their branches and hold large part of the Indian insurance market.

Life Insurance Corporation (LIC)

• LIC is the richest life insurance company in India, which was established in 1956.

• The company is a market leader in life insurance.

• Provides endowment plans, term policies, whole life payable at age 100 policies and isurance cum pension products and ULIPs.

• Widely available in rural areas and focused on social security.

General Insurance Corporation (GIC)

• GIC is the only national reinsurer in India.

• Offers reinsurance support to direct insurers in India and other countries.

• Significantly used for risk spread across health, motor, marine and agriculture sectors.

• Has a global presence and is traded on Indian stock exchanges.

4 Public Sector General Insurance companies:

National Insurance Company

o Based in Kolkata, provides general insurance throughout India.

o Motor, health, rural and fire insurance products are its signature products.

New India Assurance

o The biggest public sector general insurance company.

o Operates in 28 countries.

o Provides a range of products from industrial, marine and liability to rural insurance.

Oriental Insurance Company

o Products personalised and great customer service.

o Provides policies for individuals, SMEs and corporates.

United India Insurance Company

o Operates with over 1,300 offices.

o Provides products such as motor, fire, liability, marine and personal accident.

7.5.2 Private Sector Insurers

Joint ventures, including partnerships with international players, allowed entry of private insurers in the Indian insurance sector after liberalization. These companies have led in product design, digital distribution and customer experience.

Private Life Insurers:

ICICI Prudential Life Insurance

o Joint venture of ICICI Bank with Prudential Corporation (UK).

o First private Life Insurance Company to be listed in India.

o Provides ULIPs, term plans, retirement plan.

HDFC Life Insurance

o Pioneer life insurance company and one of the digital leader.

o Providing complete life-stage products for all stages of lives.

o Strong focus on technology integration.

SBI Life Insurance

o State Bank of India & BNP Paribas Cardif are the joint venture.

o Makes use of the extensive branch network of SBI for distribution.

o Supply's savings, casualty and retirement plan.

Max Life Insurance

o Max Financial Services and Axis Bank have a joint venture.

o Emphasizes on long-term savings and protection plans.

o They have a reputation for higher claim settlement and strong customer service.

Private General Insurers:

ICICI Lombard General Insurance

o The one of Largest private General Insurance Company in India.

o Provides insurance for motor, health, travel, home and business.

o Emphasizes technology-driven claims management.

HDFC Ergo General Insurance

o A joint venture of HDFC Ltd and ERGO International (Germany).

o Offered the sales of retail and corporate insurance products.

o Renowned for handling claims smoothly and being digital savvy.

Bajaj Allianz General Insurance

o Joint venture between Bajaj Finserv and Allianz SE (Germany).

o Promotes a variety of items and provides effective tools to engage customers.

o Fully developed online web and mobile policy servicing platforms.

7.5.3 Trends in Indian Insurance Sector

The insurance ecosystem in India is experiencing a sea change under impetus of technology, regulation and customer requirement.

Digitalization of Insurance Services

• Policy servicing through mobile apps, online portals and chatbots.

• E-KYC and digital onboarding mean less paper and faster processing.

• Robo-advisors assist customers in picking the right products.

Usage-Based and Personalized Products

• Motor insurance is seeing an increase in interest for pay-as-you-drive and telematics-based pricing.

• Lifestyle and wearable data analytics powered custom health plans.

Bancassurance and Alternate Distribution Channels

• Integration of bancassurance to extend the reach.

• Digitization of brokers, web aggregators and POS agents on the increase.

The Tier 2 Plus Rural Story Focus on the Upcountry & Rural Markets

• Basic micro-insurance products aimed at less well-served segments.

• By getting government schemes and reach into rural to improve penetration.

Regulatory Push for Customer Protection

• IRDAI steps to make ULIPs and health products more transparent.

• Standardisation of policies such as Arogya Sanjeevani and Saral Jeevan Bima.

InsurTech Innovation

• Seed stage startups applying AI, blockchain and IoT to upgrade underwriting and fraud prevention.

• Policy management in the cloud and claims settlement in digital format.

Rise in Awareness Post-COVID

• Stronger appetite for term plans and health insurance.

• Move to risk coverage from saving oriented products.

7.5 Summary

ϖ Various Public and Private sector life and general insurance companies in India.

ϖThere is a strong presence of public sector insurers in life (LIC) and reinsurance targeted at the population pyramid respectively (GIC), while four leading general insurers are owned by the governments.

ϖLIC is India's largest life insurance company and has significant market penetration, especially in rural areas.

ϖ GIC is also the only national reinsurer, providing strength to direct insurers in their ability to write large & catastrophic risks.

ϖ Private Life Insurers like ICICI Prudential, HDFC Life, SBI Life and Max Life have brought innovation in terms of product design, customer service, digital interfaces etc.

ϖ Private-sector general insurance companies such as ICICI Lombard, HDFC Ergo, Bajaj Allianz provide motor, health, travel and commercial insura nce products.

ϖ Entry of the private players after 2000 has added a lot of innovations, competition and product variation in this sector.

ϖ Bancassurance, digital distribution & alternate channels have expanded the customer base and increased accessibility.

ϖ The industry is increasingly being driven by digital transformation, such as online policy issuance, mobile claims and AI-based customer service.

ϖ Personalized insurance products - Following behavior, usage, and lifestyle trends.

ϖ Focus on Tier 2 and rural markets is increasing by offering micro-insurance products & simplified policies.

ϖ AI, IoT, cloud-based platforms are being leveraged by InsurTech startups for a smooth customer experience and to avoid fraud.

ϖ The post-Covid era has raised awareness for insurance and health / protection based products.

7.6 Key Terms

Public Sector Insurers- These insurance companies are Government owned which provides life and general insurance.

Private Sector Insurers -Company owned insurance businesses with competitive products in the private sector.

LIC (Life Insurance Corporation) – The largest public sector life insurance company of India.

GIC (General Insurance Corporation) – India's sole reinsurance company helping in risk management.

Bancassurance – Sales of insurance products using banking channels.

InsurTech – Technology in the insurance sector to enhance service delivery and efficiency.

Telematics – Utilization of information from technology such as GPS to determine driving for motor insurance.

Micro-Insurance -Affordable insurance products for the low-income, informal sector.

7.7 Descriptive Questions

Write some differences between public sector and private sector insurance companies in India. Give examples of each and show how they function in the industry.

Explain the current trends in Indian insurance industry? How is the digitalization and InsurTech influencing the distribution and after sales service for insurance products?

What is the significance of LIC and GIC in Indian insurance? What do they do differently from private insurers?

Compare: Compare individual plans with group ones. For which kind it's better to use one and for which another?

What are micro-insurance and rural insurance products? Why, then, do they matter for financial inclusion in India?

Discuss the characteristics and advantages of cyber insurance. Why does it matter in the "new normal" digital world?

What is IRDAI's role over insurance companies? Describe its principal roles and powers.

How does IRDAI looks after the interests of policyholders? Explain the terms and conditions that it implements.

Write short notes on the role of some eminent private sector life and general insurance companies in India. What are they offering and how do they differ from public insurers?

Assess the effect of digital transformation and consumer-led innovation in the Indian insurance market. How have to insurers adjusted to new consumer behavior and expectations?

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Knowledge Check 1

Knowledge Check 1

1. c) Term Insurance
2. b) Medical expenses
3. c) ULIP
4. b) Cargo protection

7.10 Caselet Title

Introduction

Transformation is happening fast in India's insurance industry, spurred by digital innovation, changing customer expectations and regulatory changes. In fact, of the top players, there are two distinct models that exist — one modern private sector player known for his tech-driven agility (HDFC Life Insurance), and one legacy public sector giant with an unparalled reach and trust factor (Life Insurance Corporation [LIC] of India).

The caselet would be helpful in discussing how both companies face similar test, innovate to cater different customer requirements and deal with competitive pressures in a changing regulatory environment. It illustrates the operational, strategic and technology-led transformations that these insurers are driving to future-proof themselves in India's dynamic insurance landscape.

Background

LIC, which was established in 1956, has a strong presence in the life insurance segment with an extensive network in rural and semi-urban segments. Its power comes from its history, reach and brand credibility. But for everyone else, the company's reliance on old-fashioned paper systems and slow-moving culture are roadblocks to operating in a digital-first era.

HDFC Life, set up in 2000 after the sector was opened to firms post-liberalization, focuses on product innovation, digital onboarding and customer segmentation. Its nimble operations had made it good at reaching urban millennials and digitally savvy consumers.

Both insurers are also grappling with high consumer expectations, mounting regulatory pressure from the IRDAI and the urgency to digitize distribution and claims processing.

Problem Statement 1: Tradition and Modernisation Balance has been the idealPoliticians from both within and outside of southern Sudan convened to adopt a new constitution for the region.

LIC has a powerful brand and trust but struggles to embrace digital solutions rapidly through its vast network. It also means operating inefficiencies and delays in service, particularly in urban areas where private competitors are more tech literate.

Solution:

LIC also initiated measures such as LIC's Digital App and online premium payment and customer servicing options. It also partnered with fintech companies to launch digital onboarding process in some products, as it looked to improve customer experience even as not abandoning its brick and mortar channel of agents.

MCQ:

How is LIC planning to increase the customer servicing and in digitalisation?

A) Ignored digital technology

B) Shut down agent networks

C) Made deals with fintechs and introduced digital platforms

D) Increased premiums across products

Correct answer: C) Collaborated with fintechs and came out with digital platforms

Problem 2: Efficiently Serving the Under-Privileged Segments of the Market

HDFC Life, though digitally-forward, is unable to crack the rural and low-income markets because it has a limited brick-and-mortar footprint, and customers in these areas are sceptical about private insurers.

Solution:

HDFC life launched standard products such as Saral Jeevan Bima, simplified on boarding and tied in with micro finance institutions and post offices to sell policies. It also tasked local agents with facilitating the personal touch while relying on digital tools for backend processing.

MCQ:

What did HDFC Life do to overcome its rural market penetration issue?

A) no description which deals exclusively with 'urban' areas restricted to urban areas only

B) Raised product prices

C) Discontinued low-income policies

D) Teamed up with micro-finance organizations and employed simple products

Answer: D) Teamed up with micro-finance bodies and offered easy products

1.3 Problem Statement A third problem that has to be addresse is the fact that differentiating becomes harder and harder in a crowded market.

As there are more than 20 life insurers operating in the country, it is becoming increasingly challenging to differentiate based on product attributes. It can be really difficult for customers to comparison shop and buy the right insurance.

Solution:

Both LIC and HDFC Life offered product comparison tools, showed detailed benefit illustrations and carried out financial literacy drives. HDFC Life also highlighted the role of personalised digital solutions through AI driven chatbots, need based advisory platforms.

MCQ:

How are insurers standing apart in an increasingly crowded market?

A) Reducing features

B) Offering identical products

C) Enhancing transparency and personalization

D) Hiding charges and terms

Answer: C) Increasing transparency, and personalisation

Conclusion

The LIC-HDFC Life case brings out how insurers, both legacy behemoths and nimble-footed private ones, have to keep changing themselves in order to sustain. To remain profitable in such huge shift; digital transformation, strategic alliances, rural foray and customer centric innovation will be imperative to not only meet the regulatory expectations set by IRDAI but also gain long-term trust of policyholders in an evolving financial landscape.

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Unit 8: Mutual Funds – Part I: Basics of Investments & Mutual Funds

Learning Objectives

1. Funds based on risk, return, and liquidity.
2. **Understand the concept and structure of mutual funds**, including their formation, types, and functioning.
3. **Identify key stakeholders in a mutual fund** such as fund houses (AMCs), trustees, fund managers, and investors.
4. **Explain the benefits of mutual fund investments**, including diversification, professional management, and affordability.
5. **Describe different types of mutual funds** based on asset class, structure, and investment objective (e.g., equity, debt, hybrid, open-ended, ELSS).
6. **Interpret basic mutual fund terminologies** such as NAV, SIP, expense ratio, lock-in period, and entry/exit load.

Content

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8.1 Introduction to Investments

8.2 Meaning and Features of Mutual Funds

8.3 Advantages and Disadvantages of Mutual Funds

8.4 Advantages and Disadvantages of Mutual Funds

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8.8 References

8.9 Case Study

8.0 Introductory Caselet

Ravi, 28, a software engineer, had recently begun putting away some of his salary each month. So far, he had been parking his savings in a bank fixed deposit thinking it was the safest option. But after a discussion with colleagues, he realized that despite the safety fixed deposits offered, returns were limited and in many cases could not even keep up with inflation.

Keen to find alternatives, Ravi went to a money awareness seminar conducted by his company. There he discovered mutual funds — investment options in which money from individual investors is pooled and invested in equities, bonds or a combination of the two, managed by professional fund managers. He liked the ideas of Systematic Investment Plans (SIPs), diversification and long term wealth creation.

Still, Ravi was uncertain. He wasn't sure whether to stick to safe but low-yield deposits or start investing in mutual funds, which came with some risk but offered the potential of higher returns. He also wrestled with such questions as: Which mutual fund type should I select? Equity, debt, or hybrid? How much risk should I be taking at this point?

Ravi was very keen on taking a well-informed decision and went to meet an experienced financial advisor who suggested that he could begin small through SIPs in balanced (hybrid) fund. That let him get into market-linked investments while lessening the risk through diversification. Over the years, Ravi saw his investments grow, which in turn boosted his confidence and taught him why it is always best to think about finances in the long-term.

Critical Thinking Question:

Why do you think Ravi first needed to learn about the fundamentals of mutual funds before investing in them, and how were the concepts of diversification and risk reduction addressed?

8.1 Introduction to Investments

Investments An investment involves putting money or capital into an asset in order to obtain income or profit. People, companies, and institutions invest with the expectation of generating wealth, increasing their capital or earning income on a recurring basis. Equity shares, preference shares and debt instruments are some of the major types of investment vehicles.

• Equity Shares

Common stock, or common shares, are a form of ownership equity in a corporation. If people buy equity, they become partial owners and they get a portion of the profits in the form of dividends. But dividends are not guaranteed, and shareholders also carry

the greatest risk, particularly if the business does badly. In exchange, they have a potential for high capital gains if the company does well.

Example: Purchasing shares of Tata Motors on the stock market.

• Preference Shares

Preference shares are part equity and pay fixed regular dividends, with priority in a liquidation of the companies assets over ordinary shareholders. However, preference stock holders do not generally have a vote. They rank higher than equity shareholders for Dividends payments, which makes them less risky but lower return investment when compared to Equity.

Example: A firm issues preference shares at 6%, paying a fixed 6% to shareholders every year.

• Debt Instruments

Debt instruments are loans made from investors to borrowers, like companies or governments. The borrower agrees to return the principal plus a fixed amount of interest over a period of time. They are low-risk investment options, particularly with government bonds, and yield reasonable or fixed returns.

Some common debt instruments may include:

o Debentures: A company's unsecured loan.

Bonds: Issued by governments and corporations which are generally backed.

o Fixed Deposits (FDs): You can obtain FDs from banks with assured returns.

♣ For instance, purchasing a 5 year government bond with a 7% annual rate.

8.1.1 Equity as an Investment Option

Definition

Equity is ownership in a company. When you buy shares as an investor, you essentially are becoming part owner of that business. As co-owners, these individuals have the right to receive a share of the company's earnings that are distributed as dividends and they may also profit if stock prices increase in value. However, unlike fixed-income securities, with equity investments the company's performance and broader economic conditions, affect them because they have direct exposure to such things.

Features of Equity

Equity investments offer something different in that it reflects ownership in a company. The shareholders can collect dividends, but that is not assured and depends on the company's profitability and decisions taken by its board. One of the main allure of

equities is its significant growth potential, with shares possibly surging in value along with that of the company. Returns are tied to the market, rising (or falling) with company performance and macroeconomic conditions. In addition, stocks are traded on stock exchanges so liquidity is high, with investors able to buy and sell relatively easily compared to other asset classes such as real estate and other fixed income investments.

Pros of Equity

If you compare well with traditional investment options such as fixed deposits/bonds then equity can certainly give you good returns in the long run. It also offers a sense of ownership, A which gives shareholders the right to vote on certain matters that impact business operations. It also offers liquidity, because stocks can be bought or sold relatively easily on exchanges. What's more, stocks are typically a good inflation hedge, given the expected growth in company profits and stock prices that can exceed consumer-price growth over the long term.

Cons of Equity

But there are serious drawbacks to equity investments. They're considered high-risk because stock prices are volatile, bouncing around based on a variety of factors — economic conditions, market sentiment and company performance. Dividends (if declared) are not guaranteed to continue and may fluctuate. There is a loss of capital if the company does not do well or if market sentiment changes for the worse. Simply opening an account and waiting for your stock to go up doesn't work independently, it is vital to have market knowledge, time investment in researching stocks and keeping an eye on the business.

Comparison with Debentures

Equity should not be confused with similar financial instruments, such as debentures. Equity means that you own a part of the company and that is represented through stock. Debenuture is an borrowing by the company. Debenture holders have no ownership stakes but are paid fixed interest. Internationally, debentures are unsecured and do not have the backing of any asset. But in the Indian context, debentures are mostly secured with company assets kept as collateral to secure investors. That makes them safer than equity but with less potential return as well.

8.1.2 Debt as an Investment options

Definition:

Debt investments are a lender-investor's deposit of funds to the company, government or institutional borrower in return for holding a note. The borrower agrees to pay regular interest, and to repay the principal on maturity.

Features of Debt Instruments:

• Fixed income through interest payments

• Lower risk compared to equities

• Maturity period is predefined

• No holding of shares in the issuer

• Appropriate for conservative investors who desire stability

Pros of Debt:

• Provides stable and predictable income

• Safer compared to equity investments

• Preference over common equity in a liquidation

• Ideal for risk-averse investors

Cons of Debt:

• Lower returns compared to equities

• Interest income may be taxable

• Exposed to the risk of inflation (real returns could fall)

• Limited scope for capital appreciation

8.1.3 Types of Securities

Equity Shares:

o Represent ownership in a company

o Shareholders also get to vote and receive a dividend

o High Return potential coupled with market risk

Preference Shares:

o Offer a specified dividend and priority over equity stockholders in liquidation.

o Generally have no voting rights

o Safer than equity, but upside is limited

Bonds:

o Long-term obligation of a government or corporation

o Provide a fixed rate of interest and the payment of the principal at maturity

o Examples: Corporate bonds, municipal bonds

Debentures:

o Unsecured debt securities supported only by credit of issuer

o Pay regular interest

o More risky than secured bonds, but with potential for higher return DOC #1222191v3 4 Volatility The change in the price of Collateral from one day to the next due to movements in exchange rates.

Government Securities (G-Secs):

o Centrally or state governed outlets

o Assumed to be risk-free as it is sovereign-backed.

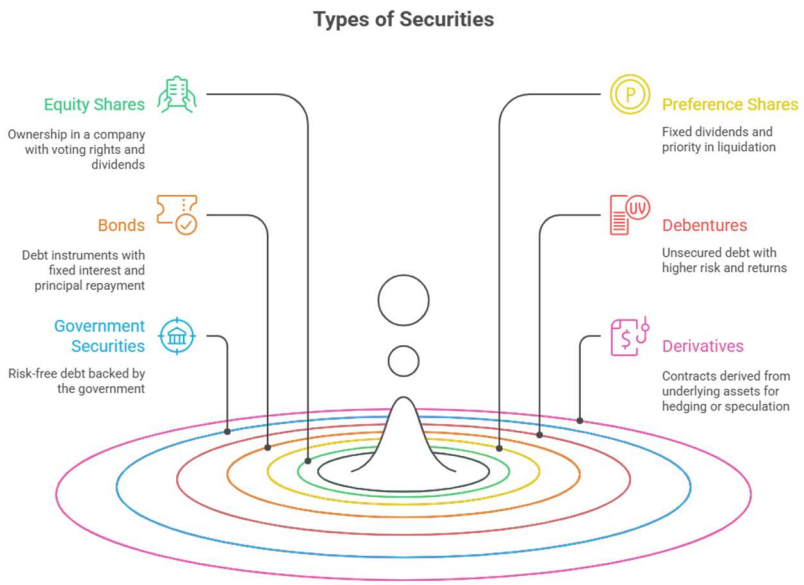
o Examples: Treasury Bills, Government Bonds

Derivatives (basic mention):

o Contracts with financial obligations based on the value of a security, commodity, or currency

o Types: Futures, Options, Forwards, Swaps

o Mostly used for hedging or speculative purpose, high risk, not suitable for a beginner



8.1.4 Risk–Return Trade-Off in Investments

Concept:

Risk-return trade-off is the basic principle of when deciding between investments, wherein it is understood that the higher risk would yield a greater return. In simple terms, if investors desire larger returns they have to take on more risk. Inversely, more secure investments commonly generate lower however extra regular returns. It will be up to each investor to weigh this trade-off against their risk tolerance, investment time frame and financial objectives.

Key Categories:

Low-Risk Investments

These provided you with capital preservation and you also made decent returns, but for mediocre growth.

• Examples:

o Bank Fixed Deposits (FDRs): ~5-6% returns per annum

o Government Securities (G-Secs): ~6–7% return

o Public Provident Fund (PPF) : ~ 7-8% tax free return

• Risk Level: Low (mainly sovereign or institution-backed)

Medium-Risk Investments

These do both safety and return in a manageable way. Returns could differ, but risks are manageable over a longer horizon.

• Examples:

o Corporate Fixed Deposits: ~8-9% returns, however credit risk associated with it

o Balanced Mutual Funds/ Hybrid Funds : ~8-12% on long-term basis

• Risk : Moderate (Market, Credit)

High-Risk Investments

This includes the risk associated with market movements and loss of capital, but also potential reward.

• Examples:

o Stocks (Direct Equity): ~10–15% or more for long-term, with high volatility

o Derivatives (Futures & Options): Offers high returns and at the same time, entails higher losses

• Risk Level: High (requires monitoring and skills)

Example Comparison:

Investment Type	Risk Level	Expected Return (Annual)	Notes
Bank Fixed Deposit	Low	5–6%	Safe, guaranteed by banks
Corporate Fixed Deposit	Medium	8–9%	Higher return, but credit risk
Equity Mutual Fund	Medium–High	10–15% (long term)	Market-linked, diversification helps
Direct Equity / Derivatives	High	Variable (up to 20% or loss)	High volatility, potential for losses

Understanding the **risk–return trade-off** helps investors make informed decisions. A conservative investor may prefer FDs or government bonds, while a growth-oriented investor with a long time horizon might opt for equity or mutual funds. Aligning investments with personal financial goals is key to successful wealth building.

Did You Know?

"The principle of risk–return trade-off is central to investing: government bonds, considered nearly risk-free, usually yield 5–6% annually, while equities, though riskier, can generate 12–15% over the long term. Investors balance these options by diversifying their portfolios according to goals, time horizon, and risk tolerance."

8.2 Meaning and Features of Mutual Funds

8.2.1 Definition and Concept of Mutual Funds

Definition:

Meaning of mutual fund In investment language, a mutual fund is simply a pooled instrument in which a collective investment is made using other people's money (cash collected from investors) to make investments on their behalf to create wealth overtime.

Concept:

Investors purchase units of the fund, and each unit represents a fractional ownership in the collective portfolio.

The fund itself is only as good as its underlying assets and investors receive a share of any profits or losses in relation to their stake.

The price for each unit is based on its Net Asset Value (NAV), which can be computed by taking the fund's total assets value and subtracting its liabilities, then dividing that amount by the number of units issued in the market.

There are two components to the returns that mutual funds generate: 1. dividends/ interest income 2. capital appreciation.

Example:

When you invest ₹1 lakh in a mutual fund, which has a corpus of ₹100 crore and the money is invested in 50 companies, then you effectively own small amounts of all those 50 investments without having to purchase every stock.

8.2.2 Features of Mutual Funds

Pooling of Funds

Mutual funds are based on a concept of pooled investment.

They raise money from thousands of investors, thus leading to a large investible corpus.

Pooling helps people with less money to access opportunities (like corporate bonds or diversified equity) which they would find hard to invest in as an individual.

Example: An individual may not have ₹50,000 to purchase a corporate bond but can invest small amounts indirectly through a mutual fund.

Diversification

Among the most favorable aspects of mutual funds is diversification and associated risk reduction.

Rather than buying one or two securities, the fund is diversified across asset classes, companies and sectors.

The effect of the bad performance of one asset on overall returns is minimized when using diversification.

Example: Let us say IT sector underperforms but banking over performs, losses are hedged with gains.

Professional Management

They are likely to be managed by professional fund managers that know how to read the market, select securities and manage risk.

They are backed by teams of researchers who scrutinize companies, industries and the economy.

Investors benefit from this without having to follow markets, read balance sheets or forecast economic cycles.

This is what makes mutual funds an appealing choice for the throngs of people who have neither the time nor expertise to actively manage investments.

Liquidity

Mutual fund units may be redeemed at any time – this makes mutual fund investments the most liquid of all other instruments.

Investors can enter or exit open-ended funds at the prevailing NAV on any business day.

Stock exchange listed close-ended funds may have a fixed lock-in but can be traded on secondary stock market.

Wind up When it comes to liquidity, the mutual fund source is actually a very flexible one.

Affordability

Minimum investment amount for mutual funds is less and all classes of people can afford to invest in mutual funds.

Investors can start an SIP of ₹500 per month.

This ease of access makes it possible for even small savers to take part in the capital market and create wealth over time.

There is also cost-efficiency given expenses, such as brokerage, research and administration fees are shared among all investors.

Activity: Exploring Mutual Fund Features

Students will select one mutual fund scheme from any AMC's official website and analyze its key details such as NAV, asset allocation, minimum investment amount, and

fund manager details. They will then identify how features like diversification, affordability, and professional management are reflected in the chosen scheme.

8.3 Advantages and Disadvantages of Mutual Funds

8.3.1 Advantages

Diversification

In a mutual fund, the investment is spread across equity shares, securities, sectors and asset classes so as to not rely on a single investment.

It gives even a small investor exposure to a wide portfolio that would be hard to assemble separately.

Example: Instead of purchasing shares in one company, an equity mutual fund would own 50 - 100 companies thus spreading risk.

Professional Expertise

Run by experienced fund managers with the backup of research teams.

It also involves ongoing monitoring, rebalancing, and risk management for investors.

Poised for consumers who don't have the experience about markets or wealth management.

Regulatory Safety (SEBI Oversight)

All Mutual Funds in India are regulated by SEBI (Securities and Exchange Board of India).

SEBI is there to make sure the markets are transparent, to protect investors and to get periodic disclosures (fund performance, expenses, risk).

This minimizes the possibility of fraud and builds investor confidence.

Easy Entry and Exit

Investors can initiate with smaller amounts through SIPs (as low as ₹500).

Open ended structure enable ease of redemption at prevailing NAV, giving the flexibility and liquidity.

Democratizes mutual funds unlike traditional investments such as real estate or gold."

8.3.2 Disadvantages

Market Risk

Mutual fund values fluctuate with changes in market conditions, so the value of your investment could be more or less than your original investment amount.

Equity funds can carry a lot of volatility in them, while even debt funds carry interest rate or credit risk.

Example: If the market declines, NAV will decrease and it may cause short-term losses.

Costs and Expense Ratio

Fees including management fees, administrative charges, and expense ratios apply to all mutual funds.

High expense ratios can create long-term drag on returns.

Funds that are managed actively typically cost more than passive options such as index funds.

Lack of Control for Investors

After making a commitment, investors cannot dictate exactly what securities the fund should own.

The fund manager has complete control over the pprtfolio.

It's the expert knowledge of professionals that investors should be uncomfortable with, which can be frustrating for those wishing to have more control.

8.4 Advantages and Disadvantages of Mutual Funds

8.4.1 Phases of Growth in Indian Mutual Fund Industry

The Unit Trust of India (UTI) was the first mutual fund in India, which was incorporated on 1963 and it operated as an autonomous government-owned corporation.

Introduced its flagship scheme Unit Scheme 1964 (US-64), which was a roaring success with investors.

UTI was a monopoly and introduced Indians to the concept of mutual fund investing.

Era of Phase II (1987–1993): Public Sector Bank Entry

Public sector banks and financial institutions were allowed to launch mutual funds in June 1987.

Prominent among those who entered the market were State Bank of India (SBI Mutual Fund), Canara Bank, Punjab National Bank and LIC Mutual Fund.

Offers diversified, but mutual funds were still controlled by public institutions.

Phase III (1993–2003): New Entrants-Private and Foreign Companies

The sector was opened up to private and foreign players by the government in 1993.

Here was a sea change of competition, professionalism and innovation.

Among the new applicants were HDFC Mutual Fund, ICICI Prudential, Franklin Templeton and Birla Sun Life.

Regulations were subsequently issued by the Securities and Exchange Board of India (SEBI), for transparency in issue, pricing and allocation of shares, to prevent fly-by-night operators and front-running activities.

Phase IV (2003–2014): Integration and Expansion

The period was marked with mergers and acquisition world over creating bigger AMCs.

Retail participation was revolutionized by the launch of Systematic Investment Plans or SIPs.

SEBI's reforms administered higher standards of disclosures, expense ratio jurisdiction and investor education.

The sector experienced a slow but steady growth, while awareness in Tier 2 and Tier 3 towns was low.

V Phase (2014-Current): Digital Growth, Retail Participation, AUM Touches All Time Highs

Gargantuan expansion aided by digital platforms, mobile apps and online SIPs.

Retail participation rose banking and governments efforts to improve financial literacy and financial inclusion as a whole.

The AUM has broken the record highs, a testament of investor's trust.

Industry trends indicate increased utilization of index funds, exchange-traded funds ("ETFs"), and passive investing.

How Ascending millennial and Gen-Z involvement is reshaping Product Innovation.

8.4.2 The Current Status and trends in Growth of Mutual Funds in India

Indian mutual fund space has grown to become one of the fastest growing areas in financial sector, boosted by buoyant investor sentiment, technology and regulatory tailwinds. The Assets Under Management (AUM) have recently crossed ₹50 lakh crore, while the Systematic Investment Plan (SIP) inflows are breaking records consistently, which reflects deepening retail involvement.

Key Growth Trends:

Retail investorBase: Retail investors, and in particular millennials and newbies, currently comprise a large amount of the investor base. Democratization of mutual fund access The rising popularity of SIPs, which enable small, regular investments, has been key to the wider coverage.

Technology Integration: The advent of e-KYC, UPI, robo-advisors and fintech platforms has made on-boarding and investing more user-friendly particularly in tier-2 or3 cities.

Product Innovation: Mutual funds have catered to various types of investors, right from thematic funds, sectoral funds for those who want to take a more concentrated sector-specific call in the market, ESG (Environmental Social Governance) are some of the names that one hears at conferences.

Shift to passive investing : Index funds and Exchange-Traded Funds(ETFs) are gathering the momentum due to low cost nature and transparency. Cost-conscious, long-term investors are favoring passive funds.

Regulator vigil: SEBI's role in enforcing transparency, checking mis-selling, and protecting investors through clear product categorisation and disclosure norms has been key.

Latest Developments: AIFs and SIFs

Mutual funds Rule the roost when it comes to retail investment, but larger investors and institutions are now turning to Alternative Investment Funds (AIFs) Social Impact Funds (SIFs):

Alternative Investment Funds (AIFs):

AIFs are private pools of funds that cater to high networth individuals (HNIs) and institutions. Hedge funds and private equity venture capital funds real estate funds are examples. They give access to non-traditional asset classes - potentially yielding more returns, but with higher risks and less liquidity. By SEBI, AIFs fall under following categories:

Category I: VC, SME and infrastructure funds partiesPositions0 Parties Category IVC, PME et fonds d'infrastructures

Category II: Private equity, and debt funds

Category III: Hedge funds and sophisticated strategies

Social Impact Funds (SIFs):

A sub-set of AIFs, SIFs aim to invest in businesses that provide a quantifiable social or environmental benefit as well as financial gain. These are part of global ESG and impact investing trends to finance sectors such as healthcare, education and renewable energy.

Future Outlook

The Indian mutual fund industry is on the verge of strong growth, given the rise in disposable income, digital penetration and robust regulatory framework. The advent of AIFs and SIFs suggests that the investment industry is maturing, with a variety of products available to investors along the risk-return continuum. With enhanced financial literacy, India would emerge as one of the largest markets for mutual funds world-wide.

Knowledge Check 1

Choose the correct option:

1. **Which was the first mutual fund established in India?**
   a) SBI Mutual Fund
   b) LIC Mutual Fund
   c) UTI
   d) HDFC Mutual Fund

2. **Private sector and foreign players were allowed in Indian mutual funds in which phase?**
   a) Phase I
   b) Phase II
   c) Phase III
   d) Phase IV

3. **Systematic Investment Plans (SIPs) became popular during which phase?**
   a) UTI Era
   b) Public Sector Entry
   c) Private Sector Entry
   d) Consolidation & Growth

4. **Which recent trend has boosted mutual fund growth in India?**
   a) Monopoly of UTI
   b) Absence of regulation
   c) Digital platforms and SIPs
   d) Decline in retail participation

8.5 Summary

ϖ Indian mutual fund industry has seen five stages of growth from UTI monopoly in 1964 up to the digitization and retail driven growth till date.

ϖ Phase I (1964–1987): UTI-dominated phase that launched the first scheme and expanded investor base.

ϖ Phase II (1987–1993): The public sector banks and institutions like SBI, LIC and Canara Bank commenced competition in the industry by offering variety.

ϖ Phase III (1993–2003): The entry of private and foreign players like HDFC, ICICI, Franklin Templeton led to competition and innovation.

ϖ Phase IV (2003-2014): Characterized by M ngs, Tighter SEBI norms, Rising Power of Retail Investors with the advent of SIPs etc,.

ϖ Phase V (2014-Date): Pushed by technology, digital platforms, financial education and unprecedented growth in Assets Under Management (AUM).

ϖ AUM of the industry has crossed ₹50 lakh crore today with SIP inflows at an all-time high and growing millennial / Gen-Z participation.

ϖ Product innovation is growing, with index funds, ETFs, thematic funds and ESG funds available to meet the needs of various types of investor.

ϖ Regulatory navigation through SEBI has successfully increased transparency, investor size and minimized mis-selling activities.

ϖ By integrating technology with fintech and offering an online onboarding process, mutual funds have become increasingly accessible to retail investors throughout India.

ϖ The emphasis on affordability and financial inclusion has opened the doors of stock markets to Tier 2 and rural investors.

ϖ With increase in income, increasing digital penetration and globalization, we believe that India will continue to be one of the fastest growing mutual fund markets in the world;

8.6 Key Terms

Mutual Fund – An investment company that pools money from investors to purchase a diversified portfolio of securities.

Net Asset Value (NAV) – the value per unit of ownership in a mutual fund, computed by dividing the total value of all shares owned by its investors minus debts) which equals total assets less total liabilities on the number of units outstanding.

Systematic Investment Plan (SIP) -- This is a plan where an investor invests a fixed sum of money every month in mutual funds over time instead of all at once.

AMC (Asset Management Company) – A company that manages mutual fund schemes and puts collected money on behalf of investors.

Diversification – Risk management technique of investing in a variety of assets, sectors or securities.

Expense Ratio – The fee a mutual fund charges investors each year to manage their money, expressed as a percentage of assets.

5) Exchange Traded Fund (ETF) – These are mutual fund schemes which are traded on the exchange just like shares, and follows a stock index or commodity.

Open-Ended Fund – A mutual fund scheme where the investors can invest anytime at current NAV and exit anytime.

AUM (Assets Under Management) – The full market value of assets being managed by a Mutual Fund under all its schemes.

8.7 Descriptive Questions

Q.1: Mutual funds: Define mutual funds and describe how they function with pooling of funds and Net Asset Value (NAV).

Describe some of the characteristics of mutual funds: diversification, professional management, liquidity and low cost.

Discuss the merits of mutual funds. What are the special features of these model benefits of mutual funds?How Diversification and SEBI regulation make it more attractive to the investors?

What are mutual funds very worst pitfalls? Explain making reference to market risk, costs and lack of investor control.

Discuss the evolution of Indian mutual fund industry in five phases. Sum up major events in each Gray and "Orange Is the New Black" author stepsonJurassic world film review(The People’s Audi?

What has been SEBI's role in bringing transparency and protecting the interest of investors with respect to mutual funds?

Explain the role played by digital technology and financial literacy in increasing the size of mutual funds in India.

Discuss equity mutual funds, debt mutual funds and hybrid funds with examples.

Explain the importance of SIPs in rising retail participation in mutual funds in India.

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Answers to Knowledge Check

Knowledge Check 1

1. c) UTI
2. c) Phase III
3. d) Consolidation & Growth
4. c) Digital platforms and SIPs

8.9 Case Study

Introduction

Because of their goods costs and professional management, mutual funds have gained so much popularity among Indian Investors in last few years. But for new investors, it's often difficult to pick the fund type and understand how to manage your risk and see big rewards over time. This caselet discusses the challenges faced by an individual retail investor while entering in mutual fund markets..

Background

School teacher Meena, 32, had been depositing her savings in fixed deposits for years. And while she liked the safety of it, she found returns often didn't keep up with inflation. A colleague recommended her to try mutual funds and explained how SIP works, what is diversification, NAV etc. A little intrigued, Meena agreed to invest` 3,000 per month through the SIP route in a balanced mutual fund scheme.

She was initially suspicious of market fluctuation, but in three years, she noticed that her portfolio kept growing — despite short-term highs and lows. This experience taught her the value of risk and return trade-offs, as well as diversification in dampening volatility.

Problem 1: Discovering the Fund Type That Is Right for You

Meena was finding it difficult to choose between equity, debt and hybrid mutual funds.

Solution: She spoke to an advisor, who recommended a hedged (read balanced) fund to ease her into the world of equities and then gradually migrate towards equity funds as she became more tolerant to risk.

MCQ:

Which is the best mutual fund for beginners with medium risk appetite?

a) Equity Fund

b) Debt Fund

c) Hybrid Fund

d) Derivatives Fund

Answer: c) Hybrid Fund

Statement of problem 2: Concern for the Market Volatility

When the market started down, Meena naturally became concerned as her NAV dropped.

Solution: Her adviser told her to consider mutual funds as part of longer term investment; even if there is short-term turbulence, she could still continue SIPs.

MCQ:

What is the best course of action for investors during short-term market dips?

a) Stop SIPs immediately

b) Withdraw all investments

c) Continue SIPs regularly

d) Switch to gold

Answer: c) Continue SIPs regularly

Problem 3: The costs and returns conundrum

Meena saw some charges like expense ratios and wondered if they had lowered her returns a lot.

Solution: As hard as it can be to hear, she discovered that while mutual funds have costs, the power of diversification and professional management often make up for them — especially when selecting low-cost investments like index funds.

MCQ:

Which of the following deductions decreases investor's net in mutual funds?

a) NAV growth

b) Expense ratio

c) SIP contribution

d) Inflation hedge

Answer: b) Expense ratio

Conclusion

The path taken by Meena is symptomatic of those of the first-time mutual fund investors like her. By keeping it little in the beginning, seeking advice and disciplining through a SIP, she grew gradually while also accumulating knowledge about personal finance. The case also illustrates that mutual funds, if selected wisely and held for the long haul, can be an incredibly useful vehicle for wealth creation.

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Unit 9 Mutual Funds – Part II: Structure, Types & Key Calculations

Learning Objectives

1. **Explain the organizational structure of mutual funds** including Asset Management Companies (AMCs), Trustees, Fund Managers, and Custodians.
2. **Differentiate between types of mutual funds** based on structure (open-ended, close-ended, interval funds).
3. **Classify mutual funds by investment objective** such as equity, debt, hybrid, liquid, and index funds.
4. **Understand tax-saving funds** like Equity Linked Savings Schemes (ELSS) and their role in personal financial planning.
5. **Analyze the concept of Net Asset Value (NAV)** and explain how it is calculated.
6. **Perform basic mutual fund return calculations** such as Simple Return, Compounded Annual Growth Rate (CAGR), and XIRR.
7. **Evaluate the impact of expense ratio and loads** (entry and exit loads) on mutual fund returns.
8. **Assess performance of mutual funds** using key indicators like NAV trends, Sharpe ratio (introductory), and portfolio holdings.

Content

9.0 Introductory Caselet

9.1 Organisational Structure of Mutual Funds

9.2 Types of Mutual Funds

9.3 Important Terms in Mutual Funds

9.4 Key Calculations

9.5 Indian Mutual Fund Industry

9.6 Summary

9.7 Key Terms

9.8 Descriptive Questions

9.9 References

9.10 Case Study

9.0 Introductory Caselet

Rajiv, a 35-year-old marketing professional, was keen to invest in mutual funds but perplexed by the choices on offer. His friend went on to clarify that the mutual funds vary not only in terms of asset class but also by their structure — open-ended, close-ended and interval funds.

Curious, Rajiv explored further. Open-ended funds arethose that do not have a fixed maturity and allow investors to buy or redeem units at any time at current net asset value (NAV),which gives them flexibility, he added. Close-ended funds however have a predetermined maturity and units are listed on stock exchanges where the fitment is for disciplined long-term investors. Less commonly, interval funds — hybrids between conventional and closed-end mutual funds that open for transactions at intervals — do both.

Rajiv also understood that different mutual funds cater to different purposes — equity funds for growth, debt funds for stability, hybrid funds for balance and liquid funds for short-term needs. In the process, while reviewing schemes, he came across various terms like Net Asset Value (NAV), expense ratio, entry load and exit load that had a direct impact on his returns.

In order to make sure that he did not err, he decided to visit an advisor who helped him work out the expected returns through CAGR as so aptly explained and also understand asset costs involved in long term wealth creation. Through this exercise, Rajiv learned that knowledge of fund structure, category and key calculation are important when one is taking a decision on framework investment.

Critical Thinking Question:

Why is it necessary for a person like Rajiv to know about the structure as well as cost related aspects (NAV, expense ratio, loads) of mutual funds before investing in any particular scheme?

9.1 Organizational Structure of Mutual Funds

9.1.1 Asset Management Company (AMC)

• Definition: An AMC is the company responsible for managing mutual fund schemes and taking investment decisions on behalf of the trustees.

• Functions:

o Gathers and uses capital that is pooled from investors.

o Formulates and introduces mutual fund schemes.

o Utilizes full-time investment manager & research analyst team.

o Accountable for the management of the portfolio, risk analysis and monitoring of performance.

• Regulation:

o SEBI has prescribed a minimum net worth of ₹50 crore for AMCs and the fund house is expected to hold this capital so as to ensure that investors do not suffer due to the capital requirements in case of business failure.

o Should be open and publish scheme-related information fairly, including NAV, expense ratio and holdings.

• Example: HDFC AMC, ICICI Prudential AMC, SBI Mutual Fund.

9.1.2 Sponsor

• Definition: The sponsor is the promoter of a mutual fund in much the same way that an entrepreneur is the promoter of a company.

• Functions:

o Creates and incorporates the mutual fund trust.

o Provides primary funding (min 40% to AMC's net worth).

o Guarantees credibility, reputation and financial stability.

• Regulation:

o The sponsor should have a sound 5-year financial track record and integrity, according to SEBI.

• Example:

o SBI Mutual Fund is sponsored by SBI.

o The sponsor of HDFC Mutual Fund is HDFC Ltd.

9.1.3 Trustees

• Definition: Trustees are the guardians of the interests of investors and hold the property of the mutual fund in trust for the benefit of unitholders.

• Functions:

o To ensure AMC comply as per SEBI regulation and Trust deed.

o Approve new prospective plans.

o Supervise compliance, investor protection, and accounting.

• Role of Trustees in Governance: The Trustees act as a quolist on misgoverance by the AMC.

• Structure: Quilded may have a Board of Trustees or a One Company acting as trustee.

9.1.4 Custodian

• Definition: The custodian is an agency that maintains the security of securities and other assets of the mutual fund.

• Functions:

o Owns the assets of the fund (stocks, bonds, and other government securities).

o Clears and guarantees securities trades.

o Maintains records of securities transactions.

o Reporting to AMC and the trustees of MPT for transparency.

• Regulation:

o Custodian should be SEBI registered and independent of sponsor and AMC to avoid the conflicts of interest.

9.1.5 Role of SEB1 Financial in Regulation

• Regulatory Body: The securities Market regulator is Securities and exchange Board of India (SEBI), which regulates the Mutual fund industry under SEBI MOF regulations, 1996.

• Roles and Responsibilities of SEBI in Mutual Funds:

Approves the registration of mutual funds, AMCs and custody.

Frames rules for transparency and fair play.

Requires the disclosure of NAV, performance reports, expense ratios and portfolio holdings.

Insulates investors from mis-selling and provides grievance redressal mechanisms.

inspects, audits and may issue fines for not complying.

• Result: SEBI makes sure MF play fair, investors are protected and the industry grows in a clean manner.

Did You Know?

"A mutual fund sponsor in India must contribute at least **40% of the net worth of the AMC** to establish credibility and stability. SEBI also requires the sponsor to have a **profitable track record for at least five years**, ensuring that only financially sound and trustworthy institutions can launch mutual funds

9.2 Types of Mutual Funds

9.2.1 Based on Asset Class

Equity Funds

o Invest mainly in equities and Shares of companies.

o Risk is high, but potential return could be high in long term.

o Appropriate for long-term investors with an above-average risk tolerance.

o Examples: Large-cap funds, mid-cap funds, small-cap funds, sectoral funds.

Debt Funds

o Purchase or own interest bearing securities, like government bonds, corporate bonds, debentures and treasury bills.

o Provide stable income that is conservative and less risky than stocks.

o Appropriate for conservative investors looking for income /w capital preservation.

Hybrid Funds

Upper o Put into a combination of equity and debt Schemes.

o Trade-off between risk and return: growth (equity) vs stability (debt).

o Suitable for moderate risk investors.

o Example: Balanced funds, aggressive hybrid funds.

Thematic and Sectoral Funds

• Thematic Funds

o Invest in thematic companies (ESG, digital transformation, consumption, infrastructure).

Offering growth options that cater to macroeconomic themes.

o More risky with limited approach but highly rewarding in better conditions.

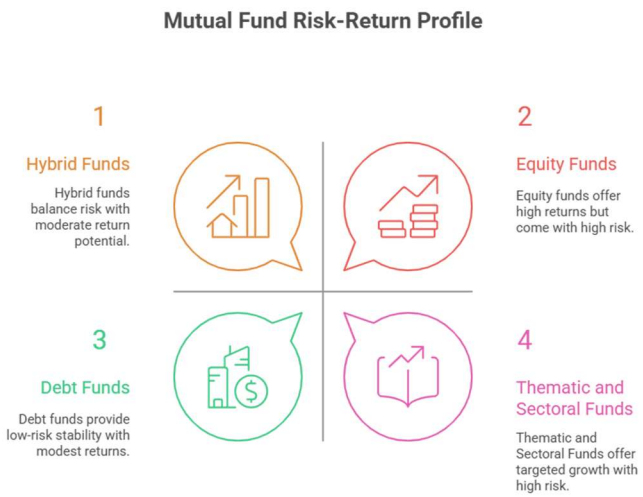
o Investor with good decision making ability knowing the theme.

• Sectoral Funds

o These are a thematic fund subset that can invest in sectors such as banking, IT, pharma or energy.

o Super high returns, super volatile during sector boom.

o Require timing and market awareness.



9.2.2 Based on Structure

Open-Ended Funds

o Permit the investors to redeem / purchase at any point of time.

o Units can be bought and sold throughout the day on the exchange at market price.

o Provide high liquidity and flexibility.

Close-Ended Funds

o Have a definite date until which they must mature (eg 3-5 years).

o The units available under this offer can now only be acquired in the initial offer period and they are listed on stock exchanges for trading.

o Make holding period that has investing passed down.

Interval Funds

o Hybrid funds that include characteristics of both open-end and close end schemes.

o Available for redemption or purchase at certain intervals.

o More prevalent in India and catered primarily to fringe investors.

9.2.3 Based on Investment Goals

Growth Funds

o Seek grow th of your investme nt by focusing on equity.

o Suitable for long-term wealth creation.

Income Funds

o Concentrate on generating a steady income stream, through investments in fixed income securities such as bonds and debentures.

o Retirees and def Job - What suits them well?

Liquid Funds

o Put money in short-term instruments of money market (up to 91 days maturity).

o Offerstor as well asPKR, and are highly liquid against relatively secure returns.

o Appropriate for parking excess cash temporarily.

Tax-Saving Funds (also known as ELSS – Equity Linked Savings Scheme)

o Equity Oriented Funds which are exempt under Section 80C of Income Tax Act.

o Minimum lock-in period (3yrs) as compared to other tax saving instruments.

o They offer double benefit of saving tax and creating wealth.

9.2.4 Other Categories

Index Funds

o Passive funds that mirror/track a particular stock market index (Nifty 50, Sensex etc).

o Reduced cost since there is limited fund manager intervention.

o Appropriate for investors who want broad market exposure.

Exchange Traded Funds (ETFs)

o Like index funds but traded as shares on stock exchanges.

o Provide the liquidity, transparency and low cost.

o Examples: Gold ETFs, Nifty ETFs.

Fund of Funds (FoFs)

o Invest in mutual funds instead of in individual securities.

o Offer instantaneous diversification across asset classes and fund houses.

o Management fees heavier as a result of stacked management.

Knowledge Check 1

Choose the correct option:

1. **Which type of fund invests mainly in company shares?**
   a) Debt Fund
   b) Equity Fund
   c) Hybrid Fund
   d) Liquid Fund

2. **Which type of mutual fund allows investors to enter or exit at any time and offers high liquidity?**
   a) Close-Ended Fund
   b) Open-Ended Fund
   c) Interval Fund
   d) Sectoral Fund

3. **Which fund combines features of both open-ended and close-ended funds?**
   a) Growth Fund
   b) Income Fund
   c) Interval Fund
   d) Index Fund

ETFs are primarily traded where?
a) Mutual Fund Houses
b) Banks
c) Stock Exchanges
d) Insurance Companies

9.3 Important Terms in Mutual Funds

9.3.1 Assets Under Management (AUM)

Meaning: The total market value of all the assets managed by a mutual fund scheme is known as assets under management (AUM).

Significance:

Reflects the breadth and popularity of a fund house or scheme.

A higher AUM indicates confidence and steadiness of investors but that is not necessary for more returns.

Example: If an AMC has ₹2 lakh crore spread across various schemes, that is its AUM.

9.3.2 Net Asset Value (NAV)

Meaning of NAV The per unit market value of the funds in a mutual fund scheme computed is referred as Net Asset Value.

$$\text{NAV} = \frac{\text{Total Assets} - \text{Liabilities}}{\text{Total Units Outstanding}}$$

Significance:

Reflects the current market price of one trading unit of a mutual fund.

Sets the purchase/redemption price of units (other than Units traded on exchanges).

Example: For a fund that has ₹100 crore as total assets, with ₹5 crore liability and 9.5 cr units in the market NAV = 10.

9.3.3 Entry Load / Exit Load

Entry Load:

A commission that one pays an investment company when one initially buys a mutual fund.

To gaurd investors, SEBI has removed entry loads in India since 2009.

Exit Load:

A fee assessed when an investor sells (redemption) fund units before a stipulated period of time.

Designed to discourage premature withdrawals.

Illustration: Redemption of ₹50,000 with a 1% exit load, leads to a deduction of ₹500.

9.3.4 Expense Ratio

Meaning: The AMC fees levied as the annual cost of managing your investment, and to cover overheads, fund manager's salaries, distribution and administration are also included in this fund.

Significance:

Affect investor returns directly — the lower the expense ratio, the higher your net return.

Active funds typically have higher expense ratios than passive funds (namely index funds).

Example: If a fund has AUM of ₹100 crore and its annual expenses amount to ₹2 crore, then its expense ratio will be 2%.

9.3.5 Systematic Investment Plan (SIP), Systematic Withdrawal Plan (SWP), and Systematic Transfer Plan (STP)

Mutual funds provide structured ways to invest or take your money out, or transfer between types of resources. These are ways to reduce risk, protect cash flow and build a return stream over time.

Systematic Investment Plan (SIP)

In a SIP, an investor invests a fixed amount at regular intervals (often on monthly or quarterly basis) in a mutual fund, mostly the equity funds. SIPs inculcate the habit of regular and disciplined long-term investment, enable rupee-cost averaging (buying more units when prices are low and fewer when prices are high) and help efficiently build wealth over a long period of time.

Example:

An investor begins a SIP of ₹2,000 monthly into an equity mutual fund over 10 years. Gradually, the investment of ₹2.4 lakh itself will multiply and become much more than its current day value – unless the market completely goes off-balance. It offers the best of compounding and disciplined investing without having to worry about market timing.

Systematic Withdrawal Plan (SWP)

A Systematic Withdrawal Plan (SWP) is one in which an investor periodically withdraws a predetermined amount from their mutual fund investment. It is well suited for those looking for monthly cash flow, like retirees or those seeking passive income, but you still have the rest of your investment invested and potentially growing.

Example:

A retiree invests ₹10 lakh in a debt mutual fund and initiates an SWP to withdraw ₹5,000 on a monthly basis. The fund keeps accumulating interest (or rewards), the

investor gets a monthly payment. This creates an ongoing revenue stream rather than having to sell the entire investment at once.

Systematic Transfer Plan (STP)

A systematic transfer plan (STP) allows an investor to transfer a fixed amount at regular intervals from one mutual fund scheme to another, typically from a low-risk fund (such as a liquid or debt fund) into a higher risk one (an equity fund), or vice versa. STPs address market timing risk and help to systematically expose investments over time to the vagaries of market volatility.

Example:

An investor gets a bonus of ₹5 lakh and keeps it in for safety in a liquid fund. They then initiate an STP to invest₹10,000 a month in a equity mutual fund. Over time, this results in less risk for investors who may be putting a lot of money into equity at once (market timing risk), but still potentially achieving higher returns progressively taking on more and more.

9.4 Key Calculations

9.4.1 NAV Calculation (Net Asset Value)

Definition:

NAV is the value per share of a mutual fund. It is the value at which investors purchase or sell fund shares. NAV is daily adjusted based on the performance of securities in the portfolio.

Formula:

$$\text{NAV} = \frac{\text{Total Assets} - \text{Liabilities}}{\text{Total Units Outstanding}}$$

Total Assets: Current market value of securities + cash + recievables.

Liabilities: Costs, charges and other liabilities.

Outstanding Units- Total units that have been sold to investors.

Step-by-Step Example:

Value of the fund = ₹100 crore

Liabilities = ₹5 crore

Units issued = 9.5 crore

That is, Now, the NAV of the scheme = ₹10 per unit.

9.4.2 Expense Ratio Calculation

Definition:

$$\text{Expense Ratio} = \frac{\text{Total Expenses}}{\text{Average AUM}} \times 100$$

The expense ratio reflects the percentage of fund assets used for administrative and other operating expenses. It directly reduces investors' returns.

Formula:

Components of Expenses:

Fund manager's fee

Brokerage charges

Marketing and distribution costs

Administrative charges

Step-by-Step Example:

Average AUM = ₹200 crore

Total expenditure per annum = 4 crore.

$$\text{Expense Ratio} = \frac{4}{200} \times 100 = 2\%$$

This is equivalent to 2% of the fund's assets being skimmed off every year as an operating fee.

9.4.3 Calculation of SIP Return (Illustrative Examples)

Concept:

In case of SIPs, the investment amount is fixed and invested at regular intervals (monthly/quarterly). Because of that, returns vary from lump sum investments. Rupee-cost averaging and compounding will work in favor of SIPs.

Illustration:

SIP = ₹1,000 for 6 months

Units purchased at different NAVs:

Month

NAV (₹)

Units Purchased

1

10

100.0

2

12

83.3

3

8

125.0

4

9

111.1

5

11

90.9

6

10

100.0

Total Investment = ₹6,000

Total Units = 610.3

If NAV after 6 months = ₹12 → Value = 610.3 × 12 = ₹7,323.6

Return = ₹1,323.6 (22% approx.)

This indicates that the SIP reduces the average cost per item.

9.4.4 CAGR and XIRR for Mutual Fund Returns

CAGR (Compounded Annual Growth Rate):

Definition: CAGR signifies the mean annual growth rate over a certain period of time and assumes profits grow with reinvestment.

Formula:

$$CAGR = \left(\frac{\text{Final Value}}{\text{Initial Value}}\right)^{\frac{1}{n}} - 1$$

Where n = number of years.

Step-by-Step Example:

Investment = ₹1,00,000

Value after 3 years = Rs.1,80,000

That equates to an annual 21.9% increase on the investment.

XIRR (Extended Internal Rate of Return):

Nature: XIRR is applicable when investments are made at different points in time (example - SIP, SWP). It computes the annual rate of return for the cash flows which include exact date of each cash flow.

Even better than CAGR for regular investments.

Illustration:

Investor B invests 5,000 Rs per month from Jan-Dec (12 months), in total 60k Rs.

Portfolio value = ₹70,000 at the end.

CAGR cannot be really calculated as in-flows were occurring on a monthly basis.

$$CAGR = \left(\frac{180000}{100000}\right)^{\frac{1}{3}} - 1 = 21.9\%$$

XIRR takes into consideration the real date of each ₹5,000's investment and redemption amount to get the actualised yearly return (which is ~16-18%, for example).

In reality, you calculate XIRR using the =XIRR(values, dates) function in Excel where:

"values" = investment outflows (negative) / redemption inflows (positive).

"dates" = dates of transaction.

Activity: Practicing Mutual Fund Calculations

Students will be divided into groups and provided with sample data on mutual fund assets, liabilities, expenses, and SIP contributions. Each group will calculate NAV,

expense ratio, and SIP returns. They will then compare their results and discuss how costs and time horizons affect overall investment performance.

9.5 Indian Mutual Fund Industry

9.5.1 Top Asset Management Companies (AMCs) in India

SBI Mutual Fund

• Began in 1987 as India's pioneer, non-UTI mutual fund.

• Supported by the trust and extensive reach of State Bank of India, the country's largest bank.

• Solid footprint in urban and rural regions.

• Popular funds: SBI Bluechip Fund, SBI Equity Hybrid Fund, SBI Small Cap Fund.

• Takes advantage of wide distribution network of schemes by SBI.

HDFC Mutual Fund

• Founded in 2000, one of the most trusted AMCs in India.

• Decent performance across equity and hybrid (blended) schemes over the long term.

• Famed for financial literacy programmes, investor awareness campaigns and a hearty focus on retail investors.

• Star schemes: HDFC Top 100 Fund, HDFC Hybrid Equity Fund, HDFC Balanced Advantage Fund.

ICICI Prudential Mutual Fund

• Partnership between ICICI Bank and Prudential Plc (UK).

• One of the largest AMC by AUM that has a diverse mix of products across equity, debt and hybrid category.

•Renown for innovation, risk management solutions and dynamic asset allocation products.

• Popular schemes: ICICI Prudential Bluechip Fund, ICICI Prudential Balanced Advantage Fund.

Nippon India Mutual Fund

• Formerly Reliance Mutual Fund, relaunched after takeover by Nippon Life Insurance (Japan).

• Strong in equity, hybrid and thematic funds.

• Growing global connections and technology-enabled investor servicing.

• Key schemes: Nippon India Growth Fund, Nippon India Small Cap Fund.

Axis Mutual Fund

• Incorporated in 2009 and part of Axis Bank Group.

• Known for its strong lineup of equity-focused products and customer-centric services.

• Drives young investors via digital platforms and SIP campaigns.

• Popular schemes: Axis Bluechip Fund, Axis Long Term Equity Fund (ELSS).

9.5.2 Leading Funds in India (Equity, Debt, Hybrid)

Equity Funds (long-term growth oriented):

• SBI Bluechip Fund – Invest in large-caps.

• HDFC Top 100 Fund – Diverse large-cap portfolio.

• ICICI Prudential Bluechip Fund – C on to lling risk while performing consistently.

• Axis Long Term Equity Fund (ELSS) – A famous scheme for tax saving in equity schemes.

Debt Funds (to protect capital and generate regular income):

• HDFC Corporate Bond Fund – Moderately high corpus in corporate debt securities.

• ICICI Prudential Short Term Fund – Suitable for investors with short-term horizon.

• SBI Magnum Gilt Fund – Puts money in government securities, regarded as safer.

• Nippon India Low Duration Fund – For short-term liquidity requirements.

Hybrid Funds (Combination of Equity and Debt):

• ICICI Prudential Balanced Advantage Fund – Dynamically between investing in equity and debt.

• HDFC Hybrid Equity Fund- Balanced strategy with good performance history.

• SBI Equity Hybrid Fund – For investors willing to take moderate risk.

• Axis Hybrid Fund – Good option for both stability plus growth oriented investors.

9.5.3 Emerging Trends in Mutual Fund Investments

Digital Transformation

• Investing has been made easier with online platforms, mobile apps and e-KYC.

• The UPI-based payments and fintech tie-ups have brought mutual funds to Tier 2, Tier 2 cities also.

• Automated services are gaining in popularity as a source of investment advice tailored to individuals.

Rise of SIPs

• Retail participation is largely driven by Systematic Investment Plans (SIPs).

• "Monthly SIP inflows are now steady over ₹15,000 crore and suggesting a strong move towards stronger daily investing."

• SIPs promote small-ticket, regular investments, making mutual funds accessible to many more.

Growth of Passive Investing

• Rising demand for index funds and ETFs known for their low cost and transparency.

• Investors moving towards passive products such as Nifty 50 ETFs & Sensex ETFs and International Index Funds.

Thematic and ESG Funds

• Rising appetite for sectoral (IT, pharma, infrastructure) and socially responsible investing (ESG funds).

• Shows increasing investor interest in integrating financial goals with values.

Rising Retail Participation

• Millennials and Gen Z are investing early in life, using SIPs and mobile apps.

• For younger investors, digital-led solutions and equity-focused schemes are popular.

Global Exposure

• Indian AMC's launching funds which will invest overseas in stocks and world indices.

• Assists investors in diversifying internationally, lessening exposure to the domestic market.

Regulatory Push by SEBI

• SEBI keeps simplifying funds categories, making disclosures mandatory and cutting expense ratios.

• Helps to promote the trust of investors and fair practices.

Did You Know?

In India, monthly **Systematic Investment Plan (SIP) inflows have crossed ₹15,000 crore**, reflecting the growing trust of retail investors in mutual funds. The rise of **digital platforms, index funds, ETFs, and ESG-focused schemes** has made investing more accessible, transparent, and aligned with global trends of responsible and low-cost investing.

9.6 Summary

v The Indian mutual fund industry has witnessed a fast paced growth surpassing ₹50 lakh crore AUM, contributed by retail and institutional investors.

v SBI Mutual Fund, HDFC Mutual Fund, ICICI Prudential, Nippon India and Axis Mutual Fund are top AMCs.

v Equity funds aim for long-term growth, debt funds for stability and hybrid ones strike the right risk-return balance.

v Popular equity funds are SBI Bluechip Fund, HDFC Top 100 Fund and Axis Long Term Equity Fund (ELSS).

v Debt funds such as HDFC Corporate Bond Fund and SBI Magnum Gilt Fund suit conservative investors.

v Hybrid funds: Funds like ICICI Prudential Balanced Advantage Fund offer a diversified portfolio with moderate risk.

v Accessibility to mutual funds has got a completely new definition now, thanks to digital platforms, fintech tie-ups and robo-advisors.

v SIPs have emerged as a mainstay for retail investors, fostering an investment culture based on long-term disciplined approach.

v Passives like index funds and ETFs are becoming more popular because they're low-cost and transparent.

v Thematic and ESG funds emerge as investor interest in sustainability, sector-focused strategies grows.

v Millennials and Gen Z have been at the forefront of digital-first investing that is prompting more retail participation.

v Regulation by SEBI in the recent past has been promoting transparency and curbing mis-selling to protect investors' interest.

9.7 Key Terms

AMC (Asset Management Company) – A company that manages mutual fund schemes and invests the money collected from investors.

Sponsor – The person who creates the trust and contributes seed capital of a mutual fund.

Trustees – custodians of the interests of investors who ensure that AMCs observe SEBI rules.

Custodian – A third-party who holds and reports mutual fund's securities.

Open-End Fund – A mutual-fund, which gives the investors an option to purchase or redeem units at any time at current NAV.

Closed-Ended Scheme – A mutual fund that is opened for a specified period and units are listed on a stock exchange.

Expense Ratio — The proportion of the assets under a fund's management that is employed to cover the operating expenses.

SIP (Systematic Investment Plan) – You invest a fixed amount periodically in mutual funds.

Exchange Traded Fund (ETF) A mutual fund scheme, but is tr Although ETFs can be traded in anywhere on the stock open market.:left1EB%Dcne° on a:.':'' j:oHN be7-exchanges; they are very similar to an index based mutual. fund scheme.

9.8 Descriptive Questions

Describe the structure of mutual funds in India and discuss the role played by AMCs, sponsors, trustees, and custodians.

Distinguish between open and close ended, interval funds with examples.

What are equity, debt and hybrid funds? Talk about who these stocks may be right for.

Define NAV and AUM. Why are these key signals for mutual-fund investors?

What are entry load, exit load, and expense ratio? What do these charges mean for investor returns?

Explain SIP, STP and SWP with their use and application in financial planning.

What is CAGR and XIRR? Illustrate how they could be used in analyzing returns on mutual funds.

Give us your views on the key trends developing in the Indian mutual fund industry i.e. – SIP growth, digital platforms, passive investing?

Reap the performance benefits of Top AMCs in India – SBI, HDFC, ICICI Prudential, Nippon India, and Axis Mutual Fund.

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Answers to Knowledge Check

Knowledge Check 1

1. b) Equity Fund
2. b) Open-Ended Fund
3. c) Interval Fund

4. c) Stock Exchanges

9.10 Case Study

Introduction

India There is a large section of retail investors using mutual funds in India. You get professional management, diversification and the option to afford investments. But, There's a Catch Picking the right kind of fund means you'll need to accept its structure, returns, risk and costs. This case investigates the optimization problem of an investor juggling among various mutual funds and matching them with financial objectives.

Background

Ramesh, a software engineer who is 30 years old, said he was looking to put some of his monthly savings to work. He had a medium risk appetite and a 10-year investment horizon. When he started looking around, there were plenty of choices: equity funds for growth, debt funds for safety and hybrid funds for some balance. He also understood charges such as expense ratio and exit load, performance parameters like NAV, SIP returns, CAGR, XIRR.

Even though he knew better, he had a hard time picking the right mix of funds. Ramesh's question underlines the necessity of structured thinking while venturing in mutual funds.

Problem Statement 1: Jumble between Equity and Debt and Hybrid Funds

Ramesh sought high returns but was concerned about equity market volatility.

Solution: He began with a hybrid fund, which balanced his equity- and debt-investment exposure, and permitted him to lower risk as he learned about market-linked returns.

MCQ:

What is the best fund type for moderate risk takers?

a) Equity Fund

b) Debt Fund

c) Hybrid Fund

d) Index Fund

Answer: c) Hybrid Fund

Problem Statement 2: Explaining Returns (CAGR vs XIRR)

Ramesh was having difficulty deciphering performance numbers. CAGR indicated average growth rates, but his SIPs needed these to be adjusted for periods higher accuracy.

Solution: His adviser told him that using XIRR is a better option for SIP investors as it factors in multiple investment made on different dates.

MCQ:

What is the best measure to calculate SIP returns?

a) NAV

b) CAGR

c) XIRR

d) Expense Ratio

Answer: c) XIRR

Problem 3: Effects of costs on returns

Ramesh spotted two such equity funds, but one came with a higher expense ratio.

Solution: He discovered that a lower expense ratio translates into higher net returns over time. So he went with the less expensive fund.

MCQ:

What is the thing that truly cuts in to an investor's net returns?

a) SIP

b) Expense Ratio

c) NAV

d) AUM

Answer: b) Expense Ratio

Conclusion

This case highlights the need for an investor to have good knowledge of fund types, return indications and cost formats when choosing mutual funds. Hybrid funds were a balanced jump start for Ramesh, while XIRR explained SIP returns and expense ratio showed path to cost efficiency. A disciplined and a financially keen mutual fund investor you need to be for making your investments fruitful.

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Unit 10: UNBFCs – Non-Banking Financial Companies

Learning Objectives

1. Understand the meaning and scope of Non-Banking Financial Companies (NBFCs).
2. Identify the different types and classifications of NBFCs in India.
3. Explain the role of NBFCs in promoting financial inclusion and economic growth.
4. Compare NBFCs with banks in terms of functions, regulations, and limitations.
5. Analyze the regulatory framework governing NBFCs under RBI guidelines.
6. Evaluate the challenges and risks faced by NBFCs in the financial sector.
7. Examine the contribution of NBFCs to credit delivery and investment in India.
8. Explore recent trends, issues, and reforms impacting NBFC operations.

Content

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10.1 Introduction to NBFCs

10.2 NBFCs vs Banks

10.3 Types of NBFCs

10.4 Regulatory Framework for NBFCs

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10.11 Case Study

10.0 Introductory Caselet

Shakti Finance Ltd., a mid-sized, semi-urban area focused NBFC which enjoyed good reputation for serving small businesses and self-employed class. It was different from banks — the loan approval, flexible documents, door-step service that it offered, made it a go-to option for many when they wanted to avail of a loan for the first time.

It grew fast for several years, branching out into vehicle loans, SME and personal loans. Profits grew consistently, and it was serving more customers. But, in the year 2019 in particular, Shakti Finance went through huge liquidity problem as few big institutional investors pulled money off their hands amid the NBFC sector's defaults hogging media headlines.

Having its cash flows decline, the company faced problems in servicing debts and gained customers' confidence.

The management was thus compelled to reconsider its business model, risk management and heavy dependency on short-term borrowings. It underscored the strengths and weaknesses of NBFCs, which are not only important for financial inclusion but also face distinct regulatory and funding hurdles.

Critical Thinking Question

Why do you think, the borrowers opted for NBFC over banks and explore the risks which comes if an NBFC grows quickly without having a solid risk management?

10.1 Introduction to NBFCs

10.1.1 Meaning and Definition of NBFCs

Meaning:

NBFCs are financial institutions that offer some of the features of banks, without holding a banking license. Their activities generally involve lending, investment, hire-purchase, leasing and financial intermediation.

Definition (RBI):

3

An NBFC performs the activities like providing loans and advances, acquisition of shares/stocks/bonds/debentures/securities issued by government or local authority, leasing, hire-purchase, insurance business or chit fund business. It excludes establishments whose sole activity is agriculture, industrial operations or commercial work (except for stock and share business), the sale purchase exchange and renting of real estate.

Key Point:

NBFCs are not allowed to take demand deposits such as those from a saving account or from a current account and they do not form part of the payment and settlement system. They are, however, an important source of credit to housing, infrastructure, transport and small-scale industries.

10.1.2 Characteristics of NBFCs

NBFCs are characterised by the following features:

Established under the Companies Act – They are companies and not banks.

Regulatory Oversight – NBFCs are mostly regulated by the Reserve Bank of India (RBI), but some may also be under SEBI or IRDAI or National Housing bank depending on their operations.

No Demand Deposits – They cannot advice and accept savings/current deposits from public.

Credit providers – Activity of deriving income from loans and advances to borrowers (such as individuals, small businesses and niche markets).

Splinter-Sector Focus – Majority of NBFCs are focused in business lines such as vehicle-financing, housing finance, gold-loans and/or microfinance.

Operational Flexibility – NBFCs provide innovative loans, faster disbursements and doorstep services.

Asset-Liability Mismatch Risk – These companies usually borrow for short durations and lend for long durations, thus are exposed to liquidity risks.

Catering to Untapped Markets – NBFCs cater to the rural and semi-urban locations of the country, where banking presence is limited.

10.1.3 Role of NBFCs in Indian Financial System

NBFCs are an important part of India's financial system as they perform many functions not provided by traditional banks and also extend credit to people who are left unserved. Their roles include the following:

Promoting Financial Inclusion

NBFCs take banking services to unbanked and under-banked segments including small business units, marginal farmers and traders. For instance, Bajaj Finance has strong penetration in tier-2 and -3 cities by providing credit to the population which was till now un-served.

Supporting Key Sectors

The NBFCs cater credit to housing, infrastructure, transport, small industry and agriculture-related activities where the real economy gets a boost. HDB Financial Services, for example, accommodates consumer loans, business finance and commercial vehicle loans in sectors critical to the economy.

Mobilization of Savings

They help to direct the savings of the household as well as institutional sector towards productive investments (bonds, debentures and equities) which lead to capital formation in the economy.

Encouraging Entrepreneurship and SMEs

NBFCs lend working capital and business loans to help smaller businesses to grow, generate income and create jobs. However, their simplified lending procedure and local presence is beneficial for the novice borrower or micro-enterprise.

Adaptation and Dynamism in Financial Services

NBFCs typically develop financial products customer needs, and disburse loans quickly; they also offer flexible repaying tenure. This flexibility enables them to serve a variety of customer wants better than traditional banks.

Contribution to Economic Growth

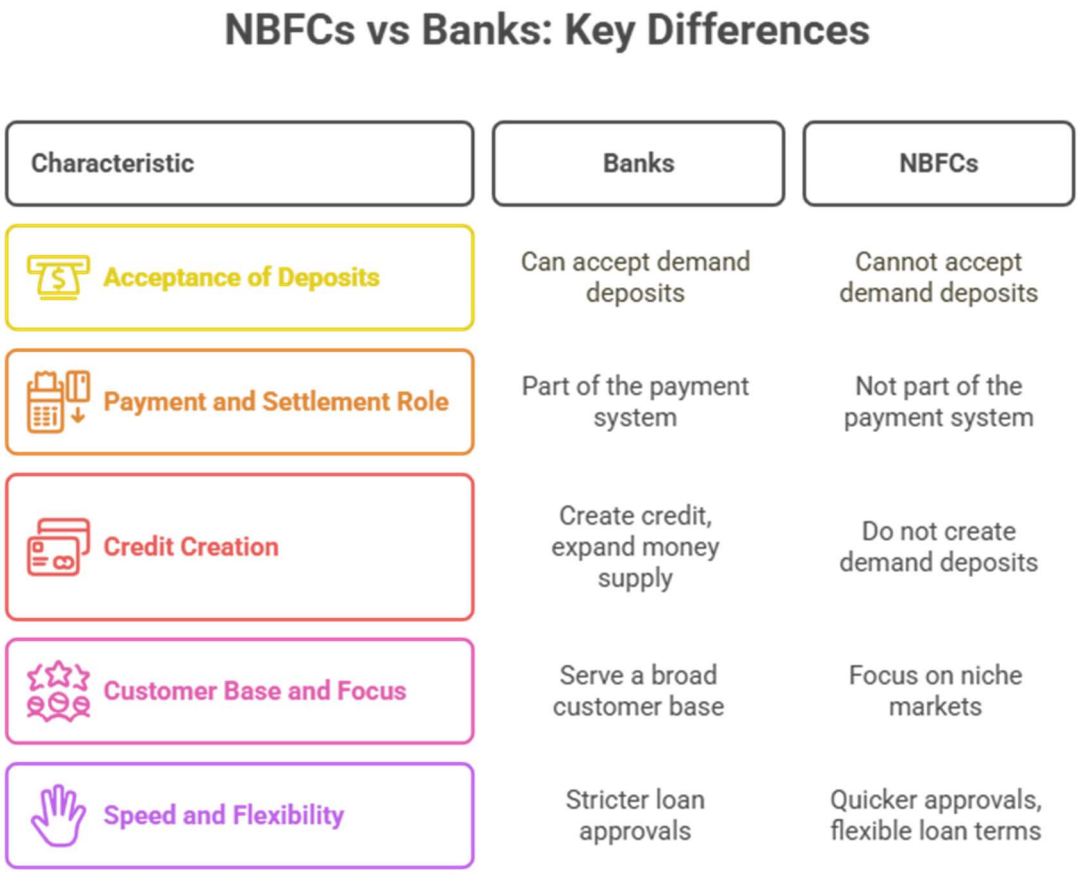
By plugging gaps in credit in a variety of sectors, NBFCs encourage consumption, support entrepreneurship and create jobs, while also making a large contribution to GDP growth.

10.2 NBFCs vs Banks

10.2.1 Key Differences in Functions and Operations

Aspect	Banks	NBFCs
1. Acceptance of Deposits	Can accept **demand deposits** (savings and current accounts).	Cannot accept demand deposits. Some may accept **term deposits** with **RBI approval**.
2. Payment and Settlement Role	Part of the **payment and settlement system** (issue cheques, cards, fund transfers).	Not part of the system. **Cannot issue cheques** drawn on themselves.
3. Credit Creation	Create credit by accepting deposits and lending, **expanding money supply**.	Do not create demand deposits; **do not contribute directly** to money supply.
4. Customer Base and Focus	Serve a **broad customer base**, from individuals to large corporations.	Often focus on **niche markets**: vehicle finance, housing, gold loans, microfinance, etc.

Aspect	Banks	NBFCs
5. Speed and Flexibility	Stricter loan approvals due to **regulatory compliance**.	Offer **quicker approvals** and more **flexible loan terms**, especially for underserved customers.



10.2.2 Regulatory Distinctions

Regulating Authority

o There are 2 types of banks (Scheduled and non-Scheduled Banks) that are regulated by the RBI, through Banking Regulation Act, 1949.

o NBFCs are registered as companies under the Companies Act, 2013, and regulated by the RBI in terms of provisions of RBI Act, 1934. However, some categories of NBFCs (e.g., Housing

Finance Company) are also supervised by other regulators i.e. the National Housing Bank (NHB), SEBI or IRDAI.

Deposit Insurance

o Deposits in bank are covered by DICGC.

o NBFC deposits are not insured by deposit insurance.

Minimum Capital Requirements

o SLR and CAR norms for banks were restructured upwards.

o NBFCs are required to maintain capital adequacy on the lines of RBI, however, this is less rigorous compared to banks.

Prudential Norms

o Banks are required to observe strict prudential norms regarding CRR and SLR.

o NBFCs need not maintain CRR or SLR but are subject to the Reserve Bank of India's (RBI) guidelines relating to capital adequacy and provisions.

10.2.3 Complementary Role of NBFCs alongside Banks

NBFCs are not a substitute but rather complement the banking system in India. These functions are mutually linked as follows:

Extending Financial Inclusion

o NBFCs serve customers that are not served by banks (people at the bottom of the pyramid) and geographic regions where banking is expensive or considered too risky.

o This increases credit outreach and further advances financial inclusion.

Specialized Financing

o NBFCs finance certain segments such as vehicle, housing and infrastructure which take the load of banks from all needs.

Partnerships with Banks

o Large number of NBFCs have co- lending arrangements, securitization/through assignments and refinancing with banking sector.

o This partnership will allow banks to reach out to a greater number of borrowers and NBFCs with lower cost of funds.

The Stability and Growth of Financial Markets

o NBFCs contribute to the development and resilience of the financial system by reducing concentration risk and diversifying sources of credit.

Activity: Comparing NBFCs and Banks

Form groups of 3–4 students. Prepare a comparison chart highlighting at least five key differences between NBFCs and banks in terms of operations, regulation, and customer focus. Each group should also discuss how NBFCs complement banks in promoting financial inclusion and present findings in class.

10.3 Types of NBFCs

Types of NBFC based on activity Non-Banking Financial Companies (NBFCs) are classified in different categories, depending based on the type of a company's business. Such categorization assists in monitoring and governing their operations, maintains soundness of activities and safeguards the interest of both investors and borrowers. All the varieties of NBFC have specific roles to fulfil and they serve various segments of the economy.

10.3.1 Asset Finance Companies (AFCs)

Definition:

*Asset Finance Company (AFCs) are a type of NBFCs, which finances the physical assets which increase productivity/quality of production. These generally consist vehicles including cars, lorry, earth moving machinery and other type machineries etc.

Features:

• Business consists mainly of financing tangible, physical resources.

• At least 60% of assets with individuals and HUF has to be invested in funding the physical assets which are used for productive purposes.

• AFCs can be utilised by transport operators, farmers and small to medium sized businesses as well as contractors that use assets for earning an income.

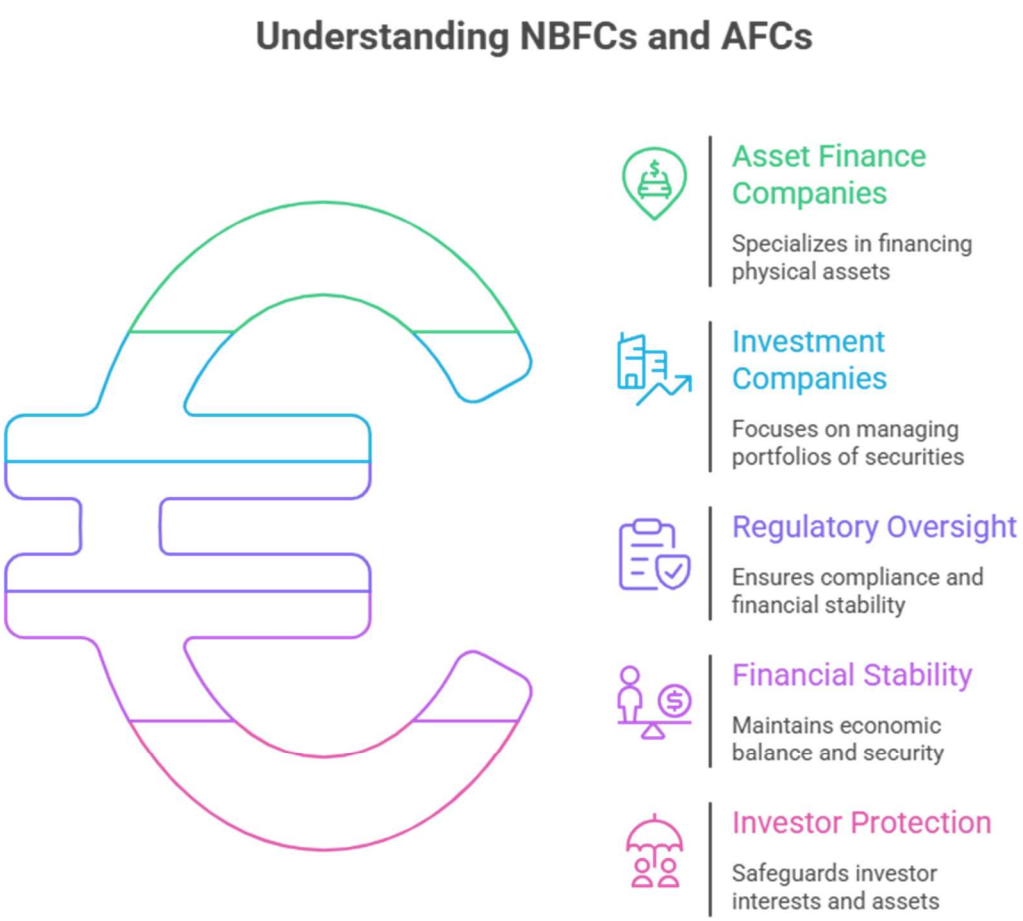
Role:

AFCs are critical in enabling access to vehicles and equipment, supporting transport, logistics, construction, agriculture and infrastructure development, among other sectors. They allow businesses to grow their operations and increase their efficiency by acquiring assets.

Example:

Companies like Tata Investment Corporation Ltd and Bajaj Holdings and Investment Ltd invest in and manage securities, shares and other financial assets portfolios. While at the outset they are categorized as Investment Companies, they signify broader NBFC involvement in

asset management and capital utilization. In asset-based financing, dedicated AFCs continue to dominate in vehicle and equipment finance (like Shriram Transport Finance Company).



10.3.2 Loan Companies (LCs)

Meaning: Loan Cos are NBFCs which lend by way of loans or advances but not for the purpose of asset financing.

Services Offered:

• Unsecured personal loans.

• Loans for consumer durables such as mobile, appliances and furniture.

• Business loans for working capital and expansion:

• Education loans for students.

Features:

• Do not concentrate on financing things.

• Less strict in extending loans to many types of customers.

• Be key to the increase in consumer credit and business support.

Role: Loan Cos find the market that has credit requirements of individuals and small enterprises, who are unable to obtain loans from banks due to stringent documentary requirements.

Example: Bajaj Finance Ltd. - Leading Loan Companies in India offers Low interest rate on personal loans and small business loans from Bajaj Finserv along with same day approval.

10.3.3 Investment Companies (ICs)

Investment Companies: Definition: Investment Companies are the NBFCs, engaged in acquisition of securities like shares, bonds, debentures and Government Securities as their principal business.

Features:

• Put money in investments to generate income and grow the capital.

• Avoid directly working with individuals or businesses as a lender.

• Income comes from dividends, interest and the appreciation of securities.

Role: These corporations are vehicles through which savings can be mobilised and channeled into the capital market, enhancing financial stability and development of the market.

Illustration: An NBFC functioning as an investment company, undertaking holding securities of diverse entities.

10.3.4 Infrastructure Finance Companies (IFCs)

Explanation: IFC is an NBFC financing for a period greater than one year of infrastructure, which includes transport sectors such as roads, ports and airports; energy and telecommunication projects etc.

Eligibility Criteria (RBI norms):

• Only minimum Net Owned Funds of ₹300 crores is the capital requirement.

• At least 75 percent of total assets must be invested in infrastructure loans.

• Should have a credit rating of at leasts 'A' or equavilent.

Role: IFCs is an important source of financing for India's infrastructure lending, which is capital-intensive and long-gestation.

Illustration: Power Finance Corporation Ltd. and Rural Electrification Corporation Ltd are major entities that have been accorded IFC function.

10.3.5 Microfinance Institutions (NBFC-MFIs)

Definition: NBFC-MFIs are financial entities engaged in lending and other activities on a small scale, to low income households or individuals, mostly in rural or semi-urban areas.

Loan Characteristics:

• Typically unsecured loans.

• RBI prescribes the maximum size of loan and lending conditions.

• Loans tend to be for income-generating purposes such as farming, handicraft or small retail businesses.

Responsibility: NBFC MFIs are important for financial inclusion. They help ottherwise marginalised groups in society, particularly women, by enabling them to access credit and supporting them to become enterpreneurs.

Example: Bharat Financial Inclusion Ltd. (previously known as SKS Microfinance) is one of the leading MFIs in India.

10.3.6 Housing Finance Companies (HFCs)

Definition: Housing Finance Companies are a part of the Non-Banking Finance Company (NBFC) and their core business is to provide finance for housing.

Regulation: HFCs were hitherto regulated by the NHB and now have to face RBI directly.

Features:

• Focuses on loans for the purchase, construction and renovation of homes.

• Play a content-mentioning role in addressing middle and low-income housing needs.

•Be a catalyst for real estate expansion and urban development.

Function: HFCs encourage home ownership and aid the government in its “Housing for All” programme.

Instances: Companies like HDFC Ltd. and LIC Housing Finance Ltd. are key players in the housing finance industry.

10.3.7 Core Investment Companies (CICs)

Definition: Core Investment Companies are those NBFCs whose asset side is predominantly made up of investments in group companies.

Asset Composition (RBI norms):

• They must have invested in a group company at least 90% of their net assets.

• Not less than 60% of this to be in equity shares.

• They cannot deal in or lend against these securities as their main business.

Role: CICs act as holding companies and anchor the financial stability and control in large corporate groups.

Example: Tata Sons Ltd. is a Core investment company for the Tata Group.

Knowledge Check 1

Choose the correct option:

1. Which type of NBFC primarily finances physical assets like vehicles and machinery?
   a) Loan Company
   b) Asset Finance Company
   c) Core Investment Company
   d) Housing Finance Company
2. An NBFC that provides small loans to low-income households is called:
   a) NBFC-MFI
   b) HFC
   c) IFC
   d) CIC
3. Which NBFC must invest at least 90% of its assets in group companies?
   a) Loan Company
   b) CIC
   c) AFC
   d) MFI
4. Which type of NBFC specializes in providing long-term loans for infrastructure projects?
   a) Investment Company
   b) Loan Company
   c) Infrastructure Finance Company
   d) Housing Finance Company

10.4 Regulatory Framework for NBFCs

10.4.1 Role of RBI in Regulating NBFCs

- All about Non Banking Firms 10.4 Functions Performed by RBI to Regulate Non-banking firms (NBFCs)

NBFCs are regulated by the Reserve Bank of India under the RBI Act, 1934. Its responsibilities include:

Registration on Granting: Only the companies registered under the Companies Act, as well as meeting the eligibility criteria set by RBI shall be able to operate and function as an NBFC.

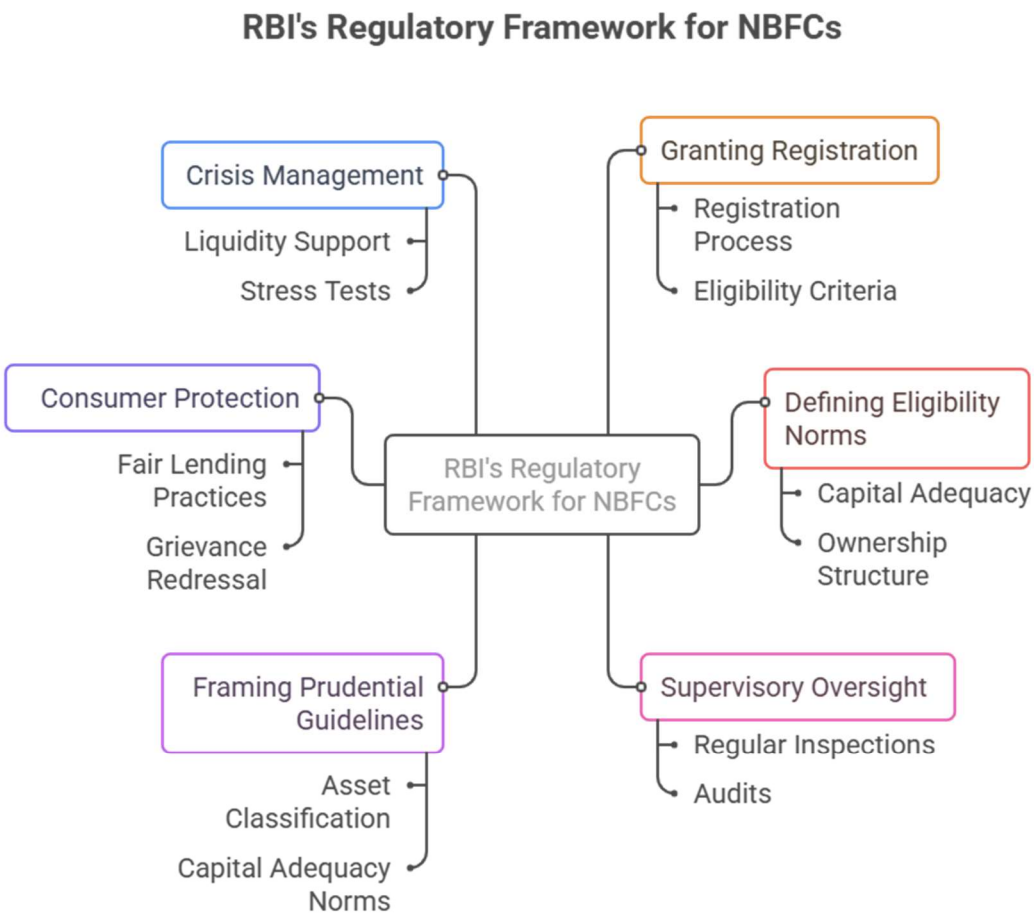
Eligibility Norms: Such as capital adequacy, ownership pattern and business profile is prescribed by RBI.

Supervisory Monitoring: Periodic inspections, audit and reporting requirements help implement prudential norms.

FRAMING OF PRUDENTIAL NORMS: Norms for classification of assets, provisioning and capital adequacy are prescribed to keep the financial health sound.

Consumer Protection: To regulate and supervise NBFCs in the interest of their depositors and borrowers.

Crisis Management: Implementing corrective action and sectoral reforms during liquidity or solvency crises in the NBFCs.



10.4.2 Key Regulatory Requirements

In order to function legally, NBFCs have to adhere to a few regulatory mandates given by RBI:

Registration

• Non-Banking Financial Companies (NBFCs) should be registered under the Companies Act, 2013.

• A Certificate of Registration (CoR) has to be acquired from the RBI to start operations.

• Specialized NBFCs (like HFC/MFI) may also require approval from sectoral regulators.

Minimum Net Owned Funds (NOF)

• NBFC has to maintain a minimum Net Owned Fund of ₹2 crore as per RBI regulation (higher in case of Infrastructure Finance Companies).

• The NOF helps in ensuring that the NBFCs have the necessary financial capabilities before they enter into public transactions.

Prudential Norms

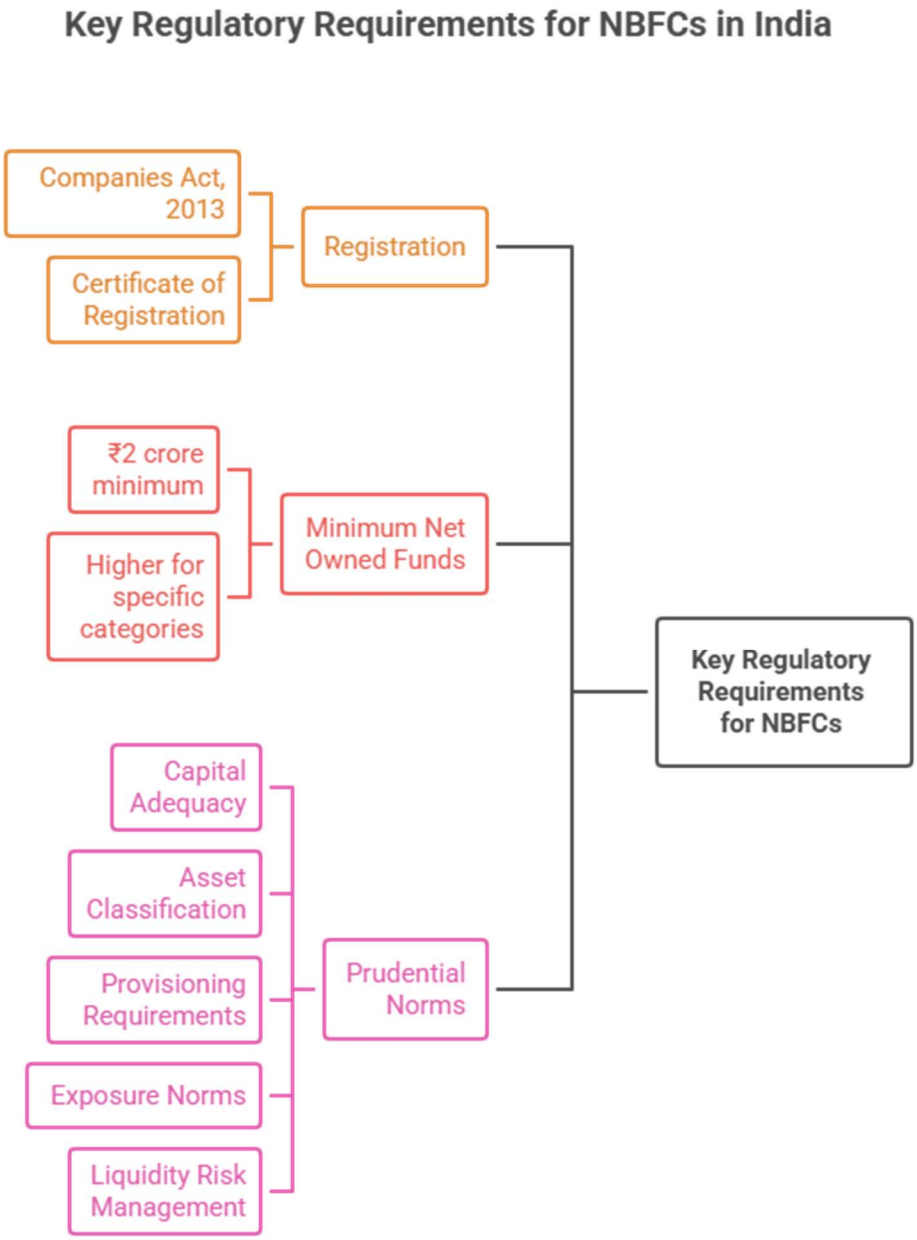
• Capital Adequacy: NBFCs shall have CRAR as prescribed by RBI.

• Asset Classification: Loans and advances are further categorized into Standard, Sub-standard, Doubtful and Loss assets with specific provisioning norms for each.

• Provisions: - NBFCs are required to make provisions for any probable losses on loans!

• Exposure Norms: Restrictions on an amount of loan to a single borrower or group in order to manage the concentration risk.

• Liquidity Risk Governance: Principles on ensuring prudent liquidity risk management by backing it up with control systems.



10.4.3 Current Reform and Policy Options

To address the sectorial challenges, RBI and Government of India introduced number of reforms in recent years:

Scale-Based Regulation (2021):

o NBFCs segregated into four layers – Base, Middle, Upper and Top – based on size of assets, nature of operation and systemic significance.

o Upper layer restrictions are more stringent (like a bank).

Liquidity Coverage Ratio (LCR):

o Big NBFCs will need to keep high-quality liquid assets as a buffer.

Harmonization of Regulations:

o Converging the different classes of NBFCs by a common regulation to avoid arbitrage between bank and NBFC.

Strengthening Governance:

o Compulsory formation of Risk Management Committees, tighter rules for auditors and tougher board oversight.

Deposit-Taking Restrictions:

o Regulating deposit-taking NBFCs more stringently to safeguard small investors.

Special Resolution Framework (2020):

o Targeting solving a challenge of insolvency and restructuring stressed NBFCs with quick resolution.

Impact:

These moves are aimed at increased transparency, lower systemic risks of NBFCs and also balancing NBFC operations more in line with the ones conducted by banks, while also leaving them the space for innovation and operating in a niche markets.

10.5 Products and Services of NBFCs

10.5.1 Retail Lending (Consumer Loans, Vehicle Loans)

Consumer Loans:

NBFCs also participate in the consumer finance space by lending on electronic appliances, furniture, and other durables for personal use. Most of these type of loans are short-term and flexible with paying back terms.

Vehicle Loans:

The NBFCs are the lead financers of two wheelers, cars and commercial vehicles. Such lenders attract borrowers, especially those not eligible for bank loans, as they have the ability to offer fast approvals, low documentation loan products and doorstep services.

Example: Bajaj Finance and Shriram Transport Finance are dominant players in consumer and vehicle loans.

Role: Retail lending by NBFCs helps in boosting the consumption demand and serves sectors like automobiles and retail trade.

10.5.2 SME and Business Financing

Definition: NBFCs are companies that are engaged in the business of providing banking services, such as loans and advances, acquisition of shares, stock, etc. NBFCs doesn't hold a full banking license and can't accept demand deposits.

Types of Services:

• Working capital loans.

• Term loans used for expansion and modernization.

• Trade finance and bill discounting.

• Equipment leasing and hire purchase.

Significance: Through accessible and flexible credit, NBFCs enable SMEs to scale up, innovate, create employment.

For example, Lendingkart and Capital Float focus on lending to SMEs leveraging technology.

10.5.3 Infrastructure Financing

Explanation: Infrastructure Finance Companies (IFCs) are NBFCs financing infrastructure Installment Credit to Households Definition: Other Financial Service Providers (OFSPs) provide credit as lease, hire purchase, etc.

Characteristics:

• High-value, long-term funding.

• Is highly risky because of project delays and regulatory hurdles.

• Requires strong asset-liability management.

Example: Infrastructure Leasing & Financial Services Ltd. (IL&FS) and Power Finance Corporation are important players in the infrastructure financing business.

Role: Infrastructure is behind all roads, seaports, airports and power projects that fuel economic growth and reach.

10.5.4 Wealth Management and Investment Services

Definition: Some types of Non-Banking Financial Companies (NBFCs) are into the business of a acquisition of shares and securities.

Services Provided:

- Asset management for high net-worth individuals(HNIs).
- Securities including stocks, shares, bonds and debentures.
- Financial products and capital market services.

Significance: NBFCs are signfiicant since they ferret household/ institutional savings into i)nve stments and elast financial markets besides capital entinaement.

Example: NBFCs including Motilal Oswal Financial Services provide wealth management and investment advisory services.

10.5.5 Insurance and Microfinance Services

Insurance Services:

NBFCs sell insurance products (life, medical and general) as corporate agents either exclusively or through subsidiary or a tie-in with an insurance company. Their strong base of agents and network across the country is instrumental in increasing insurance penetration in India.

Microfinance Services:

NBFC-MFIs only lend small amounts to poor families who use the money for income generating activities, like farming or small shops. These services empower the downtrodden — particularly females—by providing access to credit for self employment and economic independence.

Example: Bharat Financial Inclusion Ltd. is a major NBFC-MFI, whereas entities such as HDFC Life sell insurance using the coverage of NBFCs.

Job description: Insurances and micro-finance services contribute to a financial safety net, diminish vulnerabilities and stimulate inclusive growth.

"Wealth management services offered by NBFCs are not limited to high-net-worth individuals.

Did You Know?

Increasingly, middle-class investors are accessing NBFC-led investment advisory, mutual funds, and portfolio management services. By using digital platforms and data-driven tools, NBFCs are making wealth creation opportunities more accessible, personalized, and affordable to wider segments of society."

10.6 Success Stories of NBFCs

10.6.1 Bajaj Finance

Background:

Bajaj Finance Ltd., a subsidiary of the Bajaj Group, started as a vehicle finance provider in the late 80s. The family expanded into consumer lending, SME finance, commercial lending and wealth management over the years. Bajaj Finance is one of the most valuable NBFCs in India as we know it today.

Key Success Factors:

Focused on the Customer: The focus was on the customer—both in terms of a specific loan (consumer durable loans), provided for only a few products, as well as EMI being made available in an easy and low cost manner to many middle class households.

Digital Evolution: Robust penetration in technology makes it possible to get instant loan approval, mobile based services and convenient use of EMI card.

Risk Management: Conservative credit assessment and broad-based loan franchise helped to keep asset quality strong.

Brand Positioning:Used the already existing goodwill of Bajaj Group to garner trust and enlarge it on a countrywide scale.

Impact:

Bajaj Finance transformed consumer lending in India, providing millions of people with access to credit at affordable interest rates. It was instrumental in boosting retail consumption, especially of electronics, cars and lifestyle products.

10.6.2 Shriram Transport Finance

Background:

The 1979 born Shriram Transport Finance Company (STFC) is one of the largest and oldest Asset Financing non-banking companies in India. It specializes in the financing of commercial vehicles, particularly for small trucking operators and drivers who are frequently cut off from mainstream banking.

Key Success Factors:

Niche Focus: Focused on funding used commercial vehicles, which most banks had overlooked.

Relationship lending: Established long-term confidence of borrowers mostly inexperienced in credit.

Personalized Repayments: Tailored loan terms to suit truckers' uneven cash flows.

Large reach across semi-urban and rural: Wide spread to tap the under-served market.

Impact:

STFC helped small time transport operators to become rich by owning their own vehicles. It had a large impact on the logistics industry, livelihoods in rural areas and also served as an example of specialised financing.

10.6.3 Muthoot Finance

• Background : Muthoot Finance Ltd was founded in 1939 and it is the largest gold loan NBFC in India as part of The Muthoot Group.

• Core Operations:

o We cater to the financing of loans against gold jewellry which enables us to offer instant liquidity to our clients.

o Facilitates small-ticket loans, very convenient for the middle and lower strata.

• Other Services:

o Remittances in collaboration with international remittance providers.

o Foreign exchange services travelers, and businesses.

o Distribution of insurance products.

o Microfinance services for women entrepreneurs and rural communities.

• Strengths:

o Prominent brand presence in rural and semi-urban India.

o Fast credits and financed upon underlining provided collateral with the borrower's firm.

o Nationwide Spread/Branch network.

• Role in Financial Inclusion:

o Makes access to credit available who cannot be served by full fledge banking systems.

o Acts as an attachment during crisis and help households in need of funds instantly.

10.6.4 LIC Housing Finance

• Background: It was incorporated in the year 1989 being a part of Life Insurance Corporation of India (LIC).

• Core Operations:

o Grants housing loans to individuals for buying/building house/flat.

o Provides loans for maintenance /repair/extension of residential properties.

o Gives money on loan for residential construction to builders and developers.

• Target Customers:

o Salaried, self-employed, NRIs and corporate bodies.

• Special Features:

o Large amount long duration home loans at attractive interest rates and easy repayment options.

o Distinctive policy on the affordable housing under the government policies.

• Strengths:

o Ability to trust and count on LIC Organisation.

o Extensive presence and customer base in urban and semi-urban India.

• Importance:

o Supports India's growing housing demand.

o Plays a crucial part in accomplishing the government's "Housing for All by 2022" objective.

10.6.5 Power Finance Corporation Ltd (PFC)

• Background: Set up in 1986, PFC is a leading public financial institution with the status of an NBFC under the administrative control of Ministry of Power, Government of India.

• Core Operations:

0 Financially supports the power sector (generation and transmission as well as consum er subsidy).

o Funds traditional (coal, hydro, gas) and renewable energy developments (solar, wind.).

• Strategic Role:

o Acts as the nodal agency for multiple government schemes such as UDAY (Ujwal DISCOM Assurance Yojana).

o Backs infrastructure reforms to increase productivity in the Indian power sector.

• Strengths:

o High funding capability and long-term financial support.

o They are critical in connecting India's infrastructure and energy requirements,._The Geopolitical context:.

• Importance:

o Indirectly supports India's GDP growth through Avantika Group by way of reliable power infrastructure.

o Significant role in facilitating the country's move towards clean and renewable energy.

10.6.6 Other New Entrants in FinTech-NBFCs Segment

• Trend: NBFCs are moving through digitization and integrating financial services with new technology, leading to the rise of FinTech-NBFCs.

• Notable Players:

o Paytm: Digital and payment services such as digital wallets, instant loans.

o Bajaj Finserv:- Offers consumer loans, EMI cards, and online credit options.

o Lendingkart: Serves small businesses lending program through AI-based credit-scoring mechanism.

o Capital Float: Offers SME lending services and digital credit products.

o KreditBee: Provides short term personal loan to young professionals and new bees that don't have any credit history.

• Innovations in FinTech-NBFCs:

o Digital Overdraft: Mobile app based instant approvals and disbursal.

o AI and Big Data: Applied for credit score, fraud trends.

o Blockchain: Secures financial transactions.

o P2P Lending Platforms: Match borrowers with lenders.

• Impact on Financial Sector:

o Increases accessibility to financial services for the unbanked and underbanked.

o Less reliance is placed on collateralbased funding.

o Improves customer satisfaction due to faster, convenient and customizable screens.

• Challenges:

o Compliance in rapidly changing space.

o Cybersecurity and data privacy risks.

o Challenges posed by conventional banking institutions transitioning to digital operations.

10.7 Summary

ϖ NBFC is a company which provides banking services to people but they do not hold a category of bank.

ϖ They cannot maintain demand deposit accounts and be a part of the payment and settlement system but however are important intermediaries in dispensation of credit.

NBFCs are distinct from banks in their business models, regulation and market targeting, but they E. Banks operates as commercial enterprise that seeks to profit by exploiting the potentialities of the economies scale.

ϖCategories are Asset Finance Companies, Loan Companies, Investment Companies, Infrastructure Finance

ϖ The Reserve Bank of India (RBI) supervise the NBFCs through enlisting, criteria for minimum net worth owned and prudential norms however to keep stability.

ϖ NBFCs provide retail lending, SME and business loan funding, infrastructure financing, wealth management, life insurance or microfinance.

ϖ NBFC success stories like Bajaj Finalce, Shriram Transport Finance, HDFC Ltd. and the new Fintech players demonstrate that nonbank finance is making its mark in consumer credit, transport, housing and digital finance contributions to financial services.

ϖ NBFCs contribute significantly in strengthening the financial system of India by helping in mobilization of saving, supporting infrastructure development and fostering entrepreneurship and self reliance.

10.8 Key Terms

• NBFCs: Non-banking financial companies that offer banking-type services, but are not allowed to accept demand deposits or issue cheques.

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• Asset Finance Company (AFC): An NBFC that is a company and has as its principal business the financing of physical assets such as automobiles, tractors, lathe machines, generator sets, earth moving and material handling equipments etc.

• Loan Company (LC): It is an NBFC loan company which carries on its main business of providing loans and advances.

• Investment Company: An NBFC whose |main business is building a portfolio of shares, debentures and bonds.

• Infrastructure Finance Company (IFC): An NBFC which give loans mainly for infrastructure projects such as road, power and ports.

• NBFCMFI (NBFC-MFI): A non-deposit taking NBFC that finances small borrowers and low-income households in rural areas.

• Housing Finance Company (HFC): NBFC that provides housing loans for purchase/ construction/ reconstruction of residential flats or houses, purchase of residential plots and/or renovation /improvement thereof.

1

• Core Investment Company (CIC): It is an NBFC holding not less than 90% of its net assets in the form of investment in equity shares, preference shares, bonds or debentures or loans in group companies.

• Prudential Norms: Regulatory requirements regarding capital adequacy, asset classification, and provisioning for NBFCs.

10.9 Descriptive Questions

Describe Non-Banking Financial Companies (NBFCs) and discuss the significance of NBFCs in the Indian financial system.

Distinguish between NBFCs and Banks in their functioning, regulations and role in financial inclusion.

Describe different kinds of NBFCs in India with examples.

Know how RBI controls NBFCs to be explained.

Explain the major regulatory compliance for NBFCs with respect to registration, minimum NOF and prudential norms.

Consider the predominant products and services offered by NBFCs and how they have been contributing to financial markets.

Quote the reasons for success of Bajaj Finance, Shriram Transport Finance and HDFC Ltd. as top NBFCs.

Explain the impact of FinTech-based NBFCs on India's financial services industry.

Comment on the problems and risks of NBFCs, inspite of their rapid growth.

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Knowledge Check 1

1. b) Asset Finance Company
2. a) NBFC-MFI
3. b) CIC
4. c) Infrastructure Finance Company

10.11 Case Study

Introduction

NBFCs are critical to help reach the credit requirements of under-served tract of society. They extend credit for cars, homes, sm all businesses and consumer goods — frequently fasterthan banks. But rapid expansion without prudent risk management can leave NBFCs vulnerable to liquidity and regulatory problems. This case looks at Shakti Finance Ltd., a mid-sized NBFC that was caught in a severe liquidity crunch, and the need for halting further deterioration of stability within the system.

Background

Shakti Finance Ltd. had a successful reputation for providing fast, flexible loans to small businesses, vehicle owners and retail customers. Alandurai is one of the many non-urban

regions in which the company thrived, thanks to its customer-centric approach. For a few years, the company posted hefty profits and hyper-lucid loan growth.

But in 2019, after defaults emerged at a major NBFC, confidence among investors for the sector waned. Shakti Finance, which was excessively reliant on short-term market borrowings, found raising funds suddenly becoming difficult. Banks and mutual funds demanded their money back, but with little coming in from borrowers, the company was finding it difficult to stay liquid.

This crisis posed important questions on risk management, governance and sustainability of NBFCs which were heavily relying on short-term funding for long term lending."

Problem Statement 1: Asset-Liability Mismatch

Shakti Finance made short-term borrowing but gave out long-term loans. It couldn't roll over its borrowings as liquidity tightened.

Solution:

NBFCs need to develop robust ALM, diversify sources of funds and build buffers against sudden liquidity outflows.

MCQ:

How can NBFCs mitigate asset-liability mismatch risk?

a) Concentrate on lending for the short term only

b) Fund exclusively by bank indebtedness

c) Take the appropriate ALM measures and ensure fundings are diversified

d) Avoid giving loans altogether

Ans: c) Ensure healthy ALM processes and tap various sources of funds

Challenge 2: Overreliance on Institutional Funding.Description of the Problem

Shakti Finance was too dependent on banks and mutual funds for its funding. Where those institutions receded, the company's liquidity evaporated.

Solution:

NBFCs must diversify their source of funds by accessing retail investors, securitization of loan portfolio and long-term credit lines.

MCQ:

How can NBFCs lessen their dependence on a handful of funding sources?

a) Borrow only from banks

b) Repo and Sprinkle Securities Securitizing and diversifying sources

c) Increase interest rates sharply

d) Halt lending to high-risk sectors

b) Securitize and diversify Summoning the ghosts of encroaching doom sounds fun. b) securitize, diversity sources

Issue 3: Governance and Risk Oversight

Uncontrolled expansion led to default risks and operational in efficiencies at Shakti Finance.

Solution:

Healthy business practices, risk management committees and compliance with RBI's prudential norms remain central to sustainable growth.

MCQ:

What one step can enhance NBFC governance?

a) Reduce compliance reporting

b) Establish risk management committees

c) Ignore RBI regulations

d) Singleminded pursuit of profit.

Response: b) Formulation of risk management committees

Conclusion

Shakti Finance case demonstrates the robustness and vulnerabilities of NBFCs as well. Though crucial for financial inclusion and economic development, over-reliance on short-term funding, asset-liability mismatches and weak governance are often recipe for crisis. NBFCs can thus ensure sustained growth and continued investor interest by implementing strong risk management measures and compliance with regulations.

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Unit 11 Credit Rating Agencies

Learning Objectives

1. Understand the meaning and functions of credit rating agencies in financial markets.
2. Explain the process and methodology of assigning credit ratings.
3. Differentiate between types of credit ratings such as corporate, sovereign, and structured finance ratings.
4. Analyze the role of credit rating agencies in ensuring transparency and reducing information asymmetry.
5. Evaluate the impact of credit ratings on investors, borrowers, and capital market efficiency.
6. Examine the regulatory framework governing credit rating agencies in India.
7. Assess the criticisms and limitations of credit rating agencies, especially during financial crises.

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11.0 Introductory Caselet

Arvind held the position of CFO at an India-based mid-sized manufacturing company which intended to mobilise funds through a corporate bond issue. The company had to go join hands with a credit rating agency before floating the bond issue to find out its financial health and repayment capacity. Arvind understood that a strong credit rating would make it easy for the company to attract investors and borrow at low interest rates; a weak one, on the other hand, would put off potential financiers or else make fundraising extremely expensive.

The ratings firm considered the company's balance sheet, profitability, indebtedness, management quality and industry risks. After considering the company's rating it auto-assigned 'A' indicating the company had a strong ability to meet its debt obligations but was somewhat more susceptible to changes in economic conditions than higher rated companies.

With that rating the company borrowed money on very good terms and was able to get enough capital infusion. Investors, too, were put at ease: The independent rating made lending to the company less risky. But Arvind also knew that keeping up this rating depended on financial discipline – lose this rating and the company might have to pay more for its debt, which would be bad for its image.

Critical Thinking Question

Why liquidity and transparency in credit rating agencies have to be regulated by government?

11.1 Introduction to Credit Rating

1 11.1 Meaning and Definition of Credit Rating

Meaning:

A credit rating is an assessment of the creditworthiness of a borrower in general terms or with respect to a particular debt or financial obligation. Basically, it is an evaluation from independent agencies as to whether the borrower has the ability and willingness to pay back debts. Credit ratings are a means of assessing the default risk that can be associated with any given borrower or debt security product.

Definition:

Credit Rating has been defined by the Securities and Exchange Board of India (SEBI) as "an opinion regarding soundness of an entity in meeting its obligations on a timely basis and an acceptable price". Credit rating is a vicarious expression, often ranked by letter grade, (AAA, AA BBB etc), of credit behavior in respect of timely repayment of deb!

Key Points:

• Credit rating agencies are independent credit rating providers.

• Ratings can relate to companies, governments or individual financial products, such as bonds and debentures.

Higher ratings mean lower credit risk, while lower ratings indicate higher default risk.

11.1.2 Objectives of Credit Rating

The basic goals of credit-rating are as follows:

Assist with Informed Investment Decisions: -Credit ratings help investors to obtain accurate information in respect of the risk profile of a borrower or financial instrument etc.

Increase Borrower's Access to Capital: A positive rating increases borrower credibility and accessibility to find capital in an easier, more cost-efficient manner.

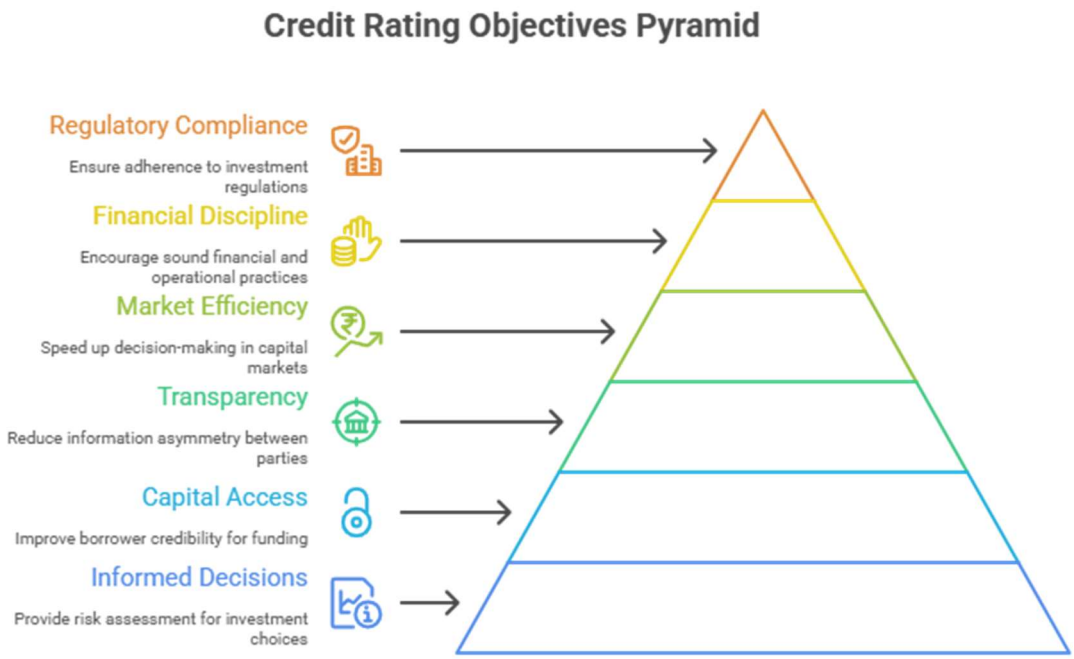
Transparency: Ratings narrow the information gap between issuers and investors by providing third party, independent views in a standardised manner.

Promote Market Efficiency: Credit ratings aid in capital markets decision making by providing a short-hand measurement of credit risk.

Benchmarking Rating: Ratings are used as benchmarks for comparing the relative creditworthiness of different entities or instruments.

Promote Financial Responsibility: Borrowers are incentivized to maintain or increase credit scores, by focusing on budgeting effectively and managing operations efficiently.

Assistance in Regulatory Compliance In several instances, regulators mandate that respondents, such as mutual funds or insurance companies should put their monies in instruments with ratings beyond a particular threshold.



11.1.3 Significance of Credit Ratings for Stakeholders

Credit ratings are crucial for various parties in financial infrastructure.

For Investors:

• To give you a measure of risk when investing in stocks.

• Provide opportunities for portfolio diversification through the identification of instruments with appropriate risk-return characteristics.

• Provide certainty in investment decisions with the help of independent expert views.

For Borrowers/Issuers:

• A good credit score can find you a better standing and credibility in the market.

• Borrowers with strong credit can borrow money at lower interest rates.

• Acts as advisory to management concerning strengths and weaknesses of financial condition.

To the Intermediaries:a.

• Support portfolio management by monitoring investments for adherence to minimum credit standards.

• Aid in adhering to statutory provision of investment norms.

For Regulators and Policymakers:

• Credit ratings provide market transparency and accountability in financial markets.

• They protect retail investors by limiting their exposure to highly speculative products.

For the Economy:

• Credit ratings help promote the development of capital markets by allocating funds more efficiently.

• Foster financial stability by mitigating the effects of banking risk on the management of losses and recovery, gains in stock prices, and capital.

Did You Know?

"Credit ratings not only guide investors but also influence government borrowing costs. A sovereign downgrade can increase a nation's interest rates on international loans, affecting its currency stability and investment inflows. Thus, ratings assigned by global agencies significantly impact economic growth, trade competitiveness, and investor confidence worldwide."

11.2 Credit Rating Scales

11.2.1 Investment Grade Ratings

Definition:

Investment grade ratings represent a high level of safety and dependability in regards to the payment of financial obligations. Organizations or instruments with such ratings are stable and less likely to default.

Detailed Features:

Solid fundamentals Issuers generally have stable cash-flow, modest leverage and healthy governance.

Investor Preference: Institutional investor such as mutual funds, insurance companies and pension funds may be permitted to invest only in investment grade instruments.

Lower Interest Rate: Borrowers with good credit ratings can borrow at lower interest rates.

Investor Confidence: Higher ratings increase the credibility of issuers and investor confidence.

Illustrative Scale (Typical):

• AAA (or Aaa): The highest credit quality; almost no risk of default. Example: Bonds of stable economies and government.

• AA (or Aa) Very high credit quality; low risk, with a little more vulnerability than AAA.

• A: High repayment ability with the sensitivity to the economy.

• BBB (or Baa): Moderate safety; lowest tier of investment grade.

Tale: Many of the biggest companies in India, such as Infosys or Reliance Industries, have tapped the market for money with strong investment grade ratings that ensures cost-effective capital.

11.2.2 Speculative / Junk Grade Ratings

Definition:

P-1 to Baa3 are prime (investment grade) ratings where the risk of default is higher. Corporations or instruments in this classification are particularly vulnerable to being unable to meet commitments during adverse conditions.

Detailed Features:

Unstable Financials: This could be excessive leverage, sharp fluctuations in earnings or a high risk business model.

Elevated Default Rate: These are issuers that will tend to default more than investment-grade organisations.

High Return, High Risk: Securities are usually issued at higher interest rates (so-called junk bonds) to attract investors who are willing to take on risk.

Investor Profile: For Speculative investors or Investors who are looking for higher yields, willing to assume default risk.

Illustrative Scale (Typical):

• BB (or Ba): A little bit speculative; will be subject to uncertainties in business or economy.

• B: Speculative; subject to adverse change but no current default.

• CCC/CC/C: Extremely poor credit quality; interest could become a default.

• D: Default; the issuer has defaulted on an obligation.

Example: During the 2008 global financial crisis, mortgage-backed securities in the United States were downgraded to junk indicating that they would most likely default.

11.2.3 Rating Symbols (e.g., AAA, AA, A, BBB, BB)

Definition:

Rating symbols are the graphic representations by which agencies communicate levels of safety as to the issuer or purported issuer of an issue of debt. While each agency, which includes CRISIL, ICRA, Moody's top rating agency no outside of India and three others – S&P & Fitch have a format that is unique to them but largely follows an international format for all.

Detailed Explanation:

• AAA/Aaa: The top rating for nearly risk-free obligations.

• AA/Aa: Has very high quality, but is of slightly lower quality than AAA.

• A: Has enough safety, but could be pressured in the wrong situations.

• BBB / Baa: The last of the investment grade category; moderate safety but consistent in normal times.

• BB/Ba: Below investment grade; speculative; uncertain.

• B: Moderate repayment capacity; may have inadequate protection against risk.

• CCC / CC / C: Default is a virtual certainty, consistently dependent on favorable conditions.

• D: Already in default.

Use of Modifiers:

• Some agencies use "+" and "–" to denote relative position within a category (for example, AA+, AA, AA–).

• Moody's employs 1, 2 and 3 in each category (e.g.: Aa1, Aa2, Aa3) to signify distinctions among rating divisions.

Importance of Notations:

• Standardization will allow comparability between issuers and instruments.

• Investors are able to quickly gauge risk without conducting the in-depth financial analysis discussed above.

• Rating notations function as market signals, affecting the industry's cost of borrowing and investor confidence — and, in some cases, even government policies.

Example: In 2020, when global rating agencies downgraded the outlook on India's sovereign rating from stable to negative, it had an immediate impact on foreign investor sentiment and borrowing costs.

Knowledge Check 1

Choose the correct option:

1. Which is the highest credit rating indicating minimal risk?
   a) AA
   b) AAA
   c) BBB
   d) BB
2. Which rating is the lowest level of investment grade?
   a) BBB
   b) BB
   c) A
   d) B
3. Which rating category represents speculative or junk grade?
   a) AA
   b) BB
   c) A
   d) AAA
4. What does a "D" rating indicate?
   a) High safety
   b) Moderate risk
   c) Default
   d) Investment grade

11.3 Factors Considered in Credit Rating

11.3.1 Business Risk Factors

Explanation:

The risks to the business are indicative of uncertainty which is connected with the company's operation central activities, and its sources of income. They depict how competitive, durable and offbeat the business model is to the market vagaries.

Detailed Aspects Considered by Agencies:

• Market Share and Competitive Position: A company with a solid competitive position and established market share is not heavily vulnerable to revenue volatility.

• Diversification: Businesses that operate in different geographies or lines of business are less susceptible to shocks in any one market.

• Operational: Effective supply chain, cost and productivity initiatives de-risk you.

• Innovation and Product Life Cycle: Firms that have an ongoing policy of innovation, or are in an industry with long product life cycle receive a higher rating.

• Concentration of a Few Customers: Overdependence on small number of CUSTOMERS increases concentration of business risk.

Illustration: An Indian IT service firm having diversified clients across the globe has less business risk than that of small information technology company which is connected to one or two clients.

11.3.2 Financial Risk Factors

Explanation:

Financial risk measures analyze financial various companies resources to meet their debt requirements. This calls for diligent examination of balance sheets, income statements and cash positions.

Detailed Aspects Considered by Agencies:

• Use of Leverage and Structural Subordination: Elevated debt to equity ratios endow increased exposure to repayment risk.

• Profitability Ratios: Robust margins - operating (16.3% vs 4.2%) and net (12.8% vs -44.5%) - indicate financial strength.

• Stable Cash Flows: Good positive operating cash flows over time ensure repaying capacity even in adverse situation.

• Liquidity Position: The short term liquidity of assets and the facility of access to bank line of credit minimize immediate risk.

• Payment Histor y: Regular payment record reflects trust and ultimately ratings improve.

• Off-balance sheet liabilities: Pure offbalance sheet items such as guarantees can undermine estimation of financial risk.

Example: A company has strong financials when compared to its peer but it's debt-equity is less than 0.5 and had a surge in cash resources while the latter has a ratio of over 3.0, but having irregular return on investments.

11.3.3 Industry Risk Factors

Explanation:

Industry risk portrays the environment outside of a company (Its external environment). Even well run businesses may find such limitations when the business is highly volatile, cyclical or heavily regulated.

Detailed Aspects Considered by Agencies:

• Cyclicality: Sectors like automobiles, steel or realty are cyclical that make them riskier during economic downturns.

• Market Growth Potential: Fast-paced industries such as renewable energy or digital services are viewed favorably.

• Competition: High competition may eat into your margins; and vice versa when you have a monopoly or an oligopoly structure.

• Barriers to Entry: Low or high barriers to entry (e.g., spectrum licenses for telecom companies) create vulnerability, and protect existing players.

• Regulatory Assistance: Industries that are subsidized or taxed by governments may also score higher.

For example, a power generation company might be assigned a stable rating given the guaranteed demand, but start-ups in the airline business may get low ratings on account of volatility and heavy competition.

11.3.4 Management Quality and Governance

Explanation:

The credit rating agencies understand that it is management decisions and governance structures affecting long-term sustaina¬bility they must assess. The financially healthy company with poor governance might still be risky.

Detailed Aspects Considered by Agencies:

• Leadership: Having experienced and visionary leadership will increase the likelihood of long-term performance confidence.

• Corporate Governance Criteria: Clear reporting, observance of laws and an independent board decreases risk.

• Strategic Decision Quality: Fit disregarded merging decision-making also affect stability through merger, acquisitions and capital allocation decisions.

• Prudent Risk Management: Proactively identify and manage business and financial risks.

• Ethicality: Past record of adherence to, no history of malpractice and standing in the market.

Sample this: HDFC Ltd. was perennially top-rated not just for its financial performance but the way it was governed, and there were few investors or regulators who did not take comfort in that.

11.3.5 Regulatory and Environmental Factors

Explanation:

The regulatory and environmental framework as relevant to the company is also taken into account, as compliance and external risks have a varying degree of impact on credit rating.

Detailed Aspects Considered by Agencies:

• Legal and Regulatory Risks: Violating tax, labor or environment regulations brings the risk of fines and reputational damage.

• Changes in Government policy: If the government suddenly changes trade, tax or interest rate policies, the profitability of a project can also change.

• Environmental and Sustainability: The ESG scores from credit rating agencies are being considered more and more in comparison. Companies subject to environmental risks (e.g., mining, chemicals) – Downward pressure on ratings.

• Macroeconomic Conditions: Sovereign and corporate ratings take into account increasing/decreasing inflation, interest rates and political stability.

• Contract and Judicial enforcement: Ratings are frequently lower in countries with low judicial system efficiency because of uncertainty about contract enforcements.

Example: NBFCs are strictly regulated by the RBI in India. Service of prudential standards – good; breach in liquidity (Read: capital) requirement leads to a downgrade.

11.4 Types of Ratings

11.4.1 Corporate Debt Ratings

A corporate debt rating is an evaluation of the credit risk of a particular debt instrument, and this rating may take into consideration the overall creditworthiness of the organization that issues it. These ratings aid investors in gauging the likelihood that a company will satisfy its debt obligations, meaning pay interest and principal as scheduled. Here is why: Importantly, though the rating goes not to the company but rather to a given debt instrument issued by that company, and it reflects risk related to that specific issue.

Various factors are taken into consideration by the credit rating agencies like CRISIL, ICRA, CARE Ratings and India Ratings while giving ratings. These can range from the company's business model, financial performance, to governance standards and industry dynamics in which the firm operates. For example, a company that is in the cyclical industry such as real estate or steel (and even if it has similar financials) might be rated lower than a firm which operates in stable sector like FMCG/ IT and so forth.

Debt instruments are rated on a standard ratings scale. Those rated AAA are relatively safe with low default risk, while AA or A also imply strong payment capacity but with a little higher risk. Low ratings as BB, B or C show prospect for default while the business is going bad (Bloomberg 2011). D-rated instruments have already defaulted.

Reliance Credit Rating Example The p erfect real life example for corporate debt rating Or Corporate Bonds ratings is going to be Reliance Industries Ltd since it's possibly one of the largest and one of the most financially sound conglomerate's in India. So if its issue of non-convertible debentures (NCDs) to the market for raising capital gets rated, say AAA by an agency like CRISIL or ICRA, it would indicate that its balance sheet is strong, it has diversified sources of income and had experience in making money. With that rating, Reliance is able to borrow at a lower interest rate than it would if investors thought they faced serious risk in lending to the company. A little-heard-of or more highly leveraged company in an unstable industry, by contrast, might be assigned a BB rating — indicating greater risk and motivating investors to demand a higher rate of interest for the added risk.

InvestorsCredit ratings are important in the purchase decision process; they influence the behavior of financial institutions and individual investors. They also affect the price of credit for corporates and influence to what extent the capital markets are open to different companies.

11.4.2 Sovereign Ratings

Ratings of sovereign debt issued by national governments Sovereign ratings are opinions that relate to the ability and willingness of a governmental entity to meet its financial obligations in full and on time. They are essential reference points for global investors which are used to assess lending risk, investing in or trading with a country via government bonds, external lending or other sovereign debt securities.

Sovereign ratings reflect a variety of macroeconomic and political variables. These are in terms of the country's political stability, its financial health (i.e. fiscal deficit as well other indicators like public debt), effectiveness of monetary policy and inflation control, comfort surrounding foreign exchange reserves, external debt profile as a whole. A solid day rating would indicate a country with good financial management, strong institutions and the ability to raise sufficient revenues to meet its obligations without defaulting.

The effect of a sovereign rating is more than psychological, it has financial effects that are tangible. The sovereign rating is also a key factor that determines the cost of government borrowing in international markets, as higher ratings mean lower credit risk. Conversely, a downgrade in credit rating indicates greater risk, which results in higher interest rates on new loans and can cause capital outflows as investors demand increased risk premium or move funds to more secure economies.

An example of this in real life is India's sovereign credit rating. India is already rated 'Baa3' by Moody's as well as 'BBB-' on S&P and Fitch, the lowest investment-grade ratings. Although those ratings reinforce the fact that India can service its debt, they are also indicative of worries about fiscal deficit and public debt numbers as well as structural economic reforms. When Moody's cut India's rating outlook to 'negative' in 2020, during the COVID-19 pandemic, saying it had a weak economic growth and fiscal pressures that might hurt India's foreign funded position — which means it could affect its appeal among global bond investors O presume such positions are money engulfed. "But over the next few years as India built up its forex reserves, undertook tax reforms and also bounced back post-pandemic, we have upgraded our outlook to 'stable', which led investors to show confidence and inflows into the country of foreign capital strengthened.

Sovereign ratings are therefore a measure of a country's economic credibility and play an important role in global investment sentiment, particularly in the case of emerging markets.

11.4.3 Structured Finance Ratings

Definition:

Structured finance ratings are assigned to instruments backed by a pool of assets, for example mortgages, auto loans or receivables, where the payment of interest and/or return of principal is dependent on the cash flows generated by the assets backing the instrument.

Key Aspects:

• Evaluate risk transfer options such as securitization.

• Assess quality of underlying assets, legal structures and credit enhancements.

• Structured products consist of MBS and ABS.

Example – insistence on relying too much on structured finance ratings of mortgage-backed securities was a problem in the 2008 global financial crisis.

11.4.4 Bank Loan Ratings

Bank loan ratings are credit assessments that have been developed specifically for bank loans, primarily large corporate or project finance loans. The ratings provide an assessment of credit risk - the level of borrower's ability to repay borrowings according to agreed terms. Unlike corporate ratings, which provide an overall perspective on a company's credit profile, loan ratings are transaction-specific and consider the risk attributes of this particular loan or credit facility.

This rating is important in assisting banks to meet regulatory norms for capital adequacy, and especially the Basel III guidelines. Under these rules, banks hold a certain level of capital against each asset, including loans, according to the risk weight given to that asset. The higher the rated loan (for example, one rated AAA or AA), the lower its considered level of risk and therefore charge a lower risk weight — whichin essence means that the bank would have to hold less capital against it. Conversely, a lower-rated loan (more risk of default) means the bank must set aside more capital to act as cushion against potential losses.

Normally, banks deploy credit rating agencies including CRISIL, ICRA and CARE Ratings among others to rate big ticket loan exposures in sectors such as infrastructure, power, manufacturing and real estate. These ratings are also now embedded in internal risk management systems, and influence the pricing of loans (higher risk means higher interest rates).

As a practical instance, consider the following: Let us say, a public sector bank has just sanctioned ₹ 2,000 crore loan to an infrastructure project (e.g., construction of a metro rail line in any major Indian city). The bank may demand a loan rating from CRISIL or ICRA before the disbursement of the amount, which will evaluate project's repayment capacity on anticipated cash flows, strength of sponsor, risk in completion, regulatory approvals and economic viability. Once the loan is rated high, for example 'AA', then the bank would have to set aside less capital under RBI's capital adequacy guidelines. But when the rating is low, either bank chooses not to lend, or provides loan at an increased interest rate in response to greater risk (or reserves more capital by cutting inefficient lending).

Thus, the ratings assigned to bank loans act as an instrument for risk assessment and capital management (Forbes, 2000), which enables banks lend prudently and uphold financial soundness in accordance with regulatory standards.

11.4.5 Grading for IPOs and Other Specialised Ratings

IPO grading is the review of the fundamentals of the issuing company in relation to all other issuers. The grading is performed by SEBI registered credit rating agencies (CRAs) such as CRISIL, ICRA and CARE Ratings which evaluate the level of risk associated with the rated instrument on different parameters. Unlike credit ratings of debt, which are predictions about the future repayment risk of the debt being rated, IPO grading does not comment on the future price or part of return that is "expected". It does not provide individualized investment advice and should not be considered as a recommendation to purchase, sell or hold any product. It provides an independent perspective on the company's credit quality and trend analysis but is not intended to include discussions of future events. The grades are such that 1 is lowest and 5 is highest - i.e., the better the fundamentals (higher scores) of a given listed company relative to other listed companies, the higher would be its score on this parameter.

Though initially IPO grading was made mandatory by SEBI in India, it was later made optional as the investors' response was lukewarm. But in its heyday IPO grading was a useful service for retail investors, particularly those who had limited access to extensive financial analysis. When, for example, VRL Logistics came up with an IPO in 2015, it had a rating of 4 on 5 from CRISIL, indicating strong fundamentals. This inspired investor confidence in the company’s operations and longevity, which helped drive the IPO to success.

Credit rating agencies, in addition to IPO grades, also sues a number of specialized ratings for multiple components of the financial and investment universe. An example is the Priority Sector of Municipal Bond Ratings, which rates debts raised by local governments or municipal institutions to finance urban infrastructural bodies. The ratings take into account the municipality's strong financial condition, revenue generating capabilities as well as a good governance structure.

Another specialized one is the Insurance Financial Strength Rating, which measures an insurance company’s capacity to meet its policyholder claims. These ratings assist policy-holders and institutional clients in managing the financial stability of their life, general (and other non-life) insurers, particularly some types of long-term contracts.

Environmental, Social and Governance (ESG) Ratings are becoming ever more important in today’s global investment landscape. These ratings measure how well a company does in terms of sustainability and making a positive ethical impact, from managing environmental risks to employee treatment and corporate governance. The ratings are often used by large institutional investors and ESG-focused funds to screen or prioritize investments. For instance, companies with a strong global presence — such as Infosys and Tata Consultancy Services (TCS) — have drawn high ESG scores that in turn appeal to long-term, sustainability-conscious investors.

Another prominent category is the eye on Structured Obligation Ratings, which assesses instruments that have enhanced credit support apart from guarantee, such as letter of comfort / escrow mechanism. Such enhancements mitigate investors' credit risk, and the rating depends not only on the issuer's profile but also on the strength and stability of the support structure that is in place. A simple example of such would be a government guaranteed infrastructure bond, where the backing by an agency of the state is what lifts it above the issuers credit trajectory.

Collectively, IPO grading and these specific ratings result in an unprecedented level of detail tailored to meet the needs of investors, regulators and stakeholders in the market, bringing transparency, risk mitigation and informed decision making to niche or emerging segments of finance.

"Activity: Identifying Rating Types"

Divide students into small groups. Provide each group with real or hypothetical scenarios, such as a government issuing bonds, a company launching an IPO, or a bank sanctioning a loan. Ask them to identify the appropriate type of credit rating and justify their choice in discussion.

11.5 Rating Process

11.5.1 Request for Rating

It starts with the issuer such as a company, bank, financial institution or a government entity approaching an agency to get its debt instruments rated.

• This could be through bonds, debentures, commercial paper, bank loans or structured products.

• In certain instances, and within regulatory limitations, particularly for public debt issuances an assigning of rating is necessary.

• The issuer enters into an agreement with the agency, which includes:

o The rating objective (instrument or issuer).

o Secrecy provisions of business secrets.

o Commissions and duties of each party.

This is kind of the formal start to an evaluation.

11.5.2 Data Collection and Analysis

After contractors have signed the agreement, the organization asks for detailed information from issuers.

Types of Data Collected:

• Financials: Restated balance sheets, income and financial projections, debt schedules and possible contingent liabilities.

• Business Metrics: Marketshare, Customer-base, Product-line-up, Supply-chain effectiveness, Competitive positioning.

• Market Intelligence Industry trends including demand cycle and growth trend of the industry; process cycles and forecasts; etc.

• Miscellaneous Documents: Loan documents, project reports, legal agreements and compliance certificates.

Analysis Conducted:

• Profitability ratios, leverage levels, the liquidity position and historical repayment behavior are examined by analysts.

• Peers comparisons are made to ensure a performance against industry average.

• Stress testing is sometimes used to model performance when the economy is performing poorly.

Here is where that comes in, and this provides the facts behind a rating.

11.5.3 Meetings with Management

Quantitative analysis is balanced with qualitative insight from meetings with the issuer's management team.

Purpose of Management Interaction:

• To comprehend the business scenario, expansion and long term strategies, and future outlook.

• So as to check risk management and governance standards along with internal controls.

• To respond to questions about financial data, projections or any unusual transactions.

• To assess the credibility, competence and integrity of leadership.

These transactions frequently reveal things that aren't captured just in numbers, whether the company is naturally attuned to changes in the market or tries its hardest to act ethically.

11.5.4 Evaluation by Rating Committee

The rating committee is the final decision-making body when it comes to determining the credit ratings. It is the central entity at a credit-rating agency that makes decisions and assigns final ratings on a debt instrument, loan or issuer. It is usually comprised of seasoned analysts, industry specialists and credit veterans who are not affiliated with the team that performed the initial rating review. This architecture is aimed at providing objectivity, transparency and prevent any conflict of interests in the eventual rating.

The lead analyst at the committee then delivers a report that discusses the issuer's financial analysis, cash flow models, risks and qualitative letters. It includes a review of business risk, industry trends, governance and quality of management as well. In addition to the numbers, analysts may provide scenarios analysis showing how market conditions or operating assumptions can impact an issuer’s credit profile.

The committee goes through a formal presentation and discussion, scoring on an SWOT basis (Strengths, Weaknesses, Opportunities and Threats based on the credit) to cover off all aspects of assessing the issuer’s credit. Members can question assumptions, demand more information or engage in a debate about the risk factors it finds. The point is to arrive at a consensus based on some sort of neutral transparent decision-making rather than just one person'⍰⍰s inclusion or exclusion. The Final Score is determined by consensus or majority (if the agency has a majority component) vote.

Of significant importance is that an explanation of the decision-making founded on its case-specific evidence justifies each such rating. This documentation is the foundation of the Rating Rationale Report which, once rated, is presented to the issuer and published. This allows to reinforce credit-rating-process credibility through accountability and auditability.

An example for how this can be done in reality is the rating exercise of a significant public infrastructure bond of an Indian state-owned power generation firm. The analytics team put up a detailed note to the rating committee on the ₹5,000 crore bond issuance which covered sectoral risks (delay in implementation, fuel scarcity) propensity of promoter entity to backstop financials and structure of the bond issue (part government guaranteed). The committee discussed whether the sovereign support warranted an upgrade. In light of the government’s past performance in meeting its undertakings and the issuer’s internal capacity to generate cash, the committee unanimously assigned a rating of AA (Stable). The report explicitly mentioned that the strong sponsor profile, partial credit enhancement and stable tariff regime supported

the rating, while operational inefficiencies and receivables delays were cited as key credit concerns.

This is an example of how the rating committee serves not only as a decision-making forum, but also as a vital gatekeeper to ensure that the rating assigned is equitable and evidence-based, and reflects expert opinion.

11.5.5 Assignment of Rating and Publication

Following the Rating Committee decision, a specific credit rating is assigned to the issuer/debt instrument. These symbols — including AAA, AA+, BBB– and so on —reflect varying degrees of credit risk and repayment capacity. The rating is usually characterized by a "rating outlook" (positive, stable, or negative) reflecting whether the rating is likely to change in the near term based on current circumstances.

Rating shall be initially shared with the issuer alongwith a Rating Rationale Report before being released in public . This report explains the rationale for rating, financial analysis, risk factors, industry prospects and any other assumptions and convictions used in the rating. An issuer is provided with a chance to review the discovery and supplement it, if necessary. The be it condition confirms the final rating of the assigned one and further obtains a written approval from issuer.

Once accepted, the rating is publicized through official channels as press releases etc., regulatory filings (e.g. SEBI or that of stock exchanges) and also on rating agency websites. It is important that this information be widely disseminated so that investors, lenders, analysts and regulators are afforded ready and consistent access to credit risk information to encourage market transparency.

But there are times when the issuer will reject the rating it has been given – particularly if it’s not as high as expected. Where this occurs, the issuer may refuse to consent to publication. However, credit rating agencies may decide to release an unsolicited rating based only on publicly available information—such as audited financials, market disclosures and industry specifics. These unsolicited ratings are not requested and assist in maintaining some level of market transparency when the issuer's cooperation is minimal.

A live example of the process was when IRFC (Indian Railway Finance Corporation) issued ₹5,000 crore bonds. CRISIL rated the bond issue at AAA (Stable) after a rating process highlighting strong government stake, guaranteed cash flows from lease contracts with Indian Railways and consistent profitable financial position. The rating was embraced by IRFC and immediately released, giving confidence to investor base and made the bonds fully subscribed at favourable rates.

There have been, however, cases where companies — especially small laggards or weaker companies — got slapped with a low rating (like BB or lower) and refused to

take it. However, rating agencies have proceeded with unsolicited ratings when listing or trading of the instruments was already taking place in the secondary market in order to guard investors against probable credit risk and to keep them updated.

The rating process ends with an assignment and publication stage, which is particularly important in terms of market discipline, pricing risk and soundness of investment.

11.5.6 Monitoring and Review of Ratings

Credit ratings are not single point-in-time measures; they're ongoing assessments which should reflect issuer credit worthiness at any given time based on its financial status, business performance and risk profile. After rating is assigned and published, rating agencies do regular surveillance and periodic reviews to maintain the rating according to issuer's updated credit profile. This on-going supervision is vital to maintaining the confidence of investors and the integrity of the market.

The monitoring is usually accompanied by formal or scheduled review at regular but predetermined intervals, as quarterly, semiannually or annually depending on the rated entity-issuer's size and its credit risk profile. In such reviews, analysts typically will review the latest financial statements and operational statistics of the issuer, position in the market and compliance with covenants. These changes contribute to the calculation of a trend, aimed at deciding when (if ever) it is best to end or revise the initial rating.

Rating agencies also perform event-driven review, not just scheduled reviews. These are prompted by changes in the company's situation — such as mergers and acquisitions, change of management, defaults on loans, changes in regulation or policy, litigation risk, or big shifts in macroeconomic conditions or the industry it operates in. These can quickly impact an issuers' credit worthiness, and must be reassessed immediately.

Depending on the results of these reviews, a company could face one of three rating maneuvers:

• An upgrade in a rating may be warranted if the issuer is healthier financially, is more capable of servicing debt, or has a stronger market position.

• A downgrade can occur if the credit profile of an issuer weakens, reflecting increasing leverage, reduced profitability, stress on liquidity or unfavorable conditions in key markets.

• A confirmation takes place when an outstanding rating is deemed accurate and adequately reflects the credit profile of the issuer.

The recently announced pay-back process of Vodafone can be cited as a case in point. In the beginning, company was in groove with the credit rating. However, following the

escalation in debt, continuous losses and non-clarity of regulatory dues rating agencies like CRISIL and CARE went for even driven reviews. The company's rating was subsequently lowered over time after reports worrying about its ability to service debt and ongoing business operations without significant equity injection. Every downgrade had notes explaining the decisions and was stamped with a "negative outlook," indicating more risk if corrective changes weren't made. On the other hand, when players such as Tata Steel or JSW Steel reported debt levels falling and better cash flows besides higher margins for multiple quarters in a row, their ratings have been reaffirmed or even upgraded with improved financials on their side.

So the surveillance and review process is an important feedback loop in the credit rating process. This is beneficial - both to protect investors and the efficiency of risk pricing in capital markets -- as it assures that ratings still reflect current conditions, are relevant and timely.

11.6 Credit Rating Industry in India

11.6.1 Evolution and Growth of Credit Rating in India

• First Phase (1980s): The concept of cr in India is served inscribed with the setting up of CRISIL (Credit Rating Information Services of India Ltd)in 1987. This introduced credit rating, initially with respect to corporate debt instruments.

• The 1990s expansion: Demand for ratings increased when Indian companies started raising money through capital markets after India's Economic liberalization in 1991. The industry saw the entry of new rating agencies like ICRA in 1991 and CARE Ratings in 1993.

• Regulatory Support: SEBI had also acknowledged the importance of ratings and mandated them for specific instruments such as debentures, public debt issues, commercial paper.

•Diversification: Rating activities developed from corporate debt to bank loan, IPO grading, securitized and structured finance products.

• Current State of Affairs: Rating agencies today offer services such as research, risk solutions and advisory while integrating environmental, social and governance (ESG) criteria into their analyses.

• World Connectivity: Indian rater companies have interconnected with the international players to enrich their methodologies and global image.

3.1 Impact: The development of credit rating in India has promoted transparency, lessened information asymmetry and boost investor confidence in financial markets.

11.6.2 Leading Indian Credit Rating Agencies

India's credit ratings framework is dominated by a few major agencies that offer independent, data-led assessments of creditworthiness in sectors. These agencies judge whether an issuer – a company, bank, government or financial instrument -- will be able to make good on its debt. They have also gradually embraced research, policy advisory and global benchmarking. Here is a closer look at prominent players in the Indian market:

CRISIL (formerly Credit Rating Information Services of India Limited) was the first credit rating agency in India, and also the first to originate in India. It was first introduced by ICICI Ltd. and Unit Trust of India (UTI) to bring transparency and organization to the borrowing and lending system. CRISIL has since then developed into a full-spectrum financial services company, and is now the leading provider of ratings, capital market information, industry analysis, detailed company and director report & credit risk documents for more than 2,30,000 India micro markets. The majority shareholder of the agency is S&P Global, one of the world's largest rating agencies, which provides CRISIL with deep access to global resources, analytics and methods. One practical instance is how CRISIL has helped in the rating of Tier-II bonds of HDFC Bank- this firm was awarded AAA, meaning it had good financial stability and the bank's borrowing cost reduced.

ICRA Limited (formerly Investment Information and Credit Rating Agency of India Limited) was established in 1991, supported by leading financial institutions such as IFCI, LIC and UTI to provide investors with professional credit rating services. ICRA provides rating services to various instruments such as long term and short term, corporate fixed deposits, commercial paper (CPs), non-convertible debentures (NCD), bank facilities, structured obligations and project finance. ICRA is a leading credit rating agency renowned for its extensive research and independent commentary on issues impacting the Indian economy, in particular the Indian financial market. Its credibility as one of the most dominant international rating agencies is further strengthened by its majority shareholding in Moody's Investors Service which helps it benchmark to global standards. For example, the ICRA has given a triple-A (aggregate credit limit) rating to Indian Railway Finance Corporation (IRFC) bonds as it is being backed by Government of India, which impact the institutional investment in infrastructure bond.

CARE Ratings (Credit Analysis and Research Ltd.) began operations in April 1993 and is currently one of the most widely respected credit rating agencies in India. CARE focuses on providing rating services to corporates: banks, sub - sovereigns and state governments; and detailed analysis is a strength of the company. CARE is known for its wide and deep mid-market/emerging- corporates coverage areas which are generally not tracked by international investors but critical to India's domestic growth. An example of CARE's reach is its rating of microfinance institutions that were servicing

people in eastern India and guided several regional banks to lend them money on favorable terms and limit their risk exposure.

Hatched as Fitch Ratings' fully-owned subsidiary, India Ratings & Research benefitted from a strong international backing at the time of its launch in the Indian market. This company provides credit ratings to various type of organizations, such as corporates, banks, insurance companies and infrastructure projects among others. Its in-depth sector risk analysis, particularly in niche sectors such as infrastructure and utilities, is what distinguishes India Ratings. The agency follows global benchmarks of rating scale and rating methodology, which helps Indian issuers to meet the needs of foreign institutional investors. India Ratings, for instance, rated a renewable energy project bond issued by a green energy firm, which enabled international ESG-focused investors to have conviction in the deal given the regulatory support available for such projects and long-term visibility of cash flows.

These credit rating agencies together constitute a key element of capital formation, risk management and investor protection in the Indian financial sector. Not just borrowing costs but the transparency and fairness of the financial market are influenced by their assessments.

11.7 Global Credit Rating Industry

11.7.1 Leading Global Agencies

Internationally, three ratings agencies, Standard & Poor's (S&P), Moody's Investors Service and Fitch Ratings – collectively known as the "Big Three" rating agents –control the credit rating market. These agencies are essential to the global financial system since they evaluate credit risk of countries, corporations, banks, and structured financial products. Their ratings are critical benchmarks for investors, lenders, regulators and central bankers around the globe — shaping the flow of capital and the terms of borrowing.

Standard & Poor's (S&P) was established 1860 and is the longest established credit rating agency. Its best known for its AAA to D rating scale which is applied to issuers and financial ratings worldwide. S&P also rates, in the public and private sector, governmental debt issues, corporate debts, commercial paper, certificates of deposit (CDs) and deposits issued by banks. S&P also publishes financial market indices, the best known of which is the S&P 500, a benchmark of stock market performance of America's largest publicly traded companies. One example of S&P's power is the U.S. sovereign credit downgrade in 2011, when S&P reduced the U.S.'s rating from AAA to AA+ because it was worried about fiscal governance. It was the first time that the U.S. had lost its AAA rating and created turmoil in markets around the world.

Also one of the largest credit rating agencies, Moody's Investors Service was founded in 1909 and has a significant presence in global financial markets. Moody's, for example, uses its own scale that runs from Aaa (highest quality) to C (in or near default). It issues credit ratings used to rate corporate debt, government bonds, municipal securities and structured finance instruments and is recognized as one of the largest providers of credit research for emerging markets. Moody's is a division of Moody's Corporation that provides economic research, financial modeling tools and risk analysis to institutional investors. An in-the-flesh example: Moody's long-growing review of India's sovereign credit rating. In 2020, amid the economic turmoil of the COVID-19 pandemic, Moody's downgraded India's rating outlook to negative, citing worries about mounting debt and slower growth. This decision had potential to affect foreign institutional investors and reaction from government of India.

Fitch Ratings is one of the "Big Three credit rating agencies", the other two being Standard & Poor's and Moody's. It is headquartered in New York City and London.Founded in 1914, Fitch was a non-profit corporation until 1997, when it was bought by form its originscite web|url=23 Jan 201325 Dec 2006}}. Fitch also has a rating network similar to S&P with ratings from AAA to D and is well-reputed for their crediting covering credit spectrum, that includes corporates and financials (loans or bonds), sovereigns or local governments, banks, insurance companies, infra etc. Fitch has been particularly regarded for its dual-headquarter structure, which gives it substantial presence in both American and European markets and an ability to take a wider view of risk around the world. For instance, Fitch itself routinely rates the creditworthiness of developing market governments like Turkey, Brazil, India and so on. The early warning notes it sounded during the European debt crisis through negative outlooks on countries including Greece and Portugal became an important tool in managing investors' risk.

Between them, S&P, Moody's and Fitch control over 90% of the global credit rating market. They are important for issues related to the cost of capital, risk premiums and regulatory capital in financial systems worldwide. Whether pricing a U.S. Treasury bond, sizing up a corporate bond issue in Europe or evaluating infrastructure debt in Asia, the ratings from these agencies create a common language of risk among global capital markets.

11.7.2 Role of Global Agencies in International Finance

• Facilitating Cross-Border Investments:

Agencies around the world offer ratings that are respected internationally, which means foreign investors can compare risks in countries and among corporations.

• Determining Sovereign Borrowing Costs:

Ratings assigned by international agencies impact on interest rates India pays for its government borrowings in overseas market. A downgrade typically makes borrowing more expensive.

• Enhancing Market Transparency:

Through giving unshackled credit rating, international agencies mitigate information asymmetry in world capital markets.

• Benchmarking Corporate Debt:

Rating is the lifeblood of multinationals when globally fund raising. Investors rely on these ratings to gauge the safety of cross-border investments.

• Influencing Capital Flows:

International credit ratings often influence the qualifying factors of countries and enterprises to draw foreign institutional investments.

• Policy and Regulatory Impact:

Sovereign ratings are frequently taken into account by international financial institutions like the IMF and The World Bank in designing financial aid programs.

11.8 Limitations of Credit Rating

11.8.1 Subjectivity and Potential Bias

• Ratings in credit issues reflect not only financial data but also other quantitative and qualitative considerations, such as prepayment risk, relative value and protection covenants.

• Ratings provided in this manner can vary among agencies for different subjects, introducing a form of subjectivity in the rating result.

• External influences, an opportunistic release of information by issuers, or methodological discrepancies can also prevent ratings from being neutral.

For example, two separate agencies may rate the same instrument slightly differently as they interpret business risk.

11.8.2 Conflict of Interest Issues

• The “issuer-pays” business model is the standard for rating agencies: the entity that wants a rating pays for it.

• There is potential for a conflict of interest, with the possible implication that service rating agencies might be inclined to give out favorable ratings in order to keep clients.

• Opponents say that this circumvents independence and creates doubts about the credibility of the ratings assigned.

Example: During the 2008 financial crisis, structured products such as mortgage-backed securities were rated highly even though they contained hidden risks, in part because of conflicts of interest.

Did You Know?

"Most credit rating agencies follow the "issuer-pays" model, where companies seeking ratings pay the agencies. This arrangement raises concerns of bias, as agencies may feel pressured to provide favorable ratings. The 2008 global financial crisis exposed this weakness, when risky mortgage-backed securities still received high credit ratings."

11.8.3 Rating Delayed Behind Market Movement

• Ratings are not always forward-looking. They may rely in part on historical and current data that may not reflect all changes occurring in the market or economy.

• Credit ratings are therefore the case that they tend to change only after negative events have affected prices or investor sentiment.

• This "lag effect" dilutes the predictiveness of the ratings in a quickly moving market.

Example: Distressed companies will sometimes be downgraded only after their financial condition has already seriously eroded and markets have already responded.

11.8.4 Over-Reliance on Ratings by Investors

• A great many investors, both retail and institutional, are highly dependent on credit ratings, with little or no independent analysis.

• Over-reliance can breed complacency, as investors come to believe that ratings are always accurate measures of credit risk.

• And if those ratings prove wrong, it can increase systemic risk.

Example: Global investors who depended entirely on ratings of structured products ahead of the 2008 crisis incurred large losses when defaults spiked.

11.9 Summary

ϖ Credit rating is an opinion on the creditworthiness of the issuers or debt instruments, provided in the form of rating symbols.

RATING PROCESS The process involves the request for rating, analysis of information, management interviews, committee deliberation, publication and ongoing monitoring.

ϖ Ratings take into account business risk, financial risk, industry environment, quality of governance and regulatory framework.

ϖ Credit rating scales are classified into investment grade (AAA to BBB) and speculative/junk grade (BB down to D).

ϖ It has varied rating type such as Corporate Debt Rating, Sovereign Ratings, Structured Finance Ratings,Bank Loan Ratings,IPO Grading& other kind of specialized ratings.

ϖ In India, CRISIL, ICRA, CARE Ratings and India Ratings are the market leaders of credit rating industry while S&P's Moody's and Fitch in globally dominate the industry.

ϖ Credit ratings provide issuers investors, intermediaries, regulators and the economy as a whole with greater certainty and better access to capital markets.

ϖ Limitations: subjective measure; conflicted interests; lags market movements and susceptible overuse by investors.

11.10 Key Terms

Credit Rating: An opinion regarding the credit status of an entity or financial instrument, using symbolic grades.

IG: Credit ratings with a low-to-moderate credit risk and strong ability to repay (AAA to BBB).

Speculative Grade: (Ratings BB through D) Rated well below investment grade; commonly referred to as junk.

Sovereign Rating: An opinion of the ability and willingness of a nation to repay its debt Obligations.

Structured Finance Rating: The rating of a security backed by pool of assets, such as mortgages or commercial loans.

Issuer-Pays Model: A method for doing business in which the company that wants a rating pays the credit ratings firm, creating the possibility of conflicts.

Rating Committee: A committee of a credit rating agency that is responsible for determining ratings based on analysis and discussion.

Rating Outlook: An agency's view of the potential direction of a rating over the next 6 – 12 months, indicating if a rating is likely to be raised, remain unchanged or lowered in future.

11.11 Descriptive Questions

Define credit rating. Discuss why it matters for issuers, investors and regulators.

Describe the major aims of credit rating agency and how it contributes to greater transparency in financial markets.

Explain the contrast between an investment grade rating and a speculative grade rating using appropriate examples.

Explain the different implications of credit rating on their part?

Describe the credit rating system from application until monitoring and review .

Discuss the growth of credit rating industry in India and the functions of the major agencies - CRISIL, ICRA and CARE.

Discuss the function of international credit rating agencies, such as S&P, Moody's and Fitch.

Describe the three primary shortcomings in credit ratings; addressing subjectivity, conflict of interest, and rating lags.

Write short notes on:

a) Structured Finance Ratings

b) Sovereign Ratings

c) IPO Grading

d) Rating Outlook

11.12 References

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Knowledge Check 1

1. b) AAA

2. a) BBB

3. b) BB

4. c) Default

11.13 Case Study

Introduction

(Reuters) - Credit rating firms are a critical party in the financial markets, as they help investors make informed decisions about lending to companies and other issuers. A high rating can lower borrowing costs and inspire investor confidence, while a low rating can lead to limited access to capital. The present case focuses on the impact of ratings on corporate financing decisions, and the problems that issuers face.

Background

New Delhi: Mid-sized steel maker Arjun Steel Ltd was slated to raise money through issue of corporate bonds to fund its expansion at a plant. In order to draw outside investor interest, the company enlisted one of the foremost credit rating agencies for a review. The rating result would directly impact the interest rate that investors would require.

The agency took into account factors such as the group's high leverage, fluctuating raw material prices and cyclical steel industry. While Arjun Steel had a well-established

position in the domestic market, its ability to service its debts was sensitive to changes in demand and international steel prices.

The company finally facing a judgment received a BBB rating, at the bottom end of the investment grade spectrum. What followed was a windfall for Arjun Steel Ltd.

Issue 1: Consequences of Lower Investment Grade rating

The BBB rating raised the company's borrowing cost, with investors requiring higher interest rates than for AA-rated peers.

Solution:

The company must improve its financial profile from reduced levels of debt, diversified sources of revenues and improved operating efficiency to satisfy the rating in the future.

MCQ:

What is the significance of getting a BBB rating?

a) Least risk and least cost of borrowing

b) Non-investment grade status

c) More expensive borrowing than stronger peers

d) No impact on fundraising

Answer: c) Borrowing is expensive relative to stronger peers

Second, Overconfidence in Ratings by Investors § 1.2.

Others got hung up on the credit rating and didn't do their own research of the company's fundamentals.

Solution:

Investors need to use credit ratings as a starting point but supplement it with their own research, including consideration of the health of the industry and company financials.

MCQ:

What would be a better way for investors to use credit ratings?

a) Make decisions based entirely on rankings

b) One input is rating and another one is an independent analysis

c) Ignore ratings completely

d) Only place money on AAA- rated instruments.

Correct: b) Consider ratings as one of the inputs and conduct independent analysis.

Issue 3: Ratings Are Behind Market Action Second is the lagging relationship between ratings downgrades and upgrades, and market movements.

During a time of plummeting steel prices, in part due to oversupply, the rating agency lowered its ratings on Arjun Steel only after investors had already priced in the risk.

Solution:

The agencies should adopt dynamic models and real-time monitoring to make sure their ratings are in tune with market fundamentals.

MCQ:

Why do ratings sometimes fail to predict immediate risks?

a) Financial information is not being reviewed by agencies

b) Ratings are in retrospect and have a time lag before they are updated

c) Ratings are never frozen permanently

d) The ratings are controlled by investors themselves

Answer: b) Ratings are lagging indicators which get re-adjudicated with delay

Conclusion

The example of Arjun Steel Ltd shows how credit ratings impact borrowing cost and investor behaviour as well as financial decisions. Ratings increase transparency and offer a uniform approach to measuring levels of risk, but the constraints—including delays in updating and the possibility for over-reliance—should be acknowledged. Firms, investors and regulators would do well to treat ratings as helpful, but not definitive signs of credit risk.

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Unit 12 Investment Banking – Part I: Concepts & Evolution

Learning Objectives

1. **State what investment banking is and describe the role it plays in financial markets.**
2. **Professional development Numerous writers have traced the history of investment banking from its roots in medieval merchant banking**
3. **Distinguish between commercial banking and investment banking, with an emphasis of their proper roles.**
4. **Outline the primary functions of investment banks – underwriting, advisory, and financing.**
5. **Illustrate the role of investment banking in economic development, capital markets and company expansion.**
6. **Evaluate the effects of major global events and regulatory changes (e.g., Glass-Steagall Act, financial crises) on innovation in investment banking.**
7. **Discuss the functions performed by investment banks in mergers & acquisitions and corporate restructuring.Evaluate how investment banking contributes to financial innovation** (e.g., derivatives, securitization, IPOs).
8. **Apply foundational concepts of investment banking** to simple business and financial case scenarios.

Content

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12.0 Introductory Caselet

Dilip Shanghvi, the billionaire founder and chairman of Sun Pharma in India.Rising Star Pharma, a mid-sized pharmaceutical company based in India, had been building up its business over the years with low-cost generic medicines. The company needed a lot of capital to expand internationally and invest in innovative research. The promoters were split on whether to hit the bank for money, or tap the stockmarket for the first time.

AFTERMATH: After brainstorming, the management decided to bring out an Initial Public Offering (IPO) which involved a fund raising of for ₹1,500 crore. But the company didn't have expertise to structure the offer, price the shares or reach out to investors. That's where an investment bank came in.

An investment bank was appointed to the lead manage the IPO. It also assisted Rising Star Pharma in drafting the prospectus, setting the issue price via the book-building process and selling the IPO to institutional and retail investors. The bank also guaranteed the issue for the promoters, saying that proceeds would be delivered to them no matter how little was subscribed by the public.

Three weeks later the IPO was three times oversubscribed, giving the company enough capital to expand. Shareholders had more confidence in the business and Rising Star Pharma was able to make a successful move from family-owned company to publicly-quoted firm.

Critical Thinking Question

What were the significant contribution of the investment bank in this IPO journey of Rising Star Pharma and what are the risks which the company would face, if it went ahead with public issue without getting it underwritten by professional investment manager?

12.1 Introduction to Investment Banking

12.1.1 Meaning and Definition of Investment Banking

Meaning

Investment banking Investment banking is a specific division of banking related to financing and raising capital for companies, individuals or governments annd involves but not limited to managing financial assets It relates particularly to issuing and placement of stocks (IPOs) and bonds for corporations. It combines financial industry expertise, strategic advisory consulting and market intelligence to provide clients with an unparalleled ability to execute high-stakes transactions including M&A, IPOs, debt restructuring and private placements. Investment Banks are financial intermediaries between capital seekers or issuers and capital providers or investors.

Definitions

• The Securities and Exchange Commission (SEC, USA) provides the following definition: 'Investment banks are financial intermediaries, which help organisations (companies or governments etc) to raise funds by underwriting the issue of securities or serving as the client's agent in the issuance (and sometimes trading) of these securities.'

• The Organisation for Economic Co-operation and Development (OECD) estimates: "Investment banking is a division of the financial industry that assists corporations and governments in raising capital via the issuance of securities and providing advice for mergers and acquisitions."

• As per the Securities and Exchange Board of India (SEBI):

1 Merchant banker (investment banker) means any person who is engaged in the business of issue management either by making arrangement regarding selling or buying or subscribing to securities as manager, consultant, adviser or rendering corporate advisory service in relation to such issue management.

(Regulation 9 of SEBI (Merchant Bankers) Regulations, 1992)

The said Indian ratio also makes it clear that it amounts to- "merchant banking services" in relation to which the requirement of registration with or regulation by SEBI is mandatory.

Key Characteristics

• Intermediary Role:

Investment banks act as an intermediary between issuers (of securities, say a company or government) and investors — helping issuers get the most favorable terms for their offerings in order to attract the amount of money they need, and helping investors find investment opportunities that will provide them with good returns.

• Deal-Making Nature:

They are used in large transactions such as IPOs, private placement and mergers and acquisitions. Their role as advisor is crucial during such periods of change.

• High-Impact Function:

Investment banks typically trade in high stakes and their strategic actions have a large impact on the market psyche, industry dynamics, and even macroeconomic stability. One prominent example was Lehman Brothers' collapse in 2008, precipitating the global financial crisis.

12.1.2 Scope and Importance of Investment Banking

Scope

Here are various types of investment banking:

Capital raising – assisting a client to raise capital by arranging the sale of shares (through an IPO, share placement) or debt (from bonds, debentures).

Corporate advisory - Strategically advising in relation to mergers & acquisitions and corporate reorganisation.

Prop Trading and Market-Making Activities: Market-making and holding of liquidity in support of client-facing intermediation businesses involving client facilitation.

Asset: Wealth Management – Portfolio management including institutions, pensions and high net worth clients.

Risk Management | Generating structured products and derivatives to manage risk.

Global Financing – Facilitating international transactions, including incorporating the unbanked into global finance.

Importance

• Investment Banking – As has been mentioned, investment banks enable the flow of productive excess capital into good investments, which build infrastructure and drive innovation and expansion.

•EFFICIENT CAPITAL MARKETS - And help in the discovery of fair price of securities through underwriting, valuation and book building mechanisms.

• Innovator – They develop new financial products (securitization, derivatives, ETFs) increasing the range of investment opportunities available to investors.

• Risk Transfer Tool — To the extent that they offer hedges for firms and governments dealing with uncertainty.

• Envoy of Globalization – They initiate multinational acquisitions, international stock offerings and global movement of capital, for economic integration.

Did You Know?

The roots of investment banking can be traced back to **merchant banks** in 17th century Europe, which financed trade voyages and government debt. Over time, these evolved into modern financial powerhouses like Goldman Sachs, JP Morgan, and Morgan Stanley."

12.1.3 Core Functions of Investment Banks

Investment banks offer specialized, high-value services to governments, corporations, and other entities. Their core functions include:

Underwriting

• Definition: Assuring the sale of new securities by buying them from issuers and reselling them to investors.

• Types:

o Firm Commitment Bank underwrites corporation's entire issue in this case it assumes the risk.

o Best Efforts Underwriting – The bank only agrees to sell whatever it can, not that it will be sold.

• Importance: Guarantees that if investor demand is shaky, companies will still be able to raise funds.

• Example: When Facebook had its initial public offering in 2012, lead underwriters included Morgan Stanley, JP Morgan and Goldman Sachs.

Advisory Services

• Advising on key strategic decisions regarding mergers, acquisitions, restructurings and disposals.

• Assisting clients on valuation, negotiation and regulatory approvals.

• Example: Goldman Sachs advised Disney in its $71 billion acquisition of 21st Century Fox in 2019.

Capital Raising

• Assisting corporations and gov- ernments in raising equity (shares) and debt (bonds, debentures).

• Private placements and Institutional placement structuring.

• Example: Investment banks will help startups raise capital from venture capitalists or private equity investors before IPOs.

Mergers & Acquisitions (M&A)

• Counseling on takeovers, buyouts and mergers.

• Diligence, valuation and structuring support to the deal team.

• Significance: Means that the best interests of shareholders are served by transactions.

• Example: In 2017, JP Morgan counseled Amazon in its purchase of Whole Foods.

Trading & Asset Management

• Trading: Proprietary trading in stocks, bonds, derivatives, currencies and commodities.

• Market Making: Getting into trades by consistently purchasing/selling securities.

• Asset management: Investment management for pension funds, insurers and wealthy individuals.
• Example: An asset manager closely linked with investment banking, BlackRock has more than $10 trillion in assets under management.

12.2 Commercial Banks vs Investment Banks

12.2.1 Differences in Objectives and Operations

Commercial Banks
• Purpose: These institutions are for the purpose of mobilizing savings and advancing funds, so as to promote rural development.
• Operations:
o Banking and acceptance of Deposit (saving accounts, fixed deposit and current account).
o Maintain credit schemes like personal, house and business lending.
o Provide payment and settlement systems such as cheques, debit/credit cards and electronic transfers.
o Earn interest on the spread between lending and deposit, called a Net Interest Margin.
• Examples: State Bank of India (SBI), HDFC Bank, Bank of America.
Investment Banks
• Mission: They specialize in assisting companies, governments and other institutions when raising capital or managing complex financial transactions. They are the mediators between securities issuers and investors.
• Operations:
o Underwrite securities offerings including IPOs and bond issues.
o Advise on mergers, acquisitions and re-organizations.
o Trade on own account, market making and asset management.
o Generate profits mostly from fees, commissions and trading.
• Examples: Goldman Sachs, Morgan Stanley, JP Morgan.
Compare: Commercial banks are involved in bank deposit, loan etc for household and firms, however investment bank provide services that related to the capital market such as large-scale stock purchases.

12.2.2 Risk Profile and Regulatory Distinctions

Commercial Banks
Commercial banks are usually less risky than investment banks as they lend solely from customer deposits, and do not facilitate trading within the market. The key risks that such funds are exposed to is credit risk, wherein the issuer of loan defaults and liquidity risk where funds may not have enough to meet withdrawal requests. Commercial banks
Commercial banks that handle retail deposits are highly regulated in order to uphold the safety of deposits and stability of the system. In India they are governed by the RBI's Prudential Norms which require them to maintain stipulated level of reserves with it and adjust their portfolios as per the central bank’s directions for safety of depositors’ moneys.

They also have similar oversight elsewhere and in other jurisdictions such as the Federal Reserve in the U.S.

Investment Banks

The investment banking business is more risky as it engages in both underwriting issues, trading of stocks and derivative markets, arranging merger and acquisitions, and dealing with structurally complicated debt securities. They are exposed not only to credit and liquidity risk, but also to market risk (price volatility), operational risk (system or process failures), and reputational risk (You did what?').

Regulatory aspects Investment banks have historically been more lightly regulated than commercial banks. In the U.S., the Glass-Steagall Act of 1933 prohibited commercial and investment banking under one roof until its repeal in 1999, opening the way for universal banks that offered both forms of business. The 2008 worldwide crash in the financial industry showed that speculation can get out of hand and spurred a wave of new regulation, including via the Dodd-Frank Act and the accompanying Volcker Rule that restricted activities like proprietary trading and investments in risky assets.

Investment banking in India is performed by commercial banks, merchant banks and other institutions as part of the following: Public issue management can be states under this head. These are regulated under the authority of the Securities and Exchange Board of India (SEBI). SEBI (Merchant Bankers) Regulations, 1992 provides that no person shall engage himself in the business of issue management as adviser or consultant unless he is registered with the Securities and Exchange Board. Amongst the regulations are minimum net worth, disclosure requirements, code of conduct and due diligence. Finally, any activities are under Reserve Bank of India (RBI) regulation when investment bank subsidiaries' acting as control functions to gather resource from public. For example, companies like ICICI Securities and SBI Capital Markets are SEBI-registered merchant bankers but they fall under the aegis of a big banking group that leads to double regulation.

This two-layer regulation in India by RBI on matters to banking sector and SEBI when it comes capital market activities, would leave overseas investment banks with no options but to operate above aboard and with due respect for homeland grown username, password owners as well as users.

Did You Know?

"The fall of Lehman Brothers in 2008 exposed the weaknesses from which more highly levered investment banks could suffer with heavy exposure to mortgage-backed securities and excessive leverage. This development was a turning point in the reinforcement of international capital regulations."

12.2.3 Specialisation in Financial Markets

-From Their Other Roles

Commercial and investment banks may appear to be dramatically different, but they work in a sense symbiotically with each other in the economy. Between them, they house the process through which savers turn their money over to borrowers and offer innovative financial products that fuel growth.
Capital Mobilization is on the of frontiers between these two types of banks. Theypheres of economy{/textquotedblright} financial electronic banks whichcollect deposits fromhouseholds and businesses in the formof savings accounts, current accounts and termdeposits. Such money is then lent out as short/medium term credit - working capital loans, home or vehicle loans. On the other hand, investment banks assist their clients to raise long-term fund through securities like shares (equity), debentures and bonds. For example, while a commercial bank could offer working capital loans to Infosys for its operational requirements, an investment bank such as Kotak Mahindra Capital or Goldman Sachs may underwrite an equity offering which would fund the company's (Infosys') expansion into new geographies.
In client segmentation for commercial banks, the target market is the general public and individual businesses, while corporate banks deal with large-scale transactions of cosumers. Investment banks, by contrast, focus on large corporations, institutional investors and governments where the deals are in hundreds of crores or even billions. HDFC Bank has proven across personal loans, credit cards and SME loans at scale, while ICICI Securities (investment banking arm of the ICICI Group) advised the Government of India during LIC IPO which was one of the largest in Indian capital market history.
Both types of institutions also shape the development of markets in various ways. Commercial banks are the engine that shifts people, from rural and under-served areas into financial inclusions to open bank accounts so that liquidity would migrate back into the mainstream economy. Investment banks weave financial innovations and globalization by introducing babies such as deri vatives, green bonds or infrastructure investment trusts (InvITs). Such as the millions of rural customers the SBI now reaches through its banking correspondents, or Morgan Stanley and JP Morgan that have innovatively brought foreign portfolio investment into India using creative cross-border financial products.
Finally, cooperation in reality demonstrates how these organizations are often alongside each other.. In most underwritings in the capital markets, for example, investment banks originate and structure the securities that they sell to their customers, while commercial banks use their large branch systems to distribute financial instruments to retail investors. Nowhere is this alignment more apparent than for universal banks like HSBC, Citigroup and Deutsche Bank that provide both commercial and investment banking in a single firm. In India, SBI Capital Markets doubles up as investment banking arm of State Bank of India in order to offer an integrated Financial services solution to meet the requirements of commercial banking clients both from public and private sectors in the country like loans

for project financing. In the case of the Bharat Bond ETF, here's what happened, for instance: Investment banks structured the offering while commercial banks sold it to retail individual investors and institutional investors.

So, while they have diverse roles, commercial and investment banks complement each other in fulfilling the brid`ge between short term liquidity on one hand and longer lead-time generation of capital which keeps financial system vibrant, innovative and wide spread.

12.3 Evolution of Investment Banking

12.3 Global Perspective on Investment Banking

• Merchant Banking Roots:

The origins of investment banking are found in the merchant banks of 17th- and 18th-century Europe, in particular the family businesses led by the Medici that helped finance roads, canals and other projects. Merchant banks mobilized capital for trade, secured deposits on behalf of the crown, and extended credit to merchants.
• Rothschild and Baring Brothers:
Families like the Rothschilds and firms such as Baring Brothers came to great power by lending governments, aiding in war supply, and behind large trade operations.
• Core Characteristics:
Initial investment banking was around issuing debt, bonds of governments and trade financing, not corporate equity markets.
Investment Banking and the 19th Century and early 20th Century
The 19th century saw the flowering on Wall Street of global investment banking. During this time, investment banks like JP Morgan & Co., Goldman Sachs and Kuhn Loeb had become financial powerhouses funnelling capital into the railroad, steel and infrastructure industries that were essential for America's rapid growth. For example, JP Morgan constructed and financed a reorganized U.S. railroad system for one of the most inefficient and indebted periods in American history, which laid the bedrock for much of American industry to follow. Likewise, Goldman deepened: starting as a small commercial paper dealer and eventually becoming a major player after underwriting public stock issues for rapidly expanding companies.
The significance of investment banks grew further during the Industrial Revolution, as a growing number of new industrial companies could not reach their capital requirements through the more "traditional" banking system. Investment banks mobilized household savings and institutional money and funneled those funds into industrial enterprise, facilitating the expansion of industries like steel, oil and manufacturing. The most famous example is Andrew Carnegie's U.S. Steel Corporation, heavily underwritten by JP Morgan

and eventually the world's first billion-dollar company after Morgan arranged to merge rival firms in 1901.

But the unregulated frenzy of early-20th-century speculation also showed the dangers of so much speculation and of conflicts of interest. In the wake of 1929 depression, the US government enacted in 1933 the Glass-Steagall Act, which prescribed a clear demarcation between commercial banking(deposit gathering and disbursal) and investment banking (underwriting and trading of securities). The new law was created to rein in speculation that had helped lead to the financial meltdown. For instance, commercial banks such as Chase National Bank had accepted deposits along with performing speculative securities underwriting; thus, imposing system risk instead. Until its repeal in 1999, Glass-Steagall had kept those overlaps at bay.

The years following World War II witnessed a significant expansion and globalization of the investment banking industry. By the mid-20th century, banks were operating across national boundaries, underwriting international bonds, handling initial public offerings (IPOs) and advising multinational corporations on mergers and acquisitions. Examples would be Rothschild & Co., who advised governments on funding post-war reconstruction, and Goldman Sachs when they became one of the leading dealmakers for corporations in takeover transactions during the 1970s/80s. There was no big global finance that didn't involve investment banks by the late 20th century, participating in a wide range of deals both in the private sector and on behalf of sovereigns dealing through global capital markets.

So investment banking developed over the 19th and 20th centuries from a U.S.-focused entity financing railroads and industrial titans into something much larger: a global industry that directly influenced not only corporate expansion but entire economic systems.

12.3.3 Global Expansion and Financial Innovations

• Big Bang and Deregulation:

The 1980s was a decade of substantial deregulation, notably the "Big Bang" reforms in London (1986), which liberalized financial markets and increased competition.

• Innovations:

New products such as derivatives, securitization, junk bonds, leveraged buyouts and hedge fund strategies were pioneered by investment banks.

• Dotcom Era:

In the 1990s, investment banks helped drive tech company funding during the dotcom boom through initial public offerings for companies like Amazon, Yahoo!, and Google.

• Global Financial Crisis (2008):

Overuse of leverage, fancy structured products (CDOs and MBS's), and speculative trading caused very large banks like Lehman Brothers to fold with the impact impacting global reforms with much tighter financial regulation.

• Post-Crisis Era:

Governments adopted tight capital adequacy standards, stress testing and restrictions on proprietary trading (e.g., Volcker Rule in the U.S.).

12.3.4 Evolution of Investment Banking in India

• Early Phase (Pre-Independence):
The Indian investment banking division initiated first under the British regulating body Grindlays which also looked after domestic growth in India.
• Post-Independence (1947–1980s):
Merchant banking services came to be offered by Indian commercial banks. The first Indian bank to have been started solely with Indian capital was the Allahabad Bank, established in 1865.
• Public Sector Dominance:
Banks like ICICI, IDBI and IFCI found a niche in project finance and advisory services within the investment-banking arena.
• Challenges:
An undeveloped industry, it was hampered by inadequate capital markets and heavy government control and restrictions on foreign investment.

12.3.5 Role of Liberalization and Reforms (Post-1991)

• Economic Liberalization:
The changes of 1991 represent a starting point, as deregulation, privatization and globalization altered India's financial markets.
• Growth of Capital Markets:
SEBI was set up and Stock exchanges were modernized (e.g., NSE in 1992); thus, a strong regulatory environment was developed.
• Liberalisation of Private and Foreign Participation :
Investment banks from across the world (including Goldman Sachs, Morgan Stanley and Citibank) tapped into India with foreign capital.
• Domestic Expansion:
Indian companies such as Kotak Mahindra, ICICI Securities and Axis Capital were among the top investment banks orchestrating IPOs, private placement deal and M&A deals.
• Recent Developments:
o Flurry of IPOs and PE deals.
o Increased significance of fintech and digital platforms as alternative source for raising capital.
o Heightened emphasis on corporate governance and transparency in conformity with international standards.

Knowledge Check 1

Choose the correct option:

1. **The origins of investment banking can be traced back to which type of institutions?**

   a) Commercial banks

   b) Merchant banks

c) Mutual funds

d) Insurance companies

2. **Which U.S. law separated commercial banking from investment banking after the Great Depression?**

   a) Dodd-Frank Act

   b) Volcker Rule

   c) Glass-Steagall Act

   d) Basel Norms

3. **The "Big Bang" reforms of 1986, which deregulated financial markets, took place in:**

   a) New York

   b) London

   c) Tokyo

   d) Paris

4. **Which was the first Indian bank to set up a merchant banking division in 1972?**

   a) ICICI Bank

   b) HDFC Bank

   c) State Bank of India

   d) Axis Bank

12.4 Major Global and Indian Investment Banks

12.4.1 Leading Global Investment Banks

Goldman Sachs

• History and Legacy: Goldman Sachs was founded in New York in 1869 as a commercial paper dealer before evolving into one of the premier investment banks on the planet.

• Primary Operations: Offers investment banking services (equity and debt underwriting, M&A advisory), securities trading (eg stock, bonds), asset management, private wealth management.

• Global Footprint: A popular option among issuers of high-visibility IPOs, such as the ones carried out by Facebook, Alibaba and Twitter.

• Influence: Who has influenced global financial markets and trained senior policy makers; a number of its former alums are occupying spots like U.S. and global economic leadership.

Morgan Stanley

• Origins: Established in 1935 after the Glass-Steagall Act mandated a separation between commercial and investment banking.

•Speciality: Major franchise in equity capital markets, institutional securities and wealth management.

• Global Reach: It was a major player during the dotcom boom, underwriting initial public offerings for tech companies like Google and Netscape.

• The Modern Era: Today, Morgan Stanley is a global giant of wealth management that retains its early roots in traditional investment banking and asset management.

J.P. Morgan (JP Morgan Chase & Co.)

• Historical Take: The 19th-century banking and railroad tycoon J.P. Morgan financed American railroads, steel companies and industrial expansion.

• Operations: Offers M&A advisory and debt and equity underwriting of asset management, treasury services.

• Worldly Footprint: An advisor to globe-spanning multinationals and governments. It advised Amazon, for instance, on its $13.7 billion takeover of Whole Foods in 2017.

• Strength: Among the world's largest financial institutions by market capitalization and assets.

Credit Suisse

• Origins: Established in 1856, in Switzerland, to finance railway projects.

• Strengths: Specialty in wealth management, private banking and investment banking. Typically strong historically in structured finance and derivatives.

• Worldwide Availability: Available in Europe, Asia and the Americas.

• Challenges: The bank has struggled with reputation and financial issues in the wake of 2008, but it is still a prominent player in investment banking and wealth advising.

Barclays

• Background: A UK financial giant that dates its history back to 1690. It transformed into a global investment bank after deregulation in the 1980s.

• Operations: Advisory, trading, underwriting and retail services in various markets.

• Turning Point: Barclays acquired the North American operations of Lehman Brothers after its bankruptcy in 2008, expanding its U.S. investment banking operations.

• Reputation: Known for its expansive European footprint along with its role as a global player in the capital markets.

12.4.2 Leading Indian Investment Banks

SBI Capital Markets (SBICAPS)

• Founded :It was set up in 1986 and is a State Bank of India subsidiary.

• Services: Offers project advisory, debt syndication, M&A advisory and equity capital market services.

• Importance: A funding mechanism for infrastructure and government disinvestment programs

• Reputation: With its lineage, SBICAPS has strong inroads into government and corporate clients leveraging SBI's network.

ICICI Securities

• Biocon, an India-based company, was established in 1978 and is today one of the country's pre-eminent integrated financial services companies.

• Services: Provides services for IPO management, institutional broking, retail advisory and corporate finance.

• Market Play: Has been involved in some of the largest I.P.O.s in India, such as those for ICICI Prudential Life and HDFC Asset Management Company.

• Strength: Marries deep knowledge of the domestic market with strong retail distribution.

Axis Capital

• Profile: Axis Bank 's Investment Banking business which is targeted at corporate and institutional clients.

• Specialties: Strong in the equity capital markets, M.&A. advisory and debt syndication.

• Role: Known for guiding companies in areas such as technology, finance and health care through I.P.O.s.

• Growth: Has grown into a solid Eddie mid- to large-cap investment banking partner.

Kotak Investment Banking

• Foundation: A division of Kotak Mahindra Bank that deals with large corporate transactions.

• Specialties: Specializes in M&A advisory, private equity placements and capital raising services.

Strengths Sources praise the team for its strong expertise on deal structuring, particularly mid-market and large corporate transactions.

• Work Highlights: Involved in a few headline M&A deals in the Indian market.

Edelweiss Financial Services

• Background: Diversified financial services firm that has expanded its investment banking business over the past two decades.

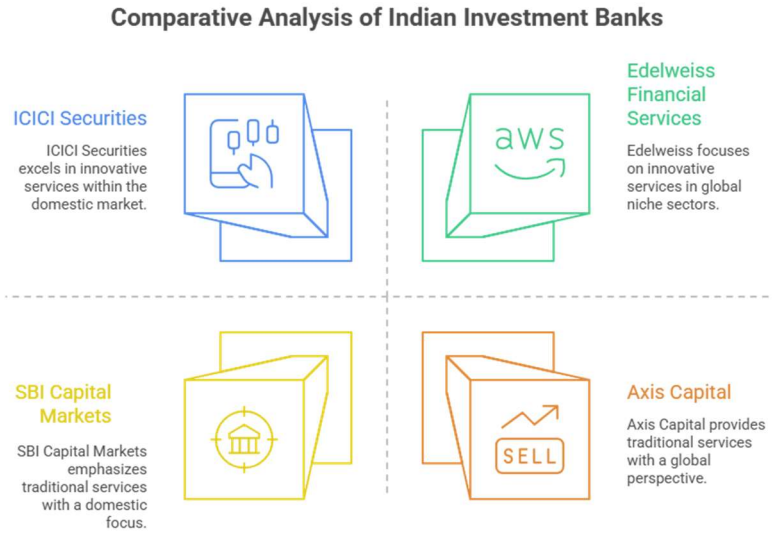
• Services: The scope of services to be provided will include corporate finance advisory, restructuring as well as private placements and equity capital market transaction.

• Strengths: Best known for advising fast-growing companies and in niche areas, such as renewable energy and infrastructure.

• Contribution: It is providing alternative type of financing other than the traditional banks and contributing in developing India’s evolving capital markets.

Form small groups and choose one Foreign and Indian investment bank. Compare their history, main functions and biggest deals. Examine the fact how now global investment

giants and compare their size and innovation with that of Indian banks' domestic growth/capital markets activity. Present findings in class discussion.



12.5 Summary

Investment banker and Investment banking: Investment Banking is a specific division of banking related to the process of raising capital for companies, support them with merger and acquisition (M&A) transactions.

ϖ It is different from commercial banking which is about deposits and loans.

ϖ Activities – Investment banks engage in underwriting, M&A advisory, capital raising, trading and asset management.

ϖ Commercial banks have less risk, and investment banks have high market and operational risks.

ϖ Acts like Glass-Steagall, the Dodd-Frank and the Volcker had influence on investing banking across globe.

Investment bankingHistory European merchant banks began financing trade (and later development projects) during the elevation of Western Europe's status in the 1600s.

ϖ In 19th and 20th centuries, investment banks financed industries, railroads and infrastructure.

ϖ It was the deregulation of the 80s that resulted in globalisation and new financial instruments like derivatives and securitsation.

ϖ The 2008 financial crisis revealed dangers from too much leverage and speculation in investment banks.

ϖ The Indian investmentfinanace banking was started in the 1970s when SBI and ICICI began to offer merchant banking services.

ϖ After 1991 liberalization, SEBI reforms and the advent of private & foreign players have caused a rapid growth.

ϖ Topteir International banks are Goldman Sachs, Morgan Stanley, JP Morgan Credit Suisse and Barclays.
Major Indian investment banks include SBI Capital Markets, ICICI Securities, Axis Capital (see previous section for list of their connections), Kotak Investment Banking and Edelweiss.
12.6 Key Terms
Investment Banking – A division of banking which serves companies and governments that need money, including underwriting and financial consulting.
Underwriting – A process where investment banks guarantee the sale of new securities by purchasing and reselling them.
MergeFs & Açquisitions (M&A) – Financial transactions in which companies combine, merge or purchase other businesses with advisory services.
IPO (Initial Public Offering) – A company's first sale of sharers to the public in a stock market.
Merchant Banking – The activities that evolved into investment banking, including commodity trading and the facilitation of government debt.
Glass-Steagall Act – The separation of commercial banking from investment banking, according to a 1933 U.S. law.
Bulge Bracket Banks The world's leading investment banks which fundraise in capital markets and lead high value deals ()
Debt Syndication – Securing debts or loans from multiple lenders for big projects.
SEBI – REGULATING THE MARKETS It is the watchdog of the Indian capital market ensuring transparency and protecting interests of investors.
12.7 Descriptive Questions
Describe investment banking and discuss the role of, importance to, and impact on the world financial system.
Distinguish between commercial and investment banks in relation to purposes, operations and risk dimensions.
Explain the primary roles of investment banks with an appropriate illustration?.
Trace the history of investment banking from its merchant banking roots to present day.
What was the effect on investment banking of significant regulations passed, such as Glass-Steagall and Dodd-Frank?
Discuss the contribution, if any, of investment banks in the 2008 GFC.
Discuss the growth of Investment Banking in India and how it boomed after 1991 liberalization.
3) Distinguish the world's major investment banks, and assess the function of these institutions in international capital markets.
Explain the role of large Indian investment banks in fund raising and corporate advisory.

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Knowledge Check 1

1. b) Merchant banks
2. c) Glass-Steagall Act
3. b) London
4. c) State Bank of India

12.9 Case Study

Introduction

FinNext Solutions, a growing Indian fintech startup that offered lending on its digital platform, enjoyed the power of strong customer relationships. The company needed plenty of cash to expand internationally and build out AI-based credit analytics. After a lot of discussion, the management decided to tap into the market with \u20B92,000 crore IPO. But structuring an IPO and reaching potential investors is something the founders knew little about. To get around these hurdles, they hired a cluster of investment banks led by Kotak Investment Banking and an international one, Morgan Stanley, as lead managers. These banks took FinNext through its regulatory adherence, the pricing approach, and investor roadshows.

The IPO was over-subscribed six times, and the demand generated during this phase not only helped FinNext raise the necessary capital but also led to a proliferation of goodwill around Finnext in the market.

Background

The story of FinNext demonstrates how investment banks have the function to connect ambitious startups with the capital market. The acquisition resulted in an indispensable offering of underwriting, pricing, investor marketing and regulatory services that companies need to make a seamless transition from private company ownership to public company ownership.

Problem Statement 1: Pricing the IPO Right

FinNext was not sure how to strike the balance between being affordable for investors and raising as much capital as possible.

Solution:

By conducting book-building and peer benchmarking the investment banks arrived at a price band that was fair and with strong investor participation.

MCQ:

How did the investment banks assist FinNext to price its IPO?

a) Setting high price arbitrarly

b) Vai book-building and dei comparables di mercato

c) Pricing as low as possible

d) With promoters only having a say

b) Through book-building and market comparisons

Problem 2: Getting to the Institutional investor(s)

The company was unknown outside its home market and faced under subscription from international investors.

Solution:

It used it international presence to hold roadshows and presentation at financial centers around the world, well as in an effort to attract more institutional investors.

MCQ:

How did Finnext win over overseas institutional investors?

a) Local retailers only Rely on local retail investors
b) Conducting global roadshows
c) Issuing only debt instruments
d) Avoiding foreign participation
Answer: b) Conducting global roadshows
Problem Definition 3: Compliance to Regulations
ButtonNavigating SEBI disclosure norms and documentation was perhaps the biggest challenge for the company.
Solution:
Kotak Investment Banking was involved in the preparation of the DRHP and SEBI regulations.
MCQ:
What was the single most important document for FinNext's IPO approval process?
a) Memorandum of Understanding
b) Draft Red Herring Prospectus
c) Shareholders' Agreement
d) Loan Syndication Report
Answer: b) Draft Red Herring Prospectus Q2. What is an offer document?
Conclusion
Investment banks are integral to help companies traverse various capital market intricacies, as the FinNext scenario bears out. Through their extensive experience in pricing, global investor marketing and legal compliance they secure successful fundraisings and long lasting market credibility.

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Unit 13 Investment Banking –Part II: Functions & Regulatory Framework

Learning Objectives

1. **Explain the extended functions of investment banks** beyond capital raising, including trading, asset management, and risk management.
2. **Analyze the role of investment banks in financial markets**, particularly in underwriting, market making, and advisory services.
3. **Evaluate the importance of regulatory frameworks** in ensuring stability and transparency in investment banking.
4. **Identify key global regulations** (e.g., Glass-Steagall Act, Dodd-Frank Act, Basel norms, Volcker Rule) and their impact on investment banking practices.
5. **Examine India's regulatory framework** governing investment banking, including SEBI, RBI, and Companies Act provisions.
6. **Assess the risks associated with investment banking activities** and the role of regulation in mitigating systemic risks.
7. **Apply regulatory concepts to case examples**, analyzing how compliance and governance affect investment banking operations.

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13.0 Introductory Caselet

It was not long before Alpha Investments, a mid-size investment bank from Singapore also rapidly expanded with capital raising, proprietary trading and cross- border M&A. At first, the firm's aggressive expansion strategy helped profits and built their reputation, attracting a mix of both corporate and institutional clients. But afterwards came questions about its risk and compliance.

In a climate of worldwide recession, Alpha Investments suffered significant trading losses from overleveraged derivative positions. Regulators in several countries, including the Monetary Authority of Singapore and the Securities and Exchange Commission in the United States, began investigating its risk management and disclosure practices.

Alpha Investments had to reorganize its operations in an effort to restore investor confidence and build long-term sustainability. It scaled back trading for the firm's own account, built up compliance staff and brought its governance structure in line with international rules such as Basel III requirements and the U.S. Dodd-Frank Act rules.

This was how investment banking, while essential for market development, could be a source of systemic risk when it operates unchecked. It also underscores the need for strong regulatory frameworks to protect investors, ensure transparency and support financial stability.

Critical Thinking Question

Why did Alpha Investments need to conform with the global regulatory requirements and what are the dangers that financial markets might face if investment banks work without any regulation?

13.1 Functions of Investment Banks

13.1.1 Capital Raising and Underwriting

Capital Raising

One of the essential roles that investment banks play is helping companies – from startups to well-established corporations – raise money. Investment Banking Companies often need cash and capital to fund new expansion, infra-structure or restructuring of operations and investment banks serve as a bridge between companies that need those funds and investors in the market place. Capital can be raised either in the form of equity (through IPO, rights issue etc.) or debt (such as bonds, debentures and loans from financial institutions). For instance, when Alibaba went public in 2014 and raised $25 billion — the largest I.P.O. in history at the time — investment banks such as Credit Suisse, Goldman Sachs and Morgan Stanley were instrumental in organizing and marketing the offering to global investors. Their participation guarante ed not only a successfully subscribed issue, but also that the company would receive enough funding to grow its global e-commerce empire.

Equally, debt capital raising is crucial in major infrastructure projects; the funding of renewable energy power stations underpinned by syndicated loans that are arranged by investment banks adds solidity and size to these expensive schemes.

Underwriting

Related to capital raising is the undertaking of underwriting, in which investment banks take on the risk for the sale of new securities. It is underwriting when the bank buys and owns securities directly from the issuer of a security, for example a U.S. Treasury or investment and commercial bank bonds, and resells them to investors in the market that is providing assurance of funding to the issuing company. There are two main types of underwriting. In a Firm Commitment deal, the bank buys all of the issue and must sell any excess at its own risk. This model guarantees the issuer raises what they hoped to, irrespective of investor demand. Conversely with a Best Efforts underwriting the bank agrees to do their best effort in selling the issue and assumes no risk of unsold stock, there by putting some of that risk back on to the issuer.

The bottom line is that underwriting adds confidence to both the issuer and investor. Issuers receive certainty of capital, and investors receive a range of investment solutions reviewed by financial professionals. An example in the real world is when Morgan Stanley underwrote Google's 2004 IPO. By assuming the risk of underwriting and controlling investor appetite, Morgan Stanley helped Google to raise $1.67 billion and also instilled confidence in a market where hype is already working overtime on what is one of the most anticipated tech listings of recent years. This deal not only showcased the importance of underwriting as a source of business stability but it also showed why such structures can help build investor confidence in new go public stocks that aren't quite yet established businesses.

13.1.2 Market Making and Trading Service

Market Making

The role of investment banks as market makers is fundamental and adds greatly to the stability and efficiency of financial markets. Market making is the process of continuously and profitably quoting buy (bid) and sell (offer/ask) prices for a wide variety of trading instruments such as equities, futures, options, currencies or commodities. Investment banks offer these quotes to ensure that there is liquidity in the market — buyers and sellers can easily buy or sell a security without large price deviations or deal delays. This brings price stability and maintains fair market conditions, in times of uncertainty. Goldman Sachs and Citadel Securities, for instance, are key market makers in the U.S. equity markets, making sure that investors can buy and sell stocks like Apple or Tesla at competitive prices even on days when trading activity spikes. Their behavior not only facilitates trading flows, but also inhibits large bid-ask spreads which may otherwise reduce investor access to the market.

Trading Services

In addition to market making, investment banks offer an array of other trading services that cater not only to institutional clients but also to individuals. These services can be broadly divided into two groups: proprietary trading, in which banks use their capital to trade financial instruments to make a profit, and client trading, entering trades on behalf of customers. The scale of trading is also huge, covering everything from stocks and bonds to foreign exchange, commodities and esoteric derivatives. For example, JPMorgan Chase runs one of the biggest trading businesses in the world, making billions of dollars worth of trades across multiple markets daily. In the same vein, Goldman Sachs is better known for its business in derivatives and foreign exchange trading, which allows corporations, hedge funds and governments to hedge their risk or bet on the direction of prices.

Significance

The value of market making/trading services derives from the changes in liquidity, efficiency, and price discovery that flows through them. Investment banks alleviate trading frictions and help to align supply with demand by being intermediaries and risk takers. This mechanism will help in determining the correct price of an asset, so that investors get to know which assets are overpriced and can take a well-informed investment decision. A real-life illustration of this played out in the early days of the COVID-19 pandemic at the beginning of 2020 when investment banks became market makers during extreme volatility. Their trading desks provided liquidity to the bond and equity markets, stabilization that helped keep prices from free-falling and reassured investors at a time of increased uncertainty. It is the interdependence of the two functions that means access to liquidity in global financial markets is easy, and simultaneously profitable for investment banks.

13.1.3 Asset Management and Wealth Management

Asset Management

Asset management is an important service provided by investment banks and other financial institutions specialising in this field, which involves managing assets on behalf of large institutional clients (such as pension funds, insurance companies, mutual funds or sovereign wealth funds) and high-net-worth-individuals. Asset management, at its heart, is the process of earning the highest possible returns on assets while mitigating risk as best an investor can (risk tolerance will differ from investor to investor) – that is done through sound strategic investment across a variety of asset classes such as equities, fixed income securities like government & municipal issued bonds and corporate bonds, real estate (direct property ownership or in holding equities/REITS), and alternative investments. Professional fund managers use sophisticated portfolio management strategies such as risk-return optimization models, the style of investing (active and passive), sectoral or geographic diversification.

A high profile real-world example is BlackRock, the world's biggest asset manager with more than $9 trillion under management. Not an investment bank, it has strong links to global

investment banking to highlight its significance. BlackRock is responsible for pension funds, exchange-traded funds (ETFs) and sovereign wealth allocations alike, providing stability and predictable returns for clients from governments to private companies. Another is the Government Pension Fund Global (GPFG) of Norway, operated with assistance from international financial institutions. One of the world's largest sovereign wealth funds, with more than $1.4 trillion in assets, it makes equity, bond and real estate investments across more than 70 countries. These examples demonstrate that asset management is not only a means to protect client capital but a significant enabler in the larger financial system by which institutional money flows through global markets.

Wealth Management

Whereas asset management is generally for institutional clients, wealth management serves individuals who are classified as high-net-worth (HNWIs) and their families. This offering is designed to support near-term investment opportunities and longer-term financial planning objectives, including estate planning, tax-efficient investing, investment advisory services in the areas of philanthropy planning or access to alternative investment opportunities such as hedge funds or private equity. Three-storey mansions such as these are typically built in wealthy districts among rolling hills, says Zhang, and they can be commissioned for anywhere between $1 million to upwards of $5 million.

UBS Wealth Management, a division of UBS Group AG, is a leading featured wealth manager worldwide managing assets worth trillions, with clients in over 50 countries. Similarly, Morgan Stanley's Wealth Management arm has grown to be a cornerstone of its business following its integration with Smith Barney, offering wealth management services on a holistic basis to high net-worth individuals. These segments also not only generate sustainable fee-based income but also stick to their clients for ever, indirectly, the bank's brand is supported and business comes back again from generation to generation."

Importance

Asset management and wealth management are both sources of fairly steady, fee-based income for investment banks, standing in contrast to the often volatile earnings from trading or underwriting. More than monetary rewards, such services help build lasting client always have someone in mind?relationships, strengthen brand affinity and establish investment banks as reliable advisors in the global financial community.

13.1.4 Research and Advisory Services

Research

Research departments are the intellectual capital of an investment bank which gives insight of equities, industries, markets and world economy. Each of these divisions has teams of analysts that specialise in certain sectors or geographical areas and write very detailed reports, which help to steer institutional and retail investors. This work includes: equity

research with buy/sell/hold recommendations, detailed valuation models and earnings forecasts for companies under coverage as well as sector-level outlooks. And by publishing such research, investment banks help investors make balanced choices and provide corporate clients a resource around which to forecast longer-term strategy.

An example of the value of research is J.P. Morgan, which has one of the best research teams in the world like a broken record. Their technology and healthcare sector reports are among the most influential in terms of institutional fund flows; nobody does deeper work or surpasses their accuracy at predicting industry trends. Likewise, Goldman Sachs' GIR is recognized for its macroeconomic views, in particular those that guide investor sentiment on global growth trends via their annual publications. Amid the COVID-19 crisis, research arm of big banks came to the fore through quick reports on impact of the crisis on sectors like airlines, hospitality and pharmaceuticals. These perspectives helped investors and executives modify strategies during times of elevated uncertainty, among many others (demonstrating the real-world importance of good-quality financial analysis).

Advisory Services

Financial advisory services Besides conducting research, investment banks also provide other financial services to companies, governments and investors. These services are potent in transactions' analysis, including (but not just like) Mergers and Acquisitions (M&A), reorganization's projects, corporate finance's choices and dutiful of derisk. Advisory specialists work on all aspects of a deal—from valuations, due diligence and negotiation to regulatory approval, closing and post-merger integration—with transaction structures that help maximize value while minimizing risk. Such expertise allows businesses to manage high-stakes decisions, in which getting the details wrong could have financially and reputationally damaging ramifications.

One well-known example was Goldman Sachs's work advising The Walt Disney Company's $71 billion deal for 21st Century Fox in 2019. Legal Suite Challenge: To enable one of the largest media acquisitions ever This history-making media acquisition balanced valuations, negotiations and strategic advice to position Disney's vision for expansion with the future of digital streaming. At the same time, Morgan Stanley and Credit Suisse worked for large multinational energy companies in merging operations and pursuing cross-border transactions that balanced the imperative to meet regulatory requirements against the need to maximize shareholder value. Since then, the following cases demonstrate how GLE's other advisory services help make transactions successful and enable corporate decisions in an economy that gets more global daily.

Significance

Research and consultancy further empower investors as well as companies to make informed decisions. Research departments give financial markets visibility, knowledge and foresight while advisory teams give businesses access to the competences required to

address complex financial issues. Together, they reaffirm the value of investment banks as trusted advisors in global finance – connecting market insight, with strategic action.

Did You Know?

"Wealth management divisions of global investment banks like UBS and Morgan Stanley collectively oversee trillions of dollars for high-net-worth clients. Interestingly, India's wealth management industry is growing rapidly, with the number of high-net-worth individuals expected to double by 2030, driving demand for personalized investment and estate planning services."

13.1.3 Asset Management and Wealth Management

13.2.1 Mergers & Acquisitions (M&A) Advisory

M&A (mergers and acquisitions) is among the very most convoluted and weighty processes in finance. Investment banks are essentially intermediaries, facilitators and consultants during M&A transactions. They are instrumental in structuring deals effectively, valuing them correctly and ensuring they're executed seamlessly to deliver long-term value for all parties involved.

a) Deal Structuring

Investment banks help design the structure of transactions and determine whether a merger, acquisition, joint venture or divestiture will best meet a client\'s needs. The financing structure is the key to how you are structuring your deal (e.g., as a cash purchase, stock-for-stock exchange or other types of debt instruments), and it will impact negotiations with banks, financial advisers, and others. Good structuring will make sure the deal is compliant and tax-effective, and is strategically aligned with the private long-term corporate strategy of both buyer and seller.

b) Valuation (Detailed)

Valuation, arguably the cornerstone of any M&A transaction, defines the "fair value" of the target company bringing management to closure with board members as it is ultimately this metric that will determine if shareholders are being diluted. Investment banks apply several

valuation techniques to come up with a sound estimate, and they might triangulate the results to reduce biases.

Discounted Cash Flow (DCF) Analysis

What Does Discounted Cash Flow (DCF) Mean? discounted cash flow, DCF: The process of valuing an investment by using the present value of its expected future cash flows.

• Process:

Project Free Cash Flows for 5 to 10 Years.

Calculate terminal value (perpetuity growth model or exit multiples).

Discount them into present value -both cash flows and terminal.

• Applicable in M&A: DCF represents the isolated value of a target company plus potential synergies (cost savings and revenue increases, for example). But it is subject to assumptions about growth rates and discount rates.

• Example: For instance, in the 2014 acquisition of WhatsApp by Facebook, DCF was used by analysts to estimate the long-term users ramp and monetization, which supported the $19 billion deal price despite negligible revenue.

Comparable Company Analysis

• Concept: In this method, a company is valued relative to traded peers by applying valuation multiples, which include P/E, EV/BIPTA, and P/B.

• Process:

Select a peer group with the same industry, size, and growth rate.

Calculate the median or average valuation multiple.

Apply the valuation multiple to the company's financial drivers value.

Use in M&A: as these multiples are brokerage seen as investor claim prices, comps provides cybersecurity 199real-time claim.

• Example: In 2016, investment bank analysts heavily used Comps to demonstrate the benchmark or LinkedIn additional avenue of valuation compared to other social networking companies and software as a service firms.

Precedent Transactions Analysis

• Concept: In this method, the past acquisition price is compared with the current company multiples.

• Process:

Identify a similar past transaction.

Analyze the multiple in the transaction (such as EV/EBITDA or EV/Revenue)

Adjust it for other multiples; such as market condition, time, control brand, and market value.

Use in M&A: this method is used mostly in the control brand or if the family method unsynergized.

• Example: In 2019, the investment banker on the Disney and 21 st century deal use precedent transactions value where the family value was unachievable.

Additional

• Synergy Valuation: in many M&A, the investment valuation depends on the estimation of cost, market synergy, or cross-selling. Thus banks always models this division to see the premium value.

• Control Premiums & Minority Discounts: Buyers always add a premium in addition to the asset purchase; further, the market value owners usually invest at currently & cloud.owner market system at a discount.

• Market Conditions: Valuation results are highly impacted by interest rates, investor attitudes and the regulatory environment.

13.2.2 Initial Public Offerings (IPOs)

One of the major capital market activities is Initial Public Offering (IPO), in which a firm goes public and offers shares to public for the first time. IPOs allow companies to raise significant capital for growth, investment in innovation, paying off debt or strategic acquisitions and provide early-stage investors with liquidity. Investment banks play a key role in this by underwriting and advising on the IPO. Their participation not only helps in efficient implementation, but also instills investor and regulator confidence.

a) Underwriting Process

Underwriting is the process that underpins IPOs by ensuring that despite market conditions, the company being listed will receive its necessary capital. With a firm commitment underwriting, investment banks buy the entire issue from the company and resells the stock to investors; thus it assumes full risk. Alternatively, they can use a best-efforts offering in which the shares are marketed and sold to investors as is, without commitment of the full subscription. This structure offers the issuing corporation a measure of certainty about its funds, and it provides investors with the comfort that comes from backing securities picked over by a careful eye.

Example: Facebook went public in 2012 with underwriters Morgan Stanley, J.P. Morgan and Goldman Sachs; it raised $16 billion. In addition, despite the early technical problems on

NASDAQ, the underwriting syndicate guaranteed enough subscription to indicate the stabilizing role of investment banks.

b) Pricing and Allotment

Pricing is perhaps the most important phase of an I.P.O. because it needs to strike a balance between what the company wants in terms of maximizing the amount of capital raised and investors, who want a reasonable entry point with a good chance at future returns. Two common approaches are used:

• Price Determined Ahead Issues, in which the issuing price is not negotiated and announced before hand.

• Book-Building, in which investors submit bids within a price range and the price is ultimately determined by demand.

Investment banks help to determine this price band, studying market conditions, peer valuation and investor appetite. They also oversee the allocation process and make sure that rules are followed for fairness among retail investors, institutional buyers, and foreign institutions.

Example: During Zomato's initial public offering in 2021, managed by Kotak Investment Banking and Morgan Stanley, the book-building process unearthed exceptional demand, exceeding the offer size by upwards of 38 times. The blockbuster pricing underscored investor faith in India's growing digital economy and was a turning point for tech IPOs in the country.

c) Listing on Stock Exchanges

Post-subscription, foreign investment banks manage the technical and regulatory aspects associated with listing the company's shares on a leading stock exchange such as NYSE (New York Stock Exchange), NASDAQ, BSE or NSE. Listing has several advantages in offering liquidity for shareholders, increasing transparency and corporate governance and improving visibility in capital markets as well. And a good IPO and listing pave the way for future fundraising via secondary offerings, convertibles or rights issues.

Illustration: Airbnb's introduction at the NASDAQ in 2020, led by Morgan Stanley and Goldman Sachs, was a huge success roller coaster ride amidst the pandemic. Airbnb's stock, which priced at $68 a share, soared more than doubling its value on the first day of trading — a sign of strong investor appetite and of the effective job done by underwriters in structuring, pricing and marketing the deal.

13.2.3 Other Advisory Services

In addition to M&A and IPO advisory, investment banks provide a wide range of specialized services to corporations, governments and financial institutions. These capabilities include offerings like private equity and venture capital fundraising, corporate restructuring, and

debt syndication - all addressing targeted financial needs at various stages in the life of a company. These services further empower the investment banks to be long-term strategic partners in international finance.

a) Private Equity and Venture Capital Fund Raising

Investment banks commonly serve in this intermediary function, being the go-between for companies that raise growth capital and private equity (PE) or venture capital (VC) firms looking for good investment opportunities. Their work involves deal structuring, investment presentations, company valuation and term negotiation to achieve the right balance of interests between companies and investors. This service can be vital for start-ups and companies growing rapidly who need significant amounts of money but aren't able to tap the public markest.

Example: In India, ICICI Securities and Axis Capital have been instrumental in enabling startups raise PE and VC funds. For example, Axis Capital helped in structuring early-stage financing rounds of technology-led companies from fintech and e-commerce, enabling these to receive global access. On a worldwide basis, Goldman Sachs has advised several unicorns including Uber on its pre-IPO funding rounds that have helped connect institutional capital with companies ready to scale. Such cases illustrate investment banks' role in helping growth companies to expand, as well as drawing in long-term institutional investors.

b) Corporate Restructuring

Corporate recovery is another key consulting service - especially for companies in financial distress or with inefficient operations. Investment banks advise on options such as liquefaction of debt, divestiture of non-core assets, spin offs or de-mergers (if the company is split into parts), debt-for-equity swaps, recapitalization and operations reorganization. They aim to turn financial fortunes around, increase operational effectiveness, streamline and save costs where possible all leading towards maximizing shareholder value.

For example, investment banks provided advice to troubled companies and financial institutions on how best to recapitalize in order to avoid running out of liquidity during the 2008 global financial crisis. The fall of Lehman Brothers and the later re-shaping of many big players revealed the importance for a crisis in financial advise. More recently too, in India, the restructuring of IL&FS Group debt in 2018 with the help of SBI Capital Markets would demonstrate how banks help engineer complex solutions to reduce heavily indebted companies for creditors and investors. They highlight the critical importance of restructuring advisory in navigating businesses through challenging periods.

c) Debt Syndication

For large-scale infrastructure and industrial projects, funding needs may exceed the capability of a single lender. In these cases, the investment banks lead arrange(s) the

repayment financing, pooling the loans they and other (if any) "junior" investors have given to a company. They discuss terms, interest rates and repayment schedules to make sure a project gets the financing it needs while sharing lenders' risks. This is particularly applicable for the capital-intensive sectors like infrastructure, power and energy, where debt syndication assumes significance.

Example:Along side metro-rail systems, highways and the like debt syndication for projects involvingthe power plants has been pioneered by SBI Capital Markets which is one of Indian investment banking pioneers. For example, it was instrumental in organizing the financing of the Mumbai Metro and a number of renewable energy projects, showing how debt syndication is behind national infrastructure development. On the international front, Barclays and HSBC have both been major arrangers of syndicated loans for oil and gas projects in the Middle East effectively demonstrating there is a global demand for this product.

Significance of Core Activities

The central advisory roles of investment banks thus suggest that they are indeed the "builders of financial markets. M&A advisory allows companies to grow in a strategic way, adding value for shareholders. IPO services support companies on their way from private to public ownership, through opening access to the long-term funds. And other advisory services, such as private equity fundraising, restructuring and debt syndication will facilitate impressive startups to grow fast, distressed companies to emerge from crises or major infrastructure projects to find vital financing. By doing so, investment banks contribute both to the capital formation process and economic stability and growth regionally (nationally) but also at broader level globally.

Activity: Exploring Core Investment Banking Services

Students will select a recent corporate event such as an IPO, merger, or debt syndication reported in financial news. In groups, they must identify the investment bank(s) involved, describe their role, and present how the bank's activities contributed to the success or failure of the transaction.

13.3 Regulatory Framework of Investment Banking

13.3.1 Global Regulatory Environment

Investment banking regulations Global regulation of investment banks encompasses a complex mix of national and supranational instruments oriented at promoting transparency in financial markets, stability, investor protection etc. Investment banks are cross-border, complex entities that raise capital, trade and advise so adherence to rules is essential in preserving market integrity and preventing systemic disasters. Opinion Leaders Such features are likewise expected to come under the regulatory spotlight with OCRs emerging around the world, and this includes some of most significant regimes such as US Security & Exchange Commission (SEC), U.K.'s Financial Conduct Authority (FCA)and, European Union's Markets in Financial Instruments Directive (MiFID II).

a) The SEC (U.S.)

The Securities and Exchange Commission (SEC) was created in 1934 after the stock market crash of 1929, as the US securities regulator. Its jurisdiction includes running IPOs, trading in securities, mutual funds and investment advisors, as well as oversight of investment banks when facilitating activities such as capital raising and mergers and acquisitions. The SEC's Anti-Fraud, Insider Trading Prohibition The SEC is responsible for enforcing anti-fraud provisions that ensure investor confidence in our financial markets. A foundational tenet of its architecture is forced disclosure, a requirement that firms disclose complete and accurate financial information to the public.

The SEC has, from the outset, been a critical player in the IPO market for mega unicorns such as Facebook's initial public offering in 2012, reviewing and approving the company's S-1 filing and seeing that disclosures about revenue streams, user growth and risk factors were up to snuff. This ensured transparency for investors prior to company's listing on the NASDAQ . The SEC has been responsible for ensuring compliance, contributing to the stability of the U.S. market and fostering confidence among global investors.

b) FCA (Financial Conduct Authority – U.K.)

The FCA was launched in 2013 to take over from the Financial Services Authority (FSA), which had been heavily criticised for regulatory failures that were highlighted by the 2008 financial crisis. And, the FCA regulates a wide range of financial providers from bank to brokers, to insurance companies and investment advisors; this is all underpinned by their strong focus on consumer welfare and integrity. Among its duties are the enforcement of conduct-of-business rules, looking out for fair treatment of clients and preserving the integrity of U.K. financial markets.

The UK has also had a reputation for an aggressive enforcement against market abuse – and that is another regulatory tool in the FCA's box. In 2012, for instance, Barclays was fined £59.5 million (eventually leading to much larger settlements with regulators in the United States) for its role in manipulating the London Interbank Offered Rate (LIBOR). This matter

demonstrates the FCA's commitment to holding individuals and firms accountable for failures in culture and governance, as well as improving control measures regarding commodities trading at its central hub – London.

c) Directive on Markets in Financial Instruments (MiFID - EU)

MiFID is One of the largest, and certainly the most detailed of attempts to standardize financial regulation across Europe under one regime. The legislation's provisions cover trading venues, investment services and client protections, introducing rules intended to make the market more transparent and accountable. One requirement is the "best-execution principle," which requires investment banks to execute deals for clients on terms that are as favorable as possible.

Moreover, MiFID II imposed much tougher rules on unbundling research – forcing asset managers to pay for research separately rather than as part of trading commissions. This reform had profound implications on the way international investment banks conduct their business, it fostered transparency and controlled potential conflict of interests. It also expanded post-trade reporting and prices disclosure, granting investors more visibility on how the executions were made. Global banks with operations in Europe have made huge operational changes to comply with MiFID II, highlighting the importance of the EU's role as a regulator setting global standards for financial markets.

13.3.2 Regulatory Framework in India

India's investment banking regulation framework is dominantly regulated by one apex governing body i.e. the Securities and Exchange Board of India (SEBI) which regulates the security markets in India. SEBI has contributed marvelously in the development of India"s capital market and over more than 25 years from the time of its formation till date, SEBI is continuously striving hard to make Indian investors feel safe, to remove complexities involved in trading of securities. It covers merchant bankers, stock exchanges, mutual funds and investment banks and intermediaries in the capital market.

a) Role of SEBI

There are other merchant bankers and investment banks to regulate too, in addition to the first-time equity offerings (IPOs), rights issues and debt offers that it must clear and monitor. It also monitors activities like underwriting, issue management and market making to make sure that those involved follow fair and ethical procedures. One of the important dimensions of SEBI's influence has been its attempts at improving corporate governance, preventing insider trading and demanding transparency in time. These have contributed to improving investor confidence in the Indian capital markets.

Example: SEBI played a proactive role in the 2021 Zomato IPO, asking for wide-ranging disclosures on financial performance, risk factors and its loss-making status. Through the

imposition of transparency, SEBI informed investors and encouraged one of India's most successful tech IPOs.

b) Disclosure Norms

In order to control the threat of information asymmetry, SEBI has imposed stringent disclosure requirements via its ICDR Regulations. Under these norms, firms issuing shares need to disclose a number facets including their audited financial statements, the promoters' shareholding pattern, details of business risk factors and the use of proceeds. Not only does such a disclosure system enable investors to evaluate the merits of an offering, but it encourages accountability by companies issuing these securities.

Example: While writing the prospectus for Life Insurance Corporation of India IPO in 2022, Indian capital markets regulator SEBI ordered detailed disclosures on financial health, regulatory obligations, risk factors, and government ownership structure of the insurer. These sort of requirements allowed for fully informed investors to know where LIC was weakest or strongest before they even put in an order.

c) Eligibility of Merchant Bankers

SEBI also controls the business of merchant bankers, which encompasses all regulating institutions, managing a public issue and offering investment banking services. A company wishing to be recognized a Category I Merchant Banker needs to register itself with SEBI (Securities Exchange Board of India) and should have a net worth of not less than ₹ 5 crore, as well as professionals who are experts in finance, law and compliance. Upon approval, these institutions may handle IPOs as well as underwriting and consulting services for corporate restructuring.

Illustration: SBI Capital Markets and ICICI Securities that are among India's top investment banks, are SEBI-registered Merchant Bankers of Category I. They have coordinated several significant IPOs including SBI Cards (2020) and Nykaa (2021), with substantial contribution in structuring, underwriting and marketing these offerings. Their adherence to SEBI's guidelines is a testimony on how regulations are conducive for both the competency and accountability in the investment banking industry.

13.3.3 Compliance and Ethical Responsibilities

(Global)factors affecting the position of Investment Banks Because they have so much power in terms of leverage and their role in global financial markets, investment banks have significant compliance and ethical obligations. As they deal with high value transactions, capital raising and advisory services it is important for the industry players to comply both within the rule of law and when engaging in ethical practices to ensure that public confidence is not shaken.

a) Compliance Responsibilities

Investment banks need to follow numerous regulatory requirements for financial markets, to make them transparent and safe. Primary duties include adjusting to Anti-Money Laundering (AML) and Know Your Customer (KYC) guidelines, to help prevent black money flowing through the banking sector for terror causes and illegal activity. Banks are also required to comply with capital adequacy standards, such as those prescribed by Basel III framework, so they will have enough ready cash to withstand market volatility. I also happen to be excited about the potential for Jibo-and other robots-to create new markets and standards that take laws in countries across borders into account, also taking variations in reporting authorities into account.

Non-compliance can have serious consequences, such as heavy fines, reputational damage and even licence suspensions. Example: In 2012, HSBC was fined $1.9 billion by U.S. authorities for not having sufficient anti-money laundering (AML) controls that would have stopped drug cartels and sanctioned entities from laundering money through its global operations. This case illustrates the significant role of compliance in protecting the integrity of financial systems and building public confidence.

b) Ethical Responsibilities

"Beyond the requirements of the law, investment banks are also expected to adhere to high ethical standards in their business conduct." A primary ethical question is how an institution can pursue transactions such as these without a conflict of interest--to paraphrase Taleb, "a bank that advises and underwrites the same transaction should treat its clients fairly rather than maim them for profit." Fairness in pricing and allocation of shares during IPO is also important, as unfair practices towards few investors leads to victimization and loss of credibility. Similarly, research departments should be insulated so analysts' write-ups are not influenced by the bank's investment banking business. They must also strike a balance in protecting client confidentiality while making disclosures required by regulation to regulators, which is yet one more example of the tightrope that banks have to walk between fiduciary responsibility and regulator visibility.

Example: Ten of the largest investment banks in the United States, including Goldman Sachs and Merrill Lynch, together paid $1.4 billion in fines in 2003 for producing overly optimistic equity research that was tainted by their investment banking business. It illustrated how biased research can deceive investors and undermine the integrity of financial markets, underscoring the importance of "ethical fire walls" inside banks.

c) Global Importance of Ethics

There is no question that flawed ethical standards can undermine entire economies, as the global financial crisis of 2008 has so clearly demonstrated. Top investment banks bundled risky subprime mortgages into complex securities and misled investors about their safety. When these investments imploded, it led to a global recession that wiped out trillions of dollars in wealth and threw many people out of work. It was clear that wrongdoing in

investment banking is not simply a question of individual sins throughout corporates, and is instead something that poses a systemic threat to the world's economy.

Ever since, regulators around the world have stressed professional codes of conduct, corporate governance changes and tighter scrutiny to help repair investor confidence. In the U.S., The Dodd-Frank Act (2010) tightened scrutiny of derivatives trading, while MiFID II (2018) strengthened transparency and investor protection in Europe. The reforms show a hungry world's attempts to bake ethics into the regulatory architecture of investment banking.

Knowledge Check 1

Choose the correct option:

1. **Which body regulates securities markets in the United States?**
   a) RBI
   b) SEC
   c) SEBI
   d) FCA

2. **MiFID II is a regulatory framework applied in:**
   a) USA
   b) UK
   c) EU
   d) India

3. **The apex regulator of Indian securities markets is:**
   a) IRDAI
   b) RBI
   c) SEBI
   d) NSE

4. **Minimum net worth required for SEBI Category I Merchant Banker is:**
   a) ₹1 crore
   b) ₹3 crore
   c) ₹5 crore
   d) ₹10 crore

13.4 Summary

ϖ Investment banks undertake activities such as raising capital, underwriting, trading, portfolio management and advisory services.

ϖ M&A or Mergers & acquisitions advisory requires deal structuring, valuation and due diligence for ensuring successful transaction.

ϖInvestment banks control IPO through underwriting, price fixing, allotment and listing on stock exchange.

ϖ Others range of advisory services include raising Private Equity, Corporate restructuring and Debt syndication for big projects.

ϖ At a global level, the investment banking activities are regulated by regulators like SEC (U.S.) FCA (U.K.), MiFID (EU).

ϖ In India, SEBI functions to guard the investors against merchant bankers, IPO discourse and issue management.

ϖ Disclosure norms make public issues transparent by making available the financial, risk and promoter track-records in detail.

ϖ Qualification of merchant bankers in India is — SEBI registration, expertism and minimum net worth.

ϖ Compliance requirements and more AML, KYC LISTING REQUIREMENTS Listing Requirements are not applicable as Company is not listed.

ϖ Ethical obligation calls for transparency, no conflict of interest, integrity in research and advice.

13.5 Key Terms

Underwriting – Procedure whereby investment bankers buy up securities from issuers and then sell them to investors.

Market Making – Available bid and ask prices are provided by investment banks to maintain liquidity in financial markets.

Mergers & Acquisitions (M&A) – Transactions in which companies combine, sell or acquire other businesses.

Book-Building – The process in an IPO when investors bid within a price band for discovery of the issue.

Due Diligence – Complete examination of financial, legal, and operational records of a company prior to a proposed transaction.

Debt Syndication – Obtaining big loans by collecting money from a number of lenders(select few only) under a single agreement.

MiFID II – A European Union directive for transparency, investor protection and fair competition in the securities market.

SEBI – Securities and Exchange Board of India- regulator for the securities market and merchant banks.

Disclosure Norms – Standard of mandatory disclosure of financial, risk and promoter details in public issues for investor security.

Conflict of Interest – A condition where the various roles that an investment bank plays may not be in line with fairness or client interest.

13.6 Descriptive Questions

Describe the primary services provided by investment banks and their activities in financial markets.

Describe M&A Advisory including the deal structuring, valuation and due diligence process.

Explain how investment banks underwrite an IPO and take it public.

Examine the significance of other advisory services like private equity placement, corporate reorganization and debt syndication.

Compare and contrast the international regulatory regimes applied to investment banks noting SEC (US),FCA (UK) & MiFID (EU).

Discuss the functions of SEBI in investment banking business in India with particular reference to disclosure norms and merchant banker criteria?

What are the obligations that investment banks have to comply in for example AML, KYC and capital adequacy?

Explain the ethical duties of investment bankers and conflicts of interest.

Analyse the extent to which effective regulation ensures investors' protection and system stability in international financial transactions.

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Answers to Knowledge Check

Documentation.

Knowledge Check 1

1. b) SEC
2. c) EU
3. c) SEBI
4. c) ₹5 crore

13.8 Case Study

Introduction

FinEdge Technologies which is an Indian SaaS company in it's growth stage viad a ₹3,000 crore Initial Public Offering (IPO) to fund its expansion into Southeast Asia. "Although the business had a good financial performance and market prospects, underwriting, disclosure compliance and global investors participation in our IPO process were quite challenging.

The company hired a group of investment banks—Kotak Investment Banking and Morgan Stanley among them--as lead managers. I-banks were behind drafting the DRHP, pricing the issue and SEBI's disclosure norms. The stumbling block quickly became the valuation rift, regulatory prerequisite and distance from foreign investorsf communication with them.

Background

Investment bankers play a two-fold role in IPOs, they help the company to raise capital, and make sure that business follows all the stringent regulations. FinEdge was a high growth startup but adhering to SEBI guidelines, handling the expectations of global investors in running it and dealing with pressure on pricing were key challenges for the banks.

Problem Statement 1: Valuation Disputes

Management sought a high premium, while banks had counselled for a "conservative" range to lure investors.

Answer : The banks used book-building, price and peer comparison to decide a fair price band.

MCQ:

How did the discriminating banks resolve disputes over valuation?

a) By charging the maximum price conceivable

b) By a process of book building and on the basis of market comparables.

c) By ignoring SEBI rules

d) Allowing the promoters to choose 308.

Answer: b Through book building and market comparables

Challenge2: Disclosure and Compliance

SEBI mandated such disclosures, but in the first place FinEdge didn't include risk factors regarding its foreign operations.

Ans: Merchant bankers have prepared a revised DRHP as per SEBI ICDR Regulations.

MCQ:

What is the document that IPOs need to be compliant with?

a) Memorandum of Association

b) Draft Red Herring Prospectus

c) Shareholders' Agreement

d) Term Loan Report

Answer: b) Draft Red Herring ProspectusraDraft red herring prospectus[contains the disclosures as specified in [Schedule XXI]] of either of a company seeking listing or offer for sale and should prepare to file the same with ROC (Registrar of Companies)in any one-electronic form.

Problem Structure 3: Worldwide Investor Relations

FinEdge received low interest from international institutions in the absence of visibility.

Solution: The investment banks hosted a roadshow in London, Singapore and New York to focus on the company's growth opportunities.

MCQ:

What that caused more global investing?

a) Cutting IPO size

b) Avoiding foreign investors

c) Conducting global roadshows

d) Exclusively have retail investors

Answer: c) Conducting global roadshows

Conclusion

The FinEdge IPO case study throws light on how investment banks fuse functional skills (valuation, underwriting, investor connect) and regulatory concerns (SEBI disclosures, eligibility norms). The deal's ultimate fate hinged on a delicate treaty between company demands and market reality, illustrating how both art and science play a role in investment banking.

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Unit 14: Broking Firms & Stock Exchanges

Learning Objectives

1. **Define broking firms and stock exchanges** and explain their role in financial markets.
2. **Differentiate between types of broking services** (full-service brokers, discount brokers, and online trading platforms).
3. **Explain the functions of stock exchanges**, including listing, trading, settlement, and investor protection.
4. **Analyze the importance of regulatory frameworks** governing broking firms and exchanges in India and globally.
5. **Identify the structure and working of leading global and Indian stock exchanges** such as NYSE, NASDAQ, NSE, and BSE.
6. **Examine the role of brokers in facilitating trades, ensuring liquidity, and maintaining market efficiency.**
7. **Evaluate challenges and emerging trends** in broking and exchanges, such as algorithmic trading, fintech innovations, and investor protection measures.

Content

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14.2 Types of Broking Firms

14.3 Functions and Services of Broking Firms

14.4 Stock Exchanges in India

14.5 Types of Brokerage Accounts

14.6 Trading Mechanism

14.7 Regulatory Framework & Compliance

14.8 Leading Broking Firms

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14.14 Case Study

14.0 Introductory Caselet

About InvestEase: InvestEase is an online broking firm that thrives on technology, started its operations in India in 2015 with a vision of making investing simple for retail investors. Non-traditional full-service brokers had traditionally collected high commissions, but InvestEase changed the business model and became a discount brokerage by adopting flat-fee trades on a mobile-first app.

Within a few years, InvestEase had lured millions of young investors, many of them novices to the capital markets. With its provision of effortless account opening, cheap trading, live prices and investor education, it revolutionized the way Indians dealt with stocks, mutual funds and derivatives.

But the company grappled with troubles as well. The platform's technology was tested by surging trading volumes with the occasional outages. Changes in the SEBI disclosure norms and margin system required constant system and internal control enhancements.

Yet despite these obstacles, InvestEase experienced rapid growth and is now a leading player in India's online brokerage industry — a broader trend of technology and regulation combining to reshape the role of broking firms and stock exchanges.

Critical Thinking Question

How did the discount brokerage model that InvestEase embraced benefit financial inclusion in India and were there any regulatory or technology risks from such fast-paced digital expansion?

14.1 Introduction to Broking Firms

Financial Market Overview

Financial markets are mechanisms that facilitate trade in assets, which include stocks, bonds, currencies and derivatives where both buyers and sellers converge to sell or buy these assets. They are essential to the transfer of money from savers (households, investors) to borrowers (businesses, governments), which leads to the efficient distribution of resources throughout the economy.

Functions of Financial Markets

• Mobilization of Savings: They give people and organizations a place to put their excess money.

• Liquidity provisioning: Financial investors can trade securities easily, which means people's money is on hand when it is needed.

• Price Discovery: Markets are instruments that assist in establishing fair value of assets through demand and supply.

• Risk Management: Instruments such as derivatives help investors to hedge uncertainties.

• Capital Formation — Businesses can raise funds through the sale of shares or bonds and invest in their expansion thereby helping the economic grow.

Types of Financial Markets

• Capital Market: It deals with long term securities (equity shares, bonds, debentures etc.).

o Primary Market: Location where new securities are offered for sale (IPOs).

• Secondary Market: It refers to the market where securities are traded (e.g., stock exchanges).

• Money market: Short-term borrowing and lending (treasury bills, commercial paper).

• Forex (Foreign Exchange Market): Trading of money worldwide.

• Derivatives Market : Contract for underlyings (options, futures).

Key Participants

• Investors & Traders – To contribute capital and liquidity.

• Corporates & Governments – Raise money by issuing shares, bonds or debts.

• Intermediates – Bankers, Brokers and Funds preside over transactions.

• Regulators – SEBI (India), SEC (USA) and so on. They ensure transparency, protect investors and maintain stability,smooth functioning of the securities market in various economies.

Importance of Financial Markets

• Driver economic growth by linking investment opportunities with capital.

• Promote financial stability with the help of risk sharing mechanisms.

• Enable global trade by serving as the markets where currency crosses are bought and sold.

• Restore investor confidence with sensible regulation and fair dealing.

14.1.1 Meaning and Definition of Broking Firms

Meaning

•A broking firm (in the case of individual brokers, also known as a brokerage house) is a firm or company that is in the business of buying and selling of financial instruments such as shares, bonds, interest rates, derivatives or commodities.

• These companies serve as agents for traders, in charge of executing their buy and sell orders and making money on commissions, fees or spreads.

Definition

• As per the wordings of Price Water house vs SEBI: "A stock broker means a member of recognized stock exchange who is permitted to trade on behalf of clients."

• To put it simply, broking firms are registered entities that open doors for investors to trade on the stock exchanges and act as facilitators for investment.

14.1.2 Role of Broking Firms in Financial Markets

There are a number of functions that intermediaries fulfill to allow financial markets to operate:

Trade Execution – Execute buy and sell orders on stock exchanges for individual or institutional clients.

Research and Advisory – Offer clients market analysis, investment recommendations and portfolio strategies.

Market Access – Provide trading platforms (online and offline) and infrastructure like Demat accounts, facilitating access to the capital markets.

Liquidity Provisioning - Promote an ongoing ability to trade securities, including through market liquidity and price discovery.

Risk Management – Offer margin and derivatives, as well as risk management tools for clients.

Investor Services -Implement investor awareness programs, training etc. and promote financial literacy.

Example: In India leading firms like Zerodha, ICICI Direct or HDFC Securities don't just trade but also provide you with analytics, research reports and educational material on investment.

14.1.3 Importance of Intermediaries in Capital Markets

As a intermediary, Broking firms play crucial role in the smooth functioning of the capital markets. Their significance can be emphasized as follows:

Access to investor: Retail investors don't have access to trade the exchange, they need a broker for this.

Transparency & Regulation – Regulators (for example SEBI in India) constantly monitor and ensure that brokers follow fair trading practices, have enough capital to maintain a smooth operation.

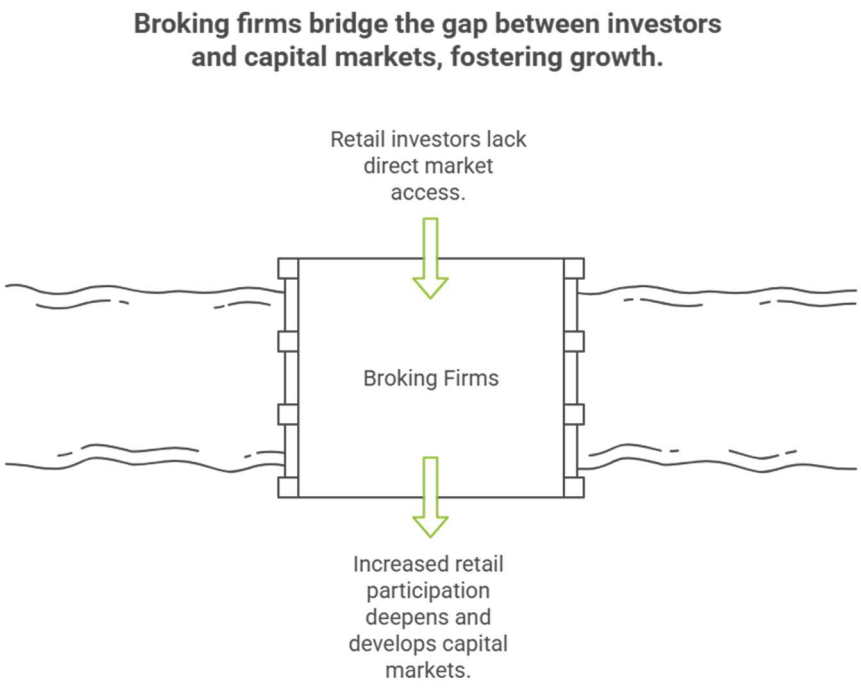
Reduced Transaction Costs: The development of contemporary brokers, most notably discount brokers has brought the costs of trading down which in turn has increased access to a greater number more people.

Protection of Investors – Brokers are responsible for upholding certain standards of morality and ensuring that the interests of clients are safe.

Market Access: Broking firms promote market depth, broaden capital markets and financial inclusion by facilitating participation of different types of investors.

Did You Know?

"India has witnessed a surge in retail participation in capital markets, with **over 12 crore Demat accounts (2023)**, largely due to the expansion of low-cost digital brokerage platforms like Zerodha, Groww, and Upstox."



14.2 Types of Broking Firms

14.2.1 Full-Service Brokerage Firms

• Meaning:

Full-service brokers.—Full-service brokerage firms provide a broad array of financial services in addition to executing trades. These services include investment advice, portfolio management, wealth planning, research reports and access to a range of asset classes.

• Features:

o Customers advisors and Relationship managers.

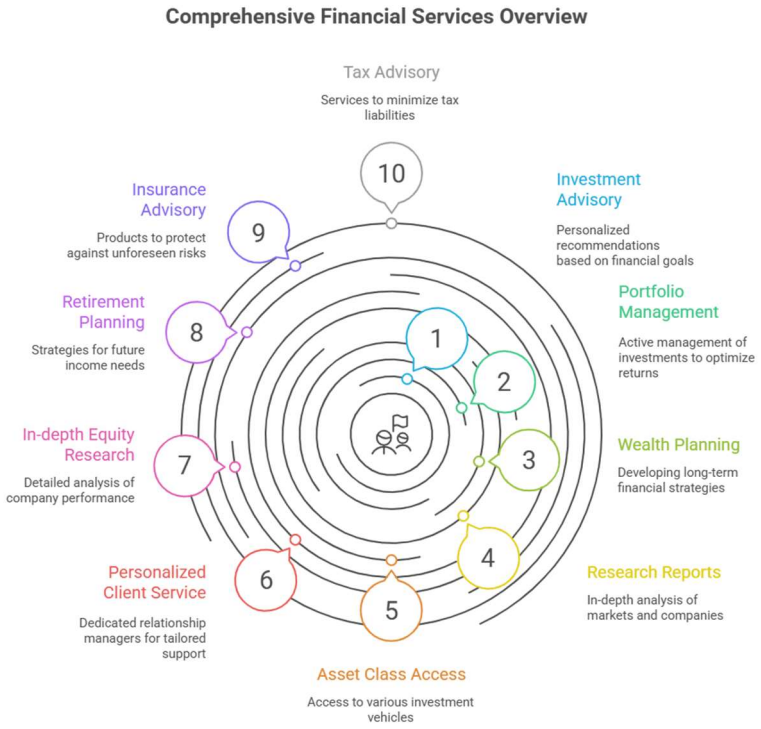
o An ability to carry out advanced equity and sector analysis.

o Help in retirement, insurance and tax planning.

o Higher brokerages are involved as against others.

• Examples:

Mr Mukherjeen Analysts' recommendations ICICI Direct, HDFC Securities, Kotak Securities.



14.2.2 Discount Brokerage Firms

• Meaning:

Discount brokers are mainly concerned with order execution and low commission fees. They usually don't offer personalized advice or research.

• Features:

o Flat-fee or low-percentage brokerage models.

o Technology-based platforms for self-directed investors.

o Limited or no advisory services.

o Popular among young, price-sensitive investors.

• Examples:

Zerodha, 5paisa, Upstox.

14.2.3 Online and Technology-Driven Brokers

• Meaning:

These are the new brokerage systems that use technology to bring us frictionless, instantaneous and cheap trading.

• Features:

o App-based and web-based trading platforms.

o Technology, such as algo trading, roboadvisors and AI-based research.

o Reduced barrier to entry for new investors.

o Emphasis on UI, speed and automation of the workflow.

• Examples:

Groww, Paytm Money, Robinhood (U.S.).

14.2.4 Institutional versus Retail Brokerage Firms

• Institutional Brokerage Firms

o SERVE LARGE CLIENTS LIKE Mutual funds, Pension Funds, Insurance companies, Hedge Funds and Foreign Institutional Investors (FIIs).

o Offer block trading capabilities, market commentary and tailored research, high-volume execution services.

o Example: Edelweiss Institutional Equities, Morgan Stanley Institutional Services.

• Retail Brokerage Firms

o Cater to retail investors and small traders.

● Include services such as online trading account, Demat service and research for the retail participation.

o Examples: Zerodha, ICICI Direct, Angel One

Choose the correct option:

What is a broker that offer research, advising and wealth management?

a) Full-service broker

b) Discount broker

c) Online broker

d) Retail broker

The following are what discount brokers are most famous for:

a) High fees

b) Flat-fee trading

c) Personalized advice

d) Insurance services

What brokers use apps, AI and robo-advisors for trading?

a) Institutional brokers

b) Full-service brokers

c) Online brokers

d) Retail brokers

Institutional brokerage firms usually serve:

a) Individual traders

b) Hedge funds

c) Small investors

d) Retail clients

14.3 Functions and Services of Broking Firms

14.3.1 Execution of Buy and Sell Orders

• Core Function:

Following are the basic services provided by broking firms: Executing order s for buying and selling of securities in stock exchanges.

• Process:

o Investors Key in orders (via browser-based platforms, Apps on their Phones and traditional methods)

o Brokers send orders to the stock exchange that are then executed based on available prices.

• Significance:

o Also makes sure investors have free access to the capital markets.

o Government Promotes liquidity and price discovery.

• Example: Retail brokers such as Zerodha or ICICI Direct help host of millions of buy/sell on NSE and BSE each day.

14.3.2 Advisory and Research Services

• Role:

An investment advice These brokers all offer advising service to clients with research reports on individual equities, derivates and macro-economy.

• Components:

o Economics and Equity research (company analysis, earnings estimates).

o Sectoral and market outlook reports.

o Investment recommendations (buy/sell/hold).

• Significance:

o Helps investors to base their decisions on evidence.

o Creates rapport and value other than transaction facilitation.

• Sample:Full-service brokers like HDFC Securities and Kotak Securities announce research calls for retail and institutional clients time to time.

14.3.3 Portfolio Management and Wealth Services

• Portfolio Management:

They act as brokers in managing client portfolios for diversification and risk-return optimization.

Services such as equity portfolios, debt tools or even hybrid funds may be part of the offering.

• Wealth Management:

Personalized solutions for HNWIs in the areas of tax planning, insurance, estate planning and alternative investments.

• Importance:

o Aid long-term investors to meet financial objectives.

o Delivers customized solutions based on client risk profiles.

• Illustration: ICICI Securities offers Portfolio Management Services (PMS) to affluent individuals who look for expert management of investments.

14.3.4 Margin Trading and Leverage Services

• Margin Trading:

They enable customers to purchase more than they could on their own with borrowed money. This amplifies gains, but also risk.

• Leverage Services:

o Brokers offer leverage in derivatives, day trading and even in equity.

o Margins are prescribed by SEBI and stock exchanges to limit the systemic risk.

• Advantages:

o Making it possible for investors to invest in opportunities with smaller amounts of money.

o Increase the liquidity and trading volume in the market.

• Risks:

o High probability of losing money if market is volatile.

o Need to manage risk well and keep good oversight of regulation.

• Example: In 2020, SEBI brought in stricter margin norms to discourage excessive leverage in Indian stock markets.

14.4 Stock Exchanges in India

14.4.1 History and Evolution of the Bombay Stock Exchange (BSE)

Origins (Pre-Independence):

• The BSE's roots go back to 1855, when a group of stockbrokers started trading informally beneath a banyan tree opposite Mumbai's Town Hall.

• 1875 – This groups formed as the The Native Share & Stock Brokers Association which distils into The Bombay Stock Exchange, the oldest stock exchange in Asia.

Post-Independence Developments:

• BSE got immediate statutory recognition when it was incorporated under the Securities Contracts (Regulation) Act, 1956.

•The exchange's profile rose through the 1970s and 1980s, but trading continued to be dominated by the open outcry system.

Modernization Phase:

• BSE in 1986 introduced the S&P BSE Sensex, India's first stock exchange index, following 30 of the market's largest and most traded companies.

• In the 1990s, BSE moved from an open-outcry exchange to a fully automated computerized mode of trading known as the BSE On-line Trading (BOLT) system.

• It demutualized in 2005, decoupling ownership and management from the right to trade.

• BOLT – BSE On-Line Trading System

In 1995, BOLT (BSE On-Line Trading) was introduced which brought the trading platform of the Stock Exchange on the screen of the stock brokers. It empowered brokers all over India for trading in an electronic field with a guarantee of instant speediness and transparency. Conceived of as a real-time alternating order book system, with nationwide access to bid across the network, ranging from ordinary retail investors to institutional clients, BOLT restored trust among investors and pumped up trading volumes. This upgrade brought BSE on par with the international exchanges and pioneered introduction of an era of internet and mobile trading in the capital market.

•

Current Status:

• Now the BSE is one of the fastest exchanges in the world with a median trading speed of 6 microseconds.

• It provides trading in equities, debt, derivatives, mutual funds and currency products.

• BSE has also been active in SME listings, helping the smaller companies to mobilise capital.

14.4.2 History and Evolution of the National Stock Exchange (NSE)

Foundation and Purpose:

— Founded in 1992, the NSE was set up by India's leading financial institutions such as IDBI, LIC and SBI with an objective to replace the country's archaic securities markets with a more modern securities environment.

• The aim was to introduce transparency, system efficiency and countrywide access in contrast to the opaque and manual model of trading prevailing over the years.

Technological Transformation:

• In 1994 NSE launched the new capital market trading system,Popularly known as "Screen Based Trading (SBT)",the Baroda based company CMC Limited designed and implemented the 'first level of automation' for NSE. This opened all markets in India for traders to trade electronically.

• It helped bring down information asymmetry and promote market efficiency.

Innovations and Contributions:

• Nifty 50:NSE had introduced it's flagship index for the Indian Equity market in August 1996.

• NSE was the first exchange to implement electronic or screen–based trading in India, derivatives (2000), debt market (1994), Exchange Traded Funds.ETFs, currency futures(2008) and options on interest rates.

• Formed National Securities Depository Limited (NSDL) in 1996, which brought industr's first paperless electronic share trading - dematerialized trading (commonly known as Demat Account) thereby reduced fraudulent practices and made the settlement process more efficient.

Current Status:

• NSE is India's biggest equities trading venue and has the largest market capitalization; (Reporting by Saikat Chatterjee; Editing by Alexander Smith)

• It is one of the five highest traded stock exchanges in the world based on trading volume.

• NSE's technology-driven services are the choice for domestic as well as foreign institutional investors.

14.4.3 Significance of BSE and NSE in Indian Capital Markets

Capital Mobilization:

o Both exchanges are mechanisms for IPOs, rights issues and debt issuances -- where companies can source long term capital.

Price Discovery:

o They enable open price discovery for securities with millions of orders being placed every day.

Liquidity Creation:

o BSE and NSE provides liquidity by allowing active trading, making it convenient for buyers to purchase a security and sellers to sell a stock at fair price.

Investor Protection:

o Robust adherence to SEBI norms, surveillance and settlement ensures investor confidence.

Global Recognition:

o Index such as BSE Sensex and NSE Nifty 50 are followed all over the world by foreign investors and included in major MSCI Emerging Market indices.

Technological Advancements:

o NSE was first to take a lead in IT followed by demat, BSE leads NSE in HFT and algo.-based trading.

Financial Inclusion:

o Sendai and Sapporo exchanges both serve the wider participation from large institutions to individual investors, including SMEs with specialized platforms.

Resilience and Stability:

o Exchanges mitigate financial stability by developing risk management, surveillance and market risk clearinghouse systems.

"Activity: Comparing BSE and NSE"

Students will work in pairs to research and compare the **BSE Sensex** and **NSE Nifty 50** in terms of history, listed companies, trading volumes, and global recognition. They will prepare a short presentation highlighting how both exchanges contribute to capital mobilization, liquidity, and investor confidence in India.

14.5 Types of Brokerage Accounts

14.5.1 Demat Accounts

Meaning and Evolution

• Dematerialized Account (Demat Account) is a type of account where the investor holds securities in an electronic form rather than taking actual possession of certificates.

• Demat accounts in India were introduced in the year 1996 by NSDL (National Securities Depository Limited) and helped participants to avoid bad deliveries which used to happen earlier through transfer of illegal shares, while it was detrimental for both Stock Exchanges – NSE & BSE.

Features

• Securely store your securities such as stocks, bonds, ETFs and mutual funds.

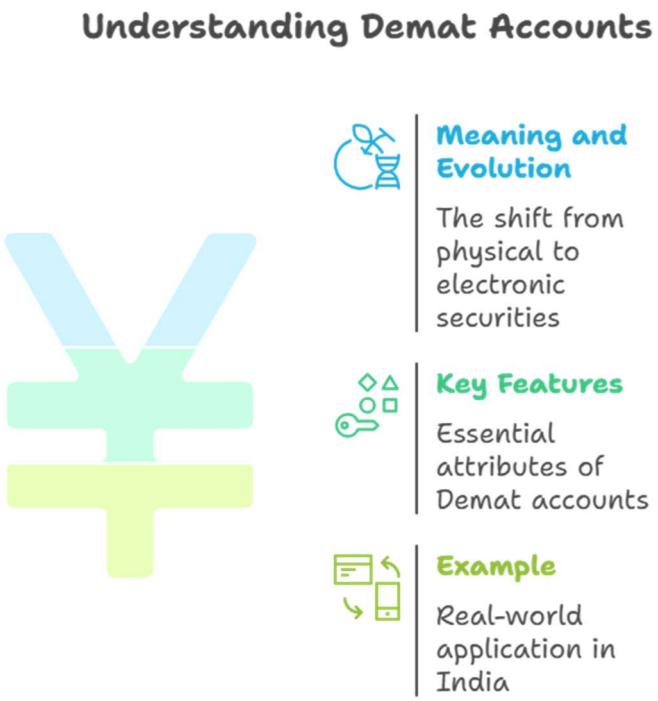
• Compulsory for all investors in India who trade on listed stocks.

• Promotes speedy settlement of trades (currently on a T+1 cycle in India).

• Easy transfer, pledging and tracking of securities.

Example

NSDL and CDSL (Central Depository Services Limited) are the Central Depositories of India, brokers such as Zerodha, HDFC Securities and ICICI Direct etc. act as intermediaries that provide Demat account facilities to their clients.



14.5.2 Trading Account

Meaning and Function

• Trading accounts allow investors to buy and sell on stock exchanges.

• While the Demat account holds shares in electronic format, the trading account is for making market orders.

Features

• Links the bank account of the investor to the Demat account for easy transfer of funds while trading.

• Requires for the trading of stocks, shares, bonds, treasuries, and such other instruments.

• Repatriation is easy since you can use a local bank account for investments. • Lot of full-service brokers also offer 3-in-1 account (Bank + Trading + Demat) for ease.

Example

ICICI Direct and Kotak Securities which cater to the upper-end clientele suit those who want 3-in-1 account services, while discount brokers - Zerodha for instance, or Upstox – deliver trading accounts linked with bank and Demat accounts through technology interfaces.

14.5.3 Full-Service Broker Accounts

Meaning

• Full-Service Broker Accounts: These are the all-in-one accounts provided by white-shoe or full-service brokerage firms. They are not just executing a trade, but adding value.

Features

• Research and Advisory: Get fundamental and technical research reports.

• Wealth Services: Investment portfolio management, tax planning, retirement planning and estate planning.

• High-touch Service: Dedicated relationship managers and support.

• Charges: Brokerage costs are usually more expensive, in many cases a percentage of the transaction value.

Suitability

• Ideal for investors who like advise from experts, HNIs and long term wealth creators.

Example

ICICI Direct, HDFC Securities and Kotak Securities offer full service accounts including advisory & wealth management bundles.

14.5.4 Discount Broker Account

Meaning

• Discount broker accounts are cost-effective, self-directed investment accounts that you manage online.

• The primary group of brokers in India, these grew with the advent of flat-fee trading structures post-2010.

Features

• Low or flat-rate brokerage fees, regardless of the value of the trade.

• Heavy use of mobile and web platforms to provide easy experience.

• No or limited personalized counseling services.

• Frequently offer sophisticated charting, analytics and an API for automated trading enthusiasts.

Suitability

• An ideal choice for retail investors, traders and young investors who are dependent on their own research or sources of external advisory.

Example

Zerodha, India's biggest discount broker, was the first to push the flat-fee brokerage model. Others like Upstox, 5paisa and Groww have followed this trend, opening the floodgates to millions of new retail investors in capital markets.

Key Insight

• Obligatory Accounts : An investor has to have a Demat account (to keep securities) and a Trading Account (to placement orders).

• Brokerage Category choice: Full-service accounts for the investors looking for advisory and wealth services, Discount brokerage accounts are best fit for cost conscious self directed individuals.

• Market Trend: The swift rise of discount and online brokers has changed the composition of India's investor base, widening it from large institutions to millions of first-time retail investors.

14.6 Trading Mechanism

14.6.1 Order Placement and Matching

• Order Placement:

o Investors give buy or sell orders through their brokers on trading terminals, mobile applications or web-based platform.

o Orders include what kind (market, limit, stop loss), how much and at what price?

o These orders are entered and routed electronically to the exchange.

• Order Matching:

o Stock exchanges use an order-driven system — in which orders from buyers and sellers are matched electronically (as used by the NSE as well as BSE, both being stock exchanges in India).

o Price-time priority determines matching:

♣ Sell Price – Lowest price that the sellers are willing to sell and buy price -Highest price buyers are willing to buy.

♣ Preceding orders are more preferred than latter ones of the same price.

o This way it is transparent and without human intervention.

14.6.2 Clearing Process

• Definition:

Clearing is the mechanism of settling the obligations of buyers and sellers after trades have been completed.

• Steps:

Verification of trade details.

Algorithm for the determination of net obligations of each party (i.e., the amount buyers must pay and sellers must deliver).

Clearing members notification of obligations.

• Importance:

o Pools several trades into final obligations to avoid confusion.

o Is a guarantee of precision and responsibility in the process of trading.

14.6.3 Settlement Process

• Definition:

Settlement is the payment and transfer of funds and securities to complete a transaction between buyers and sellers that occurs after clearing.

• Process in India:

o Adheres to a T+1 rolling settlement cycle (T is the trade date).

o Securities are credited to the account of buyer, and payment is debited from the account of seller.

• Importance:

o Reduces counterparty risk.

o Confirms the trust and confidence of investors through swift security and fund settlement.

• Example: If an investor purchases shares on Monday (T day), final settlement would take place on Tuesday (T+1).

14.6.4 Role of Clearing Corporations

• Definition:

Clearing houses interpose between purchasers and sellers and guarantee that both sides perform as promised.

• Functions:

Trade Assurance: They assure you that both parties will settle regardless of whether one party doesn't, so you're free from counterparty risk.

¡ Margin Collection: Collecting margins from brokers to avoid the disastrous price movements.

Risk control: Keep track of the risk of the market and avoid systemic risks.

Settlement Guarantee: Timely securities and funds delivery assurance.

• Examples in India:

o NSCCL (National Securities Clearing Corporation Limited): Wholly Owned Subsidiary of NSE taking care of clearing and settlement.

o ICCL (Indian Clearing Corporation Limited): Subsidiary of BSE responsible for clearing operations.

14.7 Regulatory Framework & Compliance

14.7.1 Role of SEBI in Regulating Broking Firms

• Licensing & Registration:

o SEBI (Stock Brokers and Sub-Brokers) Regulations, 1992 mandates to SEBI registration of all brokers.

o Only registered stockbrokers are allowed to do transactions on established stock exchanges.

• Monitoring & Inspections:

o SEBI checks brokers against the capital adequacy client fund segregation and disclosure guidelines.

o Periodic Verifications to analyze wrong doings.

• Regulations on Conduct:

o Brokers have an ethical code to provide with honesty, serve clients in time and not misuse client’s money.

• Investor Grievance Redressal:

o Investors can file complaints against brokers on such platforms as SCORES (SEBI Complaints Redress System).

14.7.2 Rules Governing Trading, Clearing & Settlement

• Trading Rules:

o Stock markets (NSE, BSE) work under the control of SEBI with order-driven modern transparent trading systems.

o KYC should be end to end for all the clients.

• Clearing & Settlement:

o Cleared by Clearing Corporations, NSCCL (NSE) and ICCL (BSE).

o India is on a T+1 settlement cycle to mitigate exposure to counterparty risk.

o Margin requirements and collaterals are required to protect trades.

• Risk Management Framework:

o Position limits, margin and daily mark-to-market are in place to defend market integrity.

14.7.3 Investor Protection Measures

• Client Protection Funds (IPF):

o Exchanges establish Investor Protection Funds to indemnify investors on the bankruptcy of a broker.

• Transparency Norms:

o Brokers allowed to give contract notes and keep extensive trade records.

o There needs to be mandatory periodic account statements to keep investors informed.

• Awareness Programs:

o SEBI and stock exchanges organize financial literacy initiatives towards retail investors.

• Fraud Prevention:

o Hard punishment for insider trading, front running and misleading by vigilant brokers.

14.7.4 Global Best Practices in Compliance

• United States (SEC & FINRA):

o Brokers and trading are governed by the Securities and Exchange Commission (SEC) as well as the Financial Industry Regulatory Authority (FINRA).

o Regs focus on best execution, advice suitability, and fee transparency.

• United Kingdom (FCA):

o The FCA imposes strict conduct-of-business rules which shield retail investors and safeguard fair trading practices.

• European Union (MiFID II):

o Require brokers to break out costs in a clear manner, avoid conflicts of interest and to be transparent in trade executions.

• Global Standards:

o Strong focus on KYC-AML compliance, investor appropriateness checks, personal data protection and effective grievance redressal.

14.8 Leading Broking Firms

14.8.1 Indian Broking Firms

Zerodha

• Zerodha was first established in 2010 to innovate the discount brokerage model in India.

• Its claim to fame: low-cost flat-fee trading and a tech-savvy platform (Kite).

• Is the largest retail client base in India with 1 crore plus active users.

• Services include stocks, derivatives, mutual funds and government securities.

ICICI Direct

• A unit of ICICI Securities, which is a unit of ICICI Bank.

• Provides 3-in-1accounts (bank + trading + Demat) for ease of operation with research based advisory.

• Offers equity trading, derivatives, mutual funds, insurance and wealth management services.

• Highly visible amongst long-term investors and HNIs.

HDFC Securities

• From HDFC Bank group, provides various investment options.

• It offers equities, derivatives, commodities, bonds and asset management services.

• Noted for a reliable customer service and state-of-the-art trading platforms.

Sharekhan

• Founded in 2000. one of India's first online brokerage companies.

• Offers products and services such as commodities, mutual funds, equities, derivatives and portfolio advisory.

• Famous for investor education programs and brand recognition.

Kotak Securities

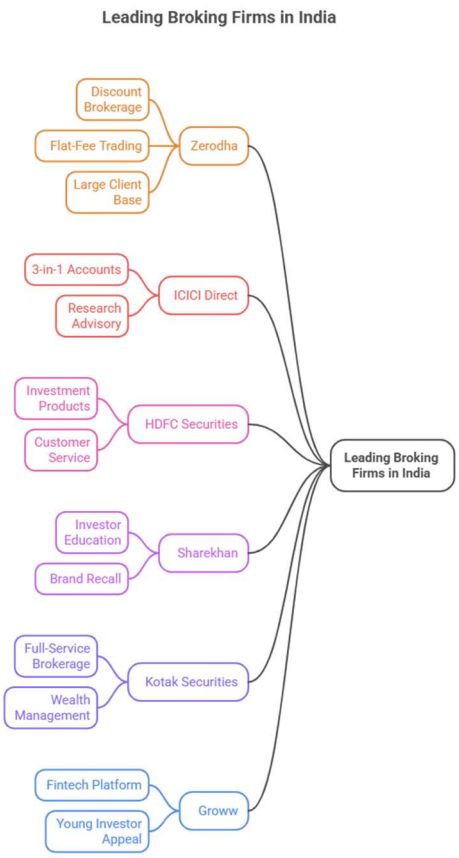
• Subsidiary of Kotak Mahindra Bank.

• Features full-service brokerage with research, advisory, margin trading and wealth services.

- Robust institutional and retail client franchise.

Groww

- A fintech-powered broker that was founded in 2016, originally specialized in mutual funds.
- Broadened offerings to include stocks, ETFs, options and IPO investing.
- A favorite with younger investors because of its easy-to-use mobile interface and low-cost model.



14.8.2 Global Brokerage Firms

Charles Schwab

One of the nation's largest brokerage and wealth management companies.

Provides online trading for equities and exchange-traded funds with zero commissions.

Offers advisory, robo-advisor and retirement planning services.

Large institutional and retail customer base of millions across the globe.

Fidelity Investments

Founded in 1946, one of the world's largest financial services companies.

Provides brokerage, mutual funds and retirement planning, wealth management.

Famed for its research and low-cost investment products.

Strong global operat i ons … with b oth institutional and retail clients.

E*TRADE

A U.S.-based online brokerage that Morgan Stanley bought in 2020.

Specializes in online stock, options, etf trading.Core competencies include:1.

Known for its digital platforms and advanced analytics; preferred by active traders.

Robinhood

Robinhood, launched in 2013, upended the U.S. brokerage industry by offering zero-commission trading on a mobile-first platform.

Great for Millennials and New Investors.

Provides equities, ETFs and options trading.

Famed for democratizing investing while also being assailed for enabling speculative trading.

14.9 Scams and Market Manipulation

14.9.1 Harshad Mehta Scam (1992)

Background:

Harshad Mehta who was popularly called the "Big Bull" had used weaknesses in the banking system to ramp up stock prices in 1992.

Modus Operandi:

He would draw massive sums of money from banks by way of bogus bank receipts (BRs).

This money fled into the market, and on a few select counters like ACC, Sterlite and Reliance, prices were pushed up artificially.

Impact:

The scam was worth more than ₹4,000 crore (an astronomical amount back them).

Stock prices crashed, revealing them to the public and causing investor wealth to evaporate along with people's confidence in financial institutions.

Regulatory Response:

Resulted in the increasing of SEBI's powers.

Introduction the era of electronic settlement, dematerialisation of shares & better bank market interface.

Did You Know?

"The 1992 Harshad Mehta scam exposed loopholes in India's banking–stock market system. At its peak, Mehta drove ACC's share price from ₹200 to nearly ₹9,000. This scandal not only caused a market crash but also led to SEBI gaining stronger regulatory powers and reforms like electronic settlements."

14.9.2 Ketan Parekh Scam (2001)

• Background:

Stockbroker Ketan Parekh rigging markets at the height of India's infamous dotcom boom.

• Modus Operandi:

o In the itch: Runs a "K-10 stock" story (companies in IT, media and telecom sectors).

o Rigged prices using funds from banks such as the Global Trust Bank but also with the help of promoters.

o Http://www.eu-enlargement.com.cy PRIVATE/CONFIDENTIAL2 o Circular trading and incestuous back scratchers caused a speculative bubble.

• Impact:

o Suspected fraud: ₹1,200 crore.

o Collapse of the market in 2001 had a serious impact on retail and institutional investors losing heavily.

• Regulatory Response:

o SEBI tightened surveillance on brokers.

o Tightened up disclosure obligations and teased out red flags designed to uncover circular trading and market manipulation.

14.9.3 Lessons for Regulators and Investors

For Regulators:

• More powerful surveillance tools to spot abnormal movements in prices.

• Regular updating of compliance systems by integrating new technologies (for example, algorithmic moniontag and assurance).

• Harder look at banks' exposure to capital markets.

For Investors:

• Don't be part of the herd and don't trust market operators blindly.

• Think about diversification instead of pursuing "hot stocks."

• Watch out for inexplicable jumps in stock prices.

Broader Impact:

• Both swindles sped up market reforms in India, including:

o Enhancement and revamping SEBI as regulator.

o NSDL/CDSL introduced for paperless settlement.

o Introduction of rolling settlement (eventually T+1).

o More transparency in IPOs and corporate governance standards.

14.10 Summary

ϖ Broking houses are engaged in buying and selling of shares on behalf of the clients such that trade execution and market access is made possible between stock markets as well as investors.

They offer services such as research and advisory, portfolio management, margin funding, among others.

ϖ Broking houses come in different categories of full service, discount, online, institutional and retail brokers.

ϖ To hold and transact in securities, investors need to have demat and trading accounts.

ϖ Stock exchanges like the BSE & NSE are operated on some of India's largest and most liquid listed companies whose secondary market has brought liquidity, transparency and price discovery to the Indian corporate sector.

ϖ BSE: BSE is Asia 's oldest stock exchange, established in 1875; NSE was the first exchange to provide a modern, fully automated screen-based system its history can be tracked from 1875.

Trading mechanisms include order entry, clearing, settlement and the function of clearing corporations.

ϖ There are institutions like SEBI who oversee brokers and trading to protect the investor and adhere to disclosures.

ϖ Transparency, AML/KYC compliance and Investor Suitability checks are international best practices.

ϖ Top brokers in India are: Zerodha, ICICI Direct, HDFC Securities, Sharekhan, Kotak Securities and Groww.

ϖ All global companies such as Charles Schwab, Fidelity, E*TRADE and Robinhood are the brokerage models all have different.

ϖ Big scams such as the Harshad Mehta (1992) and Ketan Parekh (2001) frauds exposed systemic lacunae but resulted in more robust reforms.

14.11 Key Terms

Broking firm – An authorised entity that enables its clients to buy and sell securities on a stock market.

Demat Account – An account which is used for holding a investors securities in electronic form, instead of paper certificates.

Trading Account - A type of account wherein a trader can buy and sell shares/stocks on the stock exchange.

Full-Service Broker – A broker that provides trade execution as well as research, advisory and wealth management services.

Discount Broker – A broker who offers cheap electronic trading services with no advice.

Stock Exchange – A central site or virtual market where the supply and demand for stocks, bonds, and other securities are balanced.

Clearing House – An entity which compels settlement (clearing) of trades, or sometimes guarantees payment.

Investor Protection Fund (IPF) An exchange managed fund that reimburse an investor to the extent of his transaction if a member broker is declared defaulter.

14.12 Descriptive Questions

Explain local body and other financial institutions as intermediaries in capital market.

Distinguish between full service broker, discount broker and online brokers with suitable example.

Explain the significance of Demat and trading account to investors in securities market.

Describe the major services/functions of broking firms such as advisory/ margin trading.

Discuss the history and growth of Bombay Stock Exchange (BSE) and its importance for Indian markets.

Talk about the setting up of (National Stock Exchange) NSE and how trading in India was transformed.

Describe the trading process on stock exchanges, including order entry and clearing and settlement.

Discuss the role of SEBI in regulating broking firms and safeguarding investors interests.

Focus on top Indian and global brokerage houses, contrast their models of doing business and services.

Examine the Harshad Mehta (1992) & Ketan Parekh (2001) scams and what lessons they had for both – the regulators as well as retail investors.

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Knowledge Check 1

1. a) Full-service broker
2. b) Flat-fee trading
3. c) Online brokers
4. b) Hedge funds

14.14 Case Study

Introduction

Indian stock broking industry has undergone a massive makeover with the emergence of technology based discount brokers. One of them was Zerodha, launched in 2010, and which shook up the market with a flat-fee brokerage system, easy to use platforms and low-cost trading. By reducing barriers to entry, Zerodha ushered in millions of first-time investors to India's capital markets.

But the rise of such digital platforms also presented complications. The volume placed stress on trading technology, compliance became more of a challenge and there was the added danger posed by speculative investors who had little experience betting on stocks. This case examines Zerodha's efforts to democratize market access and challenges for regulators and investors.

Background

Historically, the Indian broking space was ruled by full-service brokerage companies such as ICICI Direct, HDFC Securities and Kotak Securities. These brokers generally charged high commissions, but provided advisory and wealth management services.

Zerodha entered with a disruptive model—flat fee of ₹20 per trade—through mobile apps and online platforms. Within a decade, it overtook traditional giants to become the biggest broker in India by active clients. This was a victory that reflected the transition behavior of investors towards tech-enabled brokerage services from relationship driven ones.

Problem 1: Technology and System Reliability Solution The inherent power dissipation on-chip has always been an issue in high-speed VLSI systems.

At times during market peak hours, Zerodha's trading platform would go offline due to sudden heavy order flows.

Solution: Invest in scalable cloud infrastructure, sophisticated and realtime order-matching technology", etc pp including backup/servers for extreme peak loads.

MCQ:

How can digital brokers provide reliability under high load?

a) Reduce the number of users

b) Infrastructure Is it interchangeable – scalable Articulate the technology and now tell us about your infrastructure.

c) Only be able to place orders manually

d) Limit trading hours

Response: b) Investing in technology infrastructure that can scale

Problem Statement 2: Regulatory Compliance

With millions of new traders, compliance with SEBI's KYC norms, margin rules and risk management systems become difficult.

Solution: AI-led KYC verification, real-time margining monitoring and continuous audits for automated compliance_scale1x1 Automation mitigation_solve_Keep the Asset Classes Informed A leading stock exchange reduced costs through centralized processing of counterparty information.

MCQ:

What action steps boosts compliance for brokers in the digital space?

a) Ignoring SEBI rules

b) AI-driven KYC verification

c) Removing client records

d) Reducing investor base

Answer: b) AI-driven KYC verification

Issue 3: Retail Speculative Trading

Many first-time investors traded intraday and derivatives far in excess of their knowledge.

Solution: Investor education programs, in-app risk warnings, and required tutorials to learn derivatives trading before the account is activated.

MCQ:

How should brokers stop new investors from their over-speculation?

a) Encourage more margin trading

b) Risk education and warnings

c) Participation limited to institutions

d) Eliminate derivative products

Answer: b) To give risk education and warnings

Conclusion

His case represents how technology-driven brokers transformed Indian markets by reducing costs and increasing participation. At the same time, it underscores issues around system reliability, compliance and investor protection. Regulators such as the SEBI, and brokers themselves, must be constantly responsive to ensure technological innovation is subject to market discipline and will not undermine market stability and long term trust of the retail investor.