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THE INDIAN FINANCIAL SYSTEM

Markets, Institutions and Services

THIRD EDITION





BHARATI V. PATHAK

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The Indian Financial System

Markets, Institutions and Services

Third Edition

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Preface

The recent global financial crisis has demonstrated the extent to which our financial systems can go wrong and the ultimate impact of such scenarios on the world economic systems. As various financial systems integrate—demographically as well as geographically—they tend to gain certain synergies in terms of capacity and market access but also get exposed to high severity risks. The fact that the Indian economy was to a great extent spared from the spillover effect of the global crisis has been largely ascribed to the 'conservatism' exercised by the stakeholders including market players. Though this may not be the only reason behind this relative insulation from external risks, the importance of understanding the financial system in a holistic manner for anybody preparing to enter the economy, has been underlined beyond contention. The objective of this book, right since its first edition has been to provide a holistic view of the Indian economy. It is my pleasure to introduce the third edition of *The Indian Financial System*. Readers will find it all the more relevant in the context of recent developments.

Section I of the book is an introduction to the term 'financial system'. Chapter 1 describes the key elements and functions of a financial system, financial systems design, financial markets and the links between different types of financial markets. The second chapter puts the financial system in the context of the Indian economy by deploying a macro-economic framework analysis. The chapter also includes a literature review of studies in the Indian as well as international context in an attempt to explore the relationship between the financial system and economic growth. The third chapter gives a historical perspective of the Indian financial system in the pre-reform era, objectives of financial sector reforms and the achievements till now.

Section II of the book gives an in-depth view of Indian financial markets. Separate chapters deal with different elements of financial markets like the money market (Chapter 4), the capital market (Chapter 5) the primary market (Chapter 6), the secondary market (Chapter 8), the derivative market (Chapter 9) and the debt market (Chapter 10). In addition, disinvestment of public sector undertakings is discussed in Chapter 7 while the new financial instruments like floating rate bonds, zero coupon bonds, deep discount bonds, securitized paper, municipal bonds, etc. are discussed in Chapter 11.

Section III of the book delves into the institutional side of the financial system. An in-depth coverage of the concepts and institutional framework of various financial institutions like development finance institutions (Chapter 12), banking and non-banking institutions (Chapter 13), mutual funds (Chapter 15) and insurance sector (Chapter 16) has been provided for the benefit of the readers. A separate chapter has been dedicated to the management of non-performing assets by the banks (Chapter 14).

Section IV shifts focus to financial services that support the core financial system components like investment banking (Chapter 17), credit rating (Chapter 18), factoring and forfaiting (Chapter 20), housing finance (Chapter 21) and leasing and hire purchase (Chapter 22). The last chapter has been dedicated to the emerging issue of financial inclusion and microfinance (Chapter 23). The last section of the book deals with financial regulation and the role of regulators like RBI and SEBI.

In this edition, four new chapters—Investment Banking, Housing Finance, Leasing and Hire Purchase, and Financial Inclusion and Microfinance have been introduced. All amendments and updates till June 2010 have been incorporated in all chapters. A distinct feature of this edition is the inclusion of case studies in chapters such as primary market, derivatives, management of non-performing assets, mutual funds, insurance, and housing finance.

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A herculean task of putting together a comprehensive piece on the Indian financial system with all its diversities and nuances can never be a solo effort. Acknowledging the profoundly collaborative nature behind this exercise is not only a matter of deep gratitude but also of emotion and is thus far from formal for me.

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Bharati V. Pathak

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In India, the spread of banking in rural areas has helped in enlarging the scope of the formal financial system.

COMPONENTS OF THE FORMAL FINANCIAL SYSTEM

The formal financial system consists of four segments or components. These are: financial institutions, financial markets, financial instruments, and financial services (refer Figure 1.1).

Financial Institutions

Classification of Financial Institutions

- Banking and non-banking
- Term finance
- Specialised
- Sectoral
- Investment
- State-level

These are intermediaries that mobilise savings and facilitate the allocation of funds in an efficient manner.

Financial institutions can be classified as banking and non-banking financial institutions. Banking institutions are creators and purveyors of credit while non-banking financial institutions are purveyors of credit. While the liabilities of banks are part of the money supply, this may not be true of non-banking financial institutions. In India, non-banking financial institutions, namely, the developmental financial institutions (DFIs), and non-banking financial companies (NBFCs) as well as housing finance companies (HFCs) are the major institutional purveyors of credit.

Financial institutions can also be classified as term-finance institutions such as the Industrial Development Bank of India (IDBI), the Industrial Credit and Investment Corporation of India (ICICI), the Industrial Financial Corporation of India (IFCI), the Small Industries Development Bank of India (SIDBI), and the Industrial Investment Bank of India (IIBI).

Financial institutions can be specialised finance institutions like the Export Import Bank of India (EXIM), the Tourism Finance Corporation of India (TFCI), ICICI Venture, the Infrastructure Development Finance Company (IDFC), and sectoral financial institutions such as the National Bank for Agricultural and Rural Development (NABARD) and the National Housing Bank (NHB).

Investment institutions in the business of mutual funds Unit Trust of India (UTI), public sector and private sector mutual funds and insurance activity of Life Insurance Corporation (LIC), General Insurance Corporation (GIC) and its subsidiaries are classified as financial institutions.

There are state-level financial institutions such as the State Financial Corporations (SFCs) and State Industrial Development Corporations (SIDCs) which are owned and managed by the State governments.

In the post-reforms era, the role and nature of activity of these financial institutions have undergone a tremendous change. Banks have now undertaken non-bank activities and financial institutions have taken up banking functions. Most of the financial institutions now resort to financial markets for raising funds.

Financial Markets

Types

- Money market
- Capital market

Segments

- Primary market
- Secondary market

Financial markets are a mechanism enabling participants to deal in financial claims. The markets also provide a facility in which their demands and requirements interact to set a price for such claims.

The main organised financial markets in India are the money market and the capital market. The first is a market for short-term securities while the second is a market for long-term securities, i.e., securities having a maturity period of one year or more.

Financial markets can also be classified as primary and secondary markets. While the primary market deals with new issues, the secondary market is meant for trading in outstanding or existing securities. There are two components of the secondary market: over-the-counter (OTC) market and the exchange traded market. The government securities market is an OTC market. In an OTC market, spot trades are negotiated and traded for immediate delivery and payment while in the exchange-traded market, trading takes place over a trading cycle in stock exchanges. Recently, the derivatives market (exchange traded) has come into existence.

Financial Instruments

A financial instrument is a claim against a person or an institution for payment, at a future date, of a sum of money and/or a periodic payment in the form of interest or dividend. The term 'and/or' implies that either of the payments will be sufficient but both of them may be promised. Financial instruments represent paper wealth shares, debentures, like bonds and notes. Many financial instruments are marketable as they are denominated in small amounts and traded in organised markets. This distinct feature of financial instruments has enabled people to hold a portfolio of different financial assets which, in turn, helps in reducing

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or holding a particular asset. This information dissemination enables a quick valuation of financial assets. Moreover, by influencing the market price of a firm's debt and equity instruments, this process of valuation guides the management as to whether their actions are consistent with the objective of shareholder wealth maximisation. In addition, a financial system also minimises situations where the information is asymmetric and likely to affect motivations among operators when one party has the information and the other party does not. It also reduces the cost of gathering and analysing information to assist operators in taking decisions carefully.

A financial system also offers portfolio adjustment facilities. These are provided by financial markets and financial intermediaries such as banks and mutual funds. Portfolio adjustment facilities include services of providing a quick, cheap and reliable way of buying and selling a wide variety of financial assets.

A financial system helps in the creation of a financial structure that lowers the cost of transactions. This has a beneficial influence on the rate of return to savers. It also reduces the cost of borrowing. Thus, the system generates an impulse among the people to save more.

A well-functioning financial system helps in promoting the process of financial deepening and broadening. Financial deepening refers to an increase of financial assets as a percentage of the Gross Domestic Product (GDP). Financial depth is an important measure of financial system development as it measures the size of the financial intermediary sector. Depth equals the liquid liabilities of the financial system (currency plus demand and interest-bearing liabilities of banks and non-bank financial intermediaries divided by the GDP). Financial broadening refers to building an increasing number and variety of participants and instruments.

KEY ELEMENTS OF A WELL-FUNCTIONING FINANCIAL SYSTEM

Basic Elements of a Well-functioning Financial System

- A strong legal and regulatory environment
- Stable money
- Sound public finances and public debt management
- A central bank
- Sound banking system
- Information system
- Well-functioning securities market

The basic elements of a well-functioning financial system are (i) a strong legal and regulatory environment, (ii) stable money, (iii) sound public finances and public debt management, (iv) a central bank, (v) a sound banking system, (vi) an information system, and (vii) a well-functioning securities market.

Since finance is based on contracts, strong legal and regulatory systems that produce and strictly enforce laws alone can protect the rights and interests of investors. Hence, a strong legal system is the most fundamental element of a sound financial system.

Stable money is an important constituent as it serves as a medium of exchange, a store of value (a reserve of future purchasing power), and a standard of value (unit of account) for all the goods and services we might wish to trade in. Large fluctuations and depreciation in the value of money lead to financial crises and impede the growth of the economy.

Sound public finance includes setting and controlling public expenditure priorities and raising revenues adequate to fund them efficiently. Historically, these financing needs of the governments world over led to the creation of financial systems. Developed countries have sound public finances and public debt management practices, which result in the development of a good financial system.

A central bank supervises and regulates the operations of the banking system. It acts as a banker to the banks, banker to the government, manager of public debt and foreign exchange, and lender of the last resort. The monetary policy of the central bank influences the pace of economic growth. An autonomous central bank paves the way for the development of a sound financial system.

A good financial system must also have a variety of banks both with domestic and international operations together with an ability to withstand adverse shocks without failing. Banks are the core financial intermediaries in all countries. They perform diverse key functions such as operating the clearing and payments system, and the foreign exchange market. The banking system is the main fulcrum for transmitting the monetary policy actions. Banks also undertake credit risk analysis, assessing the expected risk and return on the projects. The financial soundness of the banking system depends on how effectively banks perform these diverse functions.

Another foundational element is information. All the participants in a financial system require information. A sound financial system can develop only when proper disclosure practices and networking of information systems are adopted.

Securities markets facilitate the issue and trading of securities, both equity and debt. Efficient securities markets promote economic growth by mobilising and deploying funds into productive uses, lowering the cost of capital for firms, enhancing liquidity, and attracting foreign investment. An efficient securities market strengthens market discipline by exerting corporate control through the threat of hostile takeovers for underperforming firms.

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The functions of a money market are

- to serve as an equilibrating force that redistributes cash balances in accordance with the liquidity needs of the participants;
- to form a basis for the management of liquidity and money in the economy by monetary authorities; and
- to provide reasonable access to the users of short-term money for meeting their requirements at realistic prices.

As it facilitates the conduct of monetary policy, a money market constitutes a very important segment of the financial system.

Capital Market A capital market is a market for long-term securities (equity and debt). The purpose of capital market is to

- mobilise long-term savings to finance long-term investments;
- provide risk capital in the form of equity or quasi-equity to entrepreneurs;
- encourage broader ownership of productive assets;
- provide liquidity with a mechanism enabling the investor to sell financial assets;
- lower the costs of transactions and information; and
- improve the efficiency of capital allocation through a competitive pricing mechanism.

Money Market and Capital Market

There is strong link between the money market and the capital market:

- Often, financial institutions actively involved in the capital market are also involved in the money market.
- Funds raised in the money market are used to provide liquidity for long-term investment and redemption of funds raised in the capital market.
- In the development process of financial markets, the development of the money market typically precedes the development of the capital market.

A capital market can be further classified into primary and secondary markets. The primary market is meant for new issues and the secondary market is one where outstanding issues are traded. In other words, the primary market creates long-term instruments for borrowings, whereas the secondary market provides liquidity through the marketability of these instruments. The secondary market is also known as the stock market.

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Primary Capital Market and Secondary Capital Market

Link Between the Primary and the Secondary Capital Market

- A buoyant secondary market is indispensable for the presence of a vibrant primary capital market
- The secondary market provides a basis for the determination of prices of new issues.
- Depth of the secondary market depends on the primary market.
- Bunching of new issues affects prices in the secondary market

Even though the secondary market is many times larger than the primary market, they are interdependent in many ways.

- The primary market is a market for new issues, but the volume, pricing, and timing of new issues are influenced by returns in the stock market. Returns in the stock market depend on macroeconomic factors. Favourable macroeconomic factors help firms earn higher returns, which, in turn, create favourable conditions for the secondary market. This in turn, influences the market price of the stock. Moreover, favourable macroeconomic factors necessitate raising fresh capital to finance new projects, expansion, and modernisation of existing projects. A buoyant secondary market, in turn, induces investors to buy new issues if they think that is a good decision. Hence, a buoyant secondary market is indispensable for the presence of a vibrant primary capital market.
- The secondary market provides a basis for the determination of prices at which new issues can be offered in the primary market.
- The depth of the secondary capital market depends upon the activities in the primary market because the bigger the entry of corporate entities, the larger the number of instruments available for trading in the secondary market. The secondary market volume surge in 2007–08 was part driven by a rampant primary market, as newly listed stocks tend to have a high turnover.
- New issues of a large size and bunching of large issues may divert funds from the secondary market to the primary market, thereby affecting stock prices.

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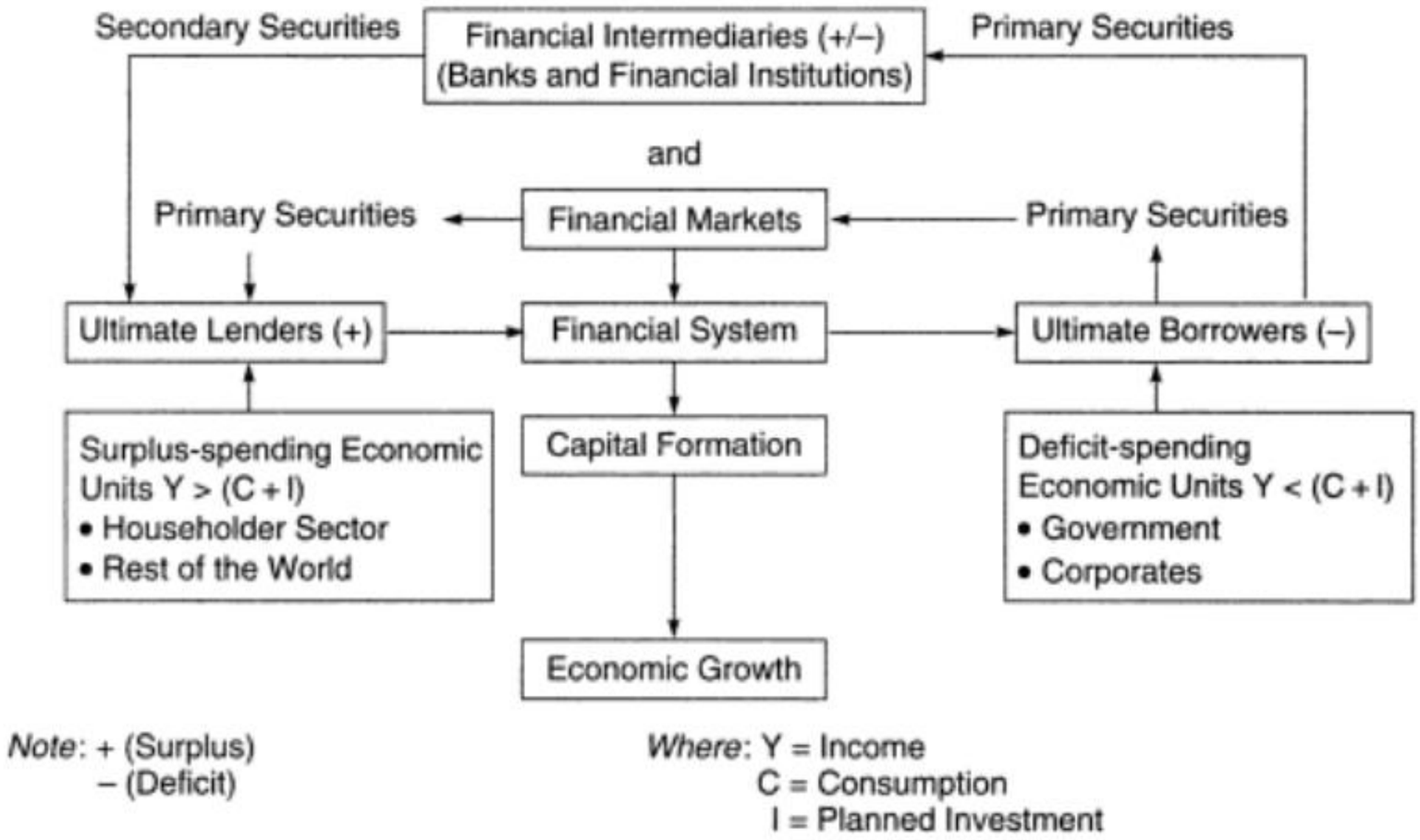


Figure 2.1 Financial System and Economic Growth

Besides linking savings and investment, the financial system helps in accelerating the rate of savings and investment by offering diversified financial services and instruments. This promotes a larger production of goods and services in the economy, leading to economic growth.

A MACRO-ECONOMIC FRAMEWORK ANALYSIS FOR EXPLORING THE ROLE OF THE FINANCIAL SYSTEM IN THE ECONOMY

The financial system is the most important institutional and functional vehicle for economic transformation. The pace of achievement of broader national objectives depends on the efficiency of the financial system.

To understand the role of the financial system in the economy, some frameworks and concepts of macroeconomics are deployed. The main tools of analysis are as follows.

National Income Accounts National income accounts extend the accounting concept to the economy as a whole. National income accounts of the sector-of-origin reveal the contribution made by different sectors of the economy to the national income and the portion of the national income they consume.

Flow of Funds Accounts The savings and investment process creates a flow of funds among sectors. Moreover, many transactions in the economy that are not included in the national income accounts take place as well. Hence, an analysis of the flow of funds accounts becomes necessary. Flow of funds brings out patterns of financing economic activities and the financial relations among various sectors of the economy. The national income accounts are combined with the flow of funds accounts to form a framework for describing the transfer of funds and supply and demand in the securities market. This framework helps to grasp the saving–investment process in the economy, essential for comprehending the working of the financial system.

Trends in Saving and Investment One of the basic influences of financial development on growth is the saving and investment rate. Among the many roles of the financial system is the augmenting and channelising of savings into productive avenues for economic growth. A study of trends in saving and investment is necessary to evaluate this role.

NATIONAL INCOME ACCOUNTS

National Income Accounts

- Use: To measure production in the economy and earnings derived from production

National income accounts is the best-known system of macro-economic flow statistics. It is used to measure production in the economy and earnings derived from production.

Both national income and product are flow concepts and are measured over a given or specified period of time. National product refers to the flow of goods and services produced by the residents of a country during any given period of time. National income represents the flow of total factor earnings available for purchasing the net flow of goods and services in the economy during any given period of time.

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The Total Flow of Finance in an Economy

- Equals the aggregation of funds raised by primary issues and secondary issues

Primary Issues

- Funds which flow directly from surplus to deficit sectors

Secondary Issues

- Funds which flow through financial intermediaries

securities reflecting debt and claims issued by financial intermediaries in order to acquire and hold primary securities. The total flow of finance in the economy is represented by the total financial issues, which is the aggregation of funds raised by primary and secondary issues.

This system is designed as a matrix. The matrix is prepared by examining the balance sheets of the various sectors at the beginning and at the end of a period. The net increase in assets is treated as uses of funds and increase in liabilities as sources of funds. Tables 2.3 and 2.4 show changes or flow of funds between two points of time. They include only the inter-sectoral flows and not the intra-sectoral flow of funds. In other words, the flow of funds accounts present a net flow of funds between sectors and between two points of time.

Table 2.3 exhibits financial flows by different sectors. The RBI publishes this data and it is available upto 2007–08.

Among the financial intermediaries, the banking sector is the most dominant. The share of claims by all financial institutions in total claims averaged 42.2 per cent during the period 1994–95 to 200–01. This share, however, marginally declined to 40.2 per cent during the period 2000–01 to 2007–08. Deposits constitute the largest source of funds for the banks and they were mobilised primarily from the household sector. Table 2.4(B). The share of non-financial institutions led by the government and to an extent by the private corporate sector increased over this period and averaged 57.8 per cent during this period. The 'rest of the world' sector has played an important role in flow of funds since 1993–94. There were significant capital through the direct as well as portfolio routes between 2003–04 to 2007–08. The share of the private corporate sector in the total claims increased from 16 per cent in 1990–91 to 35 per cent in 2000–01. By that time, the private sector was in a position to garner huge fund due to prevalent buoyant capital market conditions. This share, however, declined to 30.4 per cent during 2007–08. The Banks are the major source of finance for the private corporate sector.

The total sources of funds or the total issues can be segregated into primary issues (i.e., funds which directly flow from surplus to deficit sectors) and secondary issues (i.e., funds which flow through financial intermediaries such as banks and other financial institutions). Table 2.4 reveals a rise in the total issues from Rs. 5,877 crore in 1970–71 to Rs. 386,951 crore in 1995–96. One can see that on the one hand, the share of secondary issues registered an increasing trend, while on the other hand, there was a steady decline in the share of primary issues. This trend continued till 1993–94. This indicates the importance of financial intermediation in the Indian economy. However, this trend has reversed since 1995–96 with primary issues registering an increasing trend. The primary issues were mostly in the form of domestic primary issues. Total financial issues rose by 203.4 per cent from Rs. 9,55,620 crore in 2001–02 to Rs. 29,17,987 crore in 2007–08. The rise in secondary issues was higher compared to the primary issues.

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Flow of Funds-based Indicators of Financial Development

- Finance Ratio
- Financial Inter-relation Ratio
- New Issue Ratio
- Intermediation Ratio

Flow of Funds-based Indicators of Financial Development

The role of the Indian financial system in capital accumulation and formation can be best guaged by certain finance-deepening ratios. The financial development of a country is studied by examining changes in the following ratios which were constructed by Goldsmith (1969).

Finance Ratio (FR) It depicts the process of financial deepening in the economy. It is an indicator of the rate of financial development in relation to economic growth. It is a ratio of the total issues consisting primary and secondary claims in relation to the national income.

$$FR = \frac{\text{Total financial claims}}{\text{Net income}} = \frac{\text{Total issues}}{\text{Net national product at factor cost}}$$

Financial Inter-relation Ratio (FIR) It reflects the proportion of financial issues with respect to net capital formation in the economy. It reflects the relationship between the financial structure and the real-asset structure of the economy. In other words, the relationship between financial development and capital formation is best captured by this ratio.

$$FIR = \frac{\text{Financial assets}}{\text{Physical assets}} = \frac{\text{Total issues}}{\text{Net domestic capital formation}}$$

New Issue Ratio (NIR) It is the ratio of primary issues to net domestic capital formation. It measures the proportion of primary claims issued by non-financial institutions to net capital formation. In other words, NIR indicates how far direct issues to the savers have financed the investment by the investing sectors.

$$NIR = \frac{\text{Primary issues}}{\text{Net physical investments}} = \frac{\text{Primary issues}}{\text{Net domestic capital formation}}$$

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Intermediation Ratio (IR) It is the ratio of secondary issues to primary issues and indicates the importance of financial intermediaries in channelising financial resources. It depicts the institutionalisation of financing in the economy. It is the ratio between the financial claims issued by the financial institutions and the financial instruments issued by non-financial institutions.

$$\text{IR} = \frac{\text{Total secondary issues}}{\text{Total primary issues}}$$

As indicated in Table 2.5 all four ratios significantly increased from 1970–71 to 1995–96. The FR increased from 0.401 in 1990–91 to 0.52 in 2001–02 and 0.77 in 2007–08. This indicates a deepening of the financial markets leading to a marked rise in the institutionalisation of financing investment. It also reflects increasing separation between the acts of saving and investment.

The FIR significantly increased in the 1990s, the range being 1.75 to 2.87. This indicates that the financial structure in India grew more rapidly than the national income and there was a higher level of participation of the financial system in capital formation. The FIR ratio declined during 2004–05 and 2005–06 on account of increase in investment activity and a decline in the claims issued. The FIR significantly improved during 2007–08.

The NIR which was at a high of 1.618 in 1991–92 declined to 1.161 in 1994–95 before increasing to 1.35 in 1995–96. This downward movement reflects sluggish capital market conditions and the importance of intermediation in the Indian economy. The NIR ranged between 0.97 and 2.23 from 2001–02 and 2007–08.

The importance of financial intermediaries in channelising the financial resources is reflected in the IR which touched an all-time high of 0.89 in 1999–2000. It reflects higher involvement of the financial intermediaries in secondary issues as compared to primary issues, and importance of financial intermediaries such as banks and financial institutions in financing real activities.

TABLE 2.5 Flow of Funds-based Indicators of Financial Development in India

Year	*Finance Ratio*	*Financial Inter-relations Ratio*	*New Issue Ratio*	*Intermediation Ratio*
1970–71 to 1974–75	0.168	1.379	0.788	0.770
1975–76 to 1979–80	0.274	1.818	1.042	0.743
1980–81 to 1984–85	0.344	2.421	1.429	0.690
1985–86 to 1989–90	0.400	2.402	1.401	0.721
1990–91	0.401	1.745	1.005	0.736
1991–92	0.497	2.922	1.618	0.806
1992–93	0.384	2.183	1.186	0.840
1993–94	0.473	2.825	1.489	0.898
1994–95	0.50	2.53	1.38	0.84
1995–96	0.41	1.96	1.25	0.57
1996–97	0.37	2.05	1.12	0.83
1997–98	0.49	2.53	1.52	0.67
1998–99	0.45	2.67	1.52	0.76
1999–2000	0.37	1.81	0.96	0.89
2000–2001	0.46	2.57	1.60	0.61
2001–02	0.52	3.27	2.23	0.46
2002–03	0.51	2.75	1.63	0.69
2003–04	0.49	2.31	1.39	0.66
2004–05	0.46	1.72	0.99	0.73
2005–06	0.54	1.73	0.97	0.79
2006–07	0.63	1.93	1.19	0.63
2007–08	0.77	2.18	1.22	0.79

Source: RBI Bulletin 2007 and *Bulletin,Supplement*, Flow of Funds Accounts of the Indian Economy, 2001–02 to 2007–08, October 2009.

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in the successive budgets in the 1990s. The saving rate of the private corporate sector, however, declined in the year 2001–02 but improved marginally in 2003–04 and 2004–05. The gradual reduction in corporate tax rates and debt servicing costs more than doubled the private corporate saving rate from 3.4 per cent in 2001–02 to 8.8 per cent in 2007–08 (Tables 2.7 and 2.8).

- The public sector saving rate declined tremendously in the 1990s. In the last two years of the decade, it turned negative and touched –2.5 per cent in 2001–02 on account of increasing dissaving by government administration. This negative public savings is a major constraint on domestic resource mobilisation and has lowered the aggregate domestic saving. This dissaving reduced marginally to –1.1 per cent in 2002–03 and further to –0.3 per cent in 2003–04. Savings of the public sector touched 2.2 per cent of the GDP in 2004–05, the highest level since the late eighties. The fast recovery from negative savings of 2 per cent of the GDP in 2001–02 was on account of the steady improvement in savings of the non-departmental enterprises—other public sector companies—from 1.5 per cent to 4.1 per cent of the GDP during 2003–04 to 2006–07. However, the savings of the department enterprises-mainly railways and telecom remained largely stagnant at 0.5 per cent of the GDP during this period. The saving rate of the overall public sector was 4.5 per cent in 2007–08 (Table 2.7).
- Gross Domestic Capital Formation (investment) reached a peak of 26.9 per cent of the GDP in 1995–96, but fell to 24 per cent in 2000–01. The fall in 2000–01 was due to a deterioration in the public sector savings rate. The private corporate sector investment decelerated to 7 per cent in 2000–01 from a high of 9.4 per cent in 1995–96, but improved in the years 2001–02 and 2002–03 on account of increased profits. The private sector investments exceeded the public sector investments during 2003–04 and 2004–05. The investment was higher in fixed assets—machinery and investments.Capital formation in the public sector fell in the 1990s but rose to 6.9 per cent in 1999–2000. The rise was due to a buffer food stock and was not related with investment in fixed assets. The gross domestic capital formation rate reached a peak of 39.1 per cent in 2007–08 due to improvements in both public and private corporate investments.
- Gross Domestic Capital Formation rates remained higher than the Gross Domestic Saving till 2000–01. This resulted in a saving–investment gap. This gap in the public sector represents a fiscal deficit. The rise in the fiscal deficit was more than the rise in private savings, creating a gap which was filled in by bringing in foreign savings. Foreign savings can be explained better if we understand two measures, external current account deficit and external capital account surplus. A current account deficit means that the country's exports are not sufficient to fully pay for its imports. This results in a gap which can be covered by sale of assets, equity or debt securities to foreigners. Capital account surplus is a result of large inflows of foreign savings in the form of foreign investment and remittances. Thus, current account deficit equals capital account surplus.

Domestic saving has traditionally financed over 90 per cent of investment in India. The recourse to external saving has averaged less than one per cent of the GDP since 1991–92. There was an increased flow of foreign funds in the form of foreign capital and remittances. However, there was a deceleration of the investment rate in 2000–01 which reflected a failure of the investment demand to absorb the available resources. This led to a saving–investment surplus of 0.6 per cent of the GDP for the first time in 2001–02 after the period 1975–78 (Table 2.7). This surplus was mirrored in the current account surplus of the balance of payments. The current account balance has turned negative since 2004–05 on account of a higher investment rate as compared to savings rate.

Household Sector Financial Saving

Household Sector Financial Assets Portfolio

- Deposits
- Contractual savings
- Shares and debentures

The household sector saves in the form of currency, bank deposits, non-banking deposits, life insurance funds, provident and pension fund claims on government, shares and debentures including units of the Unit Trust of India.

For economic growth, it is necessary that saving is held in financial assets such as deposits, shares and debentures, and in the form of contractual savings rather than in currency. If savings are held in the form of currency, it is probable that they might be invested in unproductive assets like gold. Hence, an analysis of the composition of household sector savings was undertaken.

Box 2.2 Low Confidence in the Stock Market

Studies conducted by the Society for Capital Market Research and Development have found that almost 40 per cent of the investors thought of the stock market as a place where one is likely to lose money and they listed volatility and price manipulation as the factors diminishing their confidence in the market. The survey also found that mutual funds ranked below direct equity investment.

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TABLE 2.11 Saving Rate and Growth Rate of GDP in India vis-à-vis Select Asian Countries (In Per Cent)

	Gross Domestic Saving (Per Cent of GDP)						Growth Rate of GDP					
Country	*1990*	*1995*	*2000*	*2005*	*2007*	*2008*	*1990*	*1995*	*2000*	*2005*	*2007*	*2008*
China	35.2	39.6	38.0	46.6	49.9	50.4	3.8	10.9	8.4	10.4	13.0	9.0
Hong Kong	35.7	29.6	31.9	33.0	31.8	31.2	3.9	2.3	8.0	7.1	6.4	2.4
Republic of Korea	37.3	36.5	33.3	32.3	31.0	30.3	9.2	9.2	8.5	4.0	5.1	2.2
India	22.8	24.4	23.7	34.2	35.7	37.7	5.3	7.3	4.4	9.5	9.0	6.7
Indonesia	32.3	30.6	31.8	27.5	28.2	30.6	9.0	8.2	4.9	5.7	6.3	6.1
Malaysia	34.4	39.7	46.1	42.8	42.0	42.2	9.0	9.8	8.9	5.3	6.2	4.6
Singapore	44.0	50.1	46.9	48.8	52.4	50.0	9.2	8.2	10.1	7.3	7.8	1.1

*Average for the period.
Note: Data for India is for April–March and for others on a calendar year basis.
Source: Asian Development Bank.

In the case of domestic savings, the public sector needs to generate positive savings. Foreign savings in the form of foreign direct investment (FDI) can be attracted only when macro-economic fundamentals are strong and there is a well-developed and sound financial system. The latter is a prerequisite for mobilising higher domestic and foreign savings and allocating them efficiently for economic growth.

RELATIONSHIP BETWEEN THE FINANCIAL SYSTEM AND ECONOMIC GROWTH: SOME THEORETICAL AND EMPIRICAL EVIDENCE

Importance of the Financial System

- Facilitates economic activity and growth
- Helps accelerate the volume and rate of savings
- Lower financial intermediation costs
- Makes innovation least costly
- Helps in evaluating assets
- Helps the central bank to conduct monetary policy
- Monitors the management of companies

The existence of an efficient financial system facilitates economic activity and growth. The growth of financial structure is a precondition to economic growth. In other words, markets, institutions, and instruments are the prime movers of economic growth. The financial system of a country diverts its savings towards more productive uses and so it helps to increase the output of the economy.

Besides mobilising savings, the financial system helps accelerate the volume and rate of savings by providing a diversified range of financial instruments and services through intermediaries. This results in an increased competition in the financial system which channelises resources towards the highest-return investment for a given degree of risk. This lowers financial intermediation costs and stimulates economic growth.

A sophisticated financial system makes innovation least costly and most profitable, thereby enabling faster economic growth. Countries whose financial systems encourage diverse financing arrangements are able to maintain international competitiveness through updating their productive capacities.

In addition to affecting the rate as well as the nature of economic growth, a financial system is useful in evaluating assets, increasing liquidity, and producing and spreading information.

Financial systems often develops in response to changing patterns of demand for funds. In the 1970s, there was a worldwide increase in the demand for risk management services. Many financial systems met this demand by increasing trading activity and by the development of many new risk management products. Hence, economic growth can also stimulate growth of the financial system.

Financial markets represent the deep end of the financial system; the deeper the system, greater its stability and resilence. A well-developed money and government securities market helps the central bank to conduct monetary policy effectively with the use of market-based instruments. Well-developed financial markets are also required for creating a balanced financial system in which both, financial markets and financial institutions play important roles. An imbalance between the two leads to financial crisis, as it happened in South-east Asia.

The financial system plays an important role in disciplining and guiding management companies, leading to sound corporate governance practices. The domestic financial system when linked to the international financial system increases capital flow with the help of financial markets. This link reduces risk through portfolio diversification and helps in accelerating economic growth.

There has been much theorising about a two-way and symbiotic relationship between the financial system and economic growth. A sophisticated and sound financial system accelerates the rate of economic growth, and the financial system, in turn, develops more with higher economic growth. This relationship between a financial system and economic growth has received considerable attention in empirical literature also.

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disinvestment of public sector undertakings (PSUs), and reform of the tax system to create a broader base of taxation by moderating tax rates.

The deregulation of industry, liberalisation of foreign exchange markets and convertibility of currency require an efficient financial system. Hence the steps to improve the financial system were an integral part of the economic reforms initiated in 1991. The improved financial system is expected to increase the efficiency of resource mobilisation and allocation in the real economy, which, in turn, would induce a higher rate of economic growth. Moreover, the soundness of the financial system is one of the fundamentals for judging the health of an economy and these measures will impart it health as well as strength.

In August 1991, the government of India appointed a high level committee under the chairmanship of M. Narasimham, former governor of the Reserve Bank of India, to look into all aspects of the financial system and make comprehensive recommendations to reform it. The committee submitted its report in November 1991, recommending reforms in both the banking sector and in the financial markets. These recommendations were gradually implemented in the beginning of 1992.

INDIAN FINANCIAL SYSTEM IN THE PRE-REFORMS PERIOD

Financial System in the Pre-reforms Period

- Closed
- Highly regulated by the government
- Segmented

Financial systems in developing countries, some two decades ago, were viewed primarily as tools in the hands of the government to be used in the development process. Financial institutions, on the one hand, were tapped for funds to finance government and public expenditure and, on the other hand, used to direct credit to the priority sector. Such a view of the functions of the financial system has changed. In many developing economies, the emphasis has now shifted from the government and public sector to private sector due to the government's failure to attain social objectives. The private sector, in order to survive and grow, has to rely on a developed financial system. Moreover, in this era of globalisation and intense competition, a continuous flow of funds is needed, from within the country and from abroad. To attract this flow of funds, a developed domestic financial system is a prerequisite.

Price Discovery

It is the process whereby market participants attempt to find an equilibrium price

The role of the financial system in the development process has changed not only in the developing economies, but worldwide as well. The emphasis in the approach to the financial system in the growth process has moved from channelising of resources to efficient credit allocation, which is largely determined by market forces. Since the South-east Asian financial crisis, financial stability occupies as important a place in the system as does efficiency of allocation.

After independence, India adopted a state-dominated development strategy wherein all allocation decisions were made by the government and its agencies. Accelerated capital accumulation by increasing domestic savings was considered to be the key to development. An increase in domestic savings was achieved by levying high taxes, suppressing consumption, and appropriating profits through ownership of commercial enterprises. The role of the financial system was limited in this state-dominated environment. Banks were the dominant financial institutions for accumulation of savings and financing of trade and industrial activities. The financial system had a limited role in capital accumulation, since it could not provide incentives for higher savings as interest rates were not only controlled but also repressed. Moreover, the government pre-empted household saving through high levels of statutory and cash reserve requirements. Banks and financial institutions merely acted as deposit agencies.

The resource mobilisation in the primary capital market was also subject to several controls which prevented the process of price discovery. The allocation decisions were made by the government, limiting the allocative efficiency of the financial system. Banks and financial institutions directed credit to priority sectors at subsidised rates decided by the government. In order to offset the subsidised rates, banks charged higher interest rates from other borrowers and paid lower rates to depositors. These interest rate controls and high regulations inhibited proper pricing of resources and limited the allocative efficiency. Thus, the Indian financial system till the early 1990s was a closed, restricted, highly regulated, and segmented system.

In the 1990s, there was a paradigm shift in development from a state-dominated to a market-determined strategy. This shift was a result of the government's failure in achieving a higher growth rate. On the one hand, the government could not generate resources for investment or public services; on the other, there was an erosion in public savings. Thus, a failure of the government's restrictive and regulating policies and a need to adopt a market-determined strategy of development were the causes for undertaking reforms in the financial system. Reforms aimed at improving operational and allocative efficiency of the financial system.

OBJECTIVES OF FINANCIAL SYSTEM REFORMS

Reforms in the financial system aimed at increasing competitive efficiency in the operation of the system, making it healthy and profitable and imparting to it an operational flexibility and autonomy for working efficiently. These would result in giving the saver a wide choice with regard to

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instruments and institutions and enhance his confidence in the system. This would greatly augment the accumulation of capital funds.

The basic priority in the early reforms period was to remove structural rigidities and inefficiencies in the financial system. The financial system, in the 1980s and early 1990s, was characterised by controls over the pricing of financial assets, restrictions on flows or transactions, barriers to entry, low liquidity, and high costs. These characteristics hindered the development of the financial system into an efficient conduit for channelising and allocating resources. Hence, the reforms primarily aimed at structural transformation in the financial system to improve efficiency, stability, and integration of various components of the financial system. Some of the structural changes initiated are free pricing of financial assets, relaxation of quantitative restrictions, removal of barriers to entry, new methods and instruments of trading, and greater participation and improvement in clearing, settlement, and disclosure practices.

The structural transformation process is now almost complete. In the second phase, the reforms aim at attaining a balance between the goals of financial stability and integrated and efficient markets.

Financial Efficiency, Stability, and Integration

Improving the efficiency of the financial system is one of the basic objectives of regulators. An efficient financial system is one which allocates savings to the most productive uses. Besides allocating financial resources, it also ensures the following.

- Information arbitrage efficiency, i.e., whether market prices reflect all the available information.
- Fundamental valuation efficiency, i.e., whether company valuations are reflected in stock prices.
- Full insurance efficiency, i.e., whether economic agents can insure against all future contingencies.

Financial markets and financial institutions are the two important components of a financial system. A financial system's efficiency is reflected in the efficiency of both financial markets and financial institutions. Several steps have been undertaken to improve the efficiency of financial institutions and markets. Liberalisation of interest rates, reduction in reserve requirements, increasing competition by allowing new private sector players, advances in technology, introduction of prudential norms such as income recognition, provisioning, and capital adequacy, and laying down of standards for corporate governance are some of the steps undertaken to improve the efficiency of the banking sector. In case of financial markets, repealing of the Capital Issues (Control) Act, 1947, free pricing, rationalisation of the process of price discovery in the form of book building and auctions, enhancing transparency through strict disclosure norms, improved trading and settlement practices, enlarging the number of participants, introduction of a transparent takeover code, encouraging the growth of firms both at home and abroad, rationalised tax structures, encouraging good market practices, introduction of real time gross settlement (RTGS) and other electronic payment mechanisms are some of the measures which have helped in improving information efficiency and bringing down transaction costs.

Financial stability has been an important goal for the regulators after the South-east Asian currency and financial crisis. Financial stability is crucial in this era of globalisation, which has increased mobility of international capital flows, and the risk of contagion of financial crisis among countries. Liberalisation and deregulation also pose several risks to financial stability. Financial instability arises due to weak fundamentals and institutional failures, resulting in panic or information asymmetry. As stated in the RBI's Report on Currency and Finance (2004), financial stability in India would mean (a) ensuring uninterrupted financial transactions, (b) maintenance of a level of confidence in the financial system amongst all the participants, and (c) absence of excess volatility that adversely affects real economic activity. In order to ensure financial stability, the government has adopted a three-fold strategy.

1. Strengthening linkages across institutions and markets.
2. Promoting soundness of financial institutions through prudential regulation and supervision.
3. Ensuring the overall macro-economic balance.

The Reserve Bank has followed a three-pronged strategy to maintain financial stability.

1. Maintaining the overall macro-economic balance, especially through the twin objectives of price stability and growth.
2. Enhancing the macro-prudential functioning of institutions and markets.
3. Strengthening micro-prudential institutional soundness through regulation and supervision.

The Reserve Bank maintains orderly conditions in various financial markets by adopting flexible operating procedures and instruments of monetary policy. The LAF operations coupled with open market operations

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help in absorbing liquidity to maintain financial stability. The Reserve Bank instituted the Market Stabilisation Scheme (MSS) to absorb persistent capital flows. The stock markets and market participants could withstand the volatility that occurred on May 17, 2004 when the results of the general elections were declared.

The operation of a financial system is influenced by overall economic activity and macro-economic changes. Hence, assessment of financial soundness and stability requires the development of macro-prudential indicators. These indicators are quantitative variables, which comprise both micro-prudential indicators of the health of individual financial institutions, and macro-economic variables related with financial system soundness. Macro-prudential indicators can help a country to assess its banking system's vulnerability to crisis; they can be extended even to financial markets. The Reserve Bank monitors macro-prudential indicators and makes them publicly available through its reports to enhance the disclosure of key financial information to markets. Macro-economic indicators include sets of indicators on the real economy, trends in balance-of-payments level and volatility of inflation, interest and exchange rates, growth of credit, correlation among financial markets, trades spillover, and contagion from investor behaviour. Micro-prudential indicators include indicators on capital adequacy, asset quality of lending and borrowing entities, management soundness, liquidity, sensitivity to market risk, and some market-based indicators, such as market prices, ratings of financial instruments, and financial institutions. To ensure financial stability, the government replaced ad hoc T-bills with the system of ways and means advances to raise funds.

Financial Market Integration

- Integration between various market segments
- Correlation between different market rates
- International integration through trade and cross-border capital flows

Integrated markets are unified markets wherein participants in one market have unrestricted access to other markets. This brings about an overall equality of returns over markets. The money market, the capital market, and the foreign exchange market remained segmented till the early 1990s due to high level of regulation and restrictions. An integration of markets is necessary for effective transmission and implementation of policies and for facilitating better functioning of markets. To enable integration, interest rates were freed, foreign capital flows and foreign participants were allowed entry, domestic companies were permitted to raise funds from outside, and participants were allowed to operate in different markets simultaneously. Besides, introduction of new products such as repos and derivatives, and improvements in technology and payment and settlement infrastructure have facilitated integration of financial markets in India. The integration of the domestic financial markets within themselves and with the foreign exchange market is reflected in trends in turnover and prices of securities in financial markets. Besides this, an analysis of the transmission of volatility in one market to other markets also helps in knowing the extent of integration of financial markets. The linkage between the call money market and foreign exchange market is found during times of volatility in foreign exchange market as commercial banks have a dominant presence in both the markets. An increase in foreign investment flows increases cross-border financial integration. As a result, the sensitivity of the Indian technology stocks to movements in the NASDAQ composite index was high in 1999–2000. The movements in the Indian stock indices are correlated with the movements in the global stock indices. The domestic integration of various segments of financial markets has been facilitated by the expansion of the online operations of two major stock exchanges—the BSE and the NSE. The regional stock exchanges have been integrated with the Interconnected Stock Exchange of India Ltd (ISE). In addition, many regional stock exchanges have become members of both the BSE and the NSE.

Conclusion

The Indian financial system is fairly integrated, stable, and efficient. There are weaknesses in the system which need to be addressed. These include a high level of non-performing assets in some banks and financial institutions, disciplinary issues with regard to non-banking financial companies, government's high domestic debt and borrowings, volatility in financial markets, absence of a yield curve, and co-operative bank scams.

The reforms in the financial system have been more capital market-centric in nature. The crisis in financial institutions such as UTI, IFCI, and IDBI unfolded the failure of prudential regulations and the government had to bail them out by refinancing them. This eroded investor confidence in public sector institutions, leading to a deceleration in the rate of domestic saving. Foreign capital flows and foreign exchange reserves have increased but the actual absorption of foreign capital is quite low. The fiscal deficit has expanded, leading to a deteriorating fiscal scene. The spreading of the sub-prime mortgage crisis, high inflation and depreciating rupee has put a pressure on the GDP growth rate.

The growth rate of GDP has increased since 2003–04 but it needs to be sustained. India has still a long way to go. We can achieve a growth rate of 8 per cent for which we need reforms in key areas such as agriculture, power and labour. Greater consolidation and competition among banks and other financial intermediaries such as mutual funds and insurance companies is needed to lower the costs of intermediation and expand the

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Box 3.1 Fifteen Years of Reforms

The economic reform process of liberalisation and globalisation was introduced in the 1990s to improve performance of all sectors and making India globally competitive. Structural reforms, encompassing all sectors of the economy, involved reorientation towards a market-based economy for fostering sustainable growth and stability.

The reforms have transformed India from a closed and trailing economy to a liberalised and steady economy. The financial sector reforms have aided growth, avoided crisis, enhanced efficiency and imparted resilience to the system. This could be achieved, as the reform process was gradually implemented, coordinated with other economic policies and sequenced with international trends. Reforms in the financial sector created a deregulated environment and enabled free play of market forces.

The growth rate of the economy had collapsed to only 0.8 per cent in 1991. However, with the advent of continuous economic reforms, the economy has recorded an average growth rate of around 6 per cent in the last decade. India has been able to break free from the dismal Hindu rate of growth of 3.5 per cent and is now on a 8 per cent growth trajectory. The Indian economy grew at 9.6 per cent in 2006–07, making it one of the world's fastest growing economies.

The abolishment of license raj and bottlenecks of control have given a lot of freedom to the Indian industry. The lowering of taxes, customs, and excise duties have triggered investments in manufacturing, improved margins, and given a greater choice to the consumer. A host of foreign players have entered the manufacturing sector leading to a significant increase in competition.

The economic fundamentals are improving. Exports are increasing and India is a destination for software services and business process outsourcing. New areas such as generic pharmaceuticals auto and ancillary and engineering products are contributing towards export growth. The Indian industry underwent a restructuring phase and is now moving into the investment cycle for expansion and modernisation. Indian industries have built world class size manufacturing capacities, acquired companies, improved quality and efficiency, and become globally competitive.

The core objectives of the financial sector reforms are strengthening of the financial sector and improving the functioning of the financial markets. Indian stock markets are one of the most exciting and vibrant markets of the world. They have the highest number of listed companies with a 300-million strong investor community. The average trading volume in these markets is now around a trillion dollars a day. The liquidity in the stock markets has increased. The return on equity in India is one of the highest in the world. Shares are trading at a price–earnings multiple of 15. A large number of foreign institutional investors (FIIs) have setup separate India sections for trading in these markets. In the US alone, there are more than 5,000 India-dedicated mutual fund schemes. The stock market index reached a peak of 21,000 in January 2008. Indian markets have come a long way since the 1992 scam. A lot of infrastructural issues such as on-line trading, demat, rolling settlement, and disclosures have been taken care of. Moreover the time period between issue closure and listing has been reduced to six days as against the earlier 15 days.

India's financial sector is integrating with that of the rest of the world. The interest rates have been freed, the statutory provisions have been reduced and prudential norms have been strengthened for players in the financial sector. Reforms have altered the organisation structure, ownership pattern, and domain of operations of financial institutions and infused greater competition.

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availability of credit and insurance in the rural areas. Reforms in sectors such as retailing, manufacturing, mining, and insurance should be carried forward. The sectoral caps for FDI should be relaxed to attract large foreign capital inflows especially in the financial services sector.

KEY TERMS

Financial Efficiency, Financial Stability, Financial Integration, Price Discovery.

SUMMARY

1. The role of the financial system was limited in the state-dominated environment. Banks were the dominant financial institutions for accumulation of savings and financing of trade and industrial activities. The financial system had a limited role in capital accumulation.
2. A failure of the government's restrictive and regulating policies and a need to adopt a market-determined strategy of development were the causes for undertaking reforms in the financial system.
3. The government initiated economic reforms in June 1991 to provide an environment of sustainable growth and stability.
4. The basic priority in the early reforms period was to remove structural rigidities and inefficiencies in the financial system.
5. The structural transformation process is now almost complete. In the second phase, the reforms aim at attaining a balance between the goals of financial stability and integrated and efficient markets.

REVIEW QUESTIONS

1. Explain the profile of the Indian financial system in the pre-reform period.
2. Why were financial system reforms undertaken in India? Discuss.
3. Explain the following terms:
   a. Financial efficiency
   b. Financial stability
   c. Financial integrity
4. What is the strategy adopted by the Reserve Bank of India to maintain financial stability.
5. Describe the Indian financial system in the pre-reform and post-reform periods.

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Part II

Financial Markets

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4

The Money Market

Chapter Objectives

This chapter will enable you to develop an understanding of the following:

1. *Meaning of Money Market.*
2. *Characteristics, functions, and benefits of the money market*
3. *Development of the money market in India*
4. *Different money market instruments such as:*
   - *Treasury bills: Types, importance, participants, and size*
   - *Commercial papers: Meaning, participants, guidelines, and size*
   - *Commercial bills: Types, features, and size*
   - *Certificates of deposit: Features, size, and comparison of CDs and CPs*
   - *Call/Notice Money Market: Importance, participants, call rate, size, and steps to convert call money market into pure inter-bank money market*
   - *Collateralised lending and borrowing obligation*
5. *Money market intermediaries such as Discount and Finance House of India and Money Market Mutual Funds*
6. *Link between the money market and the monetary policy in India*
7. *Tools for managing liquidity in the money market.*
8. *Money market derivatives*

INTRODUCTION

The money market is a market for financial assets that are close substitutes for money. It is a market for overnight to short-term funds and instruments having a maturity period of one or less than one year. It is not a physical location (like the stock market), but an activity that is conducted over the telephone. The money market constitutes a very important segment of the Indian financial system.

The characteristics of the money market are as follows.

- It is not a single market but a collection of markets for several instruments.
- It is a wholesale market of short-term debt instruments.
- Its principal feature is honour where the creditworthiness of the participants is important.
- The main players are: the Reserve Bank of India (RBI), the Discount and Finance House of India (DFHI), mutual funds, insurance companies banks, corporate investors, non-banking finance companies (NBFCs), state governments, provident funds, primary dealers, the Securities Trading Corporation of India (STCI), public sector undertakings (PSUs), and non-resident Indians.
- It is a need-based market wherein the demand and supply of money shape the market.

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Functions of the Money Market

A money market is generally expected to perform three broad functions.

- Provide a balancing mechanism to even out the demand for and supply of short-term funds.
- Provide a focal point for central bank intervention for influencing liquidity and general level of interest rates in the economy.
- Provide reasonable access to suppliers and users of short-term funds to fulfill their borrowings and investment requirements at an efficient market clearing price.

Besides the above functions, a well-functioning money market facilitates the development of a market for longer-term securities. The interest rates for extremely short-term use of money serve as a benchmark for longer-term financial instruments.

Benefits of an Efficient Money Market

An efficient money market benefits a number of players. It provides a stable source of funds to banks in addition to deposits, allowing alternative financing structures and competition. It allows banks to manage risks arising from interest rate fluctuations and to manage the maturity structure of their assets and liabilities.

A developed inter-bank market provides the basis for growth and liquidity in the money market including the secondary market for commercial paper and treasury bills.

An efficient money market encourages the development of non-bank intermediaries thus increasing the competition for funds. Savers get a wide array of savings instruments to choose from and invest their savings.

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Benefits of an Efficient Money Market

- Provides a stable source of funds to banks
- Encourages development of non-bank entities
- Facilitates government market borrowing
- Makes effective monetary policy actions
- Helps in pricing different floating interest products

A liquid money market provides an effective source of long-term finance to borrowers. Large borrowers can lower the cost of raising funds and manage short-term funding or surplus efficiently.

A liquid and vibrant money market is necessary for the development of a capital market, foreign exchange market, and market in derivative instruments. The money market supports the long-term debt market by increasing the liquidity of securities. The existence of an efficient money market is a precondition for the development of a government securities market and a forward foreign exchange market.

Trading in forwards, swaps, and futures is also supported by a liquid money market as the certainty of prompt cash settlement is essential for such transactions. The government can achieve better pricing on its debt as it provides access to a wide range of buyers. It facilitates the government market borrowing programme.

Monetary control through indirect methods (repos and open market operations) is more effective if the money market is liquid. In such a market, the market response to the central bank's policy actions are both faster and less subject to distortion.

The Indian Money Market

The average turnover of the money market in India is over Rs. 1,00,000 crore daily. This is more than 3 per cent let out to the system. This implies that 2 per cent of the annual GDP of India gets traded in the money market in just one day. Even though the money market is many times larger than the capital market, it is not even a fraction of the daily trading in developed markets.

Role of the Reserve Bank of India in the Money Market

The Reserve Bank of India is the most important constituent of the money market. The market comes within the direct purview of the Reserve Bank regulations.

The aims of the Reserve Bank's operations in the money market are

- to ensure that liquidity and short-term interest rates are maintained at levels consistent with the monetary policy objectives of maintaining price stability;
- to ensure an adequate flow of credit to the productive sectors of the economy; and
- to bring about order in the foreign exchange market.

The Reserve Bank influences liquidity and interest rates through a number of operating instruments—cash reserve requirement (CRR) of banks, conduct of open market operations (OMOs), repos, change in bank rates, and, at times, foreign exchange swap operations.

Steps to Develop the Money Market in India

The money market in India is divided into the formal (organised) and informal (unorganised) segments. One of the greatest achievements of the Indian financial system over the last 50 years has been the decline in the relative importance of the informal segment and increasing presence and influence of the formal segment upto the mid-1980s, money market was characterised by lack of depth, small number of instruments, and strict regulation on interest rates. The money market consisted of the inter-bank call market, treasury bills, commercial bills, and participation certificates.

Several steps were taken in the 1980s and 1990s to reform and develop the money market. The reforms in the money market were initiated in the latter half of the 1980s.

In the 1980s A committee to review the working of the monetary system under the chairmanship of Sukhamoy Chakravorty was set up in 1985. It underlined the need to develop money market instruments. As a follow up, the Reserve Bank set up a working group on the money market under the chairmanship of N. Vagul which submitted its report in 1987. This committee laid the blueprint for the institution of a money market. Based on its recommendations, the Reserve Bank initiated a number of measures.

- The Discount and Finance House of India (DFHI) was set up as a money market institution jointly by the Reserve Bank, public sector banks, and financial institutions in 1988 to impart liquidity to money market instruments and help the development of a secondary market in such instruments.
- Money market instruments such as the 182-day treasury bill, certificate of deposit, and inter-bank participation certificate were introduced in 1988–89. Commercial paper was introduced in January 1990.
- To enable price discovery, the interest rate ceiling on call money was freed in stages from October 1988. As a first step, operations of the DFHI in the call/notice money market were freed from

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the interest rate ceiling in 1988. Interest rate ceilings on inter-bank term money (10.5 per cent to 11.5 per cent), rediscounting of commercial bills (12.5 per cent), and inter-bank participation without risk (12.5 per cent) were withdrawn effective May 1989. All the money market interest rates are, by and large, determined by market forces. There has been a gradual shift from a regime of administered interest rates to market-based interest rates.

In the 1990s The government set up a high-level committee in August 1991 under the chairmanship of M. Narasimham (the Narasimham Committee) to examine all aspects relating to structure, organisation, functions, and procedures of the financial system. The committee made several recommendations for the development of the money market. The Reserve Bank accepted many of its recommendations.

- The Securities Trading Corporation of India was set up in June 1994 to provide an active secondary market in government dated securities and public sector bonds.
- Barriers to entry were gradually eased by (a) setting up the primary dealer system in 1995 and satellite dealer system in 1999 to inject liquidity in the market; (b) relaxing issuance restrictions and subscription norms in respect of money market instruments; (c) allowing the determination of yields based on the demand and supply of such paper; (d) enabling market evaluation of associated risks by withdrawing regulatory restriction such as bank guarantees in respect of commercial papers; and (e) increasing the number of participants by allowing the entry of foreign institutional investors (FIIs), non-bank financial institutions, and mutual funds.
- Several financial innovations in instruments and methods were introduced. Treasury bills of varying maturities and RBI repos were introduced. Auctioned treasury bills were introduced leading to market-determined interest rates.
- The development of a market for short-term funds at market-determined rates has been fostered by a gradual switch from a cash-credit system to a loan-based system, shifting the onus of cash management from banks to borrowers.
- Ad hoc and on-tap 91-day treasury bills were discontinued. They were replaced by Ways and Means Advances (WMA) linked to the bank rate. The introduction of WMA led to the limiting of the almost automatic funding of the government.
- Indirect monetary control instruments such as the bank rate—reactivated in April 1997, strategy of combining auctions, private placements, and open market operations—in 1998–99, and the liquidity adjustment facility (LAF)—in June 2000 were introduced.
- The minimum lock-in period for money market instruments was brought down to 7 days.
- The Reserve Bank started repos both on auction and fixed interest rate basis for liquidity management. Since June 5, 2000, the newly introduced liquidity adjustment facility has been effectively used to influence short-term rates by modulating day-to-day liquidity conditions. The transition to LAF was facilitated by the experiment with the interim liquidity adjustment facility (ILAF) from April 1999. This provided a mechanism for liquidity management through a combination of repos, export credit refinance, and collateralised lending facilities.
- The inter-bank liabilities were exempted from the cash reserve ratio and the statutory liquidity ratio (SLR) stipulations for facilitating the development of a term money market.
- New money market derivatives such as forward rate agreements (FRAs) and interest rate swaps (IRSs) were introduced in 1999.
- Money market instruments such as certificate of deposits and commercial paper are freely accessible to non-bank participants.
- The payment system infrastructure was strengthened with the introduction of the negotiated dealing system (NDS) in February 2002, setting-up of the Clearing Corporation of India Limited (CCIL) in April 2002 and the implementation of real time gross settlement (RTGS) system from April 2004.
- Collateral Borrowing and Lending Obligation (CBLO) was operationalised as a money market instrument through the CCIL on January 20, 2003.

Reforms in the Money Market

- New instruments
- New participants
- Changes in the operating procedures of monetary policy
- Fine tuning of liquidity management operations
- Technological infrastructure

The development and profile of the money market has changed in the nineties. A basic objective of money market reforms in the recent years has been to facilitate the introduction of new instruments and their appropriate pricing. The Reserve Bank has endeavoured to develop market segments which exclusively deal in specific assets and liabilities as well as participants. Accordingly, the call/notice money market is now a pure inter-bank market. In order to ensure systemic stability, prudential limits on exposures to the call money market have been imposed. Standing liquidity support to banks from the Reserve Bank and facilities for exceptional liquidity support have been rationalised. The various segments of the money market have integrated with the introduction and successful implementation of the LAF. The NDS and CCIL have improved the functioning of money markets. They have facilitated a speedier conversion

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of notice/call money market into a pure inter-bank money market and enabled the growth of a buoyant repo market outside the LAF.

Money Market Centres

There are money market centres in India at Mumbai, Delhi, and Kolkata. Mumbai is the only active money market centre in India with money flowing in from all parts of the country getting transacted there.

MONEY MARKET INSTRUMENTS

The instruments traded in the Indian money market are

1. Treasury bills (T-bills);
2. Call/notice money market—Call (overnight) and short notice (up to 14 days);
3. Commercial Papers (CPs)
4. Certificates of Deposits (CDs)
5. Commercial Bills (CBs)
6. Collateralised Borrowing and Lending Obligation (CBLO)

Call/notice money market and treasury bills form the most important segments of the Indian money market. Treasury bills, call money market, and certificates of deposit provide liquidity for government and banks while commercial paper and commercial bills provide liquidity for the commercial sector and intermediaries.

TREASURY BILLS

- T-Bills are short-term instruments used by the government to raise short-term funds

Treasury bills are short-term instruments issued by the Reserve Bank on behalf of the government to tide over short-term liquidity shortfalls. This instrument is used by the government to raise short-term funds to bridge seasonal or temporary gaps between its receipts (revenue and capital) and expenditure. They form the most important segment of the money market not only in India but all over the world as well.

T-bills are repaid at par on maturity. The difference between the amount paid by the tenderer at the time of purchase (which is less than the face value) and the amount received on maturity represents the interest amount on T-bills and is known as the discount. Tax deducted at source (TDS) is not applicable on T-bills.

Features of T-Bills

- They are negotiable securities.
- They are highly liquid as they are of shorter tenure and there is a possibility of inter-bank repos in them.
- There is an absence of default risk.
- They have an assured yield, low transaction cost, and are eligible for inclusion in the securities for SLR purposes.
- They are not issued in scrip form. The purchases and sales are effected through the Subsidiary General Ledger (SGL) account.
- At present, there are 91-day, 182-day, and 364-day T-bills in vogue. The 91-day T-bills are auctioned by the RBI every Friday and the 364-day T-bills every alternate Wednesday, i.e., the Wednesday preceding the reporting Friday.
- Treasury bills are available for a minimum amount of Rs. 25,000 and in multiples thereof.

Types of T-Bills

There are three categories of T-bills.

On-tap Bills On-tap bills, as the name suggests, could be bought from the Reserve Bank at any time at an interest yield of 4.66 per cent. They were discontinued from April 1, 1997, as they had lost much of their relevance.

Ad hoc Bills Ad hoc bills were introduced in 1955. It was decided between the Reserve Bank and the Government of India that the government could maintain with the Reserve Bank a cash balance of not

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less than Rs. 50 crore on Fridays and Rs. 4 crore on other days, free of obligation to pay interest thereon, and whenever the balance fell below the minimum, the government account would be replenished by the creation of ad hoc bills in favour of the Reserve Bank. Ad hoc 91-day T-bills were created to replenish the government's cash balances with the Reserve Bank. They were just an accounting measure in the Reserve Bank's books and, in effect, resulted in automatic monetisation of the government's budget deficit. A monetised deficit is the increase in the net Reserve Bank credit to the central government which is the sum of the increase in the Reserve Bank's holdings of: (a) the government of India's dated securities; (b) 91-day treasury bills; and (c) rupee coins for changes in cash balances with the Reserve Bank.

In the 1970s and 1980s, a large proportion of outstanding ad hocs were converted into long-term dated and undated securities of the Government of India. This conversion is referred to as 'funding.' Their expansion put a constraint on the Reserve Bank conduct of monetary policy and hence they were discontinued from April 1, 1997. The outstanding ad hoc T-bills and tap bills as on March 31, 1997 were funded on April 1, 1997 into special securities without any specified maturity at an interest rate of 4.6 per cent per annum. A system of Ways and Means Advances from April 1, 1997 was introduced to replace ad hoc bills and to accommodate temporary mismatches in the government of India receipts and payments.

Auctioned T-Bills Auctioned T-bills, the most active money market instrument, were first introduced in April 1992. The Reserve Bank receives bids in an auction from various participants and issues the bills subject to some cut-off limits. Thus, the yield of this instrument is market determined. These bills are neither rated nor can they be rediscounted with the Reserve Bank. At present, the Reserve Bank issues T-bills of three maturities—91-days, 182-days, and 364-days.

Importance of T-Bills

The development of T-bills is at the heart of the growth of the money market. T-bills play a vital role in the cash management of the government. Being risk free, their yields at varied maturities serve as short-term benchmarks and help in pricing different floating rate products in the market. The T-bills market is the preferred central bank tool for market intervention to influence liquidity and short-term interest rates. The development of the T-bills market is a pre-condition for effective open market operations.

Development of the T-Bills Market

Ad hoc 91-day T-bills were introduced in the mid-1950s. These bills were introduced to replenish on an automatic basis, the central government's cash balance with the Reserve Bank so that only the minimum required level was maintained. These bills opened up an era of uncontrolled monetisation of the central government's deficit. Before the 1960s, there was an active T-bills market owing to the weekly auctions of the 91-day T-bills.

In the mid-1960s, the auction system for the issue of 91-day T-bills was replaced by on-tap bills. Till 1974, the tap bills rate changed with changes in the bank rate which sustained the interest of the participants in the T-bills market. However, after 1974, the discount rate on ad hoc and tap bills was fixed uniformly at 4.6 per cent. The T-bills market lost lustre due to the administered rate regime.

However, the interest in T-bills revived with the introduction of the 182-day T-bills on an auction basis in November 1986. It also revived because of the constitution of the Discount and Finance House of India in 1988 as a money market institution.

The 182-day T-bills were discontinued in 1992 and replaced by the 364-day auction T-bills in April 1992 as part of reform measures. Subsequently, the 91-day auction T-bills were introduced in January 1993. The parallel existence of the 91-day tap T-bills and ad hoc T-bills continued till March 1997.

Thereafter, the 14-day intermediate T-bills and auction T-bills were introduced in April 1997 to provide an alternative avenue to state governments and to facilitate some foreign central banks to invest surplus funds.

The 182-day T-bills were reintroduced to provide variety in treasury bills. However, both the 182- and 14-day T-bills were discontinued from March 2001. The 182-day T-bills were reintroduced in April 2005.

The Reserve Bank's purchase and holding of T-bills have become totally voluntary with the discontinuation of the ad hoc and on-tap 91-day T-bills. Before the introduction of the auctioned T-bills, a substantial majority of the T-bills used to be held by the Reserve Bank. With the introduction of auctioned T-bills, more than 25 per cent of T-bills are held by investors other than the Reserve Bank. The auction procedures have been streamlined with notified amounts for all auctions being specified in case of competitive bids and non-competitive bids being accepted outside the notified amount. A uniform price-based auction for 91-day T-bills was introduced on an experimental basis in 1998–99. It has been successfully adopted.

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Participants in the T-Bills Market

The Reserve Bank of India, banks, mutual funds, financial institutions, primary dealers, provident funds, corporates, foreign banks, and foreign institutional investors are all participants in the T-bills market. The state governments can invest their surplus funds as non-competitive bidders in T-bills of all maturities.

Sale of T-Bills

The sale of T-bills is conducted through an auction. The method helps in price discovery, a process wherein prices in the market reflect the relative cost of production and consumption utilities with a view to achieving the optimum allocation of resources in the economy. In case of auctions, competitive bids are submitted by the participants to the Reserve Bank and the bank decides the cut-off yield/price and makes the allotment on such a basis. For an auction to be meaningful, it is necessary that auctions are conducted on a competitive bidding basis. For this purpose, the participation should be large and varied in nature. A wider participation in auctions results in increased competition, yielding better prices and improving the auction results. Primary dealers, banks, corporates, mutual funds, and others participate in the competitive bids.

Besides allotting T-bills through auction, the Reserve Bank accepts non-competitive bids from state governments, non-government provident funds, and other central banks. Non-competitive bids are accepted to encourage participants who do not have expertise in bidding. Such bids are a more efficient way of encouraging retail participation instead of having a large number of retail investors bidding competitively on their own. The Reserve Bank also participates on a non-competitive basis to primarily take up the under-subscribed issues. Non-competitive bidders are allotted T-bills at a weighted average price of the successful competitive bids. Non-competitive bids are accepted outside the notified amount.

- In a competitive bid, participants submit their bids to the Reserve Bank who then decides the cut-off yield/price and makes the allotment
- In a non-competitive bid, participants are not allowed to bid, as they do not have the expertise in bidding and are allotted bids at the weighted average price determined in competitive bidding

Types of Auctions

There are two types of auctions: (i) multiple-price auction and (ii) uniform-price auction.

Multiple-price Auction

- Each winning bidder pays the price it bid

Multiple-price Auction The Reserve Bank invites bids by price, i.e., the bidders have to quote the price (per Rs. 100 face value) of the stock which they desire to purchase. The bank then decides the cut-off price at which the issue would be exhausted. Bids above the cut-off price are allotted securities. In other words, each winning bidder pays the price it bid.

The advantage of this method is that the Reserve Bank obtains the maximum price each participant is willing to pay. It can encourage competitive bidding because each bidder is aware that it will have to pay the price it bid, not just the minimum accepted price. The disadvantage is that bidders bid more cautiously (i.e., offer lower prices) in these auctions. This is so because it may happen that bidders who paid higher prices could face large capital losses if the trading in these securities starts below the marginal price set at the auction. This is known as the 'winner's curse.' The winner's curse can be a problem in those markets where price volatility is high. In order to eliminate the problem, the Reserve Bank introduced uniform price auction in case of 91-day T-bills.

Uniform-price Auction

- Each winning bidder pays the uniform price decided by the Reserve Bank

Uniform-price Auction In this method, the Reserve Bank invites bids in descending order and accepts those that fully absorb the issue amount. Each winning bidder pays the same (uniform) price as decided by the Reserve Bank. In other words, all winning bidders are awarded the auctioned amount at the same price.

The advantages of the uniform price auction are that they tend to minimise uncertainty and encourage broader participation. On the other hand, it may be possible that uniform price auctions could reduce the need to prepare for the auction as allotment at a uniform price reduces the incentive to bid. Moreover, there are dangers of irresponsible bidding or of collusion in a uniform price auction.

Most countries follow the multiple-price auction. However, now the trend is a shift towards the uniform-price auction.

Uniform-price auction was introduced on an experimental basis on November 6, 1998 in case of 91-day T-bills. Since 1999–2000, 91-day T-bill auctions are regularly conducted on a uniform price basis.

There exists a fixed calendar for auctions of all types of T-bills. The Reserve Bank issues a press communication, two to three days prior to the auction and invites bids, indicating the date of the auction and terms such as the amount of auction and type of auction.

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The T-bill auction module was operationalised on October 22, 2003 on the Public Debt Office–Negotiated Dealing System (PDO–NDS). The auction is announced and processed on-line in a Straight-Through-Process (STP) on the system.

91-Day T-Bills

Treasury bills were sold on tap since 1965 throughout the week to commercial banks and the public at a fixed rate of 4.6 per cent. They were discontinued from April 1, 1997.

The 91-day ad hoc T-bills were created in favour of the Reserve Bank but in 1997–98 they were phased out under an agreement with the Reserve Bank and totally discontinued from April 1, 1997. The ad hoc and tap T-bills were converted into special securities without any specific maturity at an interest rate of 4.6 per cent per annum.

In 1992–93, a scheme for the issue of auctioned 91-day T-bills with a predetermined amount was introduced. The cut-off yields were significantly higher than the fixed discount rate on tap bills. The notified amount of each auction was consistent at Rs. 500 crore upto March 14, 1997. The notified amount of each auction was reduced to Rs. 100 crore with effect from March 21. Since May 2001, it has been increased from Rs. 100 to Rs. 250 crore. The notified amount was then increased to Rs. 500 crore in 2003 which was further raised to Rs. 2,000 crore from April 2004. The increase was on account of the introduction of the Market Stabilisation Scheme (MSS).

Size of the 91-Day T-Bills Market

The size of the treasury bills market is reflected in gross issues and the amount outstanding. As seen from Table 4.1, gross issues almost doubled in the year 1995–96. A gross amount of Rs. 24,050 crore was raised through 91-day T-bills. The gross issues declined substantially in the year 1997–98 as the notified amount of auctions was maintained in a narrow band of Rs. 100 crore to Rs. 300 crore. The volume of sales of the 91-day T-bills declined in the subsequent years again due to the low notified amount. In order to offer an increased amount of short-term paper the notified amount in each auction was raised from Rs. 100 to Rs. 250 crore from May 18, 2001. However, since 2001–02, due to high liquidity, persistent capital inflows and a reduction in the repo rate, both the gross issues and amount outstanding of 91-day T-Bills have increased.

The amount subscribed by the Reserve Bank as a percentage of gross issues declined in the year 1993–94 and 1994–95 but increased substantially in the year 1995–96 due to stringent liquidity conditions

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TABLE 4.1 Government of India Auctions of 91-Day T-Bills

Year	*Gross Issues (Rs. in Crore)*	*Amount Subscribed by the RBI*		*Amount Outstanding*		*Total*
		(Rs. in Crore)	*Per Cent of Gross Amount Raised*	*Outside the RBI*	*With the RBI*	*Amount Outstanding*
1992–93	1,350	1,146.90	84.9	203.10 (15)	1,146.9 (85)	1,350
1993–94	15,750	838.50	12.8	524.50 (90)	605.0 (10)	5,850
1994–95	12,450	2,404.55	19.3	732.50 (92)	67.5 (8)	800
1995–96	24,050	7,789.00	32.4	3,233.89 (50)	3,266.10 (50)	6,500
1996–97	25,200	3,368.25	13.4	4,231.63 (74)	1,468.37 (26)	5,700
1997–98	13,200	1,095.60	8.3	973.55 (61)	626.65 (39)	1,600
1998–99	16,697	3,014.00	18.1	1,276.10 (85)	224.00 (15)	1,500
1999–2000	8,155	1,523.00	18.7	1,232.00 (81)	288 (19)	1,520
2000–01	7,255	855.00	11.8		–	
2001–02	20,216	–	–	5,001.00 (100)	–	5,001
2002–03	26,402	–	–	10,672.00 (100)	–	10,672
2003–04	36,786	–	–	7,139 (100)	–	7,139

(Continued)

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TABLE 4.1 (Continued)

Year	Gross Issues (Rs. in Crore)	Amount Subscribed by the RBI		Amount Outstanding		Total
		(Rs. in Crore)	Per Cent of Gross Amount Raised	Outside the RBI	With the RBI	Amount Outstanding
2004–05	1,00,592	–	–	27,792	–	27,792
2005–06	1,03,424	–	–	16,318	–	16,318
2006–07	1,31,577	–	–	45,229	–	45,229
2007–08	2,10,365	–	–	39,957	–	39,957
2008–09	2,65,555	–	–	75,549	–	75,549
2009–10	2,96,500	–	–	71,503	–	71,503

Note: Figures in parentheses indicate per cent to total.
Source: RBI, *Annual Report*, various issues.

in the money and credit markets. The decline in this amount in the year 2000–01 reflects higher market absorption owing to spells of easy liquidity.

The average net holdings of the Reserve Bank of around 85 per cent in 1992–93 were almost nil in 2000–01. This reflects a high market interest in these short-term bills and successful conduct of open market operations. Since 2001–02, the Reserve Bank has not subscribed to issues of 91-day T-Bills (refer Table 4.1).

There was a substantial decline in the amount outstanding from 1997–98 to 1999–2000 as the notified amount of each auction was reduced to Rs. 100 crore from Rs. 500 crore. However, the amount outstanding has increased substantially since 2001–02. This reflects a high level of liquidity in the system.

Table 4.2 reveals that state governments and banks were major holders of auctioned 91-day T-bills.

TABLE 4.2 Volume, Ownership, and Composition of 91-Day T-Bills Government of India 91-Day T-Bills (Outstanding at Face Value)

March 31	RBI			Banks		State Government		Others		Foreign
	Tap Redis-counted	Ad hocs	Auction	Tap	Auction	Tap	Auction	Tap	Auction	Central Bank Auction
1993	1,287	15,430	1,147	306	155	2,083	–	160	22	–
1994	2,108	21,730	605	72	3,428	2,296	–	541	935	–
1995	1,687	23,480	68	–	38	5,969	618	394	77	–
1996	2,355	29,445	3,211	–	408	5,026	2,285	465	595	–
1997	9,544	34,130	1,468	–	2,365	6,539	1,262	605	605	–
1998	–	–	627	–	29	–	530	–	95	319
1999	–	–	224	–	827	–	–	–	249	200
2000	–	–	288	–	557	–	–	–	455	220
2001	–	–	67	–	868	–	–	–	153	630
2002	–	–	154	–	2,292	–	450	–	360	1,301
2003	–	–	–	–	6,427	–	800	–	780	700
2004	–	–	–	–	3,948	–	600	–	1,452	39
2005	–	–	–	–	21,176	–	1,755	–	4,829	32
2006	–	–	–	–	5,943	–	9,762	–	576	37
2007	–	–	–	–	12,684	–	24,250	–	6,743	5
2008	–	–	–	–	6,057	–	23,825	–	10,075	–
2009	–	–	–	–	49,914	–	544	–	25,092	–
2010	–	–	–	–	30,875	–	–	–	40,628	–

Source: *RBI Bulletin*, May 2010.

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The shares of the state governments and commercial banks in sales and outstanding amount of the 91-day T-bills have fluctuated widely over the years. These shares seem to be inversely related—whenever the share of the state governments have increased, that of the banks has declined and vice versa.

Competitive Bids and Non-competitive Bids

The competitive bid amount received to notified amount ratio was higher during 2001–02 than in 2000–01. This ratio was the highest in 2006–07. Also, the proportion of competitive bid amount received to notified amount was higher in the year 2007–08. This indicates a favourable market response to the auctions of the 91-day T-bills (Table 4.3).

Since August 1994, state governments, state-run pension funds, and eligible provident funds have been permitted to participate in the auction on a non-competitive basis. In a non-competitive bid, the participants are not allowed to bid. They have to put in their applications and are allotted bills at the weighted average price determined in competitive bidding. They are not allowed any rediscounting facility from the Reserve Bank.

In the year 1995–96, non-competitive bidders were allotted around 74 per cent of the gross total issues. In the subsequent years, the non-competitive bidders were allotted an average 33 per cent of gross issues except in the year 1997–98. In the year 2000–01, the per cent of non-competitive bids accepted to gross issues was 28 per cent, which was quite low and which further reduced to 7.6 per cent in 2003–04. The proportionate share of non-competitive bids to gross issues increased substantially in 2006–07 and 2007–08. There is a need to attract retail investors through non-competitive bids for the growth of the treasury bills market.

364-Day T-Bills

In April 1992, the 364-day T-bills were introduced to replace the 182-day T-bills.

In case of the 364-day T-bills, a multiple/discriminatory price auction is conducted where successful bidders have to pay prices (yield) they have actually bid.

Initially, the auction of the 364-day T-bills was conducted on a fortnightly basis. These auctions evoked a good response from investors such as financial institutions and banks. These bills are not rediscountable with the Reserve Bank. Since 1998–99, the periodicity of the auctions has been changed to monthly as against fortnightly.

The features of the 364-day T-bills are similar to those of the 182-day T-bills. The investors' response to these bills depends, among other things on the uncertainties in the government securities market, variations in the SLR, and yield. The notified amount of these T-bills was raised from Rs. 500 crore to Rs. 750 crore effective December 13, 2000, and to Rs. 1,000 crore from April 2002. This was further increased to Rs. 2,000 crore from April 2004 on account of the introduction of the market stabilisation scheme (MSS).

Size of the 364-Day T-Bills Market

Both the gross issues and the outstanding amount almost doubled from 1992–93 to 1997–98 and 2001–02 to 2004–05 (refer Table 4.4). These issues contributed towards the government's resource mobilisation efforts. Since 1998–99, the Reserve Bank accepted devolvement on itself. This was around 17 per cent of the gross issues. This devolvement was accepted to contain the volatility in cut-off yields. However, there was no devolvement on the Reserve Bank and Primary Dealers since 2001–02.

182-Day T-Bills

The 182-day T-bills were introduced in November 1986 to provide short-term investment opportunities to financial institutions and others. These bills were periodically offered for sale on an auction basis by the Reserve Bank. Prior to July 1988, the auctions were held every month. Since then, however, fortnightly auctions were held, synchronising with the reporting Fridays of scheduled commercial banks. These bills could not be rediscounted with the Reserve Bank.

These bills were introduced with an objective to develop the short-term money market. It turned out to be a handy instrument for entities like banks, financial institutions and corporates, to invest their

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TABLE 4.3 Auctions of 91-Day T-Bills—Competitive Bids and Non-Competitive Bids

Particulars	*1992–93*	*1993–94*	*1994–95*	*1995–96*	*1996–97*	*1997–98*	*1998–99*	*1999–2000*	*2000–01*	*2002–03*	*2003–04*	*2004–05*	*2005–06*	*2006–07*	*2007–08*	*2008–09*
Total Notified Amount (Gross Issues)	1,350.00	15,750.00	12,450.00	24,050.00	25,200.00	13,200.00	16,697.00	8,155.00	7,255.00	26,402.00	36,786.00	1,00,592	1,03,424	1,31,577	2,10,365	2,65,555
Total Bids Received	494.10	41,609.40	19,876.73	26,441.41	51,876.40	19,557.41	18,706.50	11,769.50	12,430.00	566,630.41	92,691.56	2,77,657	2,19,156	2,25,998	4,02,928	5,85,860
—Competitive	–	–	17,866.73	8,291.02	37,091.70	10,067.59	13,109.75	8,734.50	10,025.00	50,418.29	89,906.00	2,70,895	1,89,913	1,68,643	3,01,904	5,19,301
—Non-competitive	–	–	2,010.00	18,150.39	14,784.40	9,489.82	5,597.00	3,035.00	2,405.00	6,212.12	2,785.56	6,762	29,243	57,355	1,01,024	66,559
Bid Amount Accepted	203.10	15,511.50	10,045.45	16,260.29	21,308.85	11,241.65	12,523.00	6,605.50	6,470.00	26,097.12	36,785.56	1,00,597	1,03,424	1,31,577	2,10,365	2,65,558
—Competitive	–	–	8,623.70	4,255.56	14,758.82	4,235.47	6,926.00	3,650.50	4,415.00	20,035.00	34,000.00	93,830	74,181	74,222	1,09,342	1,99,000
—Non-competitive	–	–	1,421.75	12,005.13	6,550.65	7,006.18	5,597.00	2,955.00	2,055.00	6,062.12	2,785.56	6,762	29,243	57,355	1,01,023	66,558
Per Cent of Bid Amount Accepted to Bids Received	41.11	37.3	50.50	61.50	41.10	57.50	66.90	56.10	52.10	46.08	40.00	36	54	58	52	45
Per Cent of Non-competitive Bids Accepted to Total Gross Issues	–	–	14.15	73.83	30.74	53.07	33.52	36.20	28.00	23.00	7.60	6.7	28	44	48	25

Source: RBI, *Annual Report*, various issues.

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TABLE 4.4 Auctions of 364-Day T-Bills

(Rs. in Crore)

Year	Gross Issues (Bids Accepted)	Bids Received	Per Cent of Bids Accepted to Bids Received	Devolvement on RBI and PDs	Outstanding
1992–93	8,796.47	14,709.09	60	–	8,796.47
1993–94	21,019.76	46,927.36	45	–	8,385.97
1994–95	16,857.00	30,727.22	55	–	8,163.12
1995–96	1,874.70	3,370.94	55	–	1,874.70
1996–97	8,240.60	15,244.90	54	–	8,240.60
1997–98	16,246.60	25,246.63	64	–	16,246.00
1998–99	10,200.00	18,845.87	43	2,186.30	10,200.00
1999–2000	13,000.00	24,039.84	45	2,266.91	13,000.00
2000–01	15,000.00	32,506.88	41	1,827.00	15,000.00
2001–02	19,588.00	50,772.11	39	–	19,588.00
2002–03	26,126.00	68,237.70	38	–	26,126.00
2003–04	26,136.00	59,717.84	44	–	26,136.00
2004–05	47,132.00	1,10,575.00	43	–	47,132.00
2005–06	45,018.00	81,943.00	55	–	45,018.00
2006–07	53,813.00	1,43,307.4	38	–	53,813.00
2007–08	57,205.00	1,73,704.6	33	–	57,205.00
2008–09	54,550.00	1,66,371	33	–	54,550.00
2009–10	41,497.14	1,41,458.94	29	–	41,997.14

Source: RBI, *Annual Report*, various issues.

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short-term liquid funds. The bills were issued at a discount to face value for a minimum of Rs. 1 lakh and its multiples thereof. The amount raised in each auction depended upon the funds available with the market participants. These bills were eligible securities for SLR purposes and for borrowing under the 'stand by refinance facility' of the Reserve Bank. They were not purchased by state governments, provident funds, and the Reserve Bank.

The yield on the 182-day T-bills was freely determined by market forces. Also, they had an active secondary market. The notified amount was kept at Rs. 100 crore on each of the auctions.

The Reserve Bank phased out the auctions of this bill from April 28, 1992 to May 25, 1999. In May 1999, it was reintroduced. It was discontinued from May 2001 to March 2005. In April 2005, it was reintroduced.

Table 4.5 exhibits the interest of the market participants in this bill as both the gross issues and outstanding amount show an increasing trend from 1987–88 to 1991–92. Moreover, the high average cut-off yield of 9.89 per cent and a yield which tended to rise each year, had made this bill popular with investors.

After its reintroduction in May1999, the government raised Rs. 5,500 crore through these bills. Non competitive bids aggregating to Rs. 600 crore were accepted in 1999–2000 while there were no non-competitive bids in 2000–01. The devolvement on the Reserve Bank was Rs. 645 crore during 1999–2000 and Rs. 250 crore during 2000–01.

The bill was discontinued once again in May 2001. It was reintroduced in April 2005 with a notified amount of Rs. 500 crore.

14-Day T-Bills

With the 91-day tap T-bills being discontinued, a scheme for the sale of 14-day intermediate T-bills was introduced effective from April 1, 1997 and 14-day auction T-bills was introduced effective from May 20, 1997 to facilitate the cash management requirements of various segments of the economy and emergence of a more comprehensive yield curve.

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TABLE 4.5 Size of 182-Day T-Bills Market

Year	Bids Tendered (Received) (Rs. in Crore)	Bids Accepted (Gross Issues) (Rs. in Crore)	Per Cent of Bids Accepted to Bids Tendered	Cut-off Yield (At the End of the Year) (In Per Cent)	Outstanding at the End of the Year (Rs. in Crore)
1987–88	630.06	329.66	52.3	9.27	132.80
1988–89	2,141.11	1,371.60	64.1	9.42	566.50
1989–90	2,364.20	1,740.15	73.6	9.95	774.30
1990–91	4,336.43	3,425.93	79.0	10.08	1,077.59
1991–92	13,694.32	7,317.72	53.4	9.27	3,985.52
11.4.92	538.00	245.00	45.5	8.77	3,935.57
1999–2000	3,038.50	2,900.00	95	9.68	1,300.00
2000–01	5,676.00	2,600.00	46	9.43	1,300.00
2001–02	731.50	300.00	41	8.44	–
2005–06	45,870	26,828	58	6.6083	9,771
2006–07	74,431.82	36,912.25	49.6	8.204	17,206
2007–08	1,22,852.91	46,926.44	38.2	7.36	16,785
2008–09	1,13,508.93	44,303	39	5.10	20,175
2009–10	1,42,839.55	42,875	30.0	4.6162	21,500

Source: RBI, *Bulletin and Annual Report.*
RBI Bulletin, various issues.

TABLE 4.6 14-Day T-Bills: Total Bills Outstanding and Share of State Governments in Total Outstanding

Year	Outstanding Amount (Rs. in Crore)	Share of State Governments in Total Outstanding (Per Cent)
1997–98	7,759	94.8
1998–99	7,749	95.0
1999–2000	2,383	96.18

Source: RBI, *Annual Report,* various issues.

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The intermediate T-bills were introduced to help invest the surplus funds of state governments, foreign central banks, and other specified bodies with whom the Reserve Bank has special arrangements. The salient features of this bill were as follows.

- It was an alternate arrangement in place of the 91-day tap bills.
- It was sold on a non-transferable basis for a minimum amount of Rs. 1,00,000 or in multiples thereof and was issued only in book form.
- It was repaid/renewed at par 14 days from its issue.
- The discount rate was at quarterly intervals such that the effective yield of this instrument was equivalent to the interest on the Ways and Means Advances to the central government.
- The bill was rediscounted at 50 basis points higher than the discount rate. On discounting, the bills were extinguished.

Size of the 14-Day T-Bills Market

The outstanding amount, which was consistent in the first two years, came down to Rs. 2,383 crore from Rs. 7,759 crore. The share of the state governments in the total outstanding remained consistent at an average of 95 per cent in the three years.

The 14-day auction T-bills were introduced to facilitate the cash management requirements of various segments of the economy and the emergence of a more comprehensive yield curve. These bills did not devolve on the Reserve Bank unlike the 91-day T-bills. Non-competitive bids were kept outside the notified amount so that the cut-off yield would reflect liquidity conditions better. Initially, the notified amount varied within the range of Rs. 100 crore and Rs. 500 crore depending on market interest. During 2000–01, the notified amount was Rs. 100 crore per auction.

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TABLE 4.7 Auctions of 14-Day T-Bills

(Rs. in Crore)

	1997–98	1998–99	1999–2000	2000–01	2001–02
Gross Issues	69,237	18,150	1,645.3	10,480	1100
Net Issues	240	–40	125	–25	–300
Outstanding	240	200	325	300	–
Per Cent of Non-competitive Bids to Total Issues	47	57	68	50	27

Source: RBI, *Annual Report*, various issues.

The 14-day auction T-bills received a favourable response from market participants in the first year of their introduction. Thereafter, a declining trend was witnessed. The bills were discontinued from May 2001, owing to a lack of market response.

Implicit Yield at Cut-off Prices

Treasury bills are sold at a discount. The difference between the sale price and the redemption value is the return on the treasury bills or the treasury bill rate. This rate was increased to 4.60 per cent in 1974 from 2.25 per cent in 1955–56. The rate was not only administered but it was the lowest rate of interest prevalent till 1993. Since 1993, the treasury bill rate is market-determined and has been much higher than 4.6 per cent per annum, leading to a higher yield to investors.

The yield is the rate of return on a particular instrument. Implicit yield is the yield on an instrument if it is held till its maturity. This yield is calculated as follows.

If a T-bill with a face value of Rs. 100 is issued at Rs. 98, then the implicit yield is

$$= \left[\left(\frac{100}{98} \times 100\right) - 100\right] \times 4$$

$$= 8.164 \text{ per cent}$$

TABLE 4.8 Implicit Cut-off Yield (In Per Cent)

Year	91-Day T-Bills				364-Day T-Bills			
	Minimum	Maximum	Average	End of Period	Minimum	Maximum	Average	End of Period
1992–93	8.99	10.97	10.03	10.97	10.96	11.42	11.23	11.09
1993–94	7.08	11.09	8.68	7.46	9.97	11.36	11.01	9.97
1994–95	7.21	11.99	9.16	11.99	9.41	11.94	10.15	11.94
1995–96	11.40	12.97	12.67	12.97	12.08	13.16	12.87	13.12
1996–97	6.92	12.97	9.67	7.96	10.10	13.12	11.16	10.10
1997–98	5.72	7.33	6.83	7.33	7.98	9.42	8.46	7.98
1998–99	7.17	10.05	8.57	8.75	7.97	10.72	9.51	10.07
1999–2000	8.25	9.46	9.03	9.17	9.31	10.33	10.09	9.93
2000–01	7.91	10.41	8.98	8.75	8.66	10.91	9.76	8.96
2001–02	6.05	8.50	6.88	6.1326	6.16	8.85	7.30	6.1571
2002–03	5.10	7.00	5.73	5.8853	5.35	6.99	5.93	5.89
2003–04	4.16	5.47	4.59	4.3672	4.31	5.50	4.67	4.31
2004–05	4.37	5.61	4.89	5.3241	4.43	5.77	5.15	5.61
2005–06	5.12	6.69	5.51	6.1081	5.58	6.81	5.87	6.4232
2006–07	5.41	8.10	6.80	7.9770	5.90	7.98	7.07	7.9782
2007–08	4.46	7.94	7.11	7.2274	6.58	7.80	7.50	7.3508
2008–09	4.58	9.36	7.10	4.9538	4.51	9.56	7.15	5.5003
2009–10	3.11	4.50	3.57	4.3792	3.50	5.50	4.37	5.1445

Source: RBI Bulletin, various issues.

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The Reserve Bank publishes implicit yields in its weekly bulletins.

Table 4.8 presents and compares the implicit cut-off yield in case of 91-day auction T-bills and 364-day T-bills for the period 1992–93 to 2007–08.

In case of both 91-day and 364-day T-bills, the implicit yield rose in the years 1994–95 and 1995–96. The implicit yield at cut-off prices reached its peak in the year 1995–96 due to a spell of tight money market conditions. The yield declined in the next two years as liquidity conditions eased and the Reserve Bank contained the interest rate through its policy. However, in the year 1998–99, to contain the pressure in the forex market, there was a sharp 3 per cent rise in the repo rate, which led to an increase in implicit yields. With easing in liquidity conditions and gradual cuts in CRR, implicit yields declined in 2000–01.

Table 4.8 brings out a noteworthy trend. The long-term yields (364-days T-bill yields) were attractive and higher than the short-term yields (91-day T-bill yields). As seen in Figure 4.1, the spread between the two yields have narrowed and are almost convergent since 2001–02. The average cut-off yield of all the T-bills increased during 2005–06 and 2007–08 indicating tight liquidity conditions. Yields on T-bills hardened in 2007–08 on account of high inflation and inflation expectations, and hikes in the cash reserve ratio (CRR).

A drawback of implicit yields is that they may not be exactly market-determined. Primary dealers are required to bid for a minimum amount of treasury bills in auctions; this may influence yields. Moreover, the Reserve Bank takes devolvement in order to maintain yields and give signals on interest rates to the market. Hence, as treasury bills yields are dependent on and influenced by the level of liquidity in the money market, they are not preferred as benchmark rates. Moreover, a continuous rise and decline in implicit yields has hampered the growth of a smooth yield curve.

Conclusion

The size of the treasury bills market in terms of both volume of sales and outstanding has increased. The Reserve Bank has made substantial efforts to develop the treasury bills market. The bank has discontinued on-tap and ad hoc treasury bills and introduced auctioned treasury bills which have not only helped in developing the treasury bills market but have also gone a long way in enhancing the popularity of this instrument by making the yield market-determined. The primary dealer and satellite dealer systems were set up to activate the treasury bills market. This market has the potential to develop further if the market is broadened even more by increasing the number of players and instruments. Moreover, this market can be made more liquid and attractive if treasury bills futures are introduced.

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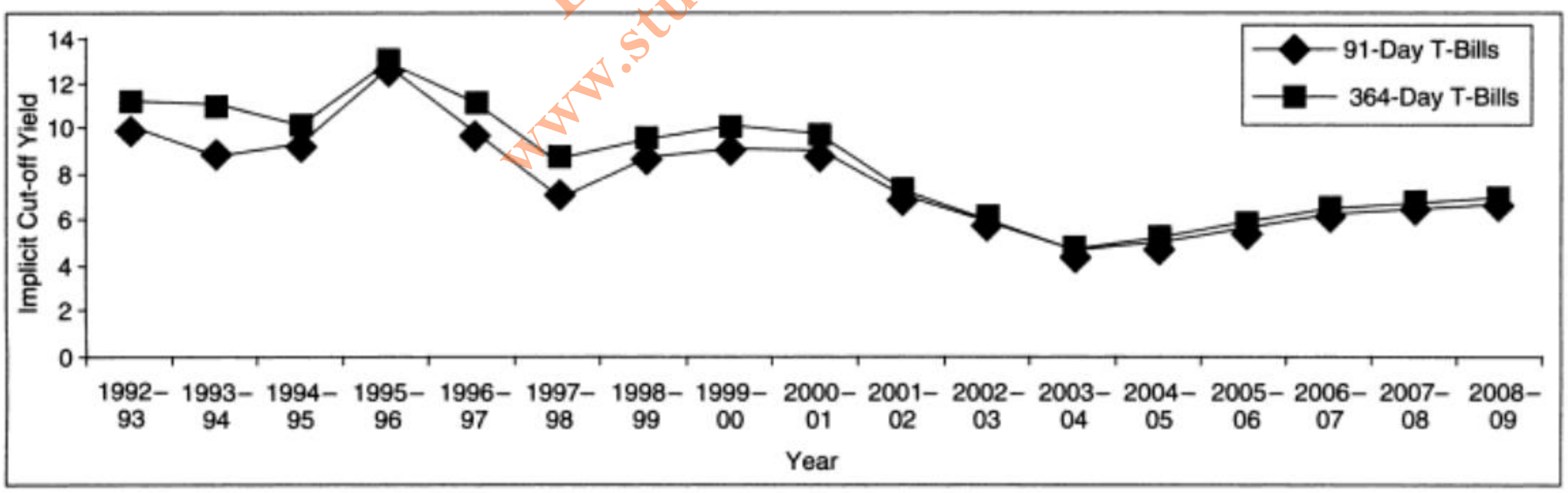


Figure 4.1 Implicit Cut-off Yield (Average) in Per Cent

- A commercial paper is an unsecured short-term promissory note issued at a discount by creditworthy corporates, primary dealers and all-India financial institutions

COMMERCIAL PAPER

The Working Group on Money Market in 1987 suggested the introduction of the commercial paper (CP) in India. The Reserve Bank introduced commercial papers in January 1990. Commercial papers have been in vogue in the United States since the nineteenth century and have become popular in money markets all over the world since the 1980s.

A commercial paper is an unsecured short-term promissory note, negotiable and transferable by endorsement and delivery with a fixed maturity period. It is generally issued at a discount by the leading

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creditworthy and highly rated corporates to meet their working capital requirements. Depending upon the issuing company, a commercial paper is also known as a finance paper, industrial paper, or corporate paper.

Initially only leading highly rated corporates could issue a commercial paper. The issuer base has now been widened to broad-base the market. Commercial papers can now be issued by primary dealers and all-India financial institutions, apart from corporates, to access short-term funds. Effective September 6, 1996 and June 17, 1998, primary dealers and satellite dealers were also permitted to issue commercial papers to access greater volume of funds to help increase their activities in the secondary market.

A commercial paper can be issued to individuals, banks, companies, and other registered Indian corporate bodies and unincorporated bodies. Non-resident Indians can be issued a commercial paper only on a non-transferable and non-repatriable basis. Banks are not allowed to underwrite or co-accept the issue of a commercial paper. Foreign institutional investors (FIIs) are eligible to invest in commercial papers but within the limits set for their investments by the SEBI.

Investors in CP

- Individuals
- Banks
- Corporates
- Unincorporated bodies
- NRIs
- FIIs

A commercial paper is usually privately placed with investors, either through merchant bankers or banks. A specified credit rating of P2 of CRISIL or its equivalent is to be obtained from credit rating agencies.

A commercial paper is issued as an unsecured promissory note or in a dematerialised form at a discount. The discount is freely determined by market forces. The paper is usually priced between the lending rate of scheduled commercial banks and a representative money market rate.

Corporates are allowed to issue CPs upto 100 per cent of their fund-based working capital limits. The paper attracts stamp duty. No prior approval of the Reserve Bank is needed to issue a CP and underwriting the issue is not mandatory.

Most CPs were issued by manufacturing companies for a maturity period of approximately three months or less. During 2001–02, manufacturing and related companies issued 67.4 per cent of total CPs, whereas 21.5 per cent of the total was issued by leasing and finance companies and the balance of 11.1 per cent by financial institutions. However, the share of manufacturing companies in the aggregate amount of CPs outstanding declined to an average of 56 per cent during 2002–03 and further to 28.9 per cent during 2008–09 and the share of leasing and finance companies markedly increased from 13 per cent in 2001–02 to 76.5 per cent in March 2008 but declined to 61.5 per cent during 2008–09. The share of manufacturing companies has gone down substantially due to enhanced efficiency in their operations, longer internal accruals, and better cash management.

There was a sharp increase in the share of FIs also. Their share increased from a meagre 1 per cent in 2001–02 to a high of 18 per cent in 2003–04 and 20 per cent in March 2005. Their share substantially reduced to 10.5 per cent in March 2006 but again increased to 16 per cent in June 2009.

The CP market is dominated by corporates having tangible net-worth of Rs. 50 crore and above. The recent RBI guidelines on investment in non-SLR securities for banks exempted CPs from the purview of such guidelines. This enabled financial institutions to raise a higher amount through CPs in 2004 and thereafter.

The Process for Issuing a CP

A resolution has to be passed by the Board of Directors approving the CP issue and authorising the executive(s) to execute the relevant documents as per the Reserve Bank's norms. The CP issue then has to be rated by a credit rating agency. The rating is usually completed within two to three weeks of receipt of necessary information. The company has to select an Issuing and Paying Agent (IPA), which has to be a scheduled bank. The IPA verifies all the documents submitted by the issuer viz., copy of board resolution, signatures of authorised executant and then issues a certificate that documents are in order. It also ensures that the issuer has the minimum credit rating as stipulated by the Reserve Bank and amount mobilised through issuance of the CP within the guarantee indicated by the credit rating agency for the specified ratings. It has also to certify that it has a valid agreement with the issuer. All the certified copies of original documents verified by it are held in its custody.

The company then has to arrange for dealers such as merchant banks, brokers, and banks for placement of the CPs which has to be completed within two weeks of opening. Every CP issue has to be reported to the Reserve Bank through the IPA.

Scheduled commercial banks are the major investors in commercial papers and their investment is determined by bank liquidity conditions. Banks prefer a commercial paper as an investment avenue rather than sanctioning bank loans. These loans involve high transaction costs and money is locked for a long time period whereas in a commercial paper which is an attractive short-term instrument, allows banks to park funds during times of high liquidity. Some banks fund commercial papers by borrowing from the call money market. Usually, the call money market rates are lower than the commercial paper rates. Hence, banks book profits through arbitrage between the two money markets. Moreover, the issuance of commercial papers has been generally observed to be inversely related to the money market rates.

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Guidelines Relating to CPs

With experience, refinements were made to this instrument by the Reserve Bank by measures such as removing/easing a number of restrictions on maturity, size of the commercial paper, requirement of minimum current ratio, and restoration of working capital finance.

The maturity period has been brought down from 91 days-6 months to 15 days-1 year. The maturity period was further brought down to 7 days in April 2004. The minimum size of the paper has been reduced from Rs. 1 crore to Rs. 5 lakh.

Until October 1994, a commercial paper was an important corporate instrument for financing working capital requirements. Corporates could have access to funds at rates lower than the PLRs through a CP. This low interest rate advantage was due to the stand-by facility wherein banks were required to restore the cash credit limit on the maturity of the paper, guaranteeing the issuer funds at the time of redemption. This stand-by facility was withdrawn in October 1994. The corporates were asked to access funds through a commercial paper on their own repayment strength. This withdrawal also imparted independence to the commercial paper as a money market instrument and its credit rating reflected the intrinsic strength of the issuer. The withdrawal of this stand-by facility led to a crash in the primary market for commercial papers in 1994–95.

Later, the CP was carved out of the Cash-Credit (CC) limits of the maximum permissible bank finance (MPBF) that the corporates had with banks. Hence, if a corporate issued a CP, the cash credit that it had with its bank was reduced by the same amount, thereby lowering the attractiveness of this instrument for the corporates. This issuance limit was delinked from the cash-credit limit in October 1996. Corporates now have the freedom to utilise their entire banking limits for issuing commercial papers.

New guidelines were released in October 2000 for providing flexibility, depth, and vibrancy to the commercial paper market. The Reserve Bank converted the paper into a stand-alone product to enable companies in the services sector to meet their short-term working capital needs more easily. Banks and financial institutions now have the flexibility to fix working capital limits after taking into account the resource pattern of a company's financing including CPs. An important feature of the revised guideline was the flexibility given to banks and financial institutions to provide stand-by assistance/credit, back-stop facility to issuers. This stand-by facility was provided to aid the long-term growth of the CP market. In addition, this facility assists banks to increase their fee-based income. The Ahmedabad Electricity Company was the first company to issue CPs worth Rs. 40 crore with a stand-by facility provided by the bank. Both the issuer and the bank provided unconditional stand-by facility to the extent of Rs. 40 crore for the entire period during which the paper remained outstanding. This issue was assigned a P1 rating by CRISIL.

Banks, financial institutions, primary dealers, and satellite dealers have been permitted to make fresh investments and hold a CP only in dematerialised form, effective from June 30, 2001. In order to provide flexibility to both issuers and investors in the CP market, the Reserve Bank allowed non-bank entities including corporates to provide an unconditional and irrevocable guarantee for credit enhancement for CP issue. The guarantor has to get a credit rating atleast one notch higher than that of the issuer from an approved credit rating agency. The offer document for the CP has to disclose the net-worth of the guarantor names of the companies to which the guarantor has issued similar guarantees, the extent of the guarantees offered and the conditions under which the guarantee will be invoked. Banks were allowed to invest in CP guaranteed by non-bank entities provided their exposure remained within the regulatory ceiling for unsecured exposures.

Summary of Guidelines for Issuance of a CP

With a view to providing flexibility to participants and adding depth and vibrancy to the CP market, the Reserve Bank issued new guidelines for the issuance of the CP in October 2000.

Eligibility Corporates, primary dealers, and all-India financial institutions are eligible to issue a CP. For a corporate to be eligible, it should have tangible net worth of Rs. 4 crore and a sanctioned working capital limit from a bank or a financial institution and the borrowal account is a standard asset.

Rating Requirement The minimum credit rating shall be P2 of CRISIL or such equivalent rating by other approved agencies.

Maturity Initially, corporates were permitted to issue a CP with a maturity between a minimum of three months and a maximum upto six months. At present, the maturity period has been brought down to a minimum of 7 days and a maximum of upto one year from the date of issue.

Denomination Minimum of Rs. 5 lakh and multiples thereof. Amount invested by a single investor should not be less than Rs. 5 lakh (face value).

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Limits and Amount A CP can be issued as a 'stand-alone' product. Banks and financial institutions will have the flexibility to fix working capital limits duly taking into account the resource pattern of companies financing including CPs.

Issuing and Paying Agent (IPA) Only a scheduled commercial bank can act as an IPA. It verifies all original certificates viz., credit rating certificates, letter of offer, and the board resolution authorising issue of the CP. It holds custody of original of credit support document if it is in the form of stand-by assistance/back stop facility with relevant declaration and confirms that the documents are in order. After authentication of the entire CP document, IPA issues an 'IPA certificate' to all subscribers of the CP in the primary market and then reports the issue to the RBI.

Investment in a CP A CP may be held by individuals, banks, corporates, unincorporated bodies, NRIs, and FIIs. Investment by FIIs would be within the limits set for their investments by the SEBI.

Mode of Issuance A CP can be issued as a promissory note or in a dematerialised form. Underwriting is not permitted. CP will be issued at a discount to face value as may be determined by the issuer. The total amount of CP proposed to be issued should be raised within a period of 2 weeks from the date on which the issuer opens the issue for subscription. Every issue of CP, including renewal, should be treated as a fresh issue.

Preference for Demat Issuers and subscribers are encouraged to prefer exclusive reliance on demat form. Banks, financial institutions and primary dealers are advised to invest only in demat form.

Stand-by Facility It is not obligatory for banks or financial institutions to provide stand-by facility. They can provide credit enhancement facility within the prudential norms.

The Reserve Bank publishes, on a monthly as well as a weekly basis, effective interest rates on CPs issued during a fortnight. At present, issuers decide on the discount rates of their CPs taking into account the Reuters/Tele rate CP reference rate as well as supply/demand forces prevailing in the market.

In order to improve transparency and strengthen efficiency reporting of all CP deals on the Negotiated Dealing System (NDS) has been made compulsory. It is proposed to rationalise and standardise various aspects of processing, settlement and documentation of CP issuance with a view to achieving the settlement atleast on T+1 basis.

Stamp Duty on CP

The stamp duty on issuance of a CP is governed by the Indian Stamp Act and is under the purview of the central government. The level of stamp duty was scaled down substantially across various maturities on March 1, 2004.

The stamp duty rate applicable to non-bank entities are five times higher than those applicable to banks. Moreover, a CP issuance attracts a stamp duty for 90 days irrespective of the tenor. Hence, stamp duty levy makes shorter tenor issuance expensive.

Size of the CP Market

The size of the CP market is reflected in the total outstanding amount of commercial papers issued by companies. The outstanding amount of commercial papers increased considerably in the initial years. The amount of commercial papers issued by corporates increased significantly from Rs. 577 crore in March 1993 to a peak of Rs. 3,264 crore in March 1994 accompanied by a decline in the average discount rate from 15.5 per cent to 11 per cent during 1993–94. But in 1994–95 and 1995–96, however, the outstanding amount of CPs declined sharply. This decline was attributed to the withdrawal of the stand-by facility of the paper in October 1994, coupled with rising interest rates and a shrinking of short-term surplus funds with banks.

Since 1996–97, the commercial paper market has picked up as it can be accessed at rates lower than the short-term PLRs of commercial banks; CPs have become an attractive source of working capital funds as their rates are less than the sub-prime lending rates. Hence, commercial papers prove to be cheaper for corporates. The CP market has also become an attractive avenue for banks to park their credit funds. This market has been growing at a rate of 12–14 per cent, since 2000–01.

The CP rates are dependent on ratings, a company's standing, and the demand–supply position of the market.

Corporates with the highest rating (P1+, PR1+, A1+) who regularly access the CP market are BPCL, HPCL, IPCL, IOC, ACC, Telco, L&T, Tata Coffee, Dabur, 1L&FS, M&M Finance, GE Caps, EID Parry, Electrosteel Castings, and Ashok Leyland Ltd.

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TABLE 4.9 Chronology of Development of CP in India

As on	*Tangible Net Worth*	*Working Capital*	*Agg. Amt. of CP Issue*	*Maturity*	*Denomination*	*Minimum CP Issued per Investors*	*Mode of Issuance*
January 1990	Rs. 10 Crore	Rs. 25 Crore	20 Per Cent of Working Capital (Fund-based Limit)	3 to 6 Months	Multiples of Rs. 25 Lakh	Rs. 1 Crore	Physical
April 24, 1990	Rs. 5 Crore	Rs. 15 Crore	20 Per Cent of Working Capital (Fund-based Limit)	3 to 6 Months	Multiples of Rs. 10 Lakh	Rs. 50 Lakh	Physical
May 30, 1991	Rs. 5 Crore	Rs. 10 Crore	30 Per Cent of Working Capital (Fund-based Limit)	3 to 6 Months	Multiples of Rs. 5 Lakh	Rs. 25 Lakh	Physical
May 13, 1992	Rs. 5 Crore	Rs. 5 Crore	75 Per Cent (Fund-based Limit)	3 to 6 Months	Multiples of Rs. 5 Lakh	Rs. 25 Lakh	Physical
October 18, 1993	Rs. 4 Crore	Rs. 4 Crore	75 Per Cent (Fund-based Limit)	3 Months to Less than One Year	Multiples of Rs. 5 Lakh	Rs. 25 Lakh	Physical
November 4, 1996	Rs. 4 Crore	–	As Sanctioned by Bank	3 Months to Less than One Year	Multiples of Rs. 5 Lakh	Rs. 25 Lakh	Physical
April 15, 1997	Rs. 4 Crore	–	As Sanctioned by Bank	1 Month to Less than One Year	Multiples of Rs. 5 Lakh	Rs. 25 Lakh	Physical
May 25, 1998	Rs. 4 Crore	–	As Sanctioned by Bank	15 Days to 365 Days	Multiples of Rs. 5 Lakh	Rs. 25 Lakh	Physical
October 10, 2000	Rs. 4 Crore	–	CP can be Issued as "Stand Alone" Product	15 Days to 365 Days	Multiples of Rs. 5 Lakh	Rs. 25 Lakh	–
April 30, 2001	Rs. 4 Crore	–	CP can be Issued as "Stand Alone" Product	15 Days to 365 Days	Multiples of Rs. 5 Lakh	–	Demat form (January 2001)
November 4, 2006	Rs. 4 Crore	–	As Sanctioned by Banks	7 Days to 365 Days	Multiples of Rs. 5 Lakh	–	Demat form

Source: www.rbi.org.in

TABLE 4.10 Structure of Stamp Duty (Effective from March 1, 2004)

(In Per Cent)

Period	*Banks*		*Non-banks*	
	Past	*Present*	*Past*	*Present*
1. Up to 3 Months	0.05	0.012	0.125	0.06
2. Above 3 Months Up to 6 Months	0.10	0.024	0.250	0.12
3. Above 9 Months Up to 12 Months	0.20	0.05	0.500	0.25
4. Above 12 Months	0.40	0.10	1.00	0.5

Source: RBI, *Annual Report*, various issues.

Nationalised banks invest in CPs as a primary market instrument. They prefer to invest in CPs only during low credit off-take period.

Leasing and finance companies were the predominant issuers of CPs partly reflecting the Reserve Bank's policy of phasing out the access of these companies to public deposits.

Mutual funds have emerged as big investors as the SEBI regulations impose a ceiling of 10 per cent in investment in unlisted paper but CP investments are excluded. Hence, a large amount of money from mutual funds is flowing to CPs. As a result, interest rates dipped to a low of 6.33 per cent in February 2005. The corporates get a direct and quick access to the institutional investors through issuance of CPs. It is a cheaper option as compared to the customary bank credit route. Moreover, the decline in stamp duty has made CPs attractive.

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Commercial bills were introduced in the money market in 1970. The RBI rediscounted genuine trade bills at the bank rate or at a rate specified by it. The development of the bills market enabled banks and financial institutions to invest their short-term surplus funds in bills of varying maturities.

Types of Commercial Bills

Types of Commercial Bills

- Demand Bill
- Usance Bill
- Clean Bill
- Documentary Bill
- Inland Bill
- Foreign Bill
- Hundi
- Derivative Usance Promissory Note

Commercial bill is an important tool to finance credit sales. It maybe a demand bill or a usance bill. A demand bill is payable on demand, i.e., immediately at sight or on presentation to the drawee. A usance bill is payable after a specified time. If the seller wishes to give some time for payment, the bill would be payable at a future date. These bills can either be clean bills or documentary bills. In a clean bill, documents are enclosed and delivered against acceptance by the drawee, after which it becomes clear. In the case of a documentary bill, documents are delivered against payment accepted by the drawee and documents of the file are held by bankers till the bill is paid.

Commercial bills can be inland bills or foreign bills. Inland bills must (a) be drawn or made in India and must be payable in India; or (b) drawn upon any person resident in India. Foreign bills, on the other hand, are (a) drawn outside India and may be payable in and by a party outside India, or may be payable in India or drawn on a party in India; or (b) it may be drawn in India and made payable outside India. A related classification of bills is export bills and import bills. While export bills are drawn by exporters in any country outside India, import bills are drawn on importers in India by exporters abroad.

The indigenous variety of bill of exchange for financing the movement of agricultural produce, called a 'hundi,' has a long tradition of use in India. It is in vogue among indigenous bankers for raising money or remitting funds or to finance inland trade. A hundi is an important instrument in India; so indigenous bankers dominate the bill market. However, with reforms in the financial system and lack of availability of funds from private sources, the role of indigenous bankers is declining.

With a view to eliminating movement of papers and facilitating multiple rediscounting, the RBI introduced an innovative instrument known as 'Derivative Usance Promissory Notes,' backed by such eligible commercial bills for required amounts and usance period (up to 90 days). The government has exempted stamp duty on derivative usance promissory notes. This has simplified and streamlined bill rediscounting by institutions and made the commercial bill an active instrument in the secondary money market. This instrument, being a negotiable instrument issued by banks, is a sound investment for rediscounting institutions. Moreover, rediscounting institutions can further discount the bills anytime prior to the date of maturity. Since some banks were using the facility of rediscounting commercial bills and derivative usance promissory notes for as short a period as one day, the Reserve Bank restricted such rediscounting to a minimum period of 15 days. The eligibility criteria prescribed by the Reserve Bank for rediscounting commercial bills are that the bill should arise out of a genuine commercial transaction showing evidence sale of goods and the maturity date of the bill should not exceed 90 days from the date of rediscounting.

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Features of Commercial Bills

Commercial bills can be traded by offering the bills for rediscounting. Banks provide credit to their customers by discounting commercial bills. This credit is repayable on maturity of the bill. In case of need for funds, banks can rediscount the bills in the money market and get ready money. Commercial bills ensure improved quality of lending, liquidity, and efficiency in money management. It is fully secured for investment since it is transferable by endorsement and delivery and it has high degree of liquidity.

The bills market is highly developed in industrial countries but it is very limited in India. Commercial bills rediscounted by commercial banks with financial institutions amount to less than Rs. 1,000 crore. In India, the bill market did not develop due to (i) the cash-credit system of credit delivery where the onus of cash management rests with banks and (ii) an absence of an active secondary market.

Measures to Develop the Bills Market

One of the objectives of the Reserve Bank in setting up the Discount and Finance House of India (DFHI) was to develop the commercial bills market. The bank sanctioned a refinance limit for the DFHI against a collateral of treasury bills and against the holdings of eligible commercial bills.

With a view to developing the bills market, the interest rate ceiling of 12.5 per cent on the rediscounting of commercial bills was withdrawn from May 1, 1989.

To develop the bills market, the Securities and Exchange Board of India (SEBI) allowed, in 1995–96, 14 mutual funds to participate as lenders in the bills rediscounting market. During 1996–97, seven more

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Guidelines for Issue of Certificates of Deposit (CDs)

Certificates of Deposit (CDs) are negotiable money market instruments and are issued in dematerialised form or as a usance promissory note, for funds deposited at a bank or other eligible financial institution for a specified time period. Guidelines for issue of CDs are presently governed by various directives issued by the Reserve Bank of India, as amended from time to time.

Eligibility CDs can be issued by (i) scheduled commercial banks excluding Regional Rural Banks (RRBs) and Local Area Banks (LABs); and (ii) select all-India Financial Institutions that have been permitted by the RBI to raise short-term resources within the umbrella limit fixed by the RBI.

Aggregate Amount Banks have the freedom to issue CDs depending on their requirements. An FI may issue CDs within the overall umbrella limit fixed by RBI, i.e., issue of CD together with other instruments viz., term money, term deposits, commercial papers, and intercorporate deposits should not exceed 100 per cent of its net owned funds, as per the latest audited balance sheet.

Minimum Size of Issue and Denominations Minimum amount of a CD should be Rs. 1 lakh, i.e., the minimum deposit that could be accepted from a single subscriber should not be less than Rs. 1 lakh and in the multiples of Rs. 1 lakh thereafter.

Who can Subscribe CDs can be issued to entities like individuals, corporations, companies, trusts, funds, and associations. Non-resident Indians (NRIs) may also subscribe to CDs, but only on a non-repatriable basis which should be clearly stated on the certificate. Such CDs cannot be endorsed to another NRI in the secondary market.

Maturity The maturity period of CDs issued by banks should be not less than 7 days and not more than 1 year. FIs can issue CDs for a period not less than 1 year and not exceeding 3 years from the date of issue.

Discount/Coupon Rate CDs may be issued at a discount on face value. Banks/FIs are also allowed to issue CDs on a floating rate basis provided the methodology of compiling the floating rate is objective, transparent and market based. The issuing bank/FI is free to determine the discount/coupon rate. The interest rate on floating rate CDs would have to be reset periodically in accordance with a pre-determined formula that indicates the spread over a transparent benchmark.

Reserve Requirements Banks have to maintain the appropriate reserve requirements, i.e., cash reserve ratio (CRR) and statutory liquidity ratio (SLR), on the issue price of the CDs.

Transferability Physical CDs are freely transferable by endorsement and delivery. Dematted CDs can be transferred as per the procedure applicable to other demat securities. There is no lock-in period for the CDs.

Loans/Buy-backs Banks/FIs cannot grant loans against CDs. Furthermore, they cannot buy-back their own CDs before maturity.

Format of CDs Banks/FIs should issue CDs only in the dematerialised form. However, according to the Depositories Act, 1996, investors have the option to seek a certificate in physical form. Accordingly, if an investor insists on a physical certificate, the bank/FI may inform the Monetary Policy Department, Reserve Bank of India, Central Office, Fort, Mumbai – 400 001 regarding such instances separately. Further, issuance of the CD will attract stamp duty. There will be no grace period for repayment of CDs. If the maturity date happens to be a holiday, the issuing bank should make the payment on the immediate preceding working day. Banks/FIs may, therefore, fix the period of deposit so that the maturity date does not coincide with a holiday to avoid loss of discount/interest rate.

Security Aspect Since physical CDs are freely transferable by endorsement and delivery, it will be necessary for banks to see that the certificates are printed on good quality security paper and necessary precautions are taken to guard against tempering with the document. They should be signed by two or more authorised signatories.

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TABLE 4.16 Certificate of Deposit and Commercial Paper: A Comparison

Year (End March)	CD		CP	
	Interest Rate (Per Cent)	Outstanding (Rs. in Crore)	Interest Rate (Rs. in Crore)	Outstanding (Rs. in Crore)
1993	12.5–16.5	9,803	15.8–16	577
1994	7–12.2	5,571	11–12	3,264
1995	10–15	8,017	14–15	604
1996	12–22.3	16,316	20.2	76
1997	7–14.3	12,134	11.3–12.3	646
1998	7.2–26	14,296	14.2–15.5	1,500
1999	8–12.5	3,717	9.1–13.3	4,770
2000	7.5–12	1,227	10–12	5,663
2001	6.5–12	771	8.75–12	5,847
2002	5.0–10.03	1,576	7.10–10.00	7,224
2003	5.0–7.1	908	6.00–7.75	5749
2004	4.21–6.34	4,764	4.70–6.5	9,706.5
2005	6.50–8.94	12,078	5.2–7.25	13,418.9
2006	4.60–8.50	43,568	6.95–925	12,767.35
2007	4.60–10.75	64,821	6.40–13.0	21,336
2008	5.50–10.75	1,47,792	6.70–14.25	32,591
2009	5.4–12.35	1,92,867	6.4–12.5	44,171
2010	3.09–11.5	3,39,279	2.83–12.5	75,506

Source: RBI, *Annual Report*, various issues.

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CALL/NOTICE MONEY MARKET

Introduction

It is by far the most visible market as the day-to-day surplus funds, mostly of banks, are traded there. The call money market accounts for a major part of the total turnover of the money market. It is a key segment of the Indian money market. Since its inception in 1955–56, the call money market has registered a tremendous growth in volume of activity.

The call money market is a market for very short-term funds repayable on demand and with a maturity period varying between one day to a fortnight. When money is borrowed or lent for a day, it is known as call (overnight) money. Intervening holidays and/or Sundays are excluded for this purpose. When money is borrowed or lent for more than a day and upto 14 days, it is known as notice money. No collateral security is required to cover these transactions. The call money market is a highly liquid market, with the liquidity being exceeded only by cash. It is highly risky as well as extremely volatile.

- Under call money market, funds are transacted on overnight basis and under notice money market, funds are borrowed/lent for a period between 2–14 days

Why Call Money

Call money is required mostly by banks. Commercial banks borrow money without collateral from other banks to maintain a minimum cash balance known as the cash reserve requirement (CRR). This inter-bank borrowing has led to the development of the call money market.

CRR is an important requirement to be met by all commercial banks. The Reserve Bank stipulates this requirement from time to time. CRR is a technique for monetary control effected by the Reserve Bank for achieving specific macro-economic objective/s such as maintaining desired levels of inflation, growth, and exchange rates. CRR refers to the cash that banks have to maintain with the Reserve Bank as a certain percentage of their total demand and time liabilities (DTL). CRR, a primary instrument of monetary policy, has been brought down from 15 per cent in March 1991 to 5 per cent in January 2009.

Prior to May 2000, banks were required to maintain 85 per cent of their fortnightly reserve requirement on a daily basis. The networking among various branches of banks was not developed enough for the

- Fortnight shall be on a reporting Friday basis and mean the period from Saturday to the second following Friday, both days inclusive

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TABLE 4.17 Annual Average Call Money Rates of Major Commercial Banks, Mumbai

Year	High	Low	Average
1990–91	21.28	11.26	15.85
1991–92	40.28	8.57	19.57
1992–93	54.40	9.07	14.42
1993–94	23.64	2.96	6.99
1994–95	26.51	2.93	9.40
1995–96	41.62	7.64	16.64
1996–97	14.56	1.05	7.84
1997–98	52.19	0.24	8.69
1998–99	20.19	3.61	7.83
1999–2000	35.00	0.10	8.87
2000–01	35.00	0.20	9.15
2001–02	22.00	3.61	7.17
2002–03	20.00	0.50	5.89
2003–04	12.00	1.00	4.62
2004–05	10.95	0.60	4.65
2005–06	8.25	0.60	5.60
2006–07	80.0	1.90	7.22
2007–08	55.0	0.01	6.07
2008–09	23.0	1.00	7.06
2009–10	9.0	1.00	3.24

NA = Not Available.
Source: RBI Bulletin, various issues.

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TABLE 4.18 Average Daily Turnover in the Money Market

Year	Average Daily Volumes in (Rs. in Crore)			
	CBLO	Market Repo	Call Money Market	Term Money Market
1997–98	–	–	22,709	–
1998–99	–	–	26,500	–
1999–2000	–	6,895	23,161	–
2000–01	–	10,500	32,157	–
2001–02	–	30,161	35,144	–
2002–03	30	46,960	29,421	195
2003–04	515	10,435	17,191	341
2004–05	6,697	17,135	14,170	526
2005–06	20,040	21,183	17,979	834
2006–07	32,390	33,676	21,725	1,012
2007–08	55,626	54,736	21,393	704
2008–09	61,552	57,320	22,436	794
2009–10	1,09,125	42,706	15,924	NA

Source: RBI, *Annual Report*, various issues.

- Growth in the activity of primary dealers supported by refinance facility from the Reserve Bank and its active operations in the market through repos which provided a floor for call rates and enhanced liquidity.

The call rates remained stable in 2003–04 and were below the reverse repo rate (earlier the repo rate). However, the call rates increased during October and November 2004 on account of higher non-food credit off-take. Increase in reserve requirement and seasonal festival cash demand which above the banks

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arising on account of decline in market value of security held as collateral. Any shortfall in the value of collateral (to cover outstanding borrowings) is collected through the end of the day margin call.

The interest rates on the CBLOs mirror call money rates. The borrowing costs in the CBLOs are low as compared to the call market.

Mutual funds and insurance companies have emerged as the largest supplier of funds as they are flush with liquidity. The cooperative banks, public and private sector banks, and primary dealers are large borrowers in this market on account of favourable borrowing cost in the CBLO segment vis-à-vis the call market.

The average daily turnover in the CBLO market has gone up on account of fall in the CBLO rates. Rates on CBLOs fall when there is a fall in overnight call money rates. When CBLO rates fall, forex dealers borrow rupees from the CBLO market to buy dollars and simultaneously agree to sell it a day later. The money is then invested in overnight dollar deposits with banks abroad which give a higher return.

The daily average turnover in the CBLO segment increased from Rs. 2,506 crore in March 2004 to a peak of Rs. 57,320 crore in March 2009 (Table 4.18). Volumes in CBLOs have increased tremendously due to the Reserve Bank's move to bar non-bank entities from the call money market. From August 6, 2005, non-banks (except PDs) were completely phased out from the call money market.

The CBLO market emerged as the preferred overnight market in 2005–06 since it offers anonymity to market participants and provides funds at a lower cost. The interest rates averaged 5.20 per cent in the CBLO segment during 2007–08 as compared with 6.07 per cent in the call money market and 5.5 per cent in market repos (outside the LAF). It is now the predominant segment of the money market and acccounted for nearly 80 per cent of the total volume during 2007–08. Enchanced transparency and real time basis of deals have attracted a large number of market participants to this segment.

In order to increase the depth and liquidity in the CBLO market, CCIL is planning to introduce an internet-based trading platform for its CBLO product which would provide access to corporates and other non-banking entities to the institutional lending and borrowing segment of money markets.

- Liabilities of scheduled commercial banks arising out of transaction in CBLO are subject to maintenance of CRR

LINK BETWEEN THE MONEY MARKET AND THE MONETARY POLICY IN INDIA

The monetary policy represents policies, objectives, and instruments directed towards regulating money supply and the cost and availability of credit in the economy. In the monetary policy framework, broad objectives are prescribed and an operating framework of policy instruments to achieve them is prepared. The monetary policy in India is an adjunct of the economic policy. The objectives of the monetary policy are not different from those of the economic policy. The three major objectives of economic policy in India have been growth, price stability, and social justice. The emphasis between the first two objectives has changed from year to year, depending upon the conditions prevailing in that year and the previous year. The objectives of the monetary policy are also price stability and growth. The government of India tries to manipulate its monetary policy through the Reserve Bank, the monetary authority in India. The objectives of the monetary policy are pursued by ensuring credit availability with stability in the external value of the rupee as well as an overall financial stability. Monetary policy actions are transmitted to the rest of the economy through changes in financial prices (e.g., interest rates, exchange rates, yields, asset prices, equity prices) and financial quantities (money supply, credit aggregates, supply of government bonds, foreign denominated bonds). Worldwide, the interest rate channel is the key channel of transmission. There is an intrinsic link between monetary policy and money market. It is through the money market that monetary policy affects the real economy.

Direct Instruments

- Reserve requirements
- Limits on refinance
- Administered interest rates
- Qualitative and quantitative restrictions on credit

The Reserve Bank seeks to influence monetary conditions through management of liquidity by operating in varied instruments. These instruments can be categorised as direct and indirect market-based instruments.

In an administered or controlled regime of money and financial markets, the Reserve Bank directly influences the cost, availability, and direction of funds through direct instruments. The management of liquidity is essentially through direct instruments such as varying cash reserve requirements, limits on refinance, administered interest rates, and qualitative and quantitative restrictions on credit.

Indirect Instruments

- Open market operations
- Repos

Since 1991, the market environment has been deregulated and liberalised wherein the interest rates are largely determined by market forces. In such an environment, the Reserve Bank influences monetary conditions through market-based, indirect instruments such as open market operations and refinance (standing facilities) / discount (market-based discount windows)/repo windows. For example, if the Reserve bank desires to inject liquidity for a short period, it could resort to repos–providing funds to the banks in exchange of securities at a predetermined interest rate and reversing the transactions at a predetermined

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Following the recommendations of the Chakravarty Committee, set up in 1985, deposit rates were made attractive to avoid financial repression associated with near zero real deposit rates. However, the interest rate structure remained complicated. There were about 50 lending categories and a large number of stipulated interest rates depending on the loan size, usage, and type of borrowers.

In 1991, the Narasimham Committee recommended that concessional interest rates should not be a vehicle for subvention and there should be real interest rates. In view of this recommendation, interest rate reforms were undertaken in money, credit, and government securities market.

Since the beginning of 1992–93, interest rates in the government securities market were progressively deregulated with the introduction of an auction system. The structure of interest rates for commercial banks was simplified. The bank rate was reactivated in April 1997, linked with deposit rates (up to one year maturity) initially. Since then it has become a signaling rate.

Moreover, with a deregulation of interest rates, borrowings by the government since 1992 have been at market-related yields. Public sector undertakings and financial institutions which were largely dependent on budgetary support for their resources, now resort to the market to raise their resource requirement.

Thus, with deregulation, the interest rate has emerged as a major instrument of resource allocation.

- The PLR is hovering around 11.00–12.00 per cent

Prime Lending Rate The prime lending rate is the minimum lending rate (PLR) charged by the bank from its best corporate customers or prime borrowers. PLRs have been deregulated gradually since April 1992 and the interest rate structure for commercial banks simplified. The six categories of lending rates were reduced to four in April 1992 and to three in April 1993.

The norms relating to the PLR have been progressively liberalised. From October 18, 1994, interest rates on loans above Rs. 2 lakh were freed and banks were permitted to determine their PLRs. From April 1998, banks were given the freedom to determine the interest rates on loans up to Rs. 2 lakh, subject to small borrowers being charged at rates not exceeding the PLR. The Reserve Bank of India advised banks to reduce the maximum spreads over their PLRs and announce it to the public along with the announcement of their PLR. The Reserve Bank also gave banks the freedom to evolve differential PLRs. Differential PLRs are different prime lending rates for different levels of maturities. Only a handful of banks came out with differential PLRs. In order to ease the rigidities in the interest rate structure, banks were given the freedom to offer all loans on fixed or floating rates while complying with the PLR stipulations, from April 2000. In April 2001, banks were allowed to offer loans at sub-PLR rates, thereby removing the practice of treating the PLR as a floor for loans above Rs. 2 lakh. Although the PLR ceased to be a floor for loans over Rs. 2 lakh, it continues to operate as a ceiling for loans up to Rs. 2 lakh taking on the role of a benchmark. At present commercial banks decide the lending rates to different borrowers (with of credit limit of over Rs. 2 lakh) subject to the announcement of the PLR as approved by their boards. Banks' PLR will now be on a 'cost plus' basis, i.e., banks have to take into account their (i) actual cost of funds, (ii) operating expenses, and (iii) a minimum margin to cover regulatory requirement of provisioning/capital charge and profit margin, while arriving at the benchmark PLR. The minimum lending rates have gradually come down to 10 per cent in October 2004 from a peak of 17 per cent in 1992–93.

The Indian Banks' Association (IBA) advised its member banks to announce a benchmark prime lending rate (BPLR) taking into account (i) actual cost of funds, (ii) operating expenses, and (iii) a minimum margin to cover regulatory requirement of provisioning/capital charge and profit margin, with the approval of their boards keeping in view the operational requirements. The banks, however, have the freedom to price their loan products below or above their BPLR based on time-varying term premia and offer floating rate products by using market benchmarks in a transparent manner. Almost all commercial banks have adopted the new system of BPLR from January 2004 and the rates are lower in the range of 25–200 basis points from their earlier PLRs. Housing finance, loans against share certificates, and consumer durable loans have been delinked from the new system.

Generally, PLRs across banks are aligned with those of a few major banks who provide the signals for changes in the PLR. The Reserve Bank publishes monthly PLRs based on the rates offered by five leading public sector banks. The PLR of the banks is based on the bank rate and has a positive correlation with it.

The RBI has directed scheduled commercial banks to switch over to the new system of base rate in place of the existing benchmark prime lending rate system from July 1, 2010. Banks may choose any benchmark to arrive at the base rate for a specific tenor that may be disclosed transparently.

Bank Rate

The rate of discount fixed by the central bank of the country for the rediscounting of eligible paper is called the bank rate. It is also the rate charged by the central bank on advances on specified collateral to banks.

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The bank rate is defined in Section 49 of the Reserve Bank of India Act, 1934, as the standard rate at which the bank is prepared to buy or rediscount bills of exchange or other commercial papers eligible for purchase under this act.

The bank rate was revised only three times in the period between 1975–96. It was reactivated in April 1997 with deposit rates (up to one year maturity) linked to it initially. With effect from April 16, 1997, the maximum term deposit rate (up to one year) of scheduled commercial banks was set at 2 per cent below the bank rate and all interest rates on advances from the Reserve Bank were linked to the bank rate. The deposit rates were completely deregulated in October 1997; the other rates continued to be linked to the bank rate. From 1997, the bank rate emerged as a signaling rate to reflect the stance of the monetary policy.

The interest rates on different types of accommodation from the Reserve Bank including refinance are linked to the bank rate. The bank rate is the central bank's key rate signal, which banks use to price their loans. The impact of bank rate announcements have been pronounced in the PLRs of commercial banks.

The bank rate was brought down from a high of 9.00 per cent in May 1998 to 6.5 per cent in October 2001. The Reserve Bank cut the bank rate to 6.25 per cent in October 2002, its lowest level since 1973. The bank rate was further brought down to 6.00 per cent in April 2003.

- Since April 2003 the bank rate is 6 per cent

The interest rate, as an instrument of monetary policy, is evolving. As interest rates in the economy cover credit, money, and securities markets, there should be linkages not only among these markets but among the rates as well. A low interest rate is the objective of the monetary policy. Low interest rates are subject to stable inflationary expectations which, in turn, depend on price stability. There are many constraints which impede the lowering of interest rates, diminishing the effectiveness of this tool. The major constraints are high intermediation costs of the banking system, large non-performing assets (NPAs) of the banks, and the government's massive borrowing programme. Also, the system of administered interest rates on certain government saving instruments, such as small savings and provident funds, leads to segmented market behaviour resulting in low convergence of rates of return on various financial instruments.

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Refinance from the Reserve Bank

The Reserve Bank uses this instrument to relieve liquidity shortages in the system, control monetary and credit conditions, and direct credit to selective sectors. The quantum and cost of the refinance facility provided to scheduled commercial banks depends upon the degree of liquidity in the banking system and the need for ensuring credit flow to select sectors. Both the quantum and cost of the refinance facility reflect the stance of the monetary policy in response to market conditions. The Reserve Bank has directed certain sector-specific refinance facilities such as food credit, export credit, government securities, and discretionary standby refinance to scheduled banks.

The Reserve Bank has gradually reduced the access to the refinance facility by raising the cost of such a facility or by adjusting the formula for fixing eligible limits. The refinance rate has now been linked to the bank rate.

The complete transition towards indirect market-based instruments requires doing away with all sector-specific and discretionary refinance facilities and moving towards a general refinance/liquidity adjustment facility.

Currently, there are only two refinance schemes available to banks—export credit refinance and general refinance. The export credit facility is formula-based and is extended to banks against their outstanding export credit eligible for refinance. From April 1, 2002, export credit refinance is being provided to scheduled banks at 15 per cent of their outstanding export credit eligible for refinance as at the end of the preceding fortnight. General refinance is provided to tide over temporary liquidity shortages faced by banks. The general refinance window has now been replaced by a collateralised lending facility within the overall framework of the interim liquidity adjustment facility.

With a view to enabling the banks to meet any unanticipated additional demand for liquidity in the context of the century date change, a 'special liquidity support' (SLS) facility was made available to all scheduled commercial banks (excluding RRBs) for a temporary period from December 1, 1999 to January 31, 2000.

With effect from April 13, 1996, banks are provided export credit refinance against their rupee export credit and post-shipment export credit denominated in US dollars taken together.

At present, banks are eligible for standing liquidity facility/export credit eligible for refinance and PDs are eligible for collateralised liquidity support from the RBI subject to certain limits. These limits are apportioned into normal facility constituting one-third of the total entitlement available at the bank rate and back-stop facility constituting the remaining two-third available at the repo rate.

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TABLE 4.19 Movement in Key Policy Rates and Reserve Requirements (In Per Cent)

Effective Since	*Bank Rate*	*Reverse Repo Rate*	*Repo Rate*	*Cash Reserve Ratio*	*Statutory Liquidity Ratio*
1990–91	10.00	–	–	15.00	38.5
1999–2000	8.00	6.00	–	9.0	25.00
2000–2001	7.00	6.00	10.0	8.00	25.0
2001–2002	6.50	6.00	9.0	5.50	25.0
June 2002	6.50	6.00	8.5	5.00	25.0
October 2002	6.25	5.50	7.5	4.75	25.0
April 2003	6.00	5.00	7.0	4.75	25.0
August 2003	6.00	4.50	7.0	4.50	25.00
March 31, 2004	6.00	4.50	6.00	4.50	25
September 18, 2004	6.00	4.50	6.00	4.75	25
October 2, 2004	6.00	4.50	6.00	5.00	25
October 27, 2004	6.00	4.75	6.00	5.00	25
April 29, 2005	6.00	5.00	6.00	5.00	25
October 26, 2005	6.00	5.25	6.25	5.00	25
January 24, 2006	6.00	5.50	6.50	5.00	25
June 9, 2006	6.00	5.75	6.75	5.00	25
July 25, 2006	6.00	6.00	7.00	5.00	25
October 31, 2006	6.00	6.00	7.25	5.00	25
December 23, 2006	6.00	6.00	7.25	5.25	25
January 6, 2007	6.00	6.00	7.25	5.50	25
January 31, 2007	6.00	6.00	7.50	5.50	25
February 17, 2007	6.00	6.00	7.50	5.75	25
March 3, 2007	6.00	6.00	7.50	6.00	25
March 30, 2007	6.00	6.00	7.75	6.00	25
April 14, 2007	6.00	6.00	7.75	6.25	25
April	6.00	6.00	7.25	6.00	25
August 4, 2007	6.00	6.00	7.75	7.00	25
November 10, 2007	6.00	6.00	7.75	7.50	25
April 26, 2008	6.00	6.00	7.75	7.75	25
May 10, 2008	6.00	6.00	7.75	8.00	25
May 24, 2008	6.00	6.00	7.75	8.25	25
June 11, 2008	6.00	6.00	8.00	8.25	25
July 5, 2008	6.00	6.00	8.50	8.50	25
July 19, 2008	6.00	6.00	8.50	8.75	25
July 30, 2008	6.00	6.00	9.00	9.00	25
August 30, 2008	6.00	6.00	9.00	9.00	25
October 11, 2008	6.00	6.00	9.00	6.50	25
March 5, 2009	6.00	3.50	5.00	5.00	24
April 21, 2009	6.00	3.25	4.75	5.00	24
Nov 7, 2009	6.00	3.25	4.75	5.00	25
Feb 13, 2010	6.00	3.25	4.75	5.50	25
March 19, 2010	6.00	3.50	5.00	5.75	25
April 24, 2010	6.00	3.75	5.25	6.00	25
July 2, 2010	6.00	4.00	5.50	6.00	25
July 27, 2010	6.00	4.50	5.75	6.00	25

Source: RBI, *Annual Report.*

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In order to rationalise the existing structure, the entire amount of support under the Special Liquidity Facility (SLF) is made available at a single refinance rate. The normal facility and back-stop facility have been merged into a single facility to be made available at a single rate viz., at the repo rate with effect from March 29, 2004. The standing liquidity facilities provided to banks (export credit refinance) and primary dealers (collateralised liquidity support) from the RBI are available at the repo rate, that is, at 9 per cent with effect from July 29, 2008

Liquidity Adjustment Facility The Narasimham Committee on Banking Sector Reforms (Report II, 1998) recommended that the Reserve Bank provide support to the market through an LAF scheme. This facility would help in the development of a short-term money market with adequate liquidity. As per the committee's recommendation, the Reserve Bank decided to introduce the LAF in phases.

The interim LAF, introduced in April 1999, provided a mechanism for liquidity management through a combination of repos, export credit refinance, supported by open market operations at set rates of interest. Banks could avail of a collateralised lending facility of up to 0.25 per cent of the fortnightly average outstanding aggregate deposits available for few weeks at the bank rate. Primary dealers were provided liquidity support against a collateral of government securities. These facilities were available subject to quantitative limits (formula-based) for a specific duration and at the bank rate. Additional limits could be availed by banks under the additional collateralised lending facility (ACLF) and by primary dealers at 2 per cent points above the bank rate.

The interim LAF was gradually converted into a full-fledged LAF scheme. It was implemented in three phases: in the first phase, the general refinance facility was replaced by the ACLF for banks and primary dealers; in the second stage, CLF for banks and primary dealer was replaced by variable reverse repo auctions; and in the final stage, with the operationalisation of the real time gross settlement sysem (RTGS), the LAF is operated at different timings of the same day if necessary.

The LAF was introduced from June 5, 2000 impart greater stability and facilitate the emergence of a short-term rupee yield curve for pricing fixed income securities. The LAF is operated through repos and reverse repos. The LAF is a tool of day-to-day liquidity management through the injection or absorption of liquidity by way of sale or purchase of securities followed by their repurchase or resale under the repo/reverse repo operations. Repo/reverse repo auctions are conducted on a daily basis except on Saturdays. The tenor of repos is one day except on Fridays and days preceding holidays. Interest rates in respect of both repos and reverse repos are decided through cut-off rates emerging from auctions conducted by the Reserve Bank on a multiple price auction basis. The auction format for from the LAF was changed from the uniform price auction method to the multiple price auction method to ensure more responsible bidding. Since February 15, 2002, members of the NDS submit LAF bids in an electronic form instead of a physical form. In August 2000, repo auctions of tenor ranging from three to seven days were introduced. In October 2003, repos for a longer tenure of 28 days were also conducted for five consecutive days. The Reserve Bank also has the option of introducing long-term repos of up to 14 days as and when required and to switch over to fixed rate repos on an overnight basis. The minimum bid size for the LAF was reduced from Rs. 10 crore to Rs. 5 crore to facilitate the participation of small operators. LAF operations are conducted in the forenoon between 9.30 a.m. and 10.30 a.m. Operations under the LAF require the availability of adequate stock of government securities with the Reserve Bank.

The Reserve Bank operationalised the second liquidity adjustment facility (SLAF), in November 28, 2005, to provide market participants a second window to adjust their liquidity requirements. The SLAF was withdrawn with effect from August 6, 2007. It was reintroduced on reporting Fridays with effect from August 1, 2008. The bids for SLAF are received between 4:00 p.m and 4:30 p.m. The salient features of SLAF are the same as those of LAF. However, the settlement of the SLAF and the LAF is conducted separately and on gross basis. As liquidity conditions turned easy, the RBI now conducts only one LAF from May 6, 2009.

LAF helps the RBI to adjust the structure of interest rates (through fixed rate repos) in response to evolving market conditions and moderate sudden liquidity shocks. LAF has facilitated systematic movement of interest rates in the overnight call markets which, in turn, help reduce the volatility in the government securities market making gilt funds more attractive. It helps the market participants to overcome mismatches in supply and demand from time to time. As this facility is available to market participants at different timings, it enables them to undertake their own liquidity management. Banks can also structure their interest rates on a floating rate basis. Further, they are not required to undertake the market risk involved in purchase of securities.

- The LAF has become the principal operating instrument for modulating liquidity conditions on a daily basis

The LAF operations combined with the judicious use of open market operations have emerged as the principal operating instrument of the monetary policy.

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Repos

The major function of the money market is to provide liquidity. To achieve this function and to even out liquidity changes, the Reserve Bank uses repos. Repo is a useful money market instrument enabling the smooth adjustment of short-term liquidity among varied market participants such as banks and financial institutions.

- Repo is a transaction in which the borrower gets funds against the collateral of securities placed with the lender. The maturity period of repos range from 1 to 14 days. At the maturity, the securities revert to the borrower, after he repays the dues

Repo refers to a transaction in which a participant acquires immediate funds by selling securities and simultaneously agrees to the repurchase of the same or similar securities after a specified time at a specified price. In other words, it enables collateralised short-term borrowing and lending through sale/purchase operations in debt instruments. It is a temporary sale of debt involving full transfer of ownership of the securities, i.e., the assignment of voting and financial rights. Repo is also referred to as a ready forward transaction as it is a means of funding by selling a security held on a spot basis and repurchasing the same on a forward basis.

Reverse repo is exactly the opposite of repo—a party buys a security from another party with a commitment to sell it back to the latter at a specified time and price. In other words, while for one party the transaction is repo, for another party it is reverse repo. A reverse repo is undertaken to earn additional income on idle cash. In India, repo transactions are basically fund management/SLR management devices used by banks.

The difference between the price at which the securities are bought and sold is the lender's profit or interest earned for lending the money. The transaction combines elements of both a securities purchase/sale operation and also a money market borrowing/lending operation. It signifies lending on a collateral basis. It is also a good hedge tool because the repurchase price is locked in at the time of the sale itself. The terms of contract is in terms of a 'repo rate,' representing the money market borrowing/lending rate. Repo rate is the annual interest rate for the funds transferred by the lender to the borrower. The repo rate is usually lower than that offered on unsecured inter-bank rate as it is fully collateralised. The factors which affect the repo rate are the creditworthiness of the borrower, liquidity of the collateral, and comparable rates of other money market instruments.

Importance of Repos Repos are safer than pure call/notice/term money and inter-corporate deposit markets which are non-collateralised; repos are backed by securities and are fully collateralised. Ownership titles of eligible securities is immediately transferred. Thus, the counter party risks are minimum. Since repos are market-based instruments, they can be utilised by central banks as an indirect instrument of monetary control for absorbing or injecting short-term liquidity. Repos help maintain an equilibrium between demand and supply of short-term funds. The repos market serves as an equilibrium between the money market and securities market and provides liquidity and depth to both the markets. By promoting greater integration between the money market and the government securities market, it helps in developing a short-term yield curve. It is a widely used instrument by central governments to adjust market liquidity. Monetary authorities can transmit policy signals through repos to the money market which has a significant influence on the government securities market and foreign exchange market. Hence, internationally, it is a versatile and the most popular money market instrument. In India too, it was a rapidly developing and thriving market until the scam of 1992–93, where this facility was grossly misused.

Types of Repos Two types of repos are currently in operation—market repos and RBI repos.

1. Market repos: The Reserve Bank itself, allowed banks to resort to repo transactions among themselves and with DFHI, and STCI. All government securities and PSU bonds were eligible for repos till 1988. Between April 1988 and mid-June 1992, only Inter-bank repos were allowed in all government securities. Market repos were popular in 1991–92 as banks did not wish to buy the securities outright because of the risk of depreciation. Moreover, since there were not many money market instruments of different maturities, repos served as a hedge against interest rate fluctuations.

Repos were misused by banks and brokers during the 1992 securities scam. Repo deals were subsequently banned in all securities except treasury bills. In June 1995, the ban was lifted, allowing restricted eligible participants and instruments, i.e., repo deals were initially allowed in treasury bills and five dated securities on the NSE. Banks, along with primary dealers, were permitted to undertake ready forward transactions. These transactions were allowed only in Mumbai provided they were routed through the SGL accounts maintained by the Reserve Bank. These restrictions were liberalised gradually. Now, all central and state government dated securities and treasury bills of all maturities are eligible for repo. The participants are required to actually hold the securities in their portfolio before undertaking repo transactions.

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Banks, along with primary dealers, were permitted to undertake ready forward transactions. These transactions were allowed only in Mumbai provided they were routed through the SGL accounts maintained by the Reserve Bank.

***Volume of turnover in market repo*:** Average daily volumes in the market repo (outside the LAF) increased from Rs. 10,500 crore in 2000–01 to Rs. 57,320 crore in 2008–09. This spurt in the volumes was due to phasing out of the non-bank entities from the call money market. In the market repo segment, mutual funds are major provider of funds, while the foreign banks, private sector banks and primary dealers are the major borrowers.

2. RBI repos: It is a mechanism through which the Reserve Bank lends/borrows money to/from banks against government securities. Repo implies injection of liquidity and reverse repo absorption of liquidity. In other words, repo is a mechanism through which the RBI lends money to the banks against government securities (by repurchasing government securities from banks) to inject liquidity in the economy and through reverse repos, it borrows money by selling government securities to absorb excess liquidity in the economy. The Reserve Bank conducts repo auctions to

- Now repo implies injection of liquidity and reverse repo absorption of liquidity

1. provide banks with an outlet for managing short-term liquidity;
2. even out short-term liquidity fluctuations in the money market; and
3. optimise return on short-term surplus liquid funds.

The Reserve Bank provides liquidity support to primary dealers, and 100 per cent gilt mutual funds in the form of repo facility. The Reserve Bank also undertakes repo/reverse repo operations with primary dealers and scheduled commercial banks as part of its open market operations.

The Reserve Bank indirectly interferes in the call money market through LAF repo/reverse repo operations to ease undue pressure on overnight call money rates and moderate liquidity conditions in the call money market. This also enables the repo market to forge close links between the money market and securities market.

- Repo is permitted in dated securities, t-bills and state development loans to persons or entities maintaining either a SGL or CSGL accounts and unlisted companies which have been issued special securities by the GOI and maintain gilt accounts with scheduled commercial banks

The Reserve Bank introduced reverse repo operations (selling government securities to repurchase later) on December 10, 1992 to influence short-term liquidity. It is a mechanism through which the Reserve Bank absorbs excess liquidity from the economy. This is apart from the liquidity support extended by the Reserve Bank to primary dealers through refinance/reverse repo facility at a fixed price.

These reverse repo auctions were introduced in December 1992. They were conducted for a period ranging from 1 day to 14 days between 1992 and 1995. From August 1993, the period of repo stabilised at 14 days consistent with the reserve make up period for banks. In February 1995, auctions were discontinued due to lack of demand on account of tight money market conditions resulting from a decline in capital inflows and sharp expansion in non-food credit. Reverse repo auctions were reintroduced on November 4, 1996, to absorb excess liquidity in the economy. Auctions of a 3 to 4 day cycle were introduced again in early 1997. The Reserve Bank switched over from discriminatory price auction repos to a daily fixed rate repo auction system in November 1997. In discriminatory price auctions, bidders submit multiple price quantity sealed bids. The auction results were announced on the same day; payment by the successful bidders at or below the cut-off repo rate was made the following day. Under the fixed rate repos system, the repo rates are pre-announced and banks/financial institutions are required to submit bids indicating the volume of repos. The results of fixed rate repos are announced on the date of submitting the bids.

Fixed rate repos indicate money market rates, bring down volatility in the foreign exchange market, and impart stability to short-term interest rates by setting a floor and ceiling for call money rates. The fixed rate auction reverse repo system was used to prevent speculative activity during foreign exchange volatility and thereby to ward off the spread of that activity during the south-east Asian crisis. Initially, the reverse repo rate was fixed at 4.5 per cent but was successively raised to reach 7 per cent with effect from December 11, 1997, and further to 9 per cent with effect from January 17, 1998. Subsequently, as the forex market stabilised, the reverse repo rate was brought down in stages to 6 per cent with effect from March 1999 to 5.5 per cent in October 2002 and 4.5 per cent in August 2003 and then hiked to 5 per cent on April 29, 2005 and 6 per cent on July 25, 2006. The reverse repos got integrated with the ILAF introduced in April 1999. The absorption of liquidity was at fixed rate reverse repos and the system of injecting liquidity through various ways, including refinance, was at interest rates linked to the bank rate, which was reactivated in April 1997. With the introduction of the liquidity adjustment facility from June 5, 2000, the Reserve Bank has been injecting liquidity into the system through repos on a daily basis at a fixed rate. During 2008–09, the RBI injected liquidity through repo operations on 158 days, while it absorbed liquidity through reverse repo on 169 days (Table 4.20).

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TABLE 4.20 Net Repos(+)/Reverse Repos(–) Outstanding

Year	Liquidity Impact of LAF Repos	Outstanding	Number of Days Bids Were Received		Number of Days of Full Acceptance of Bids	
	(Rs. in Crore)	(Rs. in Crore)	Repos	Reverse Repos	Repos	Reverse Repos
2003–04	–32,230	–34,645	06	243	04	230
2004–05	15,315	–19,330	23	242	23	242
2005–06	12,080	–7,250	78	244	76	244
2006–07	36,435	29,185	64	244	63	234
2007–08	21,165	50,350	86	225	86	165
2008–09	–51,835	–1,485	158	169	158	169
2009–10	–2,175	990	–	–	–	–

Source: RBI, *Annual Report*, 2008–09.

TABLE 4.21 Primary Liquidity Flows

(Rs. in Crore)

Year	Net Repos Under LAF	Average Daily LAF Outstanding	MSS	Average MSS Outstanding	Net OMOs
2004–05	15,315	35,592	–64,211	46,445	–2,897
2005–06	12,080	10,986	–35,148	58,792	–3,912
2006–07	36,435	21,973	–33,913	37,698	–5,125
2007–08	21,165	4,677	–1,05,418	1,28,684	5,925
2008–09	–51,835	2,885	–80,315	1,48,889	1,04,480
2009–10	–2,175	27,918	85,340	22,178	82,355

Source: RBI, *Annual Report*, various issues.

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Types of Repo Rates

- Variable rate repos
- Fixed rate repos
- Repo Rate 5.75 per cent
- Reverse Repo Rate 4.50 per cent

The Reserve Bank scrapped the 7 and 14 day repo in October 2004. At present, repo is only overnight to give banks greater flexibility in liquidity management. In case of tight liquidity conditions, the RBI conducts 2/3/7 day repo/reverse repo auctions under additional LAF. The repo auctions are conducted on all working days except Saturdays and restricted to scheduled commercial banks and primary dealers. A system of announcing the calendar of repo auctions was also introduced in January 1997. All forms of liquidity support except ways and means advances (WMA) are at the repo rate.

The reverse repo rate acts as the floor and the bank rate and repo rates as the cap for the money market. With effect from July 27, 2010, the repo rate is 5.75 per cent and the reverse repo rate is 4.50 per cent. Changes in repo and reverse repo rates effect the movement of market interest rates and asset prices as they convey information about future monetary policy and liquidity. The Repo along with the CRR has emerged as an important tool of liquidity and monetary managament.

Large Capital Flows

- Lead to sharp increase in money supply
- Lead to inflation
- Make monetary management difficult
- Lead to like in interest rates
- Tend to appreciate rupee which makes exports less competitive

Market Stabilisation Scheme To manage the foreign exchange rate, the Reserve Bank intervenes in the forex market by buying dollars flowing into the economy. This leads to a release of large rupee supply in the system which results in a flood of rupee liquidity. In order to dry off a part of this rise supply, the Reserve Bank then sells bonds to banks. In the year 2003–04, there was a sharp fall in the level of the Central Government's market borrowing programme which exhausted the stock of bonds with the Reserve Bank. The Reserve Bank's stock of government securities fell to Rs. 4,626 crore in 2003–04 from Rs. 1,67,308 crore in May 2001. There was a persistent flow of foreign exchange and this was absorbed through the Liquidity Adjustment Facility (LAF) and the open Market Operations (OMOs) conducted by the Reserve Bank. However, a depletion in the stock of securities hampered the LAF and the Open market operations of the Reserve Bank. To make up for this, the Reserve Bank signed in March 2004, a memorandum of understanding (MOU) with the Government of India for issuance of dated government securities of a maturity of less than two years and treasury bills under the MSS. The scheme came into effect from April 1, 2004. The main purpose of introducing the scheme was to absorb surplus liquidity of a more enduring nature, thus reducing the burden of sterilisation on the LAF window. These bonds have a tenor of two years and the proceeds from them remain in a separate account

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of the Reserve Bank. This account is utilised solely for redeeming the principal amount of market stabilisation bonds. The liability of the government is restricted to interest payments.

The ceiling on the outstanding amount under MSS was fixed initially at Rs. 80,000 crore on October 14, 2004 but is subject to revision through mutual assessment of the liquidity in the system. The ceiling has been since enhanced to Rs. 2,50,000 crores in view of large and continuous capital inflows. The Reserve Bank also issues an indicative schedule for the issuance of securities under the MSS to provide transparency and stability in the financial markets. The MOU on the MSS was amended on February 26, 2009 to permit the transfer of the sequestered liquidity from the MSS cash account to the normal cash account of the government. As on December 10, 2004, the outstanding stock of securities under the MSS was Rs. 51,334 crore, inclusive of Rs. 25,000 crore raised through dated securities with a residual maturity of upto two years. The outstanding stock of securities under the MSS was Rs. 64,211 crore in March 31, 2005, Rs. 31,958 crore on March 31, 2006, Rs. 62,974 crore on March 31, 2007, Rs. 1,68,392 crore on March 31, 2008, and Rs. 88,077 crore on March 31, 2009.

This scheme has enabled the Reserve Bank to improve liquidity management in the system, maintain stability in the foreign exchange market, and conduct monetary policy in accordance with the stated objectives. Liquidity Adjustment Facility (LAF) coupled with open market operations (OMOs) and Market Stabilisation Scheme (MSS) has helped the transition from direct instruments to indirect instruments, stabilisation of short-term money market rates, enabled to affect demand for funds, and modulate the supply of funds on a daily basis to meet day-to-day liquidity mismatches.

Response to Large Capital Flows

- The RBI buys dollars to prevent rupee appreciation. This leads to a large supply of rupees in the market which can create inflation and cause asset prices to go up
- To prevent a rise in inflation, the RBI issues bonds to mop up the rupee released in the system. This is known as sterilisation process

MONEY MARKET DERIVATIVES

A derivative security is a financial contract the value of which is derived from the value of an underlying asset. These assets may be stocks, currencies, interest rates, indexes, or commodities. Derivatives help manage various types of risks through hedging, arbitraging, and acquiring insurance against them. As they increase the capability of the markets to absorb risk, they enhance liquidity and reduce transaction costs in the markets for underlying assets.

The deregulation of interest rates led to an interest rate risk. This risk is the adverse impact of interest rate movements on an institution's net interest income and market value, dependent on the maturity profile of the assets and liabilities of the institutions as well as their repricing terms. This interest rate risk can be managed with the help of derivative instruments. Lack of money market derivative instruments will force banks to physically restructure their balance sheets by purchasing or shedding assets and liabilities, which might ultimately turn out to be inefficient. Derivative instruments are off-balance sheets which help banks to manage their interest rate risks without having to restructure their balance sheet and with more efficient use of capital. Hence, in July 1999, the Reserve Bank laid down guidelines to introduce two money market derivatives: interest rate swaps (IRS) and forward rate agreements (FRA). Both are over the counter derivatives. These contracts are negotiated between counter-parties and tailored to meet the needs of their contract.

IRS and FRAs are new hedging instruments introduced to give more depth to the money market as also to enable market participants to hedge interest rate risk arising on account of lending or borrowings made at fixed/variable interest rates.

Interest Rate Swap

An interest rate swap (IRS) is a financial contract between two parties, exchanging or swapping a stream of interest payments for a notional principal amount during a specified period. Such contract involves exchange or swapping of a 'fixed to floating' or 'floating to fixed' interest rate. If participants feel that rates will fall, they could receive fixed and pay floating rates. The converse is beneficial if interest rates rise.

The first interest rate swap contract was negotiated in 1981 in London. It was introduced in the United States in 1982 when the Student Loan Marketing Association (Sallie Mae) employed a fixed for floating interest rate swap to convert the interest rate character of some of its liabilities. In India, some private sector banks and institutions use interest rate swap to hedge interest rate risk. The Reserve Bank allows the use of only plain vanilla interest rate swaps.

Plain Vanilla Interest Rate Swaps

In an interest rate swap there are two counter-parties. One counter-party, say A, will make fixed, semi-annual interest payments to the other counter-party, say B, who will make semi-annual floating interest payments to A. The swap contract specifies the interest rate applicable to each party, currency in which each cash payment will be made, timetable for payments, number of days in the year, provisions to cover the contingency of a defaulting counter-party, and other issues that affect the relationship between the

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counter-parties. Payments are usually made in the same currencies. Payments are netted and only the party with the positive difference owed makes a payment equal to the netted amount. The principal is not exchanged. Hence, the term 'notional principal,' is used. On the fixed payment side, a 365-day year is assumed; on the floating payment side, a 360-day year is used. The floating side is quoted on a money market yield basis. In India, the NSE/Reuters MIBOR has been accepted as a reference rate for interest rate swaps.

Example Counter-party A pays a fixed rate of 8.25 per cent per annum on a semi-annual basis and receives from counter-party B Mibor+50 basis points. The current six month MIBOR rate is 7 per cent per annum. The notional principal is Rs. 70 lakh.

Counter-party A	8.25 per cent →	Counter-party B
Pays fixed	NSE/Reuters Mibor +	Receives fixed
Receives floating	← 50 basis points	Pays floating

Counter-party A

$$\text{(National principal)} \left(\frac{\text{Days in period}}{365}\right)\left(\frac{\text{Interest rate}}{100}\right)$$

$$= 70{,}00{,}000 \times \frac{182}{365} \times \frac{8.25}{100} = \text{Rs. } 2{,}87{,}959$$

Counter-party B

$$70{,}00{,}000 \times \frac{180}{365} \times \frac{7.50}{100} = \text{Rs. } 2{,}62{,}500$$

Net payments by counter-party A to counter-party B = Rs. 2,87,959 – Rs. 2,62,500 = Rs. 25,459.
Counter-party A will benefit if the variable interest rates rise as per his expectation and counter-party B benefits if the variable interest rates decline.

The fixed rate is market-determined, i.e., by trading in the inter-bank market while the floating rate is linked to a benchmark.

The floating rate paid in an overnight indexed swap (OIS) is the Mumbai Inter-bank Offer Rate (MIBOR) or call rate, which is fixed everyday.

The IRS market is more liquid and provides better interest rate benchmarks than the government securities market. In a government securities market, participants cannot short sell government securities, i.e., they can not sell a government security unless they actually hold it. The government securities market is a long-only market. So participants can buy government securities when they anticipate a fall in the interest rates but when they expect rates to rise, they can only reduce duration or liquidate their government security portfolio and hold cash. To overcome this limitation, banks hedge their government securities portfolio by paying the fixed rate and receiving the floating rate. When the hedging and speculative activities of banks increase, the fixed rate rises and is higher than the government security yields.

In most of these contracts, the NSE-Mumbai Inter-bank Offered Rate (MIBOR) and Mumbai Inter-bank Forward Offered Rate (MIFOR) are used as the benchmark rates. The MIFOR swaps have grown in popularity The Indian corporates preferred the external commercial borrowings route to finance their projects. External commercial borrowings are long-term foreign currency loans. A Mifor swap enables a borrower to convert a floating rate foreign currency loan into a fixed rate rupee denominated one. The fixed interest rate paid in such a swap is the Mifor. It is the sum of London Inter-Bank Offer Rate (Libor) and the US dollar-Indian rupee annualised forward premium for the same tenor. Libor is the dollar interest rate at which international banks lend to each other and it serves as a benchmark for corporate borrowing. Libor as well as the forward premium reflect the view on currency appreciation/depreciation. MIFOR swaps are used to hedge interest rate risk as well as currency risk by an entity which has exposure to foreign currency borrowing by taking an opposite position in MIFOR swap. MIBOR linked short-term paper up to 365 days, with/without daily call/put options, enables top rated corporates to raise funds from non-bank entities, particularly from mutual funds. Overnight index swap (OIS) are actively traded over-the-counter interest rate derivative. It is an interest rate swap that allows investors to swap floating interest rate in exchange for a fixed rate and swap fixed interest rate in exchange for floating rate. The floating rate (MIBOR) is linked to an overnight inter-bank call money market. Banks use this instrument to manage their liquidity by converting their fixed term deposits into floating rate and for asset liability management. The OIS are more popular in this market.

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Applications of Interest Rate Swaps

Borrowers who expect interest rates to fall can swap their fixed rate loan into a floating rate loan. Borrowers who expect interest rates to rise can swap their floating rate loan into a fixed rate loan. Borrowers who have loans benchmarked to one floating rate can swap to another floating rate to reduce their risks or take advantage of the expected movement in one benchmark rate against another.

Money market dealers can pay in fixed IRS for 90 days instead of funding government securities deals through the highly volatile call money market. Dealers can also create synthetic long tenor assets at higher than current fixed yields by swapping upwards Mibor-linked debentures. For example, a one-year AAA rated Mibor-linked debenture issued at Mibor+50 bps can be swapped into a fixed rate for the same period.

Interest rate swap can be regarded as the exchange of a fixed rate bond for a floating rate bond. It can be used to transform a fixed rate loan extending over many years into a floating rate loan and vice versa. Thus, IRSs can be viewed as a series of forward contracts. IRSs help in reducing the cost of financing, managing risks, and creating synthetic instruments (created by combining other instruments) to enter new markets.

Forward Rate Agreements

FRAs are a type of forward contracts, originally introduced by British banks in 1983. FRAs are important hedging instruments in global banking.

A forward rate agreement is a financial contract between two parties where the interest at a predetermined rate for a notional principal amount and for a specified period is exchanged at the market interest rate prevailing at the time of settlement. The market interest rate is an agreed benchmark/reference rate prevailing on the settlement date. In India, the NSE/Reuters Mibor is used as a reference rate.

The cash payment at maturity (settlement) is based on the difference between the predetermined rate and the Mibor rate.

Plain Vanilla Forward Rate Agreements

A party that is seeking protection from a possible increase in interest rates would buy FRAs; hence, he is called a purchaser. A party that wants protection from a possible decline in interest rates would sell FRAs; hence, he is a seller. It is assumed that the forward interest rate is certain to be realised. There is no risk of default on the part of the writer of the FRA. A 360-day year convention is used in computing interest.

The specified period of the contract is the point in time when the deposit is to commence and the point in time when the deposit is to terminate. For example, a 3×9 FRA is read as three months against nine months Mibor which means a six-month Mibor deposit to commence in three months and terminate in nine months.

The actual amount received is calculated as follows:

The difference between the reference rate on the contract's settlement date and the agreed interest rate is multiplied by the notional principal and the term of the deposit. The sum obtained is discounted with the reference rate to arrive at the present value which is the sum paid or received.

Example In three months an Indian bank wants to lend Rs. 75,00,000 to a client for a period of six months. The spot NSE Mibor rate is 9.25 per cent. The bank, in order to commit itself to an interest rate, approaches an FRA dealer who offers a 6-month Mibor deposit, at a rate of 9.32 per cent to commence in three months. The bank enters into the contract as an FRA buyer. The bank then offers its client a rate of 9.82 per cent (cost of funds+50 basis points), a higher rate to allow for profit and risk coverage. If interest rates rise at the time of FRA settlement and the 6-month MIBOR is at 9.95 per cent, then the pay off is calculated as follows.

1. First calculate the lending profit/loss.
   Lending profit/Loss=(Rate received – Rate paid)×principal×term.
   $$=(9.82\% - 9.95\%)\times 75,00,000\times 182/360=\text{Rs. } (-)\ 4,929$$
   This loss on lending is hedged to enable the bank to earn profit.
2. The hedge profit/loss and the amount received or paid is calculated as follows.

$$\frac{(RR - CR)\,P \times t}{[1 + RR \times t]}$$

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RR = Reference rate, here the NSE Mibor rate
CR = FRA contract rate
P = Notional Principal
t = term, here 182/360 as a six-month deposit

The numerator of the equation gives the hedge profit/loss and the denominator discounts the sum obtained to arrive at its present value.

$$= \frac{\left[(9.95\% - 9.32\%) \times 75,00,000\right] \times \frac{182}{360}}{\left(\left\{1 + 9.95\% \times \frac{182}{360}\right\}\right)}$$

$$= \frac{23888}{\{1 + 0.05030\}}$$

$$= \text{Rs. } 22,743.5$$

Hence, the net profit to the bank is Rs. 22,743.5 – Rs. 4,929 = Rs. 17,814.5.

Besides being used as a hedging vehicle, FRA can be used by banks to arbitrage against futures or swaps or cash deposits.

The FRA market tends to be limited as parties are exposed to more risk than parties to a future contract. Hence, generally institutions with strong credit undertake FRA contracts.

Participants in the IRS/FRA Market

Scheduled commercial banks (excluding regional rural banks), primary dealers, and all-India financial institutions are free to undertake FRAs/IRS as a product for their own balance sheet management or for market making. Banks/ financial institutions/primary dealers can also offer these products to corporates for hedging their balance sheet exposures. Now mutual funds are permitted to undertake FRAs/IRS. The forward rate hedging facility provides fund managers an opportunity to insulate income schemes from interest rate fluctuation. This, in turn, helps in protecting the returns to investors in a volatile interest rate scenario.

No specific permission from the Reserve Bank is required to undertake FRAs/IRS. However, when undertaking such transactions participants are required to inform the monetary policy department (MPD) and the Reserve Bank.

Guidelines Relating to IRSs/FRAs

Banks/primary dealers/financial institutions can undertake different types of plain vanilla FRAs/IRS. Swaps having explicit/implicit option features such as caps/floors are not permitted.

No benchmark rate, size and tenor have been specified in the guidelines but the Reserve Bank has left market forces to evolve a benchmark and healthy conventions and practices. The Reserve Bank has not imposed any ceiling on the minimum or maximum size of the notional principal of FRAs and IRSs. The tenor of the transactions should not exceed their underlying rupee exposure. Participants are allowed, occasionally, to undertake market making activity without subjecting themselves to underlying exposure. Before undertaking such an activity, they are expected to ensure that the necessary infrastructure and risk management systems are satisfactory.

The CCIL developed a reporting platform for OTC Interest Rate Derivatives, which would capture the transactions in OTC interest rate derivatives [Interest Rate Swaps and Forward Rate Agreement (IRS/FRA)]. The platform was operationalised on August 30, 2007. All banks and PDs have to report all their IRS/FRA trades on the reporting platform within 30 minutes from the deal time.

The participation in the market is restricted mainly to a few foreign and private sector banks, primary dealers and all India financial institutions. Most of the IRS/FRA deals have taken place with overnight rates as benchmarks.

The IRS/FRA market is still nascent in India. The Reserve Bank has introduced some measures to bring about growth in the popularity of these instruments. The measures include allowing market participants to use interest rates implied in the foreign exchange forward market as a benchmark in addition to the existing domestic money and debt market rates.

Inspite of all the measures, however, the market in these derivative instruments has not taken off as anticipated. Factors which inhibit the growth of the money market derivative instruments are as follows.

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1. Lack of awareness and perception of derivative instruments as risky keeps away many participants from utilising them for their own benefit.
2. The cost of time and resources associated with the search for a suitable swap candidate and negotiating swap terms is high.
3. Only a few private sector and foreign banks are active in this market. Most banks prefer statutory compliance in asset-liability management rather than being proactive.
4. Lack of development of proper benchmark rates has hindered the growth of this market. Most participants rely on overnight Mibor rates as benchmark rates; this has led to a large number of deals of maturity of less than one year and only a few deals for one or more than one year maturity.
5. A vibrant term money market is a precondition for the success of this market. A developed term money market can give a series of rational benchmarks but it is yet to grow.

To develop a healthy market for derivatives, there should be enough participants to provide depth and sufficient liquidity and effort should be made to develop term benchmark rates. Banks and Foreign Exchange Dealers' Association of India (FEDAI) should organise workshops to increase the awareness of the use of these products. Banks and insurance companies should be encouraged to participate actively in this market.

Introduction of New Derivative Instruments

Exchange-traded interest rate futures were launched on April 28, 2003 by the NSE and the BSE. Interest rate futures (IRF) contracts are tools for managing interest rate risk.

Interest Rate Futures Exchange-traded interest rate futures were introduced in June 2003. Interest rate futures are standardised forward contracts on a benchmark interest rate traded on a stock exchange. It allows players to trade on future rate movements and hedge underlying positions. A market participant which expects the interest rate to fall will go short on future and take a long position if the view is otherwise. The major participants in these transactions are banks, mutual funds, foreign institutional investors and bond brokers. Interest rate futures help banks in hedging their exposures, as they borrow for a short tenor and lend for long-term. Moreover, interest rate futures helps in price discovery and in evolving a better term structure. Trading in interest rate futures helps widen the underlying cash market and increase the maturity profile of government securities.

The NSE introduced futures on a notional 10-year government security 3-month treasury bill and a 10-year government zero coupon in June 2003.

Interest rate futures were discontinued by the NSE as many problems surfaced which led to a lack of interest in this product.

- Banks are allowed to use interest rate futures only for hedging their underlying government securities portfolio.
- The zero coupon yield curve (ZCYC) methodology adopted by the NSE for settlement of contracts is not an appropriate methodology. The ZCYC is a curve that depicts interest rate changes at various points in the term structure. Presently, the ZCYC takes into account the daily traded government securities and not the liquidity aspect. Less than 25 per cent are liquid as only 35–40 bonds are traded every day. And calculating discount factors using the ZCYC which factors in all bonds traded for the day, leads to error in yields as compared to market yields of government securities with similar maturity.
- The short end of the ZCYC has shown severe volatility, which renders any hedge position constituted using exchange traded interest rate futures ineffective.
- Gross market yields are touching new lows everyday making no sense to trade, even for hedgers, it makes more sense to just hold on to the government securities and do nothing.
- The interest rates have bottomed out and when interest rates increase, trading in interest rate futures will increase.

On January 5, 2004, the SEBI permitted trading of interest rate futures (IRFs) contract on an underlying 10-year coupon bearing notional bond which would be priced on the basis of the yield-to-maturity (YTM) of a basket comprising bonds with maturity ranging from 9 to 11 years. The product was launched by NSE but it did not pick up. The IRS/FRA market has remained an over-the-counter market.

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SUMMARY

1. The money market is a market for financial assets that are close substitutes for money. It is a market for overnight to short-term funds and instruments having a maturity period of one or less than one year.
2. A money market provides a balancing mechanism to even out the demand for and supply of short-term funds, a focal point for central bank intervention for influencing liquidity and general level of interest rates in the economy, and reasonable access to suppliers and users of short-term funds to fulfill their borrowings and investment requirements at an efficient market clearing price.
3. The instruments traded in the Indian money market are treasury bills (T-bills), call/notice money market—call (overnight) and short notice (up to 14 days), commercial papers (CPs), certificates of deposits (CDs), commercial bills (CBs), and collateralised borrowing and lending obligations (CBLOs).
4. Treasury bills are short-term instruments issued by the Reserve Bank on behalf of the government to tide over short-term liquidity shortfalls. There are three categories of T-bills: on-tap bills, ad hoc bills, and auctioned T-bills. The development of T-bills is at the heart of the growth of the money market. The Reserve Bank of India, banks, mutual funds, financial institutions, primary dealers, provident funds, corporates, foreign banks, and foreign institutional investors are all participants in the T-bills market. The state governments can invest their surplus funds as non-competitive bidders in T-bills of all maturities. The sale of T-bills is conducted through an auction. At present, there are two types of T-bills: 91-day and 364-day. There are two types of auctions: (i) multiple-price auction and (ii) uniform-price auction.
5. A commercial paper is an unsecured short-term promissory note, negotiable and transferable by endorsement and delivery with a fixed maturity period. It is generally issued at a discount by the leading creditworthy and highly rated corporates to meet their working capital requirements.
6. Commercial bill is a short-term, negotiable, and self-liquidating instrument with low risk. It enhances the liability to make payment on a fixed date when goods are bought on credit. In India, the bill market did not develop due to (i) the cash-credit system of credit delivery where the onus of cash management rests with banks and (ii) an absence of an active secondary market.
7. Certificates of deposit are unsecured, negotiable, short-term instruments in bearer form, issued by commercial banks and development financial institutions. CDs are issued by banks during periods of tight liquidity, at relatively high interest rates.
8. Comparing the outstanding amount in case of both CD and CP, there is an inverse relationship between the two. When the outstanding amount of CD increased, the outstanding amount of CP decreased.
9. Call/notice money market is by far the most visible market as the day-to-day surplus funds, mostly of banks, are traded there. The call money market is a market for very short-term funds repayable on demand and with a maturity period varying between one day to a fortnight. Commercial banks borrow money from other banks to maintain a minimum cash balance known as cash reserve requirement (CRR).
10. The interest rate paid on call loans is known as the 'call rate.' It is a highly volatile rate. In India, the money and credit situation is subject to seasonal fluctuation every year. The volume of call money transactions and the amount as well as call rate levels characterise seasonal fluctuation/volatility. A decrease in the call/notice money requirement is greater in the slack season (mid-April to mid-October) than in the buy season (mid-October to mid-April).
11. A four-phased exit of non-bank institutions from the call money market commenced from May 5, 2001. With effect from August 6, 2005, non-bank participants, except PDs, were completely phased out from the call/notice money market.
12. A term money market is one where funds are traded upto a period of three to six months. The term money market in India is still not developed.
13. CBLO operates under a guarantee from the CCIL. CCIL members open constituent SGL (CGSL) account with the CCIL for depositing securities, which are offered as collateral for borrowing purposes. The borrowing limits are fixed on the basis of market value of the securities deposited in the account. Similarly, borrowers can avail of funds to the extent of the marked-to-market value of securities offered as collateral. The usual tenor for trading in the bonds is between overnight to fourteen days, though technically the maturity can extend upto one year.
14. MMMFs bridge the gap between small individual investors and the money market. MMMF mobilises savings from small investors and invests them in short-term debt instruments or money market instruments.
15. The Reserve Bank seeks to influence monetary conditions through management of liquidity by operating in varied instruments. These instruments can be categorised as direct and indirect market-based instruments.
16. The management of liquidity is essentially through direct instruments such as varying cash reserve requirements, limits on refinance, administered interest rates, and qualitative and quantitative restrictions on credit. The Reserve Bank also influences monetary conditions through market-based, indirect instruments such as open market operations and refinance (standing facilities)/discount (market-based discount windows)/repo windows.
17. Reserve requirements are of two types: (i) cash reserve requirements (CRR) and (ii) statutory liquidity ratio (SLR). They are techniques of monetary control used by the Reserve Bank to achieve specific macro-economic objectives. The CRR refers to the cash that banks have to maintain with the Reserve Bank as a certain percentage of their total demand and time liabilities (DTL) while SLR refers to the mandatory investment that banks have to make in government securities.
18. The prime lending rate (PLR) is the minimum lending rate charged by the bank from its best corporate customers or prime borrowers. Prime lending rates have been deregulated gradually since April 1992 and the interest rate structure for commercial banks simplified. The six categories of lending rates were reduced to four in April 1992 and to three in April 1993.
19. The rate of discount fixed by the central bank of the country for the rediscounting of eligible paper is called the bank rate. It is also the rate charged by the central bank on advances on specified collateral to banks.
20. Currently, there are only two refinance schemes available to banks—export credit refinance and general refinance.
21. LAF (Liquid Adjustment Facility) is operated through repos and reverse repos. The LAF is a tool of day-to-day liquidity management through the absorption or injection of liquidity by way of sale or purchase of securities followed by their repurchase or resale under the repo/reverse repo operations. It provides a mechanism for injection and absorption of liquidity available to banks and to overcome mismatches in supply and demand from time to time.
22. Repo is a transaction in which the borrower gets funds against the collateral of securities placed with the lender. The maturity period of repos range from 1 to 14 days. At maturity, the securities revert to the borrower, after he repays the dues. Since repos are market-based instruments, they can be utilised by central banks as an indirect instrument of monetary control for absorbing or injecting short-term liquidity. Repos help maintain an equilibrium between demand and supply of short-term funds. The repos market serves as an equilibrium between the money market and securities market and provides liquidity and depth to both the markets. The repo rate, along with the CRR and bank rate, emerged as important tool of liquidity and monetary management.

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23. An interest rate swap (IRS) is a financial contract between two parties, exchanging or swapping a stream of interest payments for a notional principal amount during a specified period. Such a contract involves exchange or swapping of a 'fixed to floating' or 'floating to fixed' interest rate. If participants feel that rates will fall, they could receive fixed and pay floating rates. The converse is beneficial if interest rates rise.
24. A forward rate agreement (FRA) is a financial contract between two parties where the interest at a predetermined rate for a notional principal amount and for a specified period is exchanged at the market interest rate prevailing at the time of settlement. The market interest rate is an agreed benchmark/reference rate prevailing on the settlement date. In India, the NSE/Reuters Mibor is used as a reference rate.
25. The number of contracts and the notional amount in case of both IRSs and FRAs has increased tremendously.

REVIEW QUESTIONS

1. What is a money market? What steps have been taken to develop the Indian money market?
2. 'Treasury bills are an important short term source of finance for the government.' Discuss.
3. Compare certificates of deposit and commercial Papers?
4. Why has the commercial bills market not developed in India?
5. What steps have been taken to curb the call money market volatility?
6. What are repos? State the different types of repos. How does the Reserve Bank use repos as a tool for managing liquidity in the money market?
7. 'The market for interest rate swaps and forward rate agreements have not grown at the anticipated pace.' Discuss.
8. What is Market Stabilisation Scheme? Why was it introduced by RBI?
9. What is Liquidity Adjustment Facility and what are its objectives? State the tools of LAF?
10. What is CRR? What is the implication of a cut in CRR? What is the indication of a hike in CRR?
11. Discuss the link between monetary policy and money market?
12. What is CBLO? How has it emerged as a predominant segment in money market?
13. What are the prudential limits laid down by the RBI for transactions in the call money market by banks?
14. State the link between call money market and other financial markets?
15. Write short notes on
    a. Certificate of Deposit
    b. Commercial paper
    c. Treasury bills
16. Which sectors are relatively immune to interest rate shifts?
17. Which sectors are affected by interest rate changes?

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5

The Capital Market

Chapter Objectives

This chapter will enable you to develop an understanding of the following:

1. *Functions of the capital market*
2. *Primary capital market and secondary capital market*
3. *History of the Indian capital market*
4. *Capital market scams*
5. *Reforms in the capital market*

INTRODUCTION

The capital market is an important constituent of the financial system. It is a market for long-term funds—both equity and debt—and funds raised within and outside the country.

The capital market aids economic growth by mobilising the savings of the economic sectors and directing the same towards channels of productive use. This is facilitated through the following measures.

- Issue of 'primary securities' in the 'primary market,' i.e., directing cash flow from the surplus sector to the deficit sectors such as the government and the corporate sector.
- Issue of 'secondary securities' in the primary market, i.e., directing cash flow from the surplus sector to financial intermediaries such as banking and non-banking financial institutions.
- 'Secondary market' transactions in outstanding securities which facilitate liquidity. The liquidity of the stock market is an important factor affecting growth. Many profitable projects require long-term finance and investment which means locking up funds for a long period. Investors do not like to relinquish control over their savings for such a long time. Hence, they are reluctant to invest in long gestation projects. It is the presence of the liquid secondary market that attracts investors because it ensures a quick exit without heavy losses or costs.

Hence, the development of an efficient capital market is necessary for creating a climate conducive to investment and economic growth.

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Functions of a Capital Market

The functions of an efficient capital market are as follows.

- Mobilise long-term savings to finance long-term investments.
- Provide risk capital in the form of equity or quasi-equity to entrepreneurs.
- Encourage broader ownership of productive assets.
- Provide liquidity with a mechanism enabling the investor to sell financial assets.
- Lower the costs of transactions and information.
- Improve the efficiency of capital allocation through a competitive pricing mechanism.
- Disseminate information efficiently for enabling participants to develop an informed opinion about investment, disinvestment, reinvestment, or holding a particular financial asset.
- Enable quick valuation of financial instruments—both equity and debt.
- Provide insurance against market risk or price risk through derivative trading and default risk through investment protection fund.
- Enable wider participation by enhancing the width of the market by encouraging participation through networking institutions and associating individuals.
- Provide operational efficiency through
  - simplified transaction procedures;
  - lowering settlement timings; and
  - lowering transaction costs.

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- Develop integration among
  - real and financial sectors;
  - equity and debt instruments;
  - long-term and short-term funds;
  - long-term and short-term interest costs;
  - private and government sectors; and
  - domestic and external funds.
- Direct the flow of funds into efficient channels through investment, disinvestment, and reinvestment.

Primary Capital Market and Secondary Capital Market

The capital market comprises the primary capital market and the secondary capital market.

- The primary market is a market for new issues, while the secondary market is a market where outstanding or existing securities are traded

Primary Market This refers to the long-term flow of funds from the surplus sector to the government and corporate sector (through primary issues) and to banks and non-bank financial intermediaries (through secondary issues). Primary issues of the corporate sector lead to capital formation (creation of net fixed assets and incremental change in inventories). The capital formation function enables companies to invest the proceeds of a primary issue in creating productive capacities, increasing efficiency, and creating jobs which, in turn, generate wealth.

The nature of fund-raising is as follows.

Domestic

Equity issues by	— Corporates (primary issues)
	— Financial intermediaries (secondary issues)
Debt instruments by	— Government (primary issues)
	— Corporates (primary issues)
	— Financial intermediaries (secondary issues)

External

Equity issues through issue of	— Global Depository Receipts (GDR) and American Depository Receipts (ADR)
Debt instruments through	— External Commercial Borrowings (ECB)

Other External Borrowings

Foreign Direct Investments (FDI)	— in equity and debt form
Foreign Institutional Investments (FII)	— in the form of portfolio investments
Non-resident Indian Deposits (NRI)	— in the form of short-term and medium-term deposits

The **fund-raising in the primary market** can be classified as follows.

- Public issue by prospectus
- Private placement
- Rights issues
- Preferential issues

Foreign Direct Investment (FDI) and Foreign Institutional Investment (FII)

FDI is an investor which picks up more than 10 per cent stake in a company's equity. India has had a long experience with FDIs, with multinational corporations being significant players in many sectors of the economy–pharmaceuticals, consumer durables, fast moving consumer goods, engineering, and financial services. The sectors which were recently opened up for FDIs are telecom, banking and insurance. These multinational corporations either set up their wholly owned subsidiary in India or enter into a joint venture with Indian entrepreneurs. FDI is a preferred route to bridge the large savings–investment gap owing to its beneficial effects such as access to modern technologies and export markets, and direct and indirect employment reaction. However, FDI crowds out domestic investment opportunities and hence some conditions in the form of minimum level of local content, export commitment, technology transfer, and compulsory listing on the local stock-exchanges are generally imposed on FDIs. FDIs are stable by nature as they usually come into the picture only for long-term projects. They also help generate employment and bring in the latest technological innovations.

The government aims to attract FDI worth $150 billion over the next 10 years, with a thrust on infrastructure, financial services and agriculture. This will be possible only if there is a stability of policies,

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tax laws and incentives and a minimum of red tape and a corruption-free environment. The government has set up an investment commission to identify the problems of the potential investors and advise the government.

The government has revised FDI caps to 100 per cent in airports, power trading, petroleum marketing, distillation and brewing of potable alcohol, captive mining in coal and lignite, industrial explosives, and hazardous chemicals. Investment in these areas would no longer require the approval of the Foreign Investment Promotion Board.

FIIs are in the form of portfolio investments both in the primary and secondary capital markets. They help in bridging the short-to medium-term savings–investment gap. FII flows help capital formation either by subscribing to quality issues in the primary market or by releasing the existing pool of risk capital through the secondary market. FIIs can invest only upto 24 per cent in a company. Further investments would need special approval from the company's board and in any case cannot go beyond the foreign investment cap for the sector set by the government. FIIs usually help in developing capital markets. Entrepreneurs can tap the capital market by wooing FIIs and can thereby setup new projects or use the funds for expansion. However, FII investment may not be stable as there can be sudden outflows, if capital markets perform adversely, or are expected to perform negatively.

The Secondary Market This is a market for outstanding securities. An equity instrument, being an eternal fund, provides an all-time market while a debt instrument, with a defined maturity period, is traded at the secondary market till maturity. Unlike primary issues in the primary market which result in capital formation, the secondary market facilitates only liquidity and marketability of outstanding debt and equity instruments. The secondary market contributes to economic growth by channelising funds into the most efficient channel through the process of disinvestment to reinvestment. The secondary market also provides instant valuation of securities (equity and debt instruments) made possible by changes in the internal environment, i.e., through companywide and industrywide factors. Such a valuation facilitates the measurement of the cost of capital and rate of return of economic entities at the micro level. Secondary markets reduce the cost of capital by providing liquidity, price discovery and risk transfer capability. Liquidity is the ability to buy or sell an asset readily at a low cost and without a substantial impact on its price. Price discovery is the process whereby market participants attempt to find an equilibrium price which, in turn, is useful in making economic decisions. Both the government and business firms use this information to formulate future strategies. For instance, the derivatives trading reveals expected future prices of different commodities, currencies, precious metals, securities, and interest rates. Based on this information, both the government and business firms determine particulars like pricing commitments, timing of issues and expansion of production facilities.

Secondary Market

- Facilitates liquidity and marketability of securities
- Provides valuation of securities
- Reduces cost of capital
- Enables price discovery
- Creates a wealth effect

The secondary market creates a wealth effect. The bull run in the stock markets adds to the market capitalisation which notionally accrues to all investors–government, corporates, promoters, strategic holders of equity on listed companies, mutual funds and individual investors and it makes them feel wealthier. Investors also feel rich when they receive frequent dividend distribution from mutual funds or corporates. This stock market created wealth does influence consumption and growth of the economy. The wealth effect suggests that an addition in financial wealth boosts consumer spending in the long run.

The Indian secondary market can be segregated into two.

1. The secondary market for corporates and financial intermediaries. For trading in issues of corporates and financial intermediaries, there are the following entities.
   a. Recognised stock exchanges
   b. The National Stock Exchange of India Limited (NSE)
   c. The Over the Counter Exchange of India (OTCEI)
   d. The Interconnected Stock Exchange of India (ISE).

   The participants in this market are registered brokers—both individuals and institutions. They operate through a network of sub-brokers and sub-dealers and are connected through an electronic networking system.
2. The secondary market for government securities and public sector undertaking bonds. The trading in government securities is basically divided into the short-term money market instruments such as treasury bills and long-term government bonds ranging in maturity from 5 to 20 years.

   The main participants in the secondary market for government securities are entities like primary dealers, banks, financial institutions, and mutual funds.

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The secondary market transactions in government securities have been conducted through the subsidiary general ledger (SGL) since September 1994. Both the government securities and public sector undertaking bonds are now traded in the wholesale debt market (WDM) segment of the NSE, the BSE, and the OTCEI.

HISTORY OF THE INDIAN CAPITAL MARKET

The history of the capital market in India dates back to the eighteenth century when the East India Company securities were traded in the country. Until the end of the nineteenth century, securities trading was unorganised and the main trading centres were Bombay (now Mumbai) and Calcutta (now Kolkata). Of the two, Bombay was the chief trading centre wherein bank shares were the major trading stock. During the American Civil War (1860–61), Bombay was an important source of supply for cotton. Hence, trading activities flourished during the period, resulting in a boom in share prices. This boom, the first in the history of the Indian capital market, lasted for nearly half a decade. The bubble burst on July 1, 1865, when there was a tremendous slump in share prices.

Trading was at that time limited to a dozen brokers; their trading place was under a banyan tree in front of the Town Hall in Bombay. These stock brokers organised an informal association in 1875—the Native Shares and Stock Brokers Association, Bombay. The stock exchanges in Calcutta and Ahmedabad, also industrial and trading centres, materialised later. The Bombay Stock Exchange was recognised in May 1927 under the Bombay Securities Contracts Control Act, 1925.

The capital market was not well-organised and developed during the British rule because the British government was not interested in the economic growth of the country. As a result, many foreign companies depended on the London capital market for funds rather than on the Indian capital market.

In the post-independence era also, the size of the capital market remained small. During the first and second five year plans, the government's emphasis was on the development of the agricultural sector and public sector undertakings. Public sector undertakings were healthier than private undertakings in terms of paid-up capital but their shares were not listed on the stock exchanges. Moreover, the Controller of Capital Issues (CCI) closely supervised and controlled the timing, composition, interest rates, pricing, allotment, and floatation costs of new issues. These strict regulations demotivated many companies from going public for almost four and a half decades.

In the 1950s, Century Textiles, Tata Steel, Bombay Dyeing, National Rayon, and Kohinoor Mills were the favourite scrips of speculators. As speculation became rampant, the stock market came to be known as the *satta bazaar*. Despite speculation, non-payment or defaults were not very frequent. The government enacted the Securities Contracts (Regulation) Act in 1956 to regulate stock markets. The Companies Act, 1956 was also enacted. The decade of the 1950s was also characterised by the establishment of a network for the development of financial institutions and state financial corporations.

The 1960s was characterised by wars and droughts in the country which led to bearish trends. These trends were aggravated by the ban in 1969 on forward trading and *badla,* technically called 'contracts for clearing'. *Badla* provided a mechanism for carrying forward positions as well as for borrowing funds. Financial institutions such as LIC and GIC helped revive the sentiment by emerging as the most important group of investors. The first mutual fund of India, the Unit Trust of India (UTI) came into existence in 1964.

In the 1970s, *badla* trading was resumed under the guise of 'hand-delivery contracts—a group.' This revived the market. However, the capital market received another severe setback on July 6, 1974, when the government promulgated the Dividend Restriction Ordinance, restricting the payment of dividend by companies to 12 per cent of the face value or one-third of the profits of the companies that can be distributed as computed under Section 369 of the Companies Act, whichever was lower. This led to a slump in market capitalisation at the BSE by about 20 per cent overnight and the stock market did not open for nearly a fortnight. Later came a buoyancy in the stock markets when the multinational companies (MNCs) were forced to dilute their majority stocks in their Indian ventures in favour of the Indian public under FERA in 1973. Several MNCs opted out of India. One hundred and twenty-three MNCs offered shares worth Rs. 150 crore, creating 1.8 million shareholders within four years. The offer prices of FERA shares were lower than their intrinsic worth. Hence, for the first time, FERA dilution created an equity cult in India. It was the spate of FERA issues that gave a real fillip to the Indian stock market. For the first time, many investors got an opportunity to invest in the stocks of such MNCs as Colgate, and Hindustan Lever Limited. Then, in 1977, a little-known entrepreneur, Dhirubhai Ambani, tapped the capital market. The scrip, Reliance Textiles, is still a hot favourite and dominates trading at all stock exchanges.

The 1980s witnessed an explosive growth of the securities market in India, with millions of investors suddenly discovering lucrative opportunities. Many investors jumped into the stock markets for the first time. The government's liberalisation process initiated during the mid-1980s, spurred this growth.

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Participation by small investors, speculation, defaults, ban on *badla,* and resumption *of badla* continued. Convertible debentures emerged as a popular instrument of resource mobilisation in the primary market. The introduction of public sector bonds and the successful mega issues of Reliance Petrochemicals and Larsen and Toubro gave a new lease of life to the primary market. This, in turn, enlarged volumes in the secondary market. The decade of the 1980s was characterised by an increase in the number of stock exchanges, listed companies, paid-up capital, and market capitalisation.

The 1990s will go down as the most important decade in the history of the capital market of India. Liberalisation and globalisation were the new terms coined and marketed during this decade. The Capital Issues (Control) Act, 1947 was repealed in May 1992. The decade was characterised by a new industrial policy, emergence of the SEBI as a regulator of the capital market, advent of foreign institutional investors, euro-issues, free pricing, new trading practices, new stock exchanges, entry of new players such as private sector mutual funds and private sector banks, and primary market boom and bust.

Major capital market scams took place in the 1990s. These shook the capital market and drove away small investors from the market. The securities scam of March 1992 involving brokers as well as bankers was one of the biggest scams in the history of the capital market. In the subsequent years owing to free pricing, many unscrupulous promoters, who raised money from the capital market, proved to be fly-by-night operators. This led to an erosion in the investors' confidence. The M S Shoes case, one such scam which took place in March 1995, put a break on new issue activity.

The 1991–92 securities scam revealed the inadequacies of and inefficiencies in the financial system. It was the scam which prompted a reform of the equity market. The Indian stock market witnessed a sea change in terms of technology and market prices. Technology brought radical changes in the trading mechanism. The Bombay Stock Exchange was subject to nationwide competition by two new stock exchanges—the National Stock Exchange, set up in 1994, and the Over the Counter Exchange of India, set up in 1992. The National Securities Clearing Corporation (NSCC) and the National Securities Depository Limited (NSDL) were set up in April 1995 and November 1996 respectively for improved clearing and settlement and dematerialised trading. The Securities Contracts (Regulation) Act, 1956 was amended in 1995–96 for introduction of options trading. Moreover, rolling settlement was introduced in January 1998 for the dematerialised segment of all companies. With automation and geographical spread, stock market participation increased.

In the late-1990s, Information Technology (IT) scrips dominated the Indian bourses. These scrips included Infosys, Wipro, and Satyam. They were a part of the favourite scrips of the period, also known as 'new economy' scrips, along with telecommunications and media scrips. The new economy companies were knowledge intensive unlike the old economy companies that were asset intensive.

The Indian capital market entered the twenty-first century with the Ketan Parekh scam. As a result of this scam, *badla* was discontinued from July 2001 and rolling settlement was introduced in all scrips. Trading of futures commenced from June 2000, and Internet trading was permitted in February 2000. On July 2, 2001, the Unit Trust of India announced suspension of the sale and repurchase of its flagship US-64 scheme due to heavy redemption leading to a panic on the bourses. The government's decision to privatise oil PSUs in 2003 fueled stock prices. One big divestment of international telephony major VSNL took place in early February 2002. Foreign institutional investors have emerged as major players on the Indian bourses. NSE has an upper hand over its rival BSE in terms of volumes not only in the equity markets but also in the derivatives market.

It has been a long journey for the Indian capital market. Now the capital market is organised, fairly integrated, mature, more global and modernised. The Indian equity market is one of the best in the world in terms of technology. Advances in computer and communications technology, coming together on Internet are shattering geographic boundaries and enlarging the investor class. Internet trading has become a global phenomenon. Indian stock markets are now getting integrated with global markets.

A Brief History of the Rise of Equity Trading in India

July 9, 1875:	Native brokers form the Native Share and Stock Brokers' Association in Bombay. Membership fee is Re. 1. The association has 318 members.
July 9, 1875:	Native brokers form the Native Share and Stock Brokers' Association in Bombay. Membership fee is Re. 1. The association has 318 members.
1899:	The Bombay Stock Exchange acquires own premises.
1921:	Clearing houses are established for settlement of trades as volumes increase.
1923:	K. R. P. Shroff becomes the honorary president of the BSE.
1925:	The Bombay Securities Contract Control Act (BSCCA) comes into force.

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December 1, 1939:	Stock exchange building is acquired.
1943:	Forward trading banned till 1946. Only ready to deliver and hand delivery contracts permitted.
1956:	The Securities Contract Regulation Act drafted on the lines of the BSCCA comes into force.
1957:	The BSE becomes the first exchange in India to get permanent recognition.
1964:	Unit Trust of India (UTI) is born.
April 1, 1966:	K. R. P. Shroff retires and Phiroze J. Jeejeebhoy becomes new chairman.
June 29, 1969:	Morarji Desai bans forward trading.
1973:	Construction of P J Towers, named after late Phiroze Jamshedji Jeejeebhoy, starts.
January 2, 1986:	The BSE Sensex launched as the first stock market index with 1978–79 as the base year.
November 1987:	SBI Mutual Fund launches Magnum Regular Income Scheme.
April 1988:	The Securities and Exchange Board of India (SEBI) set up.
January 1992:	The SEBI given statutory powers.
May 1992:	Harshad Mehta securities scam breaks.
May 27, 1992:	Reliance is the first Indian company to make a GDR issue.
May 30, 1992:	The Capital Issues Control Act, 1947 is repealed.
September 1992:	Foreign institutional investors (FIIs) are permitted to invest in the Indian securities market.
November 1992:	Finance Minister Manmohan Singh inaugurates the Over the Counter Exchange of India.
October 30, 1993:	The first private sector mutual fund, Kothari Pioneer Mutual Fund, begins operations.
1993:	The SEBI bans *badla* trading on the BSE.
June 1994:	NSE commences operations in wholesale debt market segment.
November 1994:	The capital market segment of the NSE goes on stream. Trading is screen-based for the first time in India.
March 1995:	The BSE on-line trading system (BOLT) replaces the open outcry system.
April 1995:	The National Securities Clearing Corporation Limited, India's first clearing corporation is set up.
October 1995:	The NSE overtakes the BSE as the largest stock exchange in terms of volume of trading.
April 1996:	Nifty is born. The National Securities Clearing Corporation Limited commences operations.
November 1996:	The National Securities Depository Limited is created.
February 1997:	The SEBI releases norms for takeovers and acquisitions.
May 1997:	The BSE introduces screen-based trading.
February 1998:	Launch of automated lending and borrowing mechanism (ALBM) on the NSE.
November 1998:	The SEBI recognises the Interconnected Stock Exchange founded by 15 regional stock exchanges. This exchange starts functioning in February 1999.
March 11, 1999:	Infosys Technologies is the first company to be listed on the NASDAQ through a public offering of American Depository Receipts (ADRs).
March 22, 1999:	Central Depository Services (India) promoted by the BSE commences operations.
September 1999:	ICICI is the first Indian company to be listed on the New York Stock Exchange (NYSE).
October 11, 1999:	For the first time in the BSE's history, the Sensex closes above the 5,000 mark at 5,031.78.
January 2000:	The BSE creates a 'Z' category of scrips in addition to A, B1, and B2 comprising scrips that breached or failed to comply with the listing agreement.
February 2000:	Internet trading commences on the NSE. On February 14, 2000, the BSE Sensex hits an all-time high of 6,150. On February 21, the NSE records peak market capitalisation of Rs. 11,94,282 crore.

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April 10, 2000:	The Sensex is revamped to include Dr Reddy's Lab, Reliance Petroleum, Satyam Computers, and Zee Telefilms replacing Indian Hotels, Tata Chemicals, Tata Power, and IDBI.
June 2000:	The BSE and the NSE introduce derivatives trading in the form of index futures.
July 9, 2000:	The BSE turns 125.
October 19, 2000:	Wipro lists on the NYSE.
January 22, 2001:	The Borrowing and Lending Securities Scheme (BLESS) launched on the BSE to promote securities lending and borrowing activities.
March 2001:	Ketan Parekh scam breaks. The SEBI suspends all the broker directors of the BSE in relation to the KP scam.
May 2001:	The BSE advises compulsory demat for B2 scrips.
June 2001:	Index options start trading on the NSE.
July 2001:	A SEBI directive bans carry forward. All major securities are moved to rolling settlement. Options of individual scrips start trading on the NSE.
November 9, 2001:	The BSE and the NSE launch futures in individual stocks.

Source: Business Today, January 20, 2002, pp. 62–63.

CAPITAL MARKET SCAMS

Introduction

The post-economic liberalisation era witnessed scams with cyclical regularity in the Indian capital market. The series of scams in the capital market may lead someone to believe that scams and liberalisation are correlated phenomena.

The most infamous scam, known as the 1992 securities scam, was masterminded by Harshad Mehta and other bull operators, not without the connivance and collusion of banks. The consequences were so serious that the BSE remained closed for a month. This was followed by scams by unscrupulous promoters mostly of finance companies who took advantage of free pricing to raise money by price rigging. Such fly-by-night operators jolted both the stock exchange and investors. Besides price rigging, grey market activities were common where the share prices were quoted at a premium before they were listed on the stock exchanges. For instance, a Morgan Stanley Mutual Fund unit worth Rs. 10 was commanding a premium of Rs. 18, i.e., it was quoted at Rs. 28 during the subscription period. In March 1995, another scam known as the M. S. Shoes scam masterminded by an exporter, Pavan Sachdeva, who rigged up prices of shares, leading eventually to a crash. Once again the market had to be closed for three days. In December 1995, the Reliance shares issue—share switching scam—sprung up in which Fair Growth Financial Services, Reliance Industries, and the stock exchange itself were involved. The Bombay Stock Exchange suspended trading in the famous RIL scrip for three days.

C. R. Bhansali, a chartered accountant, shook the country's financial system in May 1997. He identified weaknesses in the regulatory framework of the country's financial system. By trimming the balance sheets of CRB capital markets, he positioned his company as a unique financial organisation with excellent prospects. This created for him an almost unlimited supply of deposits with high interest rates on the one hand, and provided him leverage to rig prices in the market on the other. The investors were lured to part with their money and risk their future.

Price rigging became a recurring ailment of the Indian capital market. This is clearly evident from the fact that, in 1998, the technique of price rigging was successfully applied in case of the BPL, Videocon, and Sterlite scrips, which created a payment crisis. Brokers, who acted in concert with Harshad Mehta, had taken large positions in these scrips. As a consequence, these scrips had to be debarred from the market for a couple of years. J. C. Parekh, the then president, and other key members on the board of the BSE were sacked by the SEBI for price rigging and insider trading in this case. The history of insider trading was repeated in March 2001 when Anand Rathi, the then president of the BSE, was caught red-handed and thereafter sacked by the SEBI alongwith six other broker directors. Ketan Parekh, the new big bull, once again exploited the loopholes and the Anand Rathi bear cartel hammered the market. The hammering rocked the stock market once again.

All the scamsters employed common ploys like price manipulation, price rigging, insider trading, cartels, collusion, and nexus among the bankers, brokers, politicians, and promoters. These ploys were successfully engineered and implemented particularly around public issues or mergers. The regulators were so ineffective that actions were undertaken only after the investors were looted of their hard-earned

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money. The ignorance of investors and greed for quick money made the scamsters' job all the more easy. Post-scam inquiries are still being carried on.

In this chapter, the first scam in the post-liberalisation era, the 1991–92 securities scam, also known as the Harshad Mehta scam and the 2001 scam, i.e., the Ketan Parekh scam are discussed in detail.

The 1991–92 Securities Scam (The Harshad Mehta Scam)

In 1991, major changes in the government policy led to the emergence of a market-oriented private enterprise economy through the removal of controls.

The economic liberalisation package compelled banks to improve their profitability. With liberalisation, entered the free interest rate regime, which meant that banks had to face interest rate uncertainty. Coupled with this was strict enforcement of the SLR requirements for banks to keep the money supply under control. Hence, public sector banks were forced to undertake more trading in government securities. The increase in interest rates on government securities with a longer period of maturity meant capital loss (depreciation) on the holding of old securities. To partly offset this loss, banks began trading of a new instrument—repos or ready forward. Repo is a means of funding by selling a security held on spot (ready) basis and repurchasing it on a forward basis.

Several banks, including foreign banks, were unwilling to purchase securities for maintaining the SLR because of the risk of depreciation. They preferred ready forward contracts with other banks, which were surplus in securities. These ready forward contracts were turned around every fortnight depending on the banks' deposit figures. Moreover, many banks had purchased public sector bonds which they could not sell due to the coupon rate hike. Many banks then violated the Reserve Bank advice and entered into ready forward deals in PSU bonds.

Repos are legal and versatile instruments but the inter-bank repos in 1991–92 were based on some inside information obtained illegally. This was confirmed by the interim report of the RBI panel on securities, which stated, 'Towards the end of March 1992, the State Bank of India (SBI) had purchased a large quantity of government securities on a ready forward basis one day prior to the date on which the coupon rate of government securities was raised.'

Besides obtaining information illegally, most of the ready forward deals were dubious and facilities like bank receipts (BRs) and SGL forms were misused. Bank receipts which were working smoothly as a mechanism (acknowledgement) for transfer of government securities amongst banks were highly misused. There were fake bank receipts in circulation and there was double counting of BRs, which led to an accelerated growth in money supply. For example, the Bank of Karad, which had an equity base of less than Rs. 1 crore, issued BRs worth more than Rs. 1,000 crore. Standard Chartered Bank, a foreign bank, accepted BRs worth Rs. 200 crore from this bank. These transactions, which were far out of proportion of the banks' own resources, were handled by a handful of brokers. All this was pointed out in the interim report, together with statistics. Of the 57,980 transactions of over Rs. 9,00,000 crore in securities entered into by banks in 14 months from April 1, 1991, a mere 5.26 per cent was made up of outright purchases. More than two-thirds of these transactions were done by four foreign banks. Over 60 per cent of the transactions were carried out through brokers. Nearly 95 per cent of these transactions—worth Rs. 8,58,511 crore, constituted commitments to repurchase or resell securities. In more than 40 per cent of these transactions, the commitments were not documented, but were a mere matter of understanding.

Most banks, with a view to increasing their profits, employed their clients' funds in stocks through their brokers. This they did by offering higher returns through portfolio management.

The stock market index the BSE Sensex—rose by leaps and bounds. Harshad Mehta, by injecting the banks' money into share trading, pushed up prices of selected scrips. Besides the banks' funds, he tapped another source of money—mutual funds. The government was encouraging the creation of mutual funds. These mutual funds, in order to increase their popularity, assured higher returns which led to sizable flow of money to the stock market. Moreover, certain industrialists engaged themselves in 'insider trading' to raise the prices of their shares to prevent hostile takeovers. Brokers, with so much money in their hands, were successful in raising the Sensex by 1,500 points in 15 days.

The boom, which began in July 1991, peaked in April 1992, before the bubble burst. Prices of many scrips such as Apollo Tyres, ACC, Castrol India, East India Hotels, GE Shipping, GNFC, Deepak Fertilisers, and Tata Chemicals shot up three times their usual value in just a year's time. National Housing Bank, Bank of Karad, Metropolitan Cooperative Bank, Standard Chartered Bank, Citibank, Bank of America, ANZ Grindlays Bank, Canbank Financial Services, and many other institutions were involved in the boom.

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Between March 1991 and March 1992, the BSE sensitive index rose by more than three-and-a-half times—from 1,168 to 4,285. At the peak level, the market capitalisation of Rs. 3 lakh crore was about half of the GDP as compared to hardly one-fifth of the GDP in the previous year. The market price–earning (P/E) ratio at 55 was not only higher than what it was in many other developing and developed countries but was far in excess of the fundamentals. The monetary size of the securities fraud was estimated to be Rs. 3,542 crore. The Sensex dropped to 3,000 and the BSE was closed for a month when the scam came to light.

The scam highlighted the loopholes in the financial system, unfair trade practices in various instruments, widespread corruption, and wrong policies. The Reserve Bank banned inter-bank repos after the scam and the pace of reforms in the financial sector also increased.

The 2001 Scam (Ketan Parekh Scam)

All over the world, investment in ICE (Information Technology, Communication and Entertainment) shares was the trend. Ketan Parekh colluded with promoters of the new economy (ICE) shares and changed the complexion of the market by buying stock known as K-10 scrips. He succeeded in lifting scrips such as HFCL, Satyam, and Global to international P/E levels.

Parekh's modus operandi was to route orders through his three broking outfits and 40 satellite brokers. He had contacts with brokers in Kolkata and Ahmedabad, who were rewarded with *badla* payments. His source of funds was non-resident Indians and the new private sector banks who accepted shares as collateral. He would pledge shares with banks as collaterals when the share prices were high. Mutual funds and foreign institutional investors, by investing heavily in technology stocks, helped KP scrips to rise high. He placed shares of Satyam at a premium of Rs. 1,000 with UTI and the shares of HFCL for Rs. 1,400 with mutual funds and foreign institutional investors. Parekh would increase the liquidity of stock when there was a strong demand or buy aggressively if one of the portfolio stocks fell.

The bull run started in May–November 1999 when Parekh started his first major round of trading aggressively in HFCL, Global, Satyam, and Zee scrips. The Sensex rose from 3,378.4 to 4,491 points. The Sensex peaked at 6,100 points before it started falling due to a global meltdown in ICE shares. There was a sharp decline in prices due to factors such as the global economic slowdown, significant market capitalisation erosion at NASDAQ and other leading stock exchanges, and bear hammering on the Indian stock exchanges in sectors such as telecommunication, media, and information technology. The sudden, sharp fall in prices of these scrips resulted in a huge depletion in the margins on shares that were placed as securities with the banks. Consequently, the banks were, on the one hand, obliged to ask Parekh and his associates to either pledge more shares as collateral or return some of the borrowed money, and on the other, they were driven to prop the prices by pumping more money into the capital market. This resulted in a financial crunch for some major bull operators, which led to disputes in the Kolkata Stock Exchange (CSE). The crisis snowballed as the Kolkata brokers took more long positions than Parekh. Trading at Kolkata is 90 per cent unofficial. It is a cash *badla* market where Rs. 1,500–2,000 crore is rolled over every month at 21–30 per cent. As the circumstances developed, *badla* rates shot up to 80 per cent at the Kolkata stock exchange. So, Parekh defaulted on payment to Kolkata brokers which resulted in a payment crisis between March 12–17, 2001.

Seventy CSE brokers defaulted as the exchange plunged into crisis. The bear cartel on the BSE, which was bear hammering the market with inside information, was caught red-handed by the SEBI which suspended all seven broker members from the BSE governing board.

Ketan Parekh desperately borrowed huge sums from the Ahmedabad-based Madhavpura Mercantile Cooperative Bank (MMCB). The bank issued pay orders running into crores of rupees without receiving cash payment or collateral from Parekh. Pay orders are instruments issued between branches of a bank in one place. They are issued after the issuing bank collects the cash or has significant collateral. Hence, the discounting bank is sure of collection. As Parekh colluded with Ramesh Parekh, the chairman of MMCB, the latter issued pay orders without having a sufficient balance in the bank's accounts. The Bank of India (BOI) discounted Rs. 137 crore worth of pay orders which bounced. Ketan Parekh paid only Rs. 7 crore and the BOI went to a criminal court against him. The Reserve Bank specifically prohibits cooperative banks to invest in the stock market or to lend to stockbrokers. However, the latter are free to lend to individuals against a pledge of shares upto Rs. 10 lakh per borrower if the shares are in a physical form and upto Rs. 20 lakh if they are in a dematerialised form. MMCB flouted the norms of the Reserve Bank to earn higher rates of return.

The Crime Branch of India arrested Ketan Parekh on the charge of defrauding the BOI. The BSE Sensex plummeted from a peak of 6,100 points to 3,788.2 on March 30, 2001. The SEBI banned all deferral products, including *badla,* from all stock exchanges.

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Comparison of the Harshad Mehta Scam and the Ketan Parekh Scam

The Ketan Parekh scam appears to resemble the Harshad Mehta scam. Both adopted price rigging practices involving banks and mutual funds. Both took advantage of the loopholes and inadequacies in the financial system.

However, both scams are different and the difference lies in the instruments, securities, and the cause. While it was the old economy stocks, bank receipts, and SGL ledger accounts in the Harshad Mehta case, it was new economy stocks and misuse of pay orders in the Ketan Parekh scam. Harshad Mehta exploited public sector banks while Ketan Parekh misused the new private sector and cooperative bank funds. The Harshad Mehta scam indicated that capital market was free from checks and controls while the Ketan Parekh scam indicated that scams could and would occur inspite of checks and controls. The major cause of the crisis in the Ketan Parekh scam was the financial crunch resulting from bear hammering which caused a sharp fall in prices, while in 1992 crisis, the fall was an effect, not the cause of the crisis.

The Harshad Mehta scam was thought to be a bank scam rather than a securities scam as banks and institutions lost several thousand crores of rupees. It was the Harshad Mehta scam that prompted reform of the equity markets whereas the Ketan Parekh scam occurred when equity markets had radically transformed. Repos were banned by the Reserve Bank after the Harshad Mehta scam whereas in case of the Ketan Parekh scam, *badla* transactions were banned along with other deferral products.

Conclusion

This cycle of scams needs to be broken if an orderly development of the capital market for higher economic growth is to take place. It has been observed that regulators, instead of taking corrective measures, precipitate crisis. They have to be proactive instead of reactive. Regulators should develop a market intelligence system, which will give them early warning signals. The real culprits should be given deterrent punishment and there should be strict enforcement of directives and law. The capital market cannot function without the support of the banking system. If both are to survive, remain healthy and vibrant, both should develop an extra measure of self-discipline in the first instance.

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REFORMS IN THE CAPITAL MARKET

The 1991–92 securities scam prompted the government to increase the pace of reforms in the capital market. Several reform measures have been undertaken since then in both the primary and secondary segments of the equity market.

The Primary Capital Market

- The Securities and Exchange Board of India (SEBI) was set up in early 1988 as a non-statutory body under an administrative arrangement. It was given statutory powers in January 1992 through the enactment of the SEBI Act, 1992 for regulating the securities market. The two objectives mandated in the SEBI Act are investor protection and orderly development of the capital market.
- The Capital Issues (Control) Act, 1947 was repealed in May 1992, allowing issuers of securities to raise capital from the market without requiring the consent of any authority either for floating an issue or pricing it. Restrictions on right and bonus issues were also removed. The interest rate on debentures was freed. However, the new issue of capital has now been brought under the SEBI's purview and issuers are required to meet the SEBI guidelines for disclosure and investor protection, which are being strengthened from time to time to protect investor interest.
- The infrastructure of the primary capital market has been fairly diversified over the years with the setting up of a large number of merchant bankers, investment and consulting agencies, and registrars to the issue.
- The primary capital market has widened and deepened with public sector banks, financial institutions, and public sector enterprises in the infrastructure and power sectors increasingly raising resources from the market both by way of debt and equity.
- Although the process of institutionalisation of the market on the supply side started in 1987–88 when many mutual funds sponsored by banks and financial institutions were set up, it gained considerable momentum in the early 1990s when many mutual funds were set up in the private sector. There are now 37 mutual funds operating in the country with a total asset base of over Rs. 1 lakh crore.

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- The requirement to issue shares at a par value of Rs. 10 and Rs. 100 was withdrawn. This gave companies the freedom to determine a fixed value per share. This facility is available to companies which have dematerialised their shares. Moreover, the shares cannot be issued in the decimal of a rupee. The companies which have already issued shares at Rs. 10 or Rs. 100 per value are also eligible for splitting and consolidating the share values.
- Improved disclosure standards, prudential norms, and simplified issue procedures have been prescribed. Companies are required to disclose all material facts, specific risk factors associated with their projects while launching public issues and give justification for pricing on their prospectus. The offer document is not vetted by the SEBI but a code of advertisement for public issues, for ensuring fair and truthful disclosures has been introduced.
- To reduce the cost of the issue, underwriting by the issuer was made optional, subject to the condition that if an issue was not underwritten and in case it failed to secure 90 per cent of the amount offered to the public, the entire amount so collected would be refunded.
- One of the significant steps towards integrating the Indian capital market with the international capital markets was the permission given to foreign institutional investors such as mutual funds, pension funds, and country funds, to operate in the Indian market. Foreign institutional investors were initially allowed to invest only in equity shares; later, they were allowed to invest in the debt market, including dated government securities and treasury bills. The ceiling for investment by foreign institutional investors was increased from 40 per cent to 49 per cent in 2000–01. This increase can be made with the approval of shareholders through a special resolution in the general body meeting.
- Indian companies have also been allowed to raise capital from the international capital markets through issues of Global Depository Receipts, American Depository Receipts, Foreign Currency Convertible Bonds (FCCBs) and External Commercial Borrowings (ECBs). Companies were permitted to invest all ADR/GDR proceeds abroad. Two-way fungibility was announced for ADRs/GDRs in 2000–01 for persons residing outside India. Converted local shares could be reconverted into ADRs/GDRs while being subject to sectoral caps wherever applicable.
  - Various bottlenecks on the floatation of new capital issues, particularly for infrastructure projects, were removed. Requirements such as making a minimum public offer of 25 per cent of the issue, five shareholders per Rs. 1 lakh of offer, and a minimum subscription of 90 per cent are no longer mandatory for infrastructure companies.
  - With a view to helping infrastructure companies raise funds for their projects, their debt instruments are allowed to be listed on the stock exchanges without prior listing of equity. Corporates with infrastructure projects and municipal corporations are exempted from the requirements of Rule 19(2)(b) of the Securities (Contracts) (Regulation) Act, 1956 to facilitate the public offer and listing of its pure debt instruments as well as debt instruments fully or partly convertible into equity without requirement of prior listing of equity but are subject to conditions such as investment grade rating. The freedom to issue debt security without listing security granted to infrastructure companies and municipal corporations has been extended to all companies. This is subject to certain conditions. Issues below Rs. 100 crore shall carry an investment grade credit rating, issues above Rs. 100 crore shall carry an investment grade credit rating from two credit rating agencies; the issues shall comply with the provisions of Rule 19(2)(b) of the Securities Contracts (Regulation) Act, 1956 regarding the size of the public offer and the promoters shall bring in the equity contribution of 20 per cent and lock in the same for three years.
  - In respect of unlisted companies, the existing requirement of a track record of dividend payment in at least three of the preceding five years for asking an initial public offer (IPO) has been relaxed. Under the new norms, the companies will have to demonstrate an ability to pay dividend instead of showing an actual dividend paying record.
- Merchant bankers are prohibited from carrying on fund-based activities other than those related exclusively to the capital market. Multiple categories of merchant bankers have been abolished and there is only one entity, the merchant banker.
- Besides merchant bankers, various other intermediaries such as mutual funds, portfolio managers, registrars to an issue, share transfer agents, underwriters, debenture trustees, bankers to an issue, custodian of securities, venture capital funds and issues have also been brought under the purview of the SEBI.
- Since 1998–99, banks are permitted within the ceiling of 5 per cent of incremental deposits of the previous year prescribed for banks' investment in shares to (a) sanction bridge loans to companies against expected equity flows/issues for periods not exceeding one year and (b) extend loans to corporates against shares held by them to enable them to meet promoters' contribution to the equity of new companies in anticipation of raising resources. The approval of the bank's board is necessary.

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The prescription of the minimum margin of 50 per cent of loans to individuals against preference shares and debentures/bonds of corporate bodies is withdrawn. However, the margin of 50 per cent prescribed in respect of equity shares has been retained. Subsequently, the ceiling amount on advances against shares to individuals was increased from Rs. 10 lakh to Rs. 20 lakh against dematerialised securities while the minimum margin prescription was reduced from 50 per cent to 25 per cent for dematerialised shares.

- A code of conduct on advertisement has been issued for mutual funds, banning them from making any assurance or claims that might mislead the public.
- The entry norms for IPOs have been tightened by modifying the Disclosure and Investor Protection (DIP) guidelines. According to the new guidelines, IPOs five times the size of the pre-issue net worth are allowed only if the company has had a record of profitability and a net worth of Rs. 1 crore in three of the past 15 years. Companies without such a track record or a issue size beyond five times the pre-issue net worth are allowed to make IPOs only through the book-building route, with 60 per cent of the issue to be allotted to qualified institutional borrowers (QIBs). For shares issued on a preferential basis to any person by listing companies, a lock-in period of one year has been stipulated. Infrastructure companies are exempt from the requirement of eligibility norms if the project has been appraised by a public financial institution and not less than 5 per cent of the project cost is being financed by any of the institutions jointly or severally, by way of loans and/or subscription to equity.
- The SEBI DIP (Disclosure and Investor Protection) Guidelines, 2000 have been amended. Permission has been granted to foreign venture capital investors (FVCIs) registered with the SEBI and State Industrial Development Corporations (SIDCs) to participate in public issues through the book-building route as qualified institutional buyers (QIBs). There is no lock-in requirements for the pre-issue capital of an unlisted company held by venture capital funds (VCFs) and FVCIs. Exemption from the public offer requirement in view of a reduction in quantum from 25 per cent to 10 per cent and restriction of a minimum public issue size of Rs. 25 crore in respect of an IPO through the book-building issue have been removed.
- Companies in the IT, telecom, media, and entertainment sectors are allowed to tap the market with a minimum offering of 10 per cent of their equity. All public issues through this route have to satisfy the criterion of a minimum Rs. 100 crore issue size, follow the book-building route with an allocation of 60 per cent to QIBs, and maintain a minimum floating post-listing stock on a continuous basis.
- The issuer can make a public or rights offer of shares in demat form only. Investors have the option of subscribing to securities in either the physical or the dematerialised form.
- Every public-listed company making an IPO of any security for Rs. 10 crore or more is required to make an offer only in a dematerialised form.
- The SEBI prescribed new guidelines for regulating private placement of debt securities issued by the corporates. These guidelines aim to enhance transparency and protect the interest of investors in the debt securities.
- The SEBI introduced the green-shoe option facility in IPOs as a stabilisation tool for the post listing price of newly issued shares.
- The Central Listing Authority was set-up to ensure uniform and standard practices for listing the securities on stock exchanges.
- In 2001, the SEBI guidelines mandated a minimum level of public holding at 25 per cent for companies carrying out with fresh IPOs. Companies in infotech, media, and telecom sector were allowed to go public with a 10 per cent public stake. In order to ensure availability of floating stocks on a continuous basis and maintain uniformity for the purpose of continuous listing, a minimum public share-holding of 25 per cent was prescribed. This minimum 25 per cent public float would not only lead to an increase in the floating stock, but also to a higher public holding or control of shares with investors other than promoters which would make manipulation of stock prices difficult and boost liquidity in the market. According to a capital market study, there are over 136 companies in 'A' group alone with less than 25 per cent public float. According to the data provided by the National Stock Exchange, the average public holding in listed companies in India is only 13 per cent. Holding of Indian promoters in contrast is on an average as high as 48 per cent. Companies like Wipro whose public holding is just 6.74 per cent, Bharti Airtel (1.17 per cent), TCS (5.19 per cent), and several state-owned companies such as MMTC (0.02 per cent), ONGC (1.82 per cent), SAIL (2.08 per cent), BHEL (2.23 per cent), and NTPC (2.57 per cent) will be impacted by this move. This fall in public float was on account of a substantial rise in open offers arising from hostile takeover bids and mergers and acquisitions in the last few years; SEBI gave a time frame of two years to

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maintain this minimum level. Hence, to increase public stakes, promoters can either offload their existing equity shares in the open market through an offer for sale or issue fresh shares. This move failed to yield results as promoters resisted. In 2008, the government has made it mandatory for all listed firms, which do not have a public shareholding of 25 per cent, to increase their shareholding annually by 3–5 per cent.

- In March 2003, the SEBI introduced sweeping changes in IPO norms to boost investor confidence. It changed the eligibility criteria for IPOs—a track record of distributable profits was replaced by net tangible assets as it felt that profit figures could be fudged. According to the new norms, companies floating IPOs should have net tangible assets of Rs. 3 crore in each of the two preceding two years. Of this, not more than 50 per cent should be held in monetary assets–cash or its equivalent such as securities. It is now mandatory for companies changing their names to ensure that a minimum 50 per cent of the total revenues are derived from the business activity suggested by the new name.
- On March 29, 2005, the SEBI redefined the retail individual investor as one who applies or bids for securities of or for a value not exceeding Rs. 1 lakh. It hiked allocation for retail investors in a book-built issue from 25 per cent to 35 per cent and reduced allocation to high networth individuals (non-institutional) category. The allocation to high net-worth individuals was reduced to 15 per cent from 25 per cent. The market regulator also reduced the bidding period for a book-built issue. The SEBI reduced the bidding period from the current 5–10 days (including holidays) to 3–7 working days. It has given an option to listed issuers to either disclose price band in a red-herring prospectus/ an application form/an abridged prospectus or to disclose the price band/floor price atleast one day before opening of the bid. In order to improve contents and ensure uniformity in data display on the websites of the stock exchanges, the data will be made available for a further period of 3 days after the closure of the bid/issue. The new norms are applicable to all public issues whose offer documents are filed with the SEBI on or after April 4, 2005.
- For issues priced below Rs. 500 per share, the face value of the share should mandatorily be Rs. 10 per share. But if the issue price is Rs. 500 or more, the minimum face value should not go below Re. 1.
- Shares will now be allotted on a proportionate basis within the specified categories, with the pre-determined minimum allotment being equal to the minimum application size.
- During 2005–06 SEBI Disclosure and Investor Protection (DIP) Guidelines, 2000 relating to book-building issues were amended to introduce a specific allocation of 5 per cent for mutual funds, proportionate allotment to Qualified Institutional Buyers (QIBs) and margin requirement for QIBs.
- In order to ensure availability of floating stocks on a continuous basis and maintain uniformity for the purpose of continuous listing, a minimum public shareholding of 25 per cent was prescribed by SEBI in case of all listed companies barring a few exceptions.
- To assist the retail investors, SEBI gave in-principle approval for grading of IPOs by the rating agencies at the option of the issuers. SEBI will not certify the assessment made by the rating agencies.
- The disclosure requirements were rationalised during the year. Listed companies which have a satisfactory track record of filing periodic returns with the stock exchanges are exempted from repititive disclosures in case of rights and public issues by them. An issuer company is permitted to make a rights issue by dispatching an abridged letter of offer which shall contain disclosures as required to be given in the case of an abridged prospectus. A listed company can fix and disclose the issue price in case of a rights issue, any time prior to fixing of the record date in consultation with the designated stock exchange and in case of public issue through fixed price rate, at anytime prior to filing of the prospectus with the Registrar of Companies. In order to facilitate additional resource mobilisation, a company is permitted to issue further shares after filing a draft offer document with SEBI, provided full disclosures as regards the total capital to be raised from such further issues are made in the draft offer document.
- The facility of electronic clearing services (ECS) was extended to refunds arising out of public issue so as to ensure faster and hassle free refunds.
- Companies are permitted to take multiple routes to raise capital at the same time, even after a prospectus for an IPO or public offer is filed with the regulator. Companies are now only required to update their prospectus with details about the additional capital being raised through other routes. This new relaxation will help corporates to efficiently plan their capital-raising programmes.
- Venture Capital and private equity forms are barred to sell their stake in a company after its IPO. Now, only those firms that have invested more than a year before the company goes public can sell their shares on listing.
- For public/rights issues of debt instruments, credit rating from one credit rating agency would be sufficient now which had to be done from at least two agencies before. This was done to reduce the cost of issuance of debt instruments.

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- Stock exchanges have also undergone some major structural reforms. The boards of various stock exchanges have been made broad-based so that they represent different interests and not just the interests of their members. Stock exchanges, brokers, and sub-brokers have been brought under the regulatory purview of the SEBI.
- Companies are allowed to buy back their own shares for capital restructuring, subject to the condition that the buy back does not exceed 25 per cent of the paid-up capital and free reserves of the concerned company. This buy back has been allowed to improve liquidity and enhance wealth of the shareholder.
- The insider trading regulations have been formulated prohibiting insider trading and making it a criminal offence, punishable in accordance with the provisions under the SEBI Act, 1992.
- Regulations are also in place for take over and substantial acquisition of shares to make the take over process more transparent and mindful of the interests of small shareholders. In September 2002, the SEBI amended the Takeover Code by accepting the Bhagwati Committee recommendations on takeovers. As per the new code, if an acquirer gains control of over 15 per cent in a company which already owns 15 per cent in another company, the acquirer has to declare open offers for shareholders of both the companies. Also, any change in management control will result in an open offer, even though the equity stake is below 15 per cent. Shareholders can withdraw shares already tendered in an open offer and sell them in the open market or to another acquirer at a higher price. Acquirers now have to disclose their holdings in companies at various levels of acquisitions such as 5 per cent, 10 per cent, and 14 per cent. Once the holding touches the 15 per cent mark, the acquirer then has to make disclosures at every 2 per cent acquisition, thereby ensuring full transparency in acquisition.
- An index-based market wide 'circuit breaker' system has also been introduced to check a sudden rise in security price, in speculation and over-trading. This system becomes active at three stages of the index movements either way, at 10 per cent,15 per cent and 20 per cent. As an additional measure of safety, individual scrips-wise bands of 20 per cent either way can be imposed for all securities except those available for stock options.
- In February 1999, trading terminals were allowed to be set up abroad for facilitating market participation by non-residents. Internet trading was permitted in February 2000.
- For ensuring greater market transparency, SEBI, in 1999, banned negotiated and cross deals (where both the seller and buyer operate through the same broker). Moreover, all private off-market deals in both shares as well as listed corporate debts were banned. So these deals are routed only through trading screens.
- Since June 2000, trading of futures has begun. Both the NSE and the BSE have created proper facilities for derivatives trading, including conducting of regular training programmes for the same. The Securities Contracts (Regulation) Act, 1956 has been amended for introduction of options trading. Trading of index-based and stock-based options started in June and July 2001 respectively while trading of stock-based futures began in November 2001.
- It is mandatory for listed companies to announce quarterly results. This enables investors to keep a close track of the scrips in their portfolios. The declaration of quarterly results is in line with the practice prevailing in the stock markets in developed countries.
- To check price manipulation, mandatory client code and minimum floating stock for continuous listing were stipulated in November 2001.
- The government amended the Securities Contracts (Regulation) Rules, 1957 to standardise listing requirements at stock exchanges.
- A 99 per cent value at risk (VaR) based margin system for all scrips in rolling settlement was introduced from July 2, 2001.
- The central government has notified the establishment of the Investor Education and Protection Fund (IEPF) with effect from October 1, 2001. The IEPF will be utilised for the promotion of awareness amongst investors and protection of their interests.
- The restriction on short sales announced in March 7, 2001, was withdrawn with effect from July 2, 2001, as all deferral products stand banned after that date.
- It is mandatory for all brokers to disclose all details of block deals. Block deals include trading which accounts for more than 0.5 per cent of the equity shares of that listed company.
- With a view to providing greater liquidity in the secondary securities market, the SEBI allowed corporate brokers with a net worth of atleast Rs. 3 crore to extend margin trading facility to their clients in the cash segment of stock exchanges.
- A clearing corporation/clearing house, after registration with the SEBI, under the SEBI scheme for Securities Lending and Borrowing, as an approved intermediary may borrow securities for meeting shortfalls in settlement on behalf of the member.

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- The SEBI has made it mandatory for every intermediary, to make an application for allotment of unique identification numbers for itself and for its related persons, under the SEBI (Central Data Base of Market Participants) Regulations, 2003. This move aims to promote up-to-date information about all market participants. This will be made mandatory for investors and companies at a later date.
- Stock exchanges were advised to amend Clause 41 of the Listing Agreement to make it mandatory for listed companies to publish the number of investor complaints received, disposed of, unresolved along with quarterly results.
- Clearing and settlement cycle time was further contracted to T+2 with effect from April 1, 2003.
- With a view to strengthening the position, specifying accountability and protecting the interest of investors, the SEBI defined the roles of the chief executive officer and fund manager of mutual funds. It prescribed a uniform cut-off time for calculating and applying NAVs, both for subscriptions and redemptions. It also prescribed the minimum number of investors in a scheme. Further, it specified that no single investor should hold more than 25 per cent of the corpus of any scheme/plan.
- SEBI allowed mutual funds to invest in derivative securities. They were also permitted to invest upto 10 per cent of the net assets as on January 31 of each year in foreign securities with the limit of minimum US $5 million and maximum of US $50 million.
- Interest rate futures contracts were introduced in June 2003 and futures and options contracts on sectoral indices were introduced in August 2003.
- FIIs and NRIs were permitted to invest in all exchange-traded derivative contracts.
- Stock brokers were allowed to trade in commodity derivatives.
- FIIs were allowed to participate in delisting offers, sponsored ADR/GDR programmes and disinvestment by the government in listed companies.
- In order to facilitate execution of large trades without impacting the market, the stock exchanges were permitted to provide a separate trading window for block deals subject to certain conditions. The BSE and the NSE activated this window with effect from November 14, 2005.
- In order to prevent off-market trades prior to the commencement of trading, the International Securities Identification Numbers (ISINs) of IPOs will be activated by the depositories only on the date of commencement of trading on the stock exchanges.
- The Depositories/DPs cannot levy any charges when a BO transfers all securities lying in his/her account to another branch of the same depository participant (DP) or to another DP of the same depository or another depository, provided the BO accounts at the transferee DP and at transferor DP are one and the same
- In order to protect the interest of minority shareholder, the Securities Contracts (Regulation) Act was amended in 2004 to recognise delisting. The draft delisting rules notified by the department of economic affairs on October 30, 2006 state that stock exchanges will have to compulsorily delist a company if
  - it has suffered losses during the preceding three consecutive years and its net worth has turned negative.
  - trading in its securities has remained suspended for more than six months, or if the securities have been 'infrequently traded' during the preceding three years.
  - it violates SCR Act or Sebi Act or the Depositories Act or rules and regulations thereunder, that warrant a penalty of Rs. 1 crore or less than three years punishment.
  - it vanishes or furnishes false addresses or there is an unauthorised change of registered office.
  - the public shareholding in the company shrinks to below the minimum level prescribed in the listing agreement.

These apart, a company can opt for delisting if it has been listed in a recognised exchange for a minimum period of three years or the delisting has been approved by three-fourth of the shareholders in a general body meeting or the promoters commit to buy the outstanding securities of the minority and non-promoter holders.

SEBI amended the listing agreement in December 2007 to improve the transparency with regard to utilisation of issue proceeds. Any company making a public offer or rights issue of more than Rs. 500 crores has to appoint a monitoring agency to monitor the utilisation of issue proceeds.

From April 21, 2008, all institutional trades in the cash market are margined on a T+1 basis with margin being collected from the custodian upon confirmation of the trade. Subsequently, with effect from June 16, 2008, the collection of margins moved to an upfront basis.

In April 2008, SEBI allowed all classes of investors to short sell subject to a broad framework. SEBI also set up a full-fledged securities lending and borrowing (SLB) scheme for all participants in the market

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under the overall framework of 'Securities Lending Scheme, 1997'. Naked short selling is not allowed and FIIs are prohibited from day trading.

Comprehensive risk management for the cash market and margining of institutional trades in the cash market have been specified by SEBI. In September 2008, SEBI introduced trading in rights entitlements.

Brokers can offer to their clients an electronic facility known as Direct Market Access Facility (DMA), which enables their clients to place orders directly into an exchange-traded system.

Elements of Market Design in Indian Securities Market, 1992 and 2003

Features 1	*1992* 2	*2003* 3
Regulator	No specific regulator, but central government oversight.	A specialised regulator for securities market (SEBI) vested with powers to protect investors' interest and to develop and regulate securities market. The SROs strengthened.
Intermediaries	Some of the intermediaries (stock brokers, authorised clerks and remisiers) regulated by the SROs.	A variety of specialised intermediaries emerged. They are registered and regulated by the SEBI (Also by the SROs). They as well as their employees are required to follow a code of conduct and are subject to a number of compliances.
Access to Market	Granted by central government.	Eligible issuers access the market after complying with the issue requirements.
Pricing of Securities	Determined by central government.	Determined by market, either by the issuer through fixed price or by the investors through book building.
Access to International Market	No access.	Corporates allowed to issue ADRs/GDRs and raise ECBs. ADRs/GDRs have two-way fungibility. FIIs allowed to trade in indian market. MFs also allowed to invest overseas.
Corporate Compliance	Very little emphasis.	Emphasis on disclosures, accounting standards and corporate governance.
Mutual Funds	Restricted to public sector.	Open to private sector and emergence of a variety of funds and schemes.
Trading Mechanism	Open outcry, available at the trading rings of the exchanges, opaque, auction/negotiated deals.	Screen-based trading system, orders are matched on price–time priority, transparent, trading platform accessible from all over country.
Aggregation Order Flow	Fragmented market through geographical distance. Order flow unobserved.	Order flow observed. The exchanges have Open Electronic Consolidated Limit Order Book (OECLOB).
Anonymity in Trading	Absent.	Complete.
Settlement System	Bilateral.	Clearing house of the exchange or the clearing corporation is the central counter-party.
Settlement Cycle	14-Day account period settlement, but not adhered to always.	Rolling settlement on a T+2 basis.
Counter-party Risk	Present.	Absent.
Form of Settlement	Physical.	Mostly electronic.
Basis of Settlement	Bilateral netting.	Multilateral netting.
Transfer of Securities	Cumbersome. Transfer by endorsement on security and registration by issuer.	Securities are freely transferable. Transfers are recorded electronically in book entry form by depositories.
Risk Management	No focus on risk management.	Comprehensive risk management system encompassing capital adequacy, limits on exposure and turnover, VaR based margining client-level gross margining, and on-line position monitoring.
Derivatives Trading	Absent.	Exchange-traded futures and options available on two indices and select securities.

Source: Chartered Secretary, April 2004, p. 485.

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6

The Primary Market

Chapter Objectives

This chapter will enable you to develop an understanding of the following:

1. *Fund-raising through prospectus, rights issues, private placement, and preferential issues*
2. *Book building : a new issue mechanism*
3. *Green-Shoe option*
4. *On-line IPOs*
5. *Trends in resources mobilised from the primary market*
6. *Trends in resources mobilised from international capital markets*

INTRODUCTION

The primary market is a market for new issues. It is also called the new issues market. It is a market for fresh capital. Funds are mobilised in the primary market through prospectus, rights issues, and private placement.

Bonus issue is also one of the ways to raise capital but it does not bring in any fresh capital. Some companies distribute profit to existing shareholders by the way of fully paid bonus shares instead of paying them a dividend. Bonus shares are issued in the ratio of the existing shares held. The shareholders do not have to pay for bonus shares but the retained earnings are converted into capital. Thus, bonus shares enable the company to restructure its capital.

Bonus is the capitalisation of free reserves. Higher the free reserves, higher are the chances of a bonus issue forthcoming from a corporate. Bonus issues create excitement in the market as the shareholders do not have to pay for them and in addition, they add to their wealth. A bonus issue results in an increase in the company's equity capital. A 1:1 bonus doubles the company's equity base. A bonus issued by a company indicates management's confidence in strong earnings, growth and maintenance of its present level of dividend rate in the future. Companies issue bonus shares for varied reasons.

- To boost liquidity of their stock: A bonus issue results in expansion of equity base, increasing the number of absolute shares available for trading.
- To bring down the stock price: A high price often acts as a deterrent for a retail investor to buy a stock. The price of a stock falls on becoming ex-bonus because an investor buying shares, ex-bonus is not entitled to bonus shares. For instance, a scrip trading at Rs. 600 cum-bonus with a 1:1 bonus begins trading at around Rs. 300 ex-bonus.
- To restructure their capital, companies with high reserves prefer to issue bonus shares as the issue not only restructures their capital but since they are perceived to be likely candidates for bonus issue by investors, they fulfil the expectation of investors.

In India, new capital issues are floated through prospectus, rights, and private placement by government companies, non-government public limited companies (private sector), public sector undertakings, banks, and financial institutions.

Issues are offered to the public through prospectus and the public subscribes directly. Section 67 of the Companies (Amendment) Act, 2000 provides that where the offer or invitation to subscribe for shares or debentures is made to 50 or more persons, then such an offer or invitation shall be deemed to be a public offering and shall have to comply with all the provisions of the act as well as the SEBI guidelines applicable to such public offerings. Public issues are open to the general public. Wide publicity about the offer is given through the media. In the past, the job of organising public issues was generally entrusted to prominent brokers but that practice has now given way to the appointment of a merchant banker for the purpose.

The direct sale of securities by a company to some select people or to institutional investors is called private placement. No prospectus is issued in private placement. Private placement covers equity shares, preference shares, and debentures. It offers access to capital more quickly than the public issue and is quite inexpensive on account of the absence of various issue related expenses.

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There are three categories of participants in the primary market. They are the issuers of securities, investors in securities, and intermediaries. The last named render services to both the issuers and investors to enable the sale and purchase of securities.

Intermediaries to an Issue

There are different intermediaries to an issue such as merchant bankers or book running lead managers (BRLM), syndicate members, registrars to the issue, bankers to the issue, auditors of the company and solicitors. The issuer discloses the addresses, telephone, fax numbers and email addresses of these intermediaries.

- Book Running Lead Manager (BRLM) is a lead merchant banker appointed by the issuer company and whose name is mentioned in the offer document of the company

Merchant Banker A merchant banker should be registered with the SEBI as per the SEBI (Merchant Bankers) Regulations, 1992 to act as a book running lead manager (BRLM) to an issue. The lead merchant banker performs most of the pre-issue and post-issue activities. The pre-issue activities of the lead manager include due diligence of company's operations/management/business plans/legal etc., drafting and designing offer document, finalising the prospectus, drawing up marketing strategies for the issue, and ensuring compliance with stipulated requirements and completion of prescribed formalities with the stock exchanges and the Registrar of Companies (ROC).

The post-issue activities include management of escrow accounts, coordinating, non-institutional allocation, intimation of allocation, coordination with the registrar for dispatching of refunds, dematerialising of securities, listing and trading of securities, and coordinating the work of other intermediaries involved in the issue process.

Registrar to the Issue The role of the registrar is to finalise the list of eligible allottees, ensure crediting of shares to the demat accounts of the eligible allottees, and dispatch refund orders.

Bankers to the Issue They are appointed in all the mandatory collection centres, and by the lead merchant banker to carry out activities relating to collection of application amounts, transfer of this amount to escrow accounts, and dispatching refund amounts.

It is now mandatory to issue all new initial public offerings (IPOs) in dematerialised form as they are compulsorily traded in dematerialised form.

FREE PRICING REGIME

Before 1992, the Controller of Capital Issues (CCI) used to regulate the new issues market under the Capital Issues (Control) Act, 1947. Companies had to obtain approval from the CCI for raising funds in the primary market. The timing, quantum, and pricing of the issue were decided by the controller. New companies could issue shares only at par, while the existing companies with substantial reserves could issue shares at a premium. This premium was based on a prescribed formula set by the CCI. The formula was based on balancing the two criteria, viz., the net assets value and price earnings value. The issue price was set far below the market price of the company's share. This fixed price mechanism resulted in underpricing of many issues.

In 1992, the Capital Issues (Control) Act, 1947 was repealed and all controls relating to raising of resources from the market were removed. Hence, now the promoters (issuers of securities) do not require the consent of any authority either for making the issue or for pricing it. The promoter and his merchant banker together decide the price of the issue. Both new and established companies are free to decide the price of their issue.

There emerged under free pricing, an alliance of dishonest promoters and greedy merchant bankers. They brought out issues with rosy but unreal projections and sold shares at very high premiums. These projections never materialised, leading to a crash in prices. Moreover, companies with a negative bottom line came back with repeated rights issues at a premium. Issues of all kinds and premiums unheard of in corporate history were made in the early days of free pricing. These issues killed the primary market. Most of these issues were quoted below their offer price on the day they were listed at the stock exchange. Of the 4,000 issues that hit the market in 1992–96, more than 3,000 quoted below their offer price on the very day they were listed. For example, Saurashtra Cements hit the market in September 1993 at Rs. 250 per share. It stood at Rs. 85 when it was listed on the stock exchange; today it fetches only Rs. 8. The free market became a free falling market in numerous cases.

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The regulator brought in strict regulations for merchant bankers, brokers, and others, and laid down guidelines for full disclosures for investors' protection. Unfortunately, this was done only when the small investors had fled the market. Today promoters are required to justify the issue price in the prospectus and make material disclosures about the risk factors in the offer document.

BOOK BUILDING—A NEW ISSUE MECHANISM IN INDIA

The mechanics of determining the offer price during the CCI regime was to offer the share at a fixed price. Here, the firm and the merchant banker decided an offer price without taking into account the investor's feedback. Fixed price offerings were made to uninformed investors. Moreover, there was a long time lag from the date of pricing to the date the issue opened, and to the date trading commenced. This raised the possibility of price fluctuations in the intervening period. Empirical evidence supports the view that fixed price offering results in high cost of capital for firms due to under-pricing of shares for attracting subscription.

The pricing pattern changed in the free pricing era. This era was characterised by unrealistic and abrupt pricing structure, which stripped the radiance of the capital market. Investors shied away from the market after burning their fingers in those premium issues that are now being quoted not only below their issue price but even below their par value.

Methods for Determining the Offer Price

- Fixed Price
- Book Building

Following the inefficient functioning of the capital market system, an alternative method, called the book building method, is slowly becoming popular in India. Book building is a mechanism through which an offer price for IPOs based on the investors' demand is determined. In the fixed price method, the investors' demand is not taken into account; the book building method explicitly uses investors' demand for shares at various prices as an important input to arrive at an offer price.

Globally, book building is a recognised mechanism for capital raising. It was book building which built the US market almost entirely in the 1940s and 1950s.

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

The book building is basically an auction of shares. Book building essentially means that the 'book is being built.' During the process on both the NSE and the BSE, investors can watch the book being built–a chart shown indicates the bid price and the number of shares being bid for. This helps the investor to know the market price. It offers investors the opportunity to bid collectively. It then uses the bids to arrive at a consensus price.

The issue of securities through book building prior to August 2009 could be done in either of the following two ways: 75 per cent book building known as partial book building and 100 per cent known as one-stage book building. The SEBI allowed partial book building with only 75 per cent of the total issue allotted for the book built portion; the remaining 25 per cent has to be compulsorily offloaded in the general market at a fixed price discovered during the book building process. The IPOs of Hughes Software and HCL Technologies are examples of partial book building which were successful. A 100 per cent book building issue implies that the entire issue is completed in a single stage, without having to make a mandatory fixed price offering. The option of 100 per cent book building was available only to those issuer companies which are to make an issue of capital of and above Rs. 100 crore. Due to these restrictive guidelines, no issue was floated using this mechanism. These guidelines were modified in 1998–99. The ceiling of issue size for book building was reduced from Rs. 100 crore to Rs. 25 crore. Bharti Televentures

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Difference Between Shares Offered Through Book Building and Offer of Shares Through Normal Public Issues

Features	*Fixed Price Process*	*Book Building Process*
Pricing	Price at which the Securities are Offered/Allotted is Known in Advance to the Investor.	Price at which Securities will be Offered/Allotted is Not Known in Advance to the Investor. Only an Indicative Price Range is Known.
Demand	Demand for the Securities Offered is Known Only After the Closure of the Issue.	Demand for the Securities Offered can be Known Everyday as the Book is Built.
Payment	Payment is Made at the Time of Subscription Wherein Refund is Given After Allocation.	Payment Only After Allocation.

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was the first 100 per cent book building issue. It raised Rs. 834 crore through 100 per cent book building in 2001–02. The 100 per cent book building route speeds up the public offering and allotment processes as they take place entirely through the stock exchange network. The National Stock Exchange (NSE) and the Bombay Stock Exchange(BSE) provide a real time graphic display of price and volumes of applications made towards a book building issue through the stock exchange network. This system aids in better price discovery and transparency as institutional investors have the necessary expertise to analyse the information. The 100 per cent book building route provides the option to defer or scrap the issue if the discovered price is inappropriate. Because most issuers preferred 100 per cent book building, the SEBI withdrew the 75 per cent book building option.

- Book building is a process by which demand for the proposed issue is elicited and built-up and the price at which the securities will be issued is determined on the basis of the bids received

The Book Building Process

- The company (issuer) first of all appoints one or more merchant banker(s) as book runner(s) and their name(s) shall be disclosed in the draft red herring prospectus. The lead merchant banker shall act as the lead book runner and shall be primarily responsible for the book building. There shall be only one lead book runner and if the issuer appoints more than one, they shall either be co-book runners or syndicate members.
- The lead book runner and co-book runners shall compulsorily underwrite the issue and the syndicate members shall sub-underwrite with the lead book runner/co-book runners. A 'syndicate member' means an intermediary registered with the SEBI and who is permitted to carry on the activity as an underwriter;

The details of final underwriting arrangement indicating actual numbers of shares underwritten shall be disclosed and printed in the prospectus before it is registered with the Registrar of Companies.

- The issuer shall enter into an agreement with one or more of the stock exchange(s) which have the system of on-line offer of securities. The agreement shall specify inter-alia, the rights, duties, responsibilities, and obligations of the issuer and recognised stock exchange(s) inter se.
- The book runner(s)/syndicate members shall appoint stock brokers who are members of the recognised stock exchange and registered with the SEBI, for the purpose of accepting bids, applications and placing orders with the issuer and ensure that the stock brokers so appointed are financially capable of honouring their commitments arising out of defaults of their clients/investors, if any. In case of Application Supported by Blocked Amount, Self-certified Syndicate Banks shall also accept and upload the details of such applications in electronic bidding system of the stock exchange(s). A 'Self-certified Syndicate Bank' means a banker to an issue registered with the SEBI, which offers the facility of Application Supported by Blocked Amount. The stock brokers and Self-certified Syndicate Bank accepting applications and application monies shall be deemed as 'bidding/collection centres'.

- Book Running Lead Manager (BRLM) is a lead merchant banker appointed by the issuer company and whose name is mentioned in the offer document of the company

The underwriters also collect information from potential buyers and attempts to build interest. Part of the process of collecting this information is a road show, so named because the underwriter goes from city to city making presentations about the company and the offering. The road show is conducted in the form of a press release, a broker–analyst meet and investor meet.

- The lead merchant banker shall file with the SEBI a draft red herring prospectus containing all the disclosures including total issue size, if applicable, except the price and the number of specified securities to be offered.
- Book building was first introduced in 1999 with the concept of a price band. Price band includes the floor price and the cap price. For instance, the PNB issue's price band was Rs. 350–390. Rs. 350 is the floor price–the minimum bid—and Rs. 390 is the cap price. Investors can bid at any price between Rs. 350 and Rs. 390. However, in April 2000, the SEBI moved to the concept of a fixed floor price, which led to underpricing as maximum bids were received at or just above the floor price. The SEBI reintroduced the moving price band concept in book built IPOs. In a moving price band, the range can be moved, upwards or downwards, depending on the demand and the direction in which the book is being built. The band can be moved by 20 per cent (earlier 50 per cent) either way.
- The issuer may mention the floor price or price band in the red herring prospectus.
  a. If the issuer opts not to make the disclosure of the price band or floor price in the red herring prospectus, the following shall also be disclosed in the red herring prospectus:
     i. a statement that the floor price or price band, as the case may be, shall be disclosed at least two working days (in case of an initial public offer) and at least one working day (in case of a further public offer) before the opening of the bid;

- Red Herring Prospectus is a prospectus which does not have details of either price or number of shares being offered or the amount of issue

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2. In case of a book built issue, the price of the specified securities offered to an anchor investor shall not be lower than the price offered to other applicants.
3. In case of a composite issue, the price of the specified securities offered in the public issue may be different from the price offered in rights issue and justification for such price difference shall be given in the offer document.

Whenever fully convertible debt instruments (FCDs) are issued bearing interest at a rate less than the bank rate, the offer document shall contain disclosures about the price that would work out to the investor, taking into account the notional interest loss on the investment from the date of allotment of FCDs to the date(s) of conversions.

- A public issue shall be kept open for at least three working days but not more than ten working days, including the days for which the issue is kept open in case of revision in price band. In case the price band in a public issue made through the book building process is revised, the bidding (issue) period disclosed in the red herring prospectus shall be extended for a minimum period of three working days provided that the total bidding period shall not exceed ten working days. In other words, a bid is usually open for three and not more than seven working days, which may be extended to a maximum of ten working days, in case the price band is revised.
- The issuer shall, after registering the red herring prospectus (in case of a book built issue) or prospectus (in case of fixed price issue) with the Registrar of Companies, make a pre-issue advertisement in one English national daily newspaper with wide circulation, Hindi national daily newspaper with wide circulation, and one regional language newspaper with wide circulation at the place where the registered office of the issuer is situated. The pre-issue advertisement shall include the following details: name and address of the registered office of the issuer and the lead book runner/merchant bankers, and details of the issue such as nature of the specified security, size of the issue, face value of the security, price band, the proportion of shares to be allotted to different categories of investors including anchor investor, proposed listing, disclaimer clause, time period of the opening and closing of the issue, IPO grading, and names of the bankers to the issue. The issue advertisements shall also disclose the financial ratios calculated for both upper and lower end of the price band.

Bidding Process

1. Bidding process shall be only through an electronically linked transparent bidding facility provided by recognised stock exchange(s).
2. The lead book runner shall ensure the availability of adequate infrastructure with syndicate members for data entry of the bids in a timely manner.
3. The syndicate members shall be present at the bidding centres so that at least one electronically linked computer terminal at all the bidding centres is available for the purpose of bidding.
4. During the period the issue is open to the public for bidding, the applicants may approach the stock brokers of the stock exchange/s through which the securities are offered under on-line system or Self Certified Syndicate Banks, as the case may be, to place an order for bidding for the specified securities.
5. Every stock broker shall accept orders from all clients/investors who place orders through him and every Self Certified Syndicate Bank shall accept Applications Supported by Blocked Amount from ASBA investors.
6. Applicants who are qualified institutional buyers shall place their bids only through the stock brokers who shall have the right to vet the bids.
7. The bidding terminals shall contain an on-line graphical display of demand and bid prices updated at periodic intervals, not exceeding 30 minutes.
8. At the end of each day of the bidding period, the demand including allocation made to anchor investors shall be shown graphically on the bidding terminals of syndicate members and websites of recognised stock exchanges offering electronically linked transparent bidding facility, for information of public.
9. The investors (except ASBA investors) may revise their bids.
10. The qualified institutional buyers shall not withdraw their bids after closure of bidding.
11. The identity of qualified institutional buyers making the bidding shall not be made public.
12. The stock exchanges shall continue to display on their website, the data pertaining to book built issues in an uniform format, inter alia giving category-wise details of bids received, for a period of atleast three days after closure of bids.

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- The margin collected from categories other than Qualified Institutional Buyers shall be uniform across the book runner(s)/syndicate members /Self-certified Syndicate Banks for each such investor category.

An amount of not less than 10 per cent of the application money in respect of bids placed by qualified institutional buyers and not less than 25 per cent of the application money from the Anchor investors was taken as margin money till April 30, 2010. In order to avoid inflated demand in public issues and provide level playing field to all investors subscribing for securities, all types of investors are required to bring in 100 per cent of the application money as margin money along with the application for securities in public issues.

Determination of Price

1. The issuer shall, in consultation with lead book runner, determine the issue price based on the bids received.
2. On determination of the price, the number of specified securities to be offered shall be determined (i.e., issue size divided by the price to be determined).
3. Once the final price (cut-off price) is determined, all those bidders whose bids have been found to be successful (i.e., at and above the final price or cut-off price) shall be entitled for allotment of specified securities.
4. Retail individual investors may bid at 'cut off' price instead of their writing the specific bid price in the bid forms.
5. The lead book runner may reject a bid placed by a qualified institutional buyer for reasons to be recorded in writing provided that such rejection shall be made at the time of acceptance of the bid and the reasons therefore shall be disclosed to the bidders.

Necessary disclosures in this regard shall also be made in the red herring prospectus.

Registering of Prospectus with Registrar of Companies

The final prospectus containing all disclosures in accordance with the provisions of these regulations including the price and the number of specified securities proposed to be issued shall be registered with the Registrar of Companies.

Applications Supported by Blocked Amount (ASBA) Process

The SEBI launched an alternate payment system for book built public issues in August 2008. The alternate payment system, called additional mode of payment through ASBA, exempts retail investors from making full advance payment and instead let the amount to be retained in bank accounts till the completion of allotment. This system co-exists with the current process, wherein cheque is used as a mode of payment by retail investors. ASBA can be used only for retail investors and on an optional basis.

ASBA is an application for subscribing to an issue, containing an authorisation to block the application money in a bank account. This system does away with the refund process and thereby reduces the time between an issue and its listing. ASBA Process is as follows:

- An ASBA investor shall submit an ASBA physically or electronically through the internet banking facility to the Self-certified Syndicate Bank (SCSB) with whom the bank account to be blocked is maintained. SCSB is a bank which offers the facility of applying through the ASBA process. ASBAs can be accepted only by SCSBs, whose names appear in the list of SCSBs displayed in SEBI's website.
- The SCSB shall then block the application money in the bank account specified in the ASBA, on the basis of an authorisation to this effect given by the account holder in the ASBA. The application money shall remain blocked in the bank account till finalisation of the basis of allotment in the issue or till withdrawal/failure of the issue or till withdrawal/rejection of the application, as the case may be.
- The SCSB shall upload the details in the electronic bidding system of the BSE or NSE.
- Once the basis of allotment is finalised, the Registrar to the Issue shall send an appropriate request to the SCSB for unblocking the relevant bank accounts and for transferring the requisite amount to the issuer's account. In case of withdrawal/failure of the issue, the amount shall be unblocked by the SCSB on receipt of information from the pre-issue merchant bankers.

- ASBA is an application by retail investors for subscribing to an issue, containing an authorisation to block the application money in a bank account.

The public issue of 20 microns was the first IPO to hit the market in September 2008 with ASBA facility for retail investors.

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Twenty four SCSBs are providing ASBA services. The SCSBs work as a single window intermediary – they collect applications, block application money in the investors' bank accounts, debit the investors' accounts, and transfer money to the escrow account on allotment of shares. The SCSB also sends aggregate information of total number of applications, shares bid for and amount to the registrar who will then reconcile the data and verify it for correctness with depository's data base. Thus, ASBA has simplified the share application and refund process.

- All investors including retail, high net worth individuals (HNIs), corporate investors, and qualified institutional buyers are eligible to apply through ASBA in public issues

The SEBI extended the ASBA facility to rights issues, The rights issues of TATA Motors and Sadhana Nitro Chem were the first to make use of this facility when the issues opened on September 29, 2008. In case of rights issues, all shareholders would be able to make use of this facility while in book-built public issues, it is the retail shareholders only who can make use of this facility. ASBA process in rights issue will enable a shareholder of the company as on record date to apply through ASBA mode by selecting the option of ASBA in the application form of rights issue to the SCSB with whom the bank account to be blocked is maintained. The rest of the process is similar to that of IPOs.

The SEBI extended this payment mode to all investors in public issues opening on or after May 1, 2010. The SEBI extended ASBA facility to the investors subscribing to new fund offers (NFOs) of mutual fund schemes launched on or offer July 1, 2010.

Allotment/Allocation in Book Built Issue

- Incase of lights issues, all shareholders of the issuer company as on the record date are eligible, provided if he/she/it:
  - (a) is holding shares in dematerialised form and has applied for entitlements
  - (b) is not a renouncee to the issue
  - (c) applies through a bank account maintained with SCSBs

In case an issuer company makes an issue of 100 per cent of the net offer to public through 100 per cent book building process:

1. not less than 35 per cent of the net offer to the public shall be available for allocation to retail individual investors;
2. not less than 15 per cent of the net offer to the public shall be available for allocation to non institutional investors i.e., investors other than retail individual investors and qualified institutional buyers;
3. not more than 50 per cent of the net offer to the public shall be available for allocation to qualified institutional buyers.

Provided that, in respect of issues made under Rule 19(2)(b) of Securities Contract (Regulation) Rules 1957 (issues for less than 25 per cent of the post-issue capital of the company), with 60 per cent mandatory allocation to qualified institutional buyers, the percentage allocation to retail individual investors and non-institutional investors shall be 30 per cent and 10 per cent, respectively.

In an issue made through the book building process, the issuer may allocate upto 30 per cent of the portion available for allocation to qualified institutional buyers to an anchor investor.

Out of the portion available for allocation to qualified institutional buyers, 5 per cent shall be allocated proportionately to mutual funds. Mutual fund applicants shall also be eligible for proportionate allocation under the balance available for Qualified Institutional Buyers.

- QIBs are prohibited to withdraw their bids after the close of the IPO, whereas retail and non-institutional bidders can withdraw till the day of allotment

Let us understand the allotment of shares to QIBs with the help of an illustration. Suppose the issue size is 100 crore shares, then 50 crore shares will be allocated to all QIBs including anchor investors, if any, and mutual funds. Out of 50 crore shares, anchor investors will be allocated 15 crore (30 per cent of 50 crore) shares and the remaining 35 crore shares will be allocated to the rest of the QIBs. Of the 35 crore shares, mutual funds will be allocated 1.75 crore (5 per cent of 35 crore) equity shares and the balance (33.5 equity shares) for all QIBs including mutual funds.

Allotment shall be made not later than 15 days from the closure of the issue failing which, interest at the rate of 15 per cent shall be paid to the investors.

According to Clause 2.1 (zd)of the SEBI (Issue of Capital and Disclosure Requirements) Regulations 2009, a QIB shall mean

- a public financial institution as defined in Section 4A of the Companies Act, 1956;
- scheduled commercial banks;
- mutual funds;
- foreign institutional investors and sub-account (other than a sub-account which, is a foreign corporate or foreign individual), registered with the SEBI;
- multilateral and bilateral development financial institutions;
- venture capital funds registered with the SEBI;
- foreign venture capital investors registered with the SEBI;
- state industrial development corporations;
- insurance companies registered with the Insurance Regulatory and Development Authority (IRDA);

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- provident funds with the minimum corpus of Rs. 25 crores; and pension funds with the minimum corpus of Rs. 25 crores;
- National Investment Fund set up by resolution no. F.No.2/3/2005-DD11dated November 23, 2005 of the Government of India.

A retail individual investor is one (i) whose shareholding was of value not exceeding Rs. 1,00,000 as on the day immediately preceding the record date to be determined by the issuer, and (ii) who applies or bids for securities of or for a value of not more than Rs. 1,00,000. He can bid in a book built issue for a value not more than Rs. 1,00,000. If he bids in excess, the bid will be segregated under the high net worth individual (HNI) category or non-institution investor (NII) category.

- A retail investor is one who can bid in a book-built issue or applies for securities for a value of not more than Rs. 1,00,000.

Merchant bankers were earlier allowed some discretion while making allotments to institutional investors. Allocation to qualified institutional buyers was determined by the book running lead manager (BRLM) based on issues like prior commitment, investor quality, price aggression, and earliness of bids. SEBI banned discretionary allotments and introduced proportionate allotments in the QIB portion.

In case of book built issues, the basis of allotment is finalised by the BRLM within two weeks from the date of closure of the issue. The allotment of shares is done on a proportionate basis within the specified categories, rounded off to the nearest integer, with predetermined minimum allotment being equal to the minimum application size. Under the earlier guidelines, if an issue was oversubscribed, applicants were chosen by drawing lots and allotted a minimum of 100 shares per minimum tradeable lot.

The registrar then ensures that the demat credit or refund as applicable is completed within 15 days of the closure of the issue. The listing on the stock exchanges is done within seven days from the finalisation of the issue.

Anchor Investor

The SEBI introduced the concept of anchor investor on June 18, 2009 to enhance issuer's ability to sell the issue, generate more confidence in the minds of retail investors and better price discovery in the issue process. The anchor investor subscribes to the issue prior to its public opening, pay an upfront margin of 25 per cent and follows it up with the remaining 75 per cent within two days of the closure of the public issue, and holds the shares for atleast one month which instills confidence in retail investors and boosts the primary market. The anchor investor would be a qualified institutional buyer (QIB) and an issuer can allot up to 30 per cent of its institutional quota to such investors.The anchor investor/s cannot be related to the promoter or promoter group or the lead managers.

- Anchor investors are qualified institutional buyers that buy a large chunk of shares a day before an IPO opens. They help arriving at an approximate benchmark price for share sales and generate confidence in retail investors

The Adani Power IPO in July 2009 was the first issue in the country to attract investors under the anchor investor scheme. The six anchor investors were T Rowe Price, AIC, Ecofin, TPG (through CLSA), Legg Mason, and Sundaram MF. SKS Micro Finance attracted 36 anchor investor in its IPO issue in August 2010.

The guidelines provide various conditions for bringing in anchor investors in public issues:

1. An anchor investor shall make an application of a value of at least Rs. 10 crore in the public issue.
2. Allocation to anchor investors shall be on a discretionary basis and subject to a minimum number of two such investors for allocation of upto Rs. 250 crore and five such investors for allocation of more than Rs. 250 crore.
3. Upto 30 per cent of the portion available for allocation to qualified institutional buyers shall be available to anchor investor(s) for allocation/allotment (anchor investor portion).
4. One-third of the anchor investor portion shall be reserved for domestic mutual funds.
5. The bidding for anchor investors shall open one day before the issue opening date.
6. Anchor investors shall pay a margin of at least 25 per cent on application with the balance to be paid within two days of the date of closure of the issue.
7. Allocation to anchor investors shall be completed on the day of bidding by anchor investors
8. If the price fixed as a result of book building is higher than the price at which the allocation is made to anchor investor, the anchor investor shall bring in the additional amount. However, if the price fixed as a result of book building is lower than the price at which the allocation is made to anchor investor, the excess amount shall not be refunded to the anchor investor and the anchor investor shall take allotment at the price at which allocation was made to it.
9. The number of shares allocated to anchor investors and the price at which the allocation is made, shall be made available in public domain by the merchant banker before opening of the issue
10. There shall be a lock-in of 30 days on the shares allotted to the anchor investor from the date of allotment in the public issue.

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11. Neither the merchant bankers nor any person related to the promoter/promoter group/merchant bankers in the concerned public issue can apply under anchor investor category. The parameters for selection of anchor investor shall be clearly identified by the merchant banker and shall be available as part of records of the merchant banker for inspection by the SEBI.
12. The applications made by qualified institutional buyers under the anchor investor category and under the non-anchor investor category may not be considered as multiple applications.

Benefits of Book Building Method

Book building enables issuers to reap benefits arising from price and demand discovery. The aim of the process is to have the issue pre-sold and preclude chances of under-subscription/devolvement. The cost and time for making public issues is lowered; the procedures are also simplified. The public issue benefits investors as they can trust the price at which the syndicate members have purchased the shares. Due to this, the possibility of price falling below par after listing is remote.

Limitations of the Book Building Method

The book building method is still at a nascent stage and not without limitations.

- The book building process adopted in India is quite different from that of the USA, wherein road shows are held and the issue price is arrived at a few hours before the issue opens. The lead manager makes a market in the paper by offering two-way quotes on the secondary market, till trading picks up. There are no such provisions in the Indian book building process.
- In India, unlike in the developed markets, the book building process is still dependent on good faith. The numbers of investors invited to apply are limited and it is the peer pressure and reputation that ensures that there are no defaults. Book building relies on much interaction among firms, merchant bankers, and investors, which is absent in India.
- There is a lack of transparency at critical steps of the book building process and the absence of strong regulation.
- Since the price fixed for the public portion as well as for the placement portion is the same, issues may not succeed in inviting the desired public response.
- It has not proved to be a good price discovery mechanism. Many issues have been listed below their issue price. The lag time of more than 60 days between issue pricing and listing is the building block to price discovery mechanism (Table 6.1).
- Issuers may have to sell cheap due to the collective bargaining power of institutions.
- High institutionalised holding may affect the stock's liquidity and make it volatile as well in case of bulk offloading.

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TABLE 6.1 Book Building Issues: How they Fared on First Day of Trading on the NSE?

S.No.	Company Name	Sector (%)	Date of Listing	Issue Price (Rs.)	Close Price on First Day of Trading (Rs.)	Close Price at End of Jun–08 (Rs.)	Price Appreciation/Depreciation on the First Day of Trading (%)	Price Appreciation/Depreciation at End June 2008 Trading (%)
1	Gammon India Projects Limited	Infrastructure	03-Apr-08	167	158.15	120.1	–5.3	–28.08
2	Sita Shree Food Products Limited	Manufacturing	07-Apr-08	30	43.7	18	45.67	–40
3	Titagarh Wagons Limited	Manufacturing	21-Apr-08	540	706.85	545.75	30.9	1.06
4	Kiri Dyes and Chemicals Limited	Manufacturing	22-Apr-08	150	158.95	148.4	5.97	–1.07
5	Gokul Refoils and Solvent Limited	Manufacturing	04-Jun-08	195	182.05	203.95	–6.64	4.59
6	Reliance Power Limited	Infrastructure	11-Feb-08	450	372.3	318.00	–17.27	–29.33

Source: NSE, *Indian Securities Market, A Review*, 2008–09.

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- The role of retail investors in determining the pricing decreases. Moreover, retail investors may not have the information to judge the issue and thus, may not be able to arrive at the correct pricing.
- The limits fixed are fungible and can be altered depending upon market conditions. If there is a low retail demand, more than 75 per cent of the issue size is allocated to institutional investors.
- Most book built IPOs, since 1999, have fared badly on the stock market—18 out of 19 are currently traded below their issue price. Only Balaji Telefilms is traded at a premium. The SEBI needs to re-examine the entire book building process at the operational level and, if need be, modify its guidelines.
- The book building system of ascertaining the cut-off price and the allocation to each applicant discriminate between return and institutional investors. It is heavily loaded against the retail or the high net worth investors to the advantage of qualified institutional buyers (QIBs). Institutional investors can revise their bids, both quantity-wise as well as on the price, and back their bids with margin money up front and not the entire amount. This preferential treatment is not available to retail investors who have to back their bids with funds. Moreover, the merchant bankers to the issue have the discretion to allot to the institutional investors which results in a small proportional allotment to retail investors.
- The share of public offer in total capital has been reduced from 75 per cent to 25 per cent and in some cases, to 10 per cent. Effectively, retail now is allotted only 8.75 per cent (35 per cent of 25 per cent) and 3.5 per cent (35 per cent of 10 per cent) of a company's total capital.
- Book building is thrust upon the retail investors even though they cannot discover price. Institutional investors have the support of information and research that aids in price discovery.
- Many scrips prices rise/fall after listing and this reflects the extent of underpricing/overpricing. Hence, a more effective price discovery is needed to avoid underpricing/overpricing.

Auction-based Book Building

The SEBI announced an additional method of auction-based book building known as pure auction for follow-on public issues in November 2009. In the regular book built issue, investors have to bid within the price band quoted by the merchant banker. This price band may not always represent the fair value. Hence, many issues have quoted at a discount in the post-listing trading sessions. Pure auction makes book building more market oriented and improves the price discovery process by allowing investors, rather than companies, to decide on the pricing of the issue. In pure auction, institutional bidders are free to bid at any price above the floor price mentioned by the company and allotment of shares will be done on a top down basis, starting from the highest bidder. Hence, each institutional investor could have a different allotment price. However, retail individual investors and non-institutional investors in such cases would be allotted shares at the floor price. The SEBI has permitted the issuer to place a cap in terms of the number of shares allotted to a single bidder and percentage to issued capital of the company in order that a single bidder does not garner all shares on offer and there is wider distribution. The biggest advantage of this is that it will bring down the institutional investors' oversubscription, as the institutional investors will bid for the quantity they intend to purchase and at a price which they are willing to purchase which will be above the floor price. They may quote a higher price to get a big block of shares at a single price. SEBI has not made it mandatory for companies coming out with follow-on public issues and it has given a choice to the companies—they can either opt for the book building or go for the pure auction or a combination of both.

- Pure Auction is an additional method of book building in which the bidders would be free to bid at any price above the floor price and allotment would be on price priority basis and at differential prices. This method can be used only for FPOs

Reverse Book Building

Reverse book building is a process wherein the shareholders are asked to bid for the price at which they are willing to offer their shares. It is just similar to reverse auctions. This process helps in discovering the exit price and is used by companies who want to delist their shares or buy-back shares from the shareholders.

The process for reverse book building is as follows.

- The acquiring company secures board and shareholders approval to delist the shares.
- The acquirer shall appoint a designated BRLM to execute the process.
- The BRLM decides the floor price and the dates for inviting bids from the shareholders. The floor price shall not be less than the following: (a) where the equity shares are frequently traded in all the recognised stock exchanges where they are listed, the average of the weekly high and low of the closing prices of the equity shares of the company during the 26 weeks or 2 weeks preceding the date on which the recognised stock exchanges were notified of the board meeting in which the delisting proposal was considered, whichever is higher, as quoted on the recognised stock exchange where the equity shares of the company are most frequently traded; (b) where the equity shares of the company are infrequently traded in all or some of the recognised stock exchanges, the floor

- Reverse book building is a price-discovery mechanism for companies who want to delist their shares or buy-back shares from the shareholders

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price shall be determined by the BRLM taking into account the following factors: (i) the highest price paid by the promoter for acquisitions, if any, of equity shares of the class sought to be delisted, including by way of allotment in a public or rights issue or preferential allotment, during the 26 weeks period prior to the date on which the recognised stock exchanges were notified of the board meeting in which the delisting proposal was considered and after that date upto the date of the public announcement; and, (ii) other parameters including return on net worth, book value of the shares of the company, earning per share, price earning multiple vis-à-vis the industry average.

- The acquiring company shall, upon receipt of in principle approval for delisting from the recognised stock exchange, make a public announcement in at least one English national daily with wide circulation, one Hindi national daily with wide circulation, and one regional language newspaper of the region where the concerned recognised stock exchange is located.
- Before making the public announcement, the acquiring company shall open an escrow account and deposit therein the total estimated amount of consideration calculated on the basis of floor price and number of equity shares outstanding with public shareholders. The escrow account shall consist of either cash deposited with a scheduled commercial bank, or a bank guarantee in favour of the merchant banker, or a combination of both.
- The acquiring company shall despatch the letter of offer to the public shareholders of equity shares, not later than 45 working days from the date of the public announcement, so as to reach them at least 5 working days before the opening of the bidding period. The letter of offer shall be sent to all public shareholders holding equity shares of the class sought to be delisted whose names appear on the register of the company or depository as on the date specified in the public announcement.
- The date of opening of the offer shall not be later than 35 working days from the date of the public announcement. The offer shall remain open for a minimum period of three working days and a maximum period of five working days, during which the public shareholders may tender their bids.
- Bidding will be done only in the electronic form and through the stock exchanges trading mechanism.
- The holders of physical equity shares may send their bidding form together with the share certificate and transfer deed to the trading member appointed for the purpose, who shall immediately after entering their bids on the system send them to the company or the share transfer agent for confirming their genuineness. The company or the share transfer agent shall deliver the certificates which are found to be genuine to the merchant banker, who shall not make it over to promoter unless the bids in respect thereof are accepted and payment made. The bids in respect of the certificates which are found to be not genuine shall be deleted from the system.
- The BRLM will give the list of trading members who are eligible to participate in the reverse book building process to the stock exchange.
- Bids will be placed through trading members at the bidding centres, whom the public shareholders may approach for placing bids on the on-line electronic system and will have to be made at or above the floor price.
- There is no cap on the bid price and revision of bids is possible. The shareholders may withdraw or revise their bids upwards not later than one day before the closure of the bidding period. Downward revision of bids is not permitted.
- The acquiring company shall not be bound to accept the equity shares at the offer price determined by the book building process. Where the acquiring company decides not to accept the offer price so determined,
  a. the company shall not acquire any equity shares tendered pursuant to the offer and the equity shares deposited or pledged by a shareholder shall be returned or released to him within ten working days of closure of the bidding period;
  b. the company shall not make the final application to the exchange for delisting of the equity shares;
  c. the promoter may close the escrow account
  d. in a case where the public shareholding at the opening of the bidding period was less than the minimum level of public shareholding required under the listing agreement, the acquiring company shall ensure that the public shareholding shall be brought up to such minimum level within a period of six months from the date of closure of the bidding.
- Within eight working days of closure of the offer, the BRLM shall make a public announcement in the same newspapers in which the public announcement was made regarding:-
  a. the success of the offer alongwith the final price accepted by the acquirer; or
  b. the failure of the offer
  c. rejection of the final price discovered by the promoters.

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- Where, pursuant to acceptance of equity shares tendered in terms of these regulations, the equity shares are delisted, any remaining public shareholder holding such equity shares may tender his shares to the promoter upto a period of at least one year from the date of delisting and, in such a case, the promoter shall accept the shares tendered at the same final price at which the earlier acceptance of shares was made. The payment of consideration for shares accepted shall be made out of the balance amount lying in the escrow account.

The reverse book building route is a difficult and costly process. Price discovery is a problem in case of small companies as their shares are thinly traded, making it difficult to delist through the reverse book building route. Unless the shares are delisted, the small companies have to pay all listing charges.

- Delisting of securities means permanent removal of securities of a listed company from a stock exchange

Conclusion

The process, methodology, and structure of book building in India has improved over the last two years. The concept has yet to gain popularity among retail investors in India. This requires some modifications at the operational level. With proper safeguards and checks, this new issue mechanism can help in reviving investor confidence.

The entire IPO process should be speeded up through upgradation of the infrastructure to ensure that funds are not blocked for long.

GREEN-SHOE OPTION

The SEBI permitted the green-shoe option in book building issues when it amended the guidelines in August 2003.

A green-shoe option means an option of allocating shares in excess of the shares included in the public issue and operating a post-listing price stabilising mechanism for a period not exceeding 30 days in accordance with the provisions of Chapter VIIIA of the DIP guidelines. Green-shoe option is an option of over-allotting shares by an issuer to the underwriter in a public offering to provide post-listing price stability to an initial public offering. This option is to the extent of 15 per cent of the issue size. It is also referred to as an over-allotment option. Over allotment is an allotment or allocation of shares in excess of the size of a public issue, made by the SA out of shares borrowed from the promoters or the pre-issue shareholders or both, in pursuance of a green-shoe option exercised by the company in accordance with the provisions of this Chapter VIIIA of the DIP guidelines.

- Green-shoe option (GSO) is also referred to as an over-allotment option. It is a mechanism to provide post-listing price stability to an initial public offering. The Green-shoe company was the first to issue this type of option, hence the name green-shoe option

The guidelines relating to green-shoe option are as follows.

- A company desirous of availing the option should seek authorisation in the general meeting for allotment of the additional shares to the stabilising agent (SA) at the end of the stabilisation period.
- The company should appoint one of the merchant bankers or book runners as the SA who will be responsible for the price stabilisation process, if required. The SA should enter into an agreement with the issuer company, prior to filing the offer document with the SEBI, clearly stating all the terms and conditions relating to this option including fees charged/expenses to be incurred by the SA for this purpose.
- The SA should also enter into an agreement with the promoter(s) who will lend their shares. The agreement should specify the maximum number of shares that may be borrowed from the promoters or the shareholders which should not be in excess of 15 per cent of the total issue size. The details of the agreements shall be disclosed in the draft prospectus, the draft red herring prospectus, the red herring prospectus, and the final prospectus.
- The promoters and pre-issue shareholders, of both unlisted and listed company, holding more than 5 per cent shares should lend the shares for the purpose of green-shoe option.
- The allocation of these shares should be on pro-rata basis to all the applicants. The stabilisation mechanism should be made available for not more than 30 days from the date when trading is permitted on the exchange(s).
- The SA shall open a special account with a bank to be referred to as the GSO Bank account and a special account for securities with a depository participant to be referred to as the GSO Demat Account.
- The money received from the applicants against the over-allotment in the green-shoe option shall be kept in the GSO Bank Account, distinct from the issue account and shall be used for the purpose of buying shares from the market, during the stabilisation period.

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- The shares bought from the market by the SA, if any, during the stabilisation period, shall be credited to the GSO Demat Account. The shares bought from the market and lying in the GSO Demat Account shall be returned to the promoters immediately, in any case not later than two working days after the close of the stabilisation period.
- The prime responsibility of the SA shall be to stabilise post-listing price of the shares. To this end, the SA shall determine the timing of buying the shares, the quantity to be bought, the price at which the shares are to be bought, etc.
- On expiry of the stabilisation period, in case the SA does not buy shares to the extent of shares over-allotted by the company from the market, the issuer company shall allot shares to the extent of the shortfall in dematerialised form to the GSO Demat Account, within five ( ) days of the closure of the stabilisation period. These shares shall be returned to the promoters by the SA in lieu of the shares borrowed from them and the GSO Demat Account shall be closed thereafter. The company shall make a final listing application in respect of these shares to all the Exchanges where the shares allotted in the public issue are listed. The provisions of Chapter XIII shall not be applicable to such allotment.
- The shares returned to the promoters shall be subject to the remaining lock-in period.
- The SA shall remit an amount equal to (further shares allotted by the issuer company to the GSO Demat Account) * (issue price) to the issuer company from the GSO Bank Account. The amount left in this account, if any, after this remittance and deduction of expenses incurred by the SA for the stabilisation mechanism, shall be transferred to the investor protection fund(s) of the stock exchange(s) where the shares of issuer company are listed, in equal parts if the shares are listed in more than one exchanges. The GSO Bank Account shall be closed soon thereafter.
- The SA shall submit a report to the stock exchange(s) on a daily basis during the stabilisation period and a final report to SEBI in the format specified in Schedule XXIX. The SA shall maintain a register in respect of each issue having the green-shoe option in which he acts as a SA.

A stabilising agent (SA) steps in and buys the shares from the market when the share price falls below the offer price. He has the discretion to decide the timing, the quantity and the price at which to buy shares for stabilising the post-listing price. To ensure the post-listing price, the SA may either buy the issuer's equity shares from institutional shareholders or purchase them from the market but not in excess of 15 per cent of the issue size. The issuer may set up a separate stabilising fund account to keep the funds as well as the shares for purpose of stabilisation. The stabilising measure serves as a cushion against temporary volatility in stock. The SA is also responsible for meeting the excess demand after the commencement of the trading activity. On expiry of the stabilisation period, in case the SA does not buy shares to the extent of shares over-allotted by the company from the market, the issuer company shall allot shares to the extent of the shortfall in dematerialised form.

The first-ever exercise of a green-shoe option in the course of a public issue was carried out by the ICICI Bank. The Life Insurance Corporation became the first institution to lend shares in the primary market. It provided 16 million shares to the DSP Merill Lynch to ensure the post-listing price.

If the issuer company opts for green-shoe option, the mechanism is as follows.

1. If a company is issuing 1,000 shares, the company will enter into an agreement regarding over-allotment option (lending excess shares) with one of the merchant bankers or book runners or lead managers known as the stabilising agent (SA) to the extent of 150 shares.
2. In pursuance with the agreement, the promoters would lend 150 shares to the SA for a limited period of 30 days from the date of listing.
3. Allotment would be made to the extent of 1,150 shares (1,000 shares issued by the company and 150 borrowed from the promoters).
4. In case, on listing, the market price falls below the issue price, the SA may buy shares from the market to the extent of 150 shares. This may counter the selling pressure and raise the market price. The shares bought by the SA are then returned to the promoters. Thus, only 1,000 shares remain listed on the exchange after 30 days.
5. In case, on listing, the share price rises rapidly, and the SA does not buy the shares from the market, then at the end of the 30 days period (or before) the over-allotment option gets invoked. The company allots 150 more shares which are then returned to the promoters. Thus, 1,150 shares remain listed on the exchange.

The green-shoe option is an investor protection measure–especially for protection of small investors during the post-listing period. This option benefits the underwriters in both bullish and bearish conditions. In a bull market, underwriters will opt for additional allotment of 15 per cent due to the index riding high.

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Box 6.1 The Green-Shoe Option

In the case of an initial public offering (IPO) by India's largest technology company—Tata Consultancy Services (TCS)—there was a green-shoe option available to the lead book runner JM Morgan Stanley, its stabilising agent (SA).

It was the volatility on the stock market before its IPO that prompted TCS to set up a stabilising fund to ensure that the market price upon listing did not go below the offer price of Rs. 850 per share. Incidentally, following its listing on August 25, 2004 at Rs. 1,076 per share, the stock price did not go below Rs. 850 during the 30 days after the trading commenced.

However, this kind of an appointment of an SA to support stock prices had earlier met with failure. In April 2004, ICICI Bank, which came out with a public issue of 12.50 crore shares to mop up Rs. 3,500 crore, had appointed DSP Merill Lynch as the stabilising agent as a cushion against temporary volatility in the stock. DSP was supposed to check that the share price never once went below the cut-off price of Rs. 280 per share. However, shareholders got a rude shock when the share price closed at Rs. 265–Rs. 15 lower than the issue price–on May 14, 2004. The stabilisation period was to end on May 22, 2004. No sooner did the stock open at Rs. 284 in morning trades, the sale of 130 crore shares led the price to dive to Rs. 277. On receiving support at this level from DSP, the share price rose to Rs. 280. But, shortly thereafter, with trading volumes reaching Rs. 33 crore on BSE and Rs. 100 crore on NSE, the scrip tanked below the issue price. It was DSP's purchase of 24.79 lakh shares (almost 50 per cent of the traded volume) on a single day that helped the stock to fall only 6.95 per cent, as against the average decline of 15 per cent in other bank stocks on that day.

Source: Capital Market, Sept. 13–26, 2004.

In such a scenario, the post-listing price will be automatically maintained and sometimes even higher than the offer price, enabling underwriters to make larger profits. However, in a bearish market, the underwriting option may not be exercised or the underwriters may buy up to 15 per cent at prices lower than the issue price from the market.

Earlier, the green-shoe option could be exercised only in book built IPOs. Now it can be exercised in all IPOs. This measure is expected to mitigate volatility and enhance investors' confidence.

ON-LINE IPOs

The on-line issue of shares is carried out via the electronic network of the stock exchanges. The guidelines for online issue of shares are incorporated in a new chapter in the SEBI (Disclosure and Investor Protection) Guidelines, 2000. The guidelines clearly state that public issue can be made either through the on-line system or through the existing banking channels. The company proposing to make a public issue through the on-line system of stock exchange has to comply with Sections 55–68A of the Companies Act, 1956 and Disclosure and Investor Protection (DIP) guidelines. The issuer company is required to enter into an agreement with stock exchanges which have the requisite system for an on-line offer and has to appoint brokers and registrars to the issue having electronic connectivity with stock exchanges.

This system reduces the time taken for the issue process and securities get listed within 15 days from the closure of the issue, thereby enabling faster access to funds. The new norms prescribe that the allotment of securities should be made not later than 15 days from the closure of the issue, failing which interest at the rate of 15 per cent should be paid to investors. Corporates, planning an IPO can reduce their stationery, printing, and other expenses. The investor also benefits as the system eliminates refunds except in case of direct application.

The SEBI, in its endeavour to bring the Indian stock market at par with its global counterparts, has issued guidelines for the on-line issue of shares by corporates. The salient features of the guidelines are as follows.

- The company will have to first enter into an agreement with a stock exchange for the on-line offer of securities.
- The company will have to appoint a registrar to the issue having electronic connectivity with the stock exchange.
- The stock exchange, in turn, will appoint the SEBI-registered brokers for accepting applications and placing orders for shares.
- The broker will collect the money from clients. In case the client fails to pay for the shares collected, the broker will have to pay the amount.
- The broker shall accept orders from clients to send the application alones with payment to the registrar to the issuer or place the order to subscribe through a broker under the on-line system.
- In case a client fails to pay the application money, the broker, through whom the client placed the order, will have to bring in the money. If the broker fails to pay, he will be declared a defaulter.

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- Net tangible assets of atleast Rs. 3 crores for three full years, of which not more than 50 per cent is held in monetary assets.
- Distributable profits in atleast three out of the preceding five years.
- Net worth of atleast Rs. 1 crore in three years.
- If there is a change in the company's name, atleast 50 per cent revenue for preceding one year should be earned from the new activity.
- The issue size should not exceed 5 times the pre-issue net worth as per the audited balance sheet of the last financial year.

To provide sufficient flexibility and also to ensure that genuine companies are not deprived, an access to the primary market on account of rigidity of the parameters, the SEBI has provided two other alternative routes to a company not meeting any of the above mentioned requirements. They are as follows.

Entry Norm II It is commonly known as 'QIB Route.'

- Issue shall be through a book building route, with atleast 50 per cent of the issue to be mandatorily allotted to the qualified institutional buyers (QIBs), failing which the money shall be refunded.
- The minimum post-issue face value capital shall be Rs. 10 crore or there shall be compulsory market making for atleast 2 years.

OR

Entry Norm III It is commonly known as 'Appraisal Route'.

- The 'project' is appraised and participated to the extent of 15 per cent by FIs/scheduled commercial banks of which atleast 10 per cent comes from the appraiser(s). In addition, atleast 10 per cent of the issue size shall be allotted to QIBs, failing which the full subscription monies shall be refunded.
- The minimum post-issue face value capital shall be Rs. 10 crore or there shall be a compulsory market making for atleast 2 years.

In addition to satisfying the aforesaid eligibility norms, the company shall also satisfy the criteria of having atleast 1,000 prospective allottees in its issue.

The SEBI has exempted the following entities from entry norms.

- Private sector banks.
- Public sector banks.
- An infrastructure company whose project has been appraised by a PFI or IDFC or IL&FS or a bank which was earlier a PFI and not less than 5 per cent of the project cost is financed by any of these institutions.
- Rights issue by a listed company.

A company cannot make a public or rights issue of debt instruments (whether convertible or not), unless it fulfills the following two conditions: credit rating of not less than investment grade is obtained from not less than two SEBI registered credit rating agencies and it should not be in the list of wilful defaulters of the Reserve Bank. Moreover, it should not have defaulted payment of interest or repayment of principal, if any, for a period of more than six months.

An issuer company should not allot non-convertible debt instrument pursuant to a public issue, if the proposed allottees are less than fifty. In such a case, the company shall have to refund the entire subscription amount received; a delay beyond eight days attracts a penal charge of 15 per cent per annum.

An unlisted company shall not make a public issue of equity share or any security convertible at later date into equity share, if there are any outstanding financial instruments or any other right that would entitle the existing promoters or shareholders any option to receive equity share capital after the initial public offering.

A company shall not make a public or rights issue of equity share or any security convertible at later date into equity share, unless all the existing partly paid-up shares have been fully paid or forfeited in a manner specified in the guidelines. A company shall not make a public or rights issue of securities unless firm arrangements of finance through verifiable means towards 75 per cent of the stated means of finance, excluding the amount to be raised through proposed public/rights issue, have been made.

In order to enable investors assess new equity issues offered through an IPO, the issuer has to get IPO grading done by atleast one credit rating agency, before filing the offer documents with SEBI or thereafter. However, the prospectus/Red Herring Prospectus must contain the grade/s given to the IPO by all credit rating agencies.

- Prospectus is an offer document in case of a public issue. It has all relevant details including price and number of shares being offered. It is registered with ROC after the closure of issue in case of a book built issue.

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- 'Offer document' means prospectus in case of a public issue or offer for sale and letter of offer in case of a rights issue
- Listed company means a company which has any of its securities offered through an offer document listed on a recognised stock exchange and also includes public sector undertakings whose securities are listed on a recognised stock exchange
- Offer for sale means offer of securities by existing shareholder(s) of a company to the public for subscription, through an offer document
- Public issue means an invitation by a company to the public to subscribe to the securities offered through a prospectus
- Issuer company means a company which has filed offer documents with the SEBI for making issue of securities

In case of a public issue by an unlisted company, the promoters shall contribute not less than 20 per cent of the post issue capital which should be locked in for a period of three years. The remaining pre-issue capital should also be locked in for a period of one year from the date of listing. Lock-in indicates a freeze on the shares and it is stipulated to ensure that promoters continue to hold some minimum percentage of shares in the company. Promoters' Participation in Excess of the required minimum contribution will be to treated as preferential allotment. Securities which were pledged with banks or financial institutions as collateral security for loans granted by such banks or financial institutions, would not be eligible for computation of minimum promoters' contribution in case of company going for public issue.

Every issuer making an issue of more than Rs. 500 crore is required to appoint a monitoring agency, which needs to file a monitoring report with the issuer company. The issuer company will in turn place the report before its Audit Committee so as to enable the Audit Committee to make appropriate recommendations to the Board of the issuer company. Further, every issuer company is required to inform material deviations in the utilisation of issue proceeds to the stock exchange and to simultaneously make public the material deviations/adverse comments of the Audit Committee/monitoring agency, through an advertisement in newspapers. This provision will not apply to (i) issues by banks and public financial institutions and (ii) offers for sale.

An issuer company has to file draft prospectus with the SEBI through a merchant banker, at least 30 days prior to the filing of the prospectus with the Registrar of Companies (ROC). The SEBI may specify changes, if any, in the draft offer document which shall have to be complied with the issuer or the lead merchant banker before filing the offer document (prospectus) with the ROC/SEs. The draft offer document is available on the SEBI website for public comments for a period of 21 days from the filing of the draft offer. The merchant banker has to ensure that all the requirements of the DIP (disclosure and investor protection) guidelines are complied with while submitting the draft offer document to the SEBI.

Some of the pertinent information that has to be disclosed in the offer document relate to earnings per share (EPS), pre-issue EPS for the last three years, pre-issue price–earnings ratio (P/E), average return on net worth in the last three years, minimum return on increased net worth required to maintain pre-issue EPS, net-asset value (NAV) per share based on last balance sheet, NAV per share after issue and comparison, thereof, with the issue price and comparison of all the accounting ratios of the issuer company. Other information include credit rating, risks in relation to the first issue, risk factors–internal and external, details of underwriting agreements, objects of the offering, funding plan, schedule of implementation, dividend policy, material developments since last balance sheet date and legal and statuary disclosures.

A company has to file a draft offer document with the SEBI atleast 21 days prior to the filing of the offer document with the registrar of companies (ROC) and stock exchanges (SEs). The SEBI may specify changes if any, in the draft offer document which shall have to be complied with the issuer or the lead merchant banker before filing the offer document (prospectus) with the ROC/SEs. The draft offer document is available on the SEBI website for public comments for a period of 21 days from the filing of the draft offer. The SEBI has extended the validity period of IPO's and rights issues to one year from three months. The SEBI issues observations in 21 days and the companies can raise the funds (launch IPO) within one year from the day when these observations were issued. The merchant banker has to ensure that all the requirements of the DIP (disclosure and investor protection) guidelines are complied with while submitting the draft offer document to the SEBI. In order to enable investors assess equity issues offered through an IPO the issuer has to get IPO grading done either before filling the offer documents with SEBI or thereafter. However, the prospectus/red herring prospectus must contain the grade(s) given to the IPO by all credit rating agencies.

The issuer is allowed to freely price the issue. The issuer and the merchant banker have to justify the issue price in the prospectus. There are two methods for determining the issue price–fixed price and the book building route. In the fixed price method, the issuer, in consultation with the merchant banker, decides the price of the issue while in book building, the issuer and the merchant bankers (book running lead manager) stipulate a floor price or a price band but the final price is discovered by market forces. On completion of the bidding process, the cut-off price is arrived at on the lines of 'Dutch' auction and the basis of allotment is finalised. The final price discovered can be any price in the price band or any price above the floor price. Usually it is the price at which the entire issue is exhausted. This issue price is called cut-off price. An issuer can go for differential pricing, i.e., pricing of an issue where one category is offered shares at a price different from the other category. In the DIP guidelines, differential pricing is allowed only if the securities to applicants in the firm allotment category is at a price higher

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TABLE 6.2 Primary Issues (IPOs)

Year	No. of Issues	(Rs. in Crore) Issue Amount
1989–1990	186	2,522
1990–1991	140	1,450
1991–1992	195	1,400
1992–1993	526	5,651
1993–1994	765	10,824
1994–1995	1,343	13,312
1995–1996	1,423	8,882
1996–1997	740	4,671
1997–1998	58	1,132
1998–1999	22	504
1999–2000	51	2,719
2000–2001	114	2,722
2001–2002	7	1,202
2002–2003	6	1,039
2003–2004	21	3,434
2004–2005	23	12,382
2005–2006	79	10,936
2006–2007	77	28,504
2006–2007	77	28,504
2007–2008	85	42,595
2008–2009	21	2,082
2009–2010	39	24,696

Source: SEBI. Bulletin July, 2010.

In case of a listed company, the aggregate issue size of the proposed issue along with all the previous issues made during the financial year should not exceed five times its pre-issue net worth as per the audited balance sheet of the last financial year. If the name of the company has been changed in the last one year, then the revenue accounted for by the activity suggested by the new name should not be less than 50 per cent of its total revenue in the preceding one full-year period.

No company can make a public or rights issue of debt instruments (whether convertible or not), unless it fulfils the following two conditions: credit rating of not less than investment grade is obtained from not less than two SEBI registered credit rating agencies and it should not be in the list of wilful defaulters of the Reserve Bank. Moreover, it should not have defaulted payment of interest or repayment of principal, if any, for a period of more than six months.

An issuer company should not allot non-convertible debt instrument pursuant to a public issue, if the proposed allottees are less than fifty. In such a case, the company shall have to refund the entire subscription amount received, a delay beyond eight days attracts a penal charge of 15 per cent per annum.

Most of the IPOs are quoted at a premium to their offer price on getting listed.

The spurt in the secondary market led to a rise in the number of IPOs in the year 2003–04. The year 2003–04 was a year of IPOs–17,821 crore as raised through 29 public offers. IPCL, CMC, Gail India, ONGC, Dredging Corporation, and IBP collectively raised Rs. 14,322 crore through the sale of government stake (Table 6.3). The enthusiastic retail participation led to an over-subcription of IPOs of large private sector companies such as Biocon, Patni Computers, TV Today, Indian Overseas Bank, and the UCO Bank.

With the new government coming in to power in May 2004, the primary market turned dull. The mega issue of Tata Consultancy Services (TCS) reversed the grim scenario. The IPO from India's top software services exporting company, Tata Consultancy Services (TCS) received an upbeat response and raised Rs. 4,713.47 crore in July 2004. The listing of TCS was a milestone for the secondary market in the September 2004 quarter. TCS debuted at Rs. 1,076 on the BSE on August 25, 2004, attracting a 26.5 per cent premium to the IPO price of Rs. 850. TCS's offer of 55.4 million shares was the biggest ever IPO in the Indian history and was oversubscribed 7.7 times and raised Rs. 54,200 crore. The National Thermal Power Corporation (NTPC) IPO, which raised Rs. 5,368.15 crore, was the first disinvestment issue since the Manmohan Singh government assumed office in May 2004.

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TABLE 6.3 IPOs from the Central Government in Financial Year 2004

Company Name	*Issue Type*	*Open Date*	*Close Date*	*Offer Price (Rs.)*	*Issue Size (Rs. in Cr.)*
IPCL	Book Building	20.02.04	27.02.04	170	1,010.46
IBP	Book Building	23.02.04	01.03.04	620	357.01
CMC	Book Building	23.02.04	28.02.04	475	190.44
Bank of Maharashtra	Fixed Price	25.02.04	04.03.04	23	230.00
Dredging Corporation	Book Building	26.02.04	04.03.04	400	224.00
GAIL (India)	Book Building	27.02.04	05.03.04	195	1,649.02
Power Trading Corporation	Book Building	01.03.04	08.03.04	16	93.6
Petronet LNG	Book Building	01.03.04	09.03.04	15	391.47
Oil and Natural Gas Corp.	Book Building	05.03.04	13.03.04	750	10,694.50

Source: Capital Market.

A staggering amount of Rs. 30,301.96 crore was raised through 30 IPOs between October 2003 and 2004, which was three times the amount raised in the last five years together. In the year 2000–01, 124 IPOs raised Rs. 5,378.38 crore. Six equity IPOs netted only Rs. 1,076 crore in 2001–02. In 2002–03, six IPOs raised an even lower amount of Rs. 1,038.69 crore. The amount collected between October 2003 and October 2004 surpassed the amount of Rs. 30,000 crore raised in 1994–the highest till now.

The amount of Rs. 30,301.96 crore was raised in 2004 through 30 IPOs as against 445 IPOs in the year 1994. Of this, Rs.19,690.18 crore, i.e., 65 per cent, was raised through disinvestment of government stake and the remaining Rs. 10,611.78 crore was raised by companies in the private sector.

Of the 60 issues in the year 2004–05, 23 issues were IPOs, of which 22 were by non-financial companies in the private sector. Public issues by six companies—ICICI Bank Limited, TCS Limited, Sterlite Industries (India) Limited, National Thermal Power Corporation Limited, Jet Airways Limited, and Punjab National Bank—accounted for 72.9 per cent of the total resource mobilisation.

Almost one-half of the amount raised during the year 2005–06 was through the IPOs. All the public issues through IPOs in 2005–06 came from the private sector companies, except one, i.e., Gujarat State Petronet Limited. During the year 2006–07, 77 issues were IPOs, constituting 90 per cent of resource mobilisation while Rs. 42,505 crore was mobilised through 85 IPOs during 2007–08. Funds mobilised through IPOs constituted 48 per cent of the total resources mobilised. However, during the year 2008–09 there were only 47 issues, of which only 21 issues were IPOs. The equity markets came under pressure because of large capital outflows and turmoil in international financial markets. Since June 2009, the primary market has revived and there was a significant increase in IPOs during 2009–10 (Table 6.2).

Follow-on Public Offering (FPO)

It is an offer of sale of securities by a listed company. FPO is also known as subsequent or seasoned public offering. SEBI (DIP) Guidelines define a listed company as a company which has any of its securities offered through an offer document listed on a recognised stock exchange and also includes public sector undertakings whose securities are listed on a recognised stock exchange. Listed companies issue FPOs to finance their growth plans. In case of a listed company, the aggregate issue size of the proposed issue along with all the previous issues made during the same financial year in terms of size (i.e., offer through offer document + firm allotment + promoters' contribution) through the offer document should not exceed five times its pre-issue net worth as per the audited balance sheet of the last financial year. If the name of the company has been changed in the last one year, then the revenue accounted for by the activity suggested by the new name should not be less than 50 per cent of its total revenue in the preceding one full-year period. Any listed company not fulfilling these conditions shall be eligible to make a public issue by complying with QIB route or appraisal route as specified for IPOs. In addition, the promoters shall contribute not less than 20 per cent of the post-issue capital or 20 per cent of the issue size. Moreover, participation by promoters in the proposed public issue in excess of the required minimum percentage shall attract the pricing provisions of guidelines on preferential allotment, if the issue price is lower than the price as determined on the basis of said preferential allotment guidelines.

SEBI has introduced fast track issues (FTI) in order to enable well-established and compliant listed companies satisfying certain specific entry norms/conditions to raise equity through follow-on and rights

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issues. These norms reduce the process of issue and thereby the time period thus enabling issuers a quick access to primary capital market. Such companies can proceed with follow-on public offers (FPOs)/right issues by filing a copy of Red Herring Prospectus (RHP)/prospectus with the registrar of companies (RoC) or the letter of offer with designated stock exchange (SE), SEBI and stock exchanges. Moreover, such companies are not required to file draft offer document for SEBI comments and to stock exchanges as the relevant information is already in the public domain.

The entry norms for companies seeking to access primary market through FTI's in case aggregate value of securities including premium exceeds Rs. 50 lakhs:

1. The shares of the company have been listed on any stock exchange having nationwide terminals for a period of at least three years immediately preceding the date of filing of offer document with RoC/SE.
2. The 'average market capitalisation of public shareholding' of the company is at least Rs. 5,000 crores for a period of one year up to the end of the quarter preceding the month in which the proposed issue is approved by the board of directors/shareholders of the issuer;
3. The annualised trading turnover of the shares of the company during six calendar months immediately preceding the month of the reference date has been at least 2 per cent of the weighted average number of shares listed during the said six months period;
4. The company has redressed at least 95 per cent of the total shareholder/investor grievances or complaints received till the end of the quarter immediately preceding the month of the date of filing of offer document with RoC/SE.
5. The company has complied with the listing agreement for a period of at least three years immediately preceding the reference date;
6. The impact of auditors' qualifications, if any, on the audited accounts of the company in respect of the financial years for which such accounts are disclosed in the offer document does not exceed 5 per cent of the net profit/loss after tax of the company for the respective years;
7. No prosecution proceedings or show cause notices issued by the Board are pending against the company or its promoters or whole time directors as on the reference date; and
8. The entire shareholding of the promoter group is held in dematerialised form as on the reference date. For the purposes of this clause:
   a. 'Reference date' shall mean:
      i. in case of a public issue of securities by a listed company satisfying all the requirements specified in this clause, the date of filing of Red Herring Prospectus (in case of a book built issue) or prospectus (in case of a fixed price issue) with ROC; and
      ii. in case of a rights issue of securities by a listed company satisfying all the requirements specified in this clause, the date of filing of letter of offer with designated stock exchange.
   b. 'Average market capitalisation of public shareholding' shall mean the sum of daily market capitalisation of 'public shareholding' for a period of one year up to the end of the quarter preceding the month in which the proposed issue was approved by the Board/shareholders, as the case may be, divided by the number of trading days.

Listed companies with a good track record find it easier to raise funds through FPOs. During 2005–06, 24 companies raised Rs. 12,358 crore through FPOs, while during 2006–07 and 2007–08, only eight and seven companies raised Rs. 1,293 crore and Rs.11,916 crore, respectively, through FPOs which was less than 5 per cent of the capital raised from the primary market. Because of cumbersome procedural requirements and high cost and time, the FPOs are no longer an attractive route to raise funds. Listed companies are increasingly preferring the rights issue or Qualified Institutions Placement (QIP) route to raise funds.

Rights Issue

- Rights issue is an offer of new securities by a listed company to its existing shareholders on a pro-rata basis

Rights issue means an issue of capital under Sub-section (1) of Section 81 of the Companies Act,1956, to be offered to the existing shareholders of the company through a letter of offer. The SEBI (ICDR) Regulations define rights issue as an offer of specified securities by a listed issuer to the shareholders of the issuer as on the record date fixed for the said purpose; Section 81(1) of the Companies Act, specifies the mode of making a rights issue. As per Clause (a) of this section, the rights shares 'shall be offered to the persons who, at the date of the offer, are holders of equity shares of the company, in proportion, as nearly as circumstances admit, to the capital paid-up on those shares at that date.' Thus, for deciding the rights entitlement, only the capital paid up on each share is relevant.

Rights issue is the issue of new shares in which existing shareholders are given pre-emptive rights to subscribe to the new issue on a pro-rata basis. The right is given in the form of an offer to existing shareholders to subscribe to a proportionate number of fresh, extra shares at a pre-determined price.

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Companies offer shares on a rights basis either to expand, diversify, restructure their balance sheet or raise the promoter stake.

Promoters offer rights issues at attractive price often at a discount to the market price due to a variety of reasons. Firstly, they want to get their issues fully subscribed to. Secondly, to reward their shareholders. Thirdly, it is possible that the market price does not reflect a stock's true worth or that it is overpriced, prompting promoters to keep the offer price low. Fourthly, to hike their stake in their companies, thus, avoiding the preferential allotment route which is subject to lot of restrictions. Moreover, funds can be raised by a company through this route without diluting the stakes of both its existing shareholders and promoters.

Rights Issue is different from public issue:

- In a rights issue, new shares are offered to existing shareholders while in a public issue shares are offered to public at large.
- In case of rights, shareholders can renounce their 'rights entitlement' (REs) while there is no rights entitlement in case of public issue.
- Rights shares are allotted based on shareholding as on record date as against 'proportionate allotment' based on application size in public issues. All details of shareholders on a record date is available with the company, other than those who have purchased RE from the market and become eligible for rights issue subsequently.

According to the SEBI guidelines, no listed issuer company shall make any rights issue of securities, where the aggregate value of such securities, including premium, if any, exceeds Rs. 50 lakh, unless a draft letter of offer has been filed with the SEBI, through a merchant banker, at least 30 days prior to the filing of the letter of offer with the designated stock exchange.

The ICDR regulations put restrictions on the issue of rights shares: (a) No issuer shall make a rights issue of equity shares if it has outstanding fully or partly convertible debt instruments at the time of making rights issue, unless it has made reservation of equity shares of the same class in favour of the holders of such outstanding convertible debt instruments in proportion to the convertible part thereof and (b) the equity shares reserved for the holders of fully or partially convertible debt instruments shall be issued at the time of conversion of such convertible debt instruments on the same terms on which the equity shares offered in the rights issue were issued.

A listed issuer who wants to raise funds through a rights issue shall announce a record date for the purpose of determining the shareholders eligible to apply for specified securities in the proposed rights issue. The issuer shall not withdraw rights issue after announcement of the record date. If the issuer withdraws the rights issue after announcing the record date, it shall not make an application for listing of any of its specified securities on any recognised stock exchange for a period of 12 months from the day on which the record date was announced. The issuer may seek listing of its equity shares allotted pursuant to conversion or exchange of convertible securities issued prior to the announcement of the record date, on the recognised stock exchange where its securities are listed.

Companies issue right shares by sending a letter of offer to the shareholders whose names are recorded in the books on a particular date. A shareholder has four options in case of rights. The first is to exercise his rights, i.e., buy new shares at the offered price, second is to renounce his rights and sell them in the open market, third is to renounce part of his rights and exercise the remainder, and lastly, choose to do nothing. Thus, rights issue application form has three parts. Part A deals with application by the shareholders (including request for additional shares), Part B deals with form of renunciation to be filled in by the shareholders who desire to renounce their RE, and Part C deals with application by renouncee(s). Also, shareholders can request for split application forms wherein they want to renounce only a part of their entitlement and want to apply for the rest of their entitlement or the shareholders want to renounce their entitlement in favour of more than one person.

Rights market has been a favoured capital mobilising route for the corporate sector. However, this market shrunk from Rs. 15,000 crore a year to just about Rs. 1,500 crore. This was due to an absence of a trading platform for the post-issue trading of rights. Rights were traded through brokers by way of an over-the-counter market which does not lead to efficient price discovery. Hence, those shareholders who do not subscribe to their entire entitlement let the unsubscribed rights expire. In addition, the rights issue process was cumbersome wherein the issue has to be kept open for 30 days and the disclosure norms are stringent. In order to activate the rights market and to make the process cheaper and faster, the SEBI eased the disclosure norms relating to the rights issue. For rights issues, the issuer is required to give only the audited accounts of the last financial year and audited or unaudited financials with limited review results for the remaining period instead of five years' restated financials required earlier. Since rights are issued to shareholders who have already been receiving information about the company on a regular basis, the issuer need not give a summary of the industry and its business or information on its

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past performance or management. Disclosures that have been done away with include summary of the industry and business of the issuer company, promise vs. performance with respect to earlier/previous issues, management discussion, and analysis. The disclosures relating to financial statements, litigations, risk factors, etc. have been simplified.

In order to enable corporates to raise money faster, SEBI reduced the time line for approving a rights issue from 109 to 43 days. The reduction in timeline approved for rights issues include: the number of days for the notice period for a board meeting to be reduced from seven days to two working days; the notice period for record date to be reduced from 15/21/30 days to seven working days for all scrips; issue period to be reduced from minimum 30 days to a minimum of 15 days with a maximum of 30 days; and the time for completion of post-issue activity to be reduced from 42 days to 15 days. This will help the corporates to lower the risk due to an adverse change in market conditions and keep project costs under control.

In September 2008, the SEBI proposed trading in rights entitlements (RE) both electronically and physically through the stock exchange platform. Rights would be given a separate ISIN (code number for the security in a depository system) for it to trade on the exchange.

The proposed trading will work as follow:

(A) Electronic Rights Issue Process

1. The issuer fixes a Record date to identify eligible shareholders. These shareholders would be entitled to subscribe to the proposed rights issue.
2. The issuer dispatches a letter to each shareholder informing that the rights entitlements have been credited into their respective demat accounts and duration of trading in RE and attaching the Letter of Offer and a Blank Application Form (unlike the present form which has shareholders' name and entitlement printed on it) to all the shareholders on the record date.
3. The blank application forms shall also be available with the stock exchanges, merchant bankers, and brokers. Further, soft copy of the same shall be available on the websites of the aforesaid intermediaries.
4. The Registrar, on the instruction of the issuer, shall through credit corporate action, credit the RE in the given ratio into the demat accounts of the eligible shareholders (as on record date).
5. The Rights issue shall thereafter open for (a) subscription and (b) renunciation/trading of RE electronically through the stock exchange platform.
6. Trading will happen in REs on the secondary market platform of the stock exchanges as it happens in case of ordinary shares. To separate the trading of REs from the trading of ordinary shares, a separate ISIN shall be given for the REs.
7. Shareholders, who do not want to exercise their RE, can renounce their RE by selling their REs on the electronic trading platform of stock exchanges.
8. The shareholders who have not renounced their RE and the renouncees who don't want to renounce their RE further shall apply for shares against their RE during the issue period (which includes the trading period of RE) by submitting the application form received with the Letter of Offer/downloaded blank application form or by submitting the required information on a blank paper and submit the requisite payment instrument to Bankers to the issue.
9. Trading of RE may close at least three working days before closure of the rights issue so as to avoid last minute rush in submitting applications and to ensure that beneficial owner of REs have sufficient time to submit an application form. Once trading of REs closes, ISIN assigned to REs shall be suspended.
10. After the closure of trading and settlement of the trades done, the depositories shall make available the list of RE holders on the date the ISIN was suspended and the list of shareholders on the record date to the Registrar with their respective number of REs.
11. Thereafter, the Registrar shall reconcile the application by matching the number of shares applied for with number of RE available in the respective demat accounts based on the aforesaid list.
12. The registrar shall finalise the allotment and thereafter on the instruction of the issuer, credit the rights shares through a credit corporate action, to the respective demat accounts.
13. Thereafter, the Registrar shall through a corporate action debit the REs from the respective demat accounts for (a) shares allotted and (b) lapsed REs.

(B) Physical Rights Issue Process

1. The issuer fixes a Record date to identify eligible shareholders. These shareholders would be entitled to subscribe to the proposed Rights Issue.

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2. The issuer dispatches the Letter of Offer and Composite Application Form (CAF) with a pre-printed unique no., name of the shareholder and his/her entitlement, to all the eligible shareholders on the record date.
3. The Rights issue shall thereafter open for (a) subscription and (b) renunciation/trading of RE physically.
4. The shareholders who have not renounced their RE and the renouncees shall apply for shares against their RE during the issue period (which includes the trading period of RE) by submitting the CAF or by submitting the required information on a blank paper and submit the requisite payment instrument to Bankers to the issue.
5. Trading of RE may close at least three working days before closure of the rights issue so as to avoid last minute rush in submitting applications and to ensure that beneficial owner of REs have sufficient time to submit an application form.
6. The Bankers to the Issue shall send the CAF/blank paper application to the Registrar.
7. Thereafter, the Registrar shall reconcile the application form as per the current practice.
8. The Registrar shall finalise the basis of allotment and send the physical share certificates to the shareholders.

The rights issues market made a come back after remaining dormant for over a decade. Companies find it easier to raise funds through rights issues when the primary market is in doldrums. Most of the rights issues were offered at a discount to the ruling market price. Hence, shareholders enthusiastically responded to the rights issues. Fund mobilisation of Rs. 32,518 crore through rights issues in 2007–08 was the highest since 1992–93 (Table 6.4).

Besides the rights issue, several companies prefer private placement route to raise funds.

Indian Depository Receipts (IDRs)

Just as Indian companies tap foreign capital markets to raise funds, similarly, foreign companies can now issue their shares to Indian nationals in India. To enable Indian investors to diversify risk and as a step

TABLE 6.4 Rights and Preferential Equity Issues

Year	Rights Issues		Preferential Equity Issues	
	No.	Amount	Amount	No.
1992–93	488	12,630	NA	NA
1993–94	384	9,306	NA	NA
1994–95	351	6,793	NA	NA
1995–96	291	6,520	NA	NA
1996–97	131	2,724	NA	NA
1997–98	49	1,703	NA	NA
1998–99	26	568	NA	NA
1999–00	28	1,560	NA	NA
2000–01	27	729	12,330	335
2001–02	15	1,041	4,640	243
2002–03	12	431	1,912	313
2003–04	22	1,007	1,745	1,180
2004–05	26	3,616	6,966	4,428
2005–06	36	4,088	14,164	
2006–07	39	3,710	27,082	
2007–08	32	32,518	41,673	
2008–09	25	12,637		
2009–10	29	8,319		

Source: Prime Database.

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Indian Depository Receipts

- Enable foreign companies to raise capital in India
- Enable Indian investors to diversify risk
- Enable globalisation of Indian stock exchanges

towards integration of the Indian capital market with the international capital markets, foreign companies are allowed to access the Indian capital market by issuing Indian depository receipts (IDRs).

An IDR is an instrument denominated in Indian rupees in the form of a depository receipt against the underlying equity of issuing company to enable foreign companies to raise funds from the Indian capital market.

The Companies Act was amended in 2002 to permit foreign companies to offer shares in the form of depository receipts in India. However, the Department of Company Affairs (DCA) laid down the guidelines in February 2004. The salient features of the Companies (Issue of Indian Depository Receipts) Rules, 2004 are as follows.

- Only those companies registered overseas and having a pre-issue paid up capital and free reserves of atleast USD 50 million and minimum average market capitalisation of at least USD 100 million during the three financial years preceding the issue would be eligible to tap the Indian capital market.
- The issuing company should have made profits for atleast five years prior to the issue and a dividend record of not less than 10 per cent in those years. Also, the issuing company has to ensure that pre-issue debt equity ratio is not more than 2:1.
- The issuing company should be listed in its home country and not been prohibited to issue securities by any regulatory Body and has a good track record with respect to compliance with securities market regulations.
- Foreigners, resident or employed in India, subsidiaries of global corporations and foreign funds registered in India would also be eligible to invest in IDRs.
- The application would be required to be made atleast 90 days ahead of the opening of the issue in the format laid down along with a refundable fee of USD 10,000. On receiving the approval, an issue fee of 0.5 per cent subject to a minimum of Rs. 10 lakh would have to be paid for issues of upto Rs. 100 crore. Where the issue size exceeds Rs. 100 crore, a fee of 0.25 per cent, would be payable on an amount exceeding Rs. 100 crore.
- The repatriation of proceeds of the issue would be subject to the laws in force relating to export of foreign exchange.
- The IDRs shall not be redeemable into underlying equity shares for a period of one year from the date of issue. IDRs can be converted into the underlying equity shares only after the expiry of one year from the date of the issue of the IDR, subject to the compliance of the related provisions of Foreign Exchange Management Act and Regulations issued there under by the RBI in this regard.
- The IDRs issued in a financial year can not exceed 15 per cent of the issuing company's paid-up capital and free reserves.
- The IDRs will have to be denominated in Indian Rupees and will have to be listed on one or more stock exchanges.
- The issuer shall appoint an overseas custodian bank, with whom the underlying equity shares shall be deposited and a domestic depository which shall be authorised to issue the IDRs. For the issue of IDRs, a merchant banker should also be appointed. Overseas Custodian Bank is a banking company which is established in a country outside India and has a place of business in India and acts as custodian for the equity shares of issuing company against which IDRs are proposed to be issued. Domestic Depository is a custodian of securities registered with the SEBI and authorised by the issuing company to issue Indian Depository Receipts. It is also responsible to distribute dividend or other corporate action on the IDRs to the IDR holders in proportion to their holdings of IDRs. Merchant Banker registered with SEBI is responsible for due diligence and filing the draft prospectus with the SEBI.
- The draft prospectus shall be filed by the issuer with the ROC and the SEBI. Copies of certain documents as specified have to be filed. The SEBI may specify changes to be made in the offer document within a period of 21 days.
- Statement of variation of utilisation of funds from the projected figures and the quarterly audited financial results shall be published in English language newspapers in India.
- On the receipt of dividends or other corporate action, the domestic depository shall distribute them proportionately among the IDR holders.
- IDRs will be listed on one or more recognised stock exchanges having nation-wide trading terminals in India and may be purchased, possessed, and freely transferred by persons resident in India as defined under the Foreign Exchange Management Act, 1999 (FEMA). IDRs can be transferred and redeemed, subject to the provisions of the FEMA.

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The guidelines also clearly state that the IDR issuer would have to fulfil the eligibility criteria laid down by the SEBI and that it should obtain prior approval of the SEBI to make any issue.

The SEBI has prescribed its own set of norms which would also have to be adhered to by the IDR issuer.

Eligibility for Issue of IDRs No issuer shall make an issue IDRs unless

1. it fulfills the eligibility criteria as specified in Rule 4 of the IDR Rules;
2. it is listed in its home country;
3. it has not been prohibited to issue securities by any Regulatory Body; and
4. it has good track record with respect to compliance with securities market regulations.

- The first ever issue of IDRs was by Standard Chartered Bank on May 28, 2010. Of 240 million IDRs sold, 36 million IDRs were placed with anchor investors. Each IDR represent one-tenth of Stan Chart's UK listed stock (10IDRs = 1 share)

Investors

1. IDRs can be purchased by any person who is resident in India as defined under FEMA. NRIs and FIIs cannot purchase or possess IDRs unless special permission of the Reserve Bank of India is taken.
2. Investments by Indian Companies in IDRs shall not exceed the investment limits, if any, prescribed for them under applicable laws.
3. Automatic fungibility of IDRs is not permitted.
4. In every issue of IDR:
   a. At least 50 per cent of the IDRs issued shall be subscribed to by QIBs;
   b. The balance 50 per cent shall be available for subscription by non-institutional investors (i.e., investors other than QIBs and retail individual investors) and retail individual investors, including employees. IDRs shall be allocated among non-institutional investors, retail individual investors and employees at the discretion of the issuer. The manner of allocation shall be disclosed in the prospectus for IDRs.
5. The minimum application amount in an IDR issue shall be Rs. 20,000/-
6. Procedure to be followed by each class of applicant for applying shall be mentioned in the prospectus.

Minimum Issue Size The size of an IDR issue shall not be less than Rs. 50 crore.

Minimum Subscription If the company issuing the IDRs does not receive the minimum subscription of 90 per cent of the issued amount on the date of closure of the issue, or if the subscription level falls below 90 per cent after the closure of issue on account of cheques having being returned unpaid or withdrawal of applications, the company shall forthwith refund the entire subscription amount received. If there is a delay beyond eight days after the company becomes liable to pay the amount, the company shall pay interest at the rate of 15 per cent per annum for the period of delay.

The SEBI has extended the facility of anchor investors to issue of IDRs on similar terms as applicable to public issues made by domestic companies. Moreover, at least 30 per cent of issue size of the IDRs shall be reserved for allocation to retail individual investors, who may otherwise be crowded out. IDRs have not taken off so far.

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Private Placement Market

In the primary capital market, corporates can raise resources through public issues, rights issues, and private placement. In the case of public issues, securities are allotted to the general public. In the case of rights issues, securities are allotted to the existing shareholders on a pro-rata basis. In contrast, private placement refers to the direct sale of newly issued securities by the issuer to a small number of investors through merchant bankers. These investors are selected clients such as financial institutions, corporates, banks, and high net worth individuals. Company law defines a privately placed issue to be the one seeking subscription from 50 members.

- Private placement refers to the direct sale of newly issued securities by the issuer to a small number of investors through merchant bankers. The number of investors can go only up to 49

The private placement route offers several advantages to the issuer for raising resources. The time taken by, as well as the cost of issue for the private placement route is much less for the issuer as compared to the public and rights issues. Privately placed issues can be tailor-made to suit the requirements of both the issuer and the investor, to give them greater flexibility than public or rights issues. Moreover, private placement does not require detailed compliance of formalities, rating, and disclosure norms as required in public or rights issues. These advantages make the market quite popular in the USA where generally, debt instruments are privately placed.

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TABLE 6.5 Resource Mobilisation in the Private Placement Market

(Rs. in Crore)

Year	Private Sector						Public Sector						Grand Total	
	Financial Institutions		Non-financial Institutions		Total		Financial Institutions		Non-financial Institutions		Total			
	No. of Issues	Amt	No. of Issues	Amt	No. of Issues	Amt	No. of Issues	Amt	No. of Issues	Amt	No. of Issues	Amt	No. of Issues	Amount
1995–96	–	2,136.0	–	1,934.0	–	4,070.0	–	4,552.0	–	4,739.0	–	9,291.0	–	13,361.0
1996–97	–	1,847.0	–	646.0	–	2,493.0	–	6,541.0	–	6,032.0	–	12,573.0	–	15,066.0
1997–98	–	4,323.7	–	4,878.5	139	9,202.2	–	9,659.7	–	11,236.7	118	20,896.4	257	30,098.6
1998–99	87	12,174.2	93	4,823.5	180	16,997.7	67	20,382.4	69	12,298.9	136	32,681.3	316	49,679.0
1999–00	176	10,875.2	191	8,528.3	367	19,403.5	119	17,981.3	92	23,874.2	211	41,855.5	578	61,254.0
2000–01	208	13,262.6	171	9,843.0	379	23,105.6	112	26,201.2	96	18,529.6	208	44,730.8	587	67,836.4
2001–02	363	16,019.0	309	12,601.0	672	28,620.0	167	17,358.0	119	18,898.0	286	36,256.0	958	64,876.0
2002–03	327	9,454.0	550	15,623.0	877	25,077.0	157	20,407.0	110	21,464.0	267	41,871.0	1144	66,948.0
2003–04	344	12,250.7	296	6,209.2	640	18,759.9	132	26,461.3	102	18,679.4	234	45,140.7	874	63,900.6
2004–05	255	20,974.2	462	14,820.0	717	35,794.2	124	25,531.2	69	22,080.1	193	47,611.2	910	83,405.4
2005–06	375	26,463.0	571	14,727.0	946	41,190.0	137	39,165.0	32	16,119.0	169	55,284.0	1,115	96,473.0
2006–07	632	48,414.0	892	33,426.0	1,524	81,841.0	127	52,217.0	30	11,908.0	157	64,025.0	1,681	1,45,866.0
2007–08	905	88,291.0	711	41,386.0	1,616	1,29,677.2	132	56,185.5	67	26,862.7	199	83,048.2	1,815	2,12,725.4
2008–09P	683	60,245.9	370	32,789.8	1,053	93,035.7	123	64,608.8	105	45,101.1	228	1,09,709.1	1,281	2,02,744.8

P: Provisional

Source: RBI, *Hand book of Statistics on Indian Economy*, 2006.

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Available data indicates that private placement has become the preferred route for raising resources by both private and public sector companies. In India, this route has gained immense importance during the last few years, in view of the prolonged subdued conditions in the new issues market.

Table 6.5 reveals that in the year 1997–98, the amount of resources raised through private placement almost doubled from Rs. 15,066 crore to Rs. 30,098 crore. Again, in the years 1999–2000 and 2000–01, the amount of resources doubled from Rs. 30,098 crore to Rs. 67,837 crore. The share of resources mobilised through private placement in these years accounted for nearly 88 per cent of the total resources mobilised from the primary market. This route was preferred due to dormant conditions prevailing in the capital market.

The public sector garnered huge resources from the private placement market. Its average share during the seven years, from 1995–96 to 2001–02 was 68 per cent in total private placements. The major all-India development financial institutions, the state-level undertakings, and PSUs tapped this market to raise a large amount of funds. The private sector's share in total private placement was on an average 40 per cent in the last fourteen years. (Table 6.6)

Mobilisation of resources through private placement increased by 30.5 per cent in 2004–05 and 15.5 per cent in 2005–06. The public sector companies garnered a large amount of resources through private placement.

In terms of instruments, debt instruments, mainly bonds and debentures of different maturities, were preferred the most. The equity portion was raised in the form of preference shares.

The factors that led to private placement becoming a favoured route for Indian corporates and financial institutions are as follows.

- The prolonged subdued conditions in the primary market since 1995–96.
- Private placements in India were not bound by any regulatory system till September 2003.
- Private placements have no lock-in period except when it is in favour of promoters.
- There is no compliance system for merchant bankers in private placement as in the case of public issues.
- The limit on a bank's investment on debt has been removed which has made this market more buoyant.
- Through private placements, issuing banks can raise their Tier II capital in order to prop up the capital adequacy ratio.

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TABLE 6.6 Share of Public Sector and Private Sector in Private Placement Market and Share of Private Placement in Total Resources Mobilised in the Primary Market

Year	*Share of Private Sector (In %) in Private Placement*	*Share of Public Sector (In %) in Private Placement*	*Share of Private Placement in Total Resource Mobilisation (In %)*
1995–96	31	69	39
1996–97	17	83	49
1997–98	31	69	87
1998–99	34	66	84
1999–2000	32	68	89
2000–01	36	64	91
2001–02	44	56	90
2002–03	37	63	94
2003–04	42	58	90
2004–05	42	58	79
2005–06	44	56	72
2006–07	58	42	78
2007–08	57	43	64
2008–09	46	54	93

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Box 6.2 Preferential Allotments

The preferential allotment route has been grossly misused by both MNCs and Indian companies. Twenty-nine MNCs had exercised the aforesaid provisions of preferential share in favour of their promoters during 1991–94. Two cases of the lowest throw-away prices at which shares were offered to their promoters were at Rs. 60 and Rs. 110 against the market price of Rs. 700 and Rs. 1,050 respectively. Nine Indian companies similarly allotted preferential shares to their promoters during 1993–94. The lowest price at which one company allotted the share was Rs. 22 against the market price of Rs. 400. Total unlawful gains made by the promoters ran into more than Rs. 2,996.56 crore for MNCs and Rs. 846 crore for Indian companies.

Source: Consumer Education and Research Centre (As reported in *The Economic Times*).

of specified securities made through a public issue, rights issue, bonus issue, employee stock option scheme, employee stock purchase scheme or qualified institutions placement or an issue of sweat equity shares or depository receipts issued in a country outside India or foreign securities;

The promoter has been defined as a person or persons who are in overall control of the company; who are instrumental in the formulation of a plan or programme pursuant to which the securities are offered to the public and those named in the prospectus as promoter(s); Provided that a director or officer of the issuer or a person, if acting as such merely in his professional capacity, shall not be deemed as a promoter. Provided further that a financial institution, scheduled bank, foreign institutional investor, and mutual fund shall not be deemed to be a promoter merely by virtue of the fact that 10 per cent or more of the equity share capital of the issuer is held by such person; Provided further that such financial institution, scheduled bank and foreign institutional investor shall be treated as promoter for the subsidiaries or companies promoted by them or for the mutual fund sponsored by them;

A promoter group includes the promoter, an immediate relative of the promoter (i.e., a spouse of that person, or a parent, brother, sister, or child of the person or of the spouse); in case the promoter is a company, a subsidiary or holding company of that company; any company in which the promoter holds 10 per cent or more of the equity capital of the promoter; any company in which a group of individuals or companies or combinations thereof who holds 20 per cent or more of the equity capital in that company also holds 20 per cent or more of the equity capital of the issuer company. In case, the promoter is an individual, any company in which 10 per cent or more of the share capital is held by the promoter or an immediate relative of the promoter or a firm or HUF in which the 'promoter' or any one or more of his immediate relative is a member; any company in which a company specified above holds 10 per cent or more of the share capital; any HUF or firm in which the aggregate share of the promoter and his immediate relatives is equal to or more than 10 per cent of the total, and all persons whose shareholding is aggregated for the purpose of disclosing in the prospectus shareholding of the promoter group. Provided that a financial institution, scheduled bank, foreign institutional investor, and mutual fund shall not be deemed to be promoter group merely by virtue of the fact that 10 per cent or more of the equity share capital of the issuer is held by such person: Provided further that such financial institution, scheduled bank, and foreign institutional investor shall be treated as promoter group for the subsidiaries or companies promoted by them or for the mutual fund sponsored by them;

A company can make preferential issue of equity shares, warrants, partly convertible debentures (PCDs), fully convertible debentures (FCDs), or any other financial instruments convertible into or exchanged with equity shares at a later date. A listed company is permitted to make a preferential issue only if its entire shareholding is held in dematerialised form. In case of preferential issues, the entire pre-preferential allotment shareholding should be under lock-in. The lock-in period shall commence from the relevant date upto a period of six months from the date of preferential allotment. The shareholders who have sold their shares during the six months period prior to the relevant period would not be eligible for allotment of shares on a preferential basis.

The SEBI has issued norms for preferential allotment which are as follows:

- The total preferential investments issued to promoters is to be locked in for three years. The lock-in period of shares allotted on conversion of warrants shall start when shares are allotted and not when warrants are allotted.
  - The upfront margin to be paid by allottees of warrants has been raised to 25 per cent from 10 per cent. This is expected to discourage promoters from issuing warrants to themselves at a discount in a bull run and then do not honour their commitments if the stock prices fall.
- The details of the amount utilised out of preferential issue proceeds are to be disclosed under an appropriate head in the balance sheet of the company, indicating the purpose for which such money has been utilised. Even the details of the unutilised money are also to be disclosed in the balance sheet under a separate head indicating the form in which such unutilised money has been invested.

- 'Preferential Allotment' includes issue of shares on preferential basis and/or through private placement made by a company in pursuance of a resolution passed under Sub-section (IA) of Section 81 of the Companies Act,1956 and issue of shares to the promoters and their relatives either in public issue or otherwise
- Lock-in indicates a freeze on the shares and it is stipulated to ensure that the promoters continue to hold some minimum percentage of shares in the company

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Preference for Preferential Issues

- To enhance holding of promoters
- Can be pledged with banks
- Easier Norms
- Low cost
- Management control to institutional investors

- Preferential allotment should be at a price not less than the higher of the following: The average of the weekly high and low of the closing prices of the scrip quoted on a stock exchange during the six months preceding the date of general meeting or the average of the weekly high and low of the closing prices of the scrip quoted on a stock exchange during the two weeks preceding the date of general meeting. [Clause 13.1.1.1]
- Where the equity shares of a company have been listed on a stock exchange for a period of less than six months as on the relevant date; the issue of shares on preferential basis can be made at a price not less than higher of the following: The price at which shares were issued by the company in its IPO or the average of the weekly high and low of the closing prices of the related shares quoted on the stock exchange during the period shares have been listed preceding the relevant date or during the two weeks preceding the relevant date provided that on completing a period of six months of being listed on a stock exchange, the company shall recompute the price of the share in accordance with the provisions mentioned above and if the price at which shares were allotted on a preferential basis under this clause was lower than the price so computed, the difference shall be paid by the allottees to the company. The preferential allotment guidelines were amended to enable companies with listing history of less than six months also to raise money through preferential allotment, subject to complying with the modified pricing and disclosure norms.

Further, the listed companies intending to make preferential allotment would be required to obtain PAN from each applicant before making the allotment. Debt restructuring framework should commence from the date of allotment and continue for a period of one year. In case of partly paid-up shares, the lock-in period should commence from the date of allotment and continue for a period of one year from the date when shares become fully paid-up.

Preferential allotment is carried out for various reasons: to enhance the promoters' holding by issuing share warrants to themselves; as part of debt restructuring/conversion of loans; for the purpose of strategic investments by institutional/foreign investors; to issue shares by way of Employees Stock Option Plans (ESOPs); for fresh issue to shareholders other than promoters and for take-over of company by management group.

Promoters Pledge their Holdings

- to release their earlier pledged holdings,
- to cash in on the bull run,
- to finance their private transactions, or
- as a collateral for their companies' borrowings

Companies use the preferential allotment route to raise working capital. Besides, the company can choose among the varied types of investors for its preferential issue. Institutional investors like private equity funds prefer preferential issue route as it enables management control in the issuing company and the lock-in period is only one year. One of the reasons why companies prefer to allot preferential shares to their promoters is that they can be pledged with banks either to release their earlier holdings which are not under lock-in or to release fresh funds to cash in on the bull run. The preferential allotment route is preferred in bullish market.

Preferential issues enable quick fund raising at low cost and allow a company to take on board its business partners like technology collaborators, to raise their commitment to the company. Moreover, increase in investments by promoters and institutional investors boosts the confidence of retail investors However, it increases the equity base of a company which leads to a decline in the earnings per share. Since the beneficiaries are promoters or outsiders, the relative holding of existing shareholders declines. Hence, it is an inequitable way of raising funds. In most cases, promoters are allotted additional shares at times when the company may not be in need of funds. This adversely affects the valuation ratios and brings down the stock prices thereby affecting the interests of existing shareholders.

Qualified Institutions Placement (QIP)

It has emerged as a new fund raising investment for listed companies in India. QIP is an issue of equity shares or securities convertible into equity shares by a listed company to qualified institutional buyers only, in terms of provisions of Chapter XIIIA of SEBI(DIP) guidelines. Through a QIP issue, funds can be raised from foreign as well as domestic institutional investors without getting listed on a foreign exchange, which is a lengthy and cumbersome affair. Also, unlike a private placement, there is no lock-in clause. The

Box 6.3 Private Equity (PE)

Private equity investments have increased in India. In 2006, over USD 7 bn were invested by PE firms in India. Private equity is a long-term equity investment by a fund in private and public (listed) firms with successful business models and a potential for a higher growth. Private equity plays an important role in the growth of enterprises. It helps the investee companies in promoting their growth by providing capital knowledge and skills. It also helps in formulating and shaping the corporate strategy of investee firms and improving their corporate governance. Some PE firms such as Warbury Pincus Investments, GW Capital Investment, and GA Partners Investment have invested in highly successful companies like Bharti, Spectramind, ICICI ventures, Biocon, Patni Computers, and many others.

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issue process is not only simple but can be completed speedily since the company issues equity shares and does not create a derivative investment as is the case with GDR/ADR. Investors also gain since they invest directly in equity shares and do not have to bear the cost of holding and converting depository receipts. Unlike GDRs, a QIP issue can be offered to a wider set of investors including Indian mutual funds, banks and insurance companies, as well as, foreign institutional investors. As there is no new stock exchange listing, the issue is free from the hassles of continuing disclosures and administrative costs.

SEBI issued guidelines for Qualified Institutions Placement on May 8, 2006. Key features of the same are:

- Qualified Institutions Placement is a private placement of equity shares or convertible securities by a listed company to Qualified Institutions Buyers

Issuer A company whose equity shares are listed on a stock exchange having nation-wide trading terminals for a period of atleast one year and which is complying with the prescribed requirements of minimum public shareholding of the listing agreements will be eligible to raise funds in domestic market by placing securities with Qualified Institutional Buyers (QIB).

Securities Securities which can be issued through QIP are equity shares, or any securities other than warrants, which are convertible into or exchangeable with equity shares. A security, which is convertible or exchanged into equity shares at any time, after allotment of security but not later than sixty months from the date of allotment can be issued. The specified securities shall be made fully paid up at the time of allotment.

Investors/Allottees The specified securities can be issued only to QIBs, as defined under subclause (v) of Clause 2.2.2 B of the SEBI (DIP) Guidelines. Such QIBs shall not be promoters or related to promoters of the issuer, either directly or indirectly. Each placement of the specified securities issued through QIB shall be on private placement basis, in compliance with the requirements of the first provision to clause (a) of Sub-section (3) of Section 67 of the Companies Act, 1956. A minimum of 10 per cent of the securities in each placement shall be allotted to Mutual Funds. For each placement, there shall be atleast two allottees for an issue of size upto Rs. 250 crores and at least five allottees for an issue size in excess of Rs. 250 crore. Further, no single allottee shall be allotted in excess of 50 per cent of the issue size. Investors shall not be allowed to withdraw their bids/applications after closure of the issue.

- The issuing company is required to allot atleast 10 per cent of the total issue to mutual funds.

Issue Size The aggregate funds that can be raised through QIPs in one financial year shall not exceed five times of the networth of the issuer at the end of its previous financial year.

Placement Document Issuer shall prepare a placement document containing all the relevant and material disclosures. There will be no pre-issue filing of the placement document with SEBI. The placement documents will be placed on the websites of the stock exchanges and the issuer.

Pricing The floor price of the specified securities shall be determined on a basis similar to that for GDR/FCCB issues and shall be subject to adjustment in case of corporate actions such as stock splits, rights issues, bonus issue, etc. The floor price for QIPs is based on two weeks average with the relevant date being the day on which the board meets to take the decision to open the QIP.

Other Procedural Requirements The resolution approving QIP, passed under Sub-section (1 A) of Section 81 of the Companies Act, 1956 or any other applicable provision, will remain valid for a period of 12 months from the date of passing of the resolution. There shall be a gap of at least six months between each placement in case of multiple placements of specified securities pursuant to authority of the same shareholders' resolution. Issuer and Merchant Banker shall submit documents/undertakings, if any, specified in this regard in the listing agreement, for the purpose of seeking in-principle approval and final permission from Stock Exchanges for listing of the specified securities.

QIP is an increasingly preferred route to raise funds. During 2007–08, 38 companies raised Rs. 25,525 crore through QIP route. Due to the global financial crisis, only three issuers raised Rs. 264 crore through QIPs during 2008–09. With stabilisation in the global financial markets, there was a sharp rise in the QIP issues. A staggering amount of Rs. 42,729 crore was raised by 62 issuers through QIPs during 2009–10.

RESOURCE MOBILISATION FROM THE PRIMARY MARKET

Both PSUs and private companies tapped the market to finance capital expansion activity and growth plans.

Table 6.7 gives a bird's-eye view of resources mobilised from the primary market through prospectus, rights, and private placement. Table 6.7 reflects three distinct trends in resource mobilisation from the primary market through prospectus and rights issues. It indicates an increasing trend from 1991–92 to 1994–95, a decreasing trend from 1995–96 onwards, with unsustained spells of revival in 1998–99 and

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TABLE 6.7 Capital Raised

(Rs. Crore)

Year	Total		Category Wise				Issuer-type				Equities				Instrument-wise					
			Public		Rights		Listed		IPOs		At Par		At Premium		CCPS/FCDs		Bonds/NCDs		Others	
	No.	Amt	No.	Amt	No.	Amt	No.	Amt	No.	Amt	No.	Amt	No.	Amt	No.	Amt	No.	Amt	No.	Amt
1999–00	93	7,817	65	6,257	28	1,560	42	5,098	51	2,719	30	786	52	3,780	0	0	10	3,200	2	51
2000–01	151	6,108	124	5,378	27	729	37	3,385	114	2,722	84	818	54	2,408	2	142	10	2,704	1	36
2001–02	35	7,543	20	6,502	15	1,041	28	6,341	7	1,202	7	151	8	1,121	0	0	16	5,601	4	670
2002–03	26	4,070	14	3,639	12	431	20	3,032	6	1,039	6	143	11	1,314	0	0	8	2,600	2	13
2003–04	57	23,272	35	22,265	22	1,007	36	19,838	21	3,434	14	360	37	18,589	0	0	6	4,324	0	0
2004–05	60	28,256	34	24,640	26	3,616	37	15,874	23	12,382	6	420	49	23,968	0	0	5	3,867	0	0
2005–06	139	27,382	103	23,294	36	4,088	60	16,446	79	10,936	10	372	128	27,000	0	0	0	0	1	10
2006–07	124	33,508	85	29,797	39	3,711	47	5004	77	28,504	2	12	119	32,889	0	0	2	356	1	249
2007–08	124	87,029	92	54,511	32	32,518	39	44,434	85	42,595	7	387	113	79,352	2	5,687	2	1,603	0	0
2008–09	47	16,220	22	3,582	25	12,637	25	12,637	21	2,082	5	96	40	14,176	1	448	1	1,500	0	0
2009–10	76	57,555	47	49,236	29	8,319	34	30,399	39	24,696	1	9	71	54,866	1	180	3	2,500	0	0

Note: FCD: Fully Convertible Debenture; NCD: Non-Convertuble Debenture; CCPS: Cumulative Convertible Preference Share.
Source: SEBI Bulletin.

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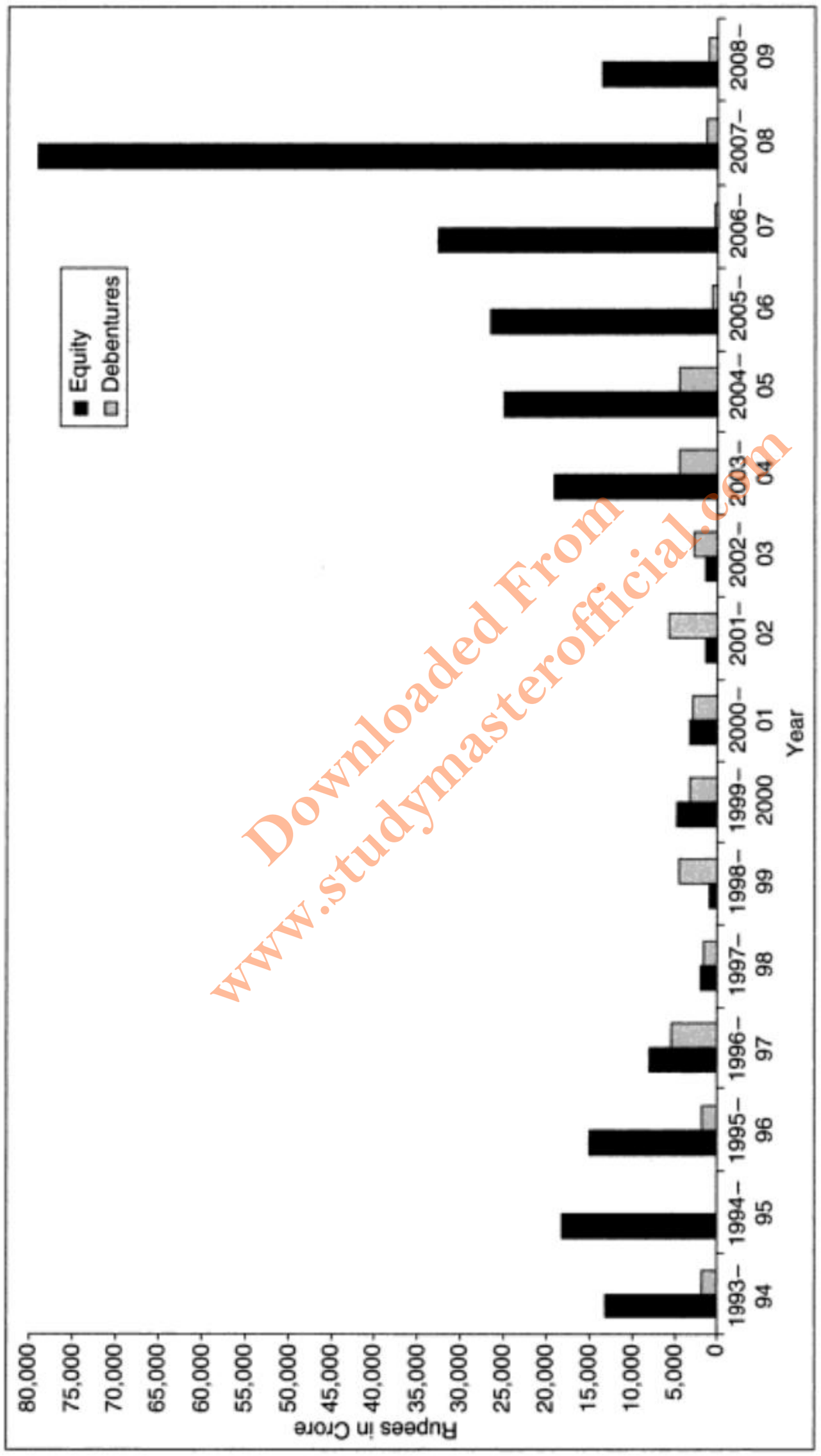


Figure 6.2 Resources Mobilised from the Primary Market—Instrument Wise

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an increasing trend since 2003 (Figure 6.2). The growth rate of new capital issues through prospectus and rights was the highest (232 per cent) in 1992–93—a year immediately after the reforms were initiated. This growth was partly a result of the abolition of the Capital Issues (Control) Act with effect from May 1992 and the freeing of the pricing of issues that followed as a consequence. Huge resources were raised also in the following two years. This was due to a spurt in equity issues with premium and a wide variety of innovative/hybrid instruments.

The primary market was quite depressed from 1995–96. This overall decline could be attributed to factors operating on the demand and supply sides. The scams which took place in the secondary market adversely affected the primary market. Many fraudulent promoters cheated investors which led to a loss in investor confidence. Moreover, prices of many issues floated at a high premium declined upon listing. All these factors drove away investors from the primary market. Moreover, strict disclosure standards and entry point norms prescribed by the SEBI and an overall slowdown in the economy and in the industry partly led to deceleration in the primary market.

The decline in resources raised by public sector through prospectus and rights was much sharper as both the government companies and non-financial PSUs did not tap this market for three consecutive years. The public sector preferred the private placement route for raising resources.

The declining trend was again reversed in 2003–04. The phenomenal success of the Maruti IPO, the booming stock markets, low interest rates, and good economic growth forecast led to a revival of the primary market. There was a record increase in capital raised from primary markets during 2007–08 both through public issues and private placement. The global financial crisis took a toll on global financial markets leading to a sharp decline in the number and size of new issues during 2008–09. The private sector tapped the primary market by issuing rights shares while the public sector raised funds only through private placements. With the easing of liquidity pressures in the global financial markets, there was a spurt in primary market activity in the second quarter of 2009–10. There were a large number of primary issuances and private placements by both private and public sector companies.

Non-government Public Limited Companies (Private Sector)

During the CCI regime, most of the companies in the private sector were not motivated to make public issues as the issue price was set below the intrinsic worth of the share. With reforms, many companies came forward with a large number of issues.

Table 6.8 reveals that the average share of the private sector in resources mobilised through prospectus and rights was around 45 per cent in the 1990s. A record growth rate of 220 per cent and a record share of 91 per cent in resources mobilised through prospectus and rights was recorded in 1992–93, a year immediately after the reforms were initiated. It seems that the private sector benefited the most in the era of free pricing.

The share of the private sector has declined sharply after 1994–95 and reached a dismal low of 7 per cent between 1999–2000 to 2001–02 due to loss of investor confidence and bearish conditions in the secondary market. The growth rate in resources mobilised through prospectus and rights issues also turned negative since 1995–96 signaling a bearish scenario in the new issue market.

Resource mobilisation from the private placement market declined during 2003–04 due to stringent disclosure norms prescribed by the SEBI and a spate of public issues from public sector enterprises, banks and financial institutions.

The data in Table 6.10 reflects that equity issues gained popularity after the initiation of reforms. The abolition of the CCI and free pricing has given a tremendous boost to the equity market since 1992–93. The amount of preference share issues in the total issues was negligible. These had virtually gone out of existence in the late 1970s. The re-emergence of preference shares was witnessed in 1994–95 and 1995–96 as a tax benefit was granted under Section 80M of the Income Tax Act. As per this section, if a company subscribed to the preference shares of another company, the former was entitled to tax exemption on the incoming dividends on preference shares if its dividend outgo (on equity shares) exceeded the incoming dividends. With the withdrawal of this benefit, the popularity of preference shares declined.

Debenture issues were prominent till 1990–91. Their prominence declined in the free pricing era wherein the private sector preferred to issue equity shares at a premium. The year 1997–98 was an exception as the debenture issues gained prominence over the equity issues with large companies in the financial sector relying on debt issues.

Rights issues dominated the market till 1992–93, the average proportion being 60 per cent in the total capital issues. This proportion came down steeply in the subsequent years as the prospectus issues

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TABLE 6.8 Share of the Private Sector in Resource Mobilisation from the Primary Market

Year	Amount Mobilised Through Prospectus and Rights		Amount Mobilised Through Private Placements	
	(Rs. in Crore)	(Share in Per Cent to Total Resources) (In %)	(Rs. in Crore)	(Share in Per Cent to Total Resources) (In %)
1995–96	16,075	47	4,071	12
1996–97	10,410	34	2,493	8
1997–98	3,138	9	9,202	26
1998–99	5,013	8	16,997	29
1999–2000	5,153	7	19,404	28
2000–01	4,890	77	23,106	34
2001–02	5,692	80	28,620	44
2002–03	1,878	39	25,077	37
2003–04	3,675	47	18,760	29
2004–05	13,482	62	35,794	43
2005–06	21,154	78	41,190	43
2006–07	30,603	95	81,841	56
2007–08	67,311	77	1,29,877	61
2008–09	16,220	100	93,036	46
2009–10	25,153	77	NA	NA

NA = Not Available.
Source: RBI, *Annual Report*, various issues.

TABLE 6.9 Proportion of Prospectus and Rights Issues and of Equity Preference and Debenture Issues in the Total Capital Issues by Non-government Public Limited Companies

(In Per Cent)

	1991–92	1992–93	1993–94	1994–95	1995–96	1996–97	1997–98	1998–99	1999–2000	2000–01	2001–02	2002–03	2003–04	2004–05	2005–06	2006–07	2007–08	2008–09
Equity	29.7	48.8	51.7	65.5	74.1	59.3	36.8	51	53.4	53.9	15.1	24.5	61.0	82.3	99.1	97.2	89.3	100
Preference	0.3	0.2	0.3	0.5	0.9	0.7	0.2	1	0	3.0	0	–	–	–	–	–	8.6	–
Debentures	70.0	50.0	48.0	34.0	25.0	40.0	63.0	42	46.6	43.2	84.9	75.5	39.0	17.7	0.9	2.8	2.1	–
Total	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100
Prospectus	33	35	60	74	64	74	45	52	78	89	87	75	85	87	85	89	75	18
Rights	67	65	40	26	36	26	55	48	22	11	13	25	15	13	15	11	25	82

NA=Not Available.
Source: RBI, *Annual Report*, various issues.

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became more popular with private sector companies. The proportion of issues through prospectus was highest in the years 1999–2000 and 2000–01. The companies in the information technology (IT) sector could successfully raise resources through the issue of prospectus.

The year 1992–93 witnessed a spurt not only in total equity issues but also in equity issues with premium. The premium charged as a proportion of the total amount raised had been on an average of 47 per cent from 1992–93 to 1995–96. The premium charged on equities by private corporates as a proportion of total amount of equity issues declined substantially to 23.9 per cent from 40.5 per cent in view of the prolonged bearish conditions on the stock market and reduced preference for equity issues. In the years 1997–98 and 1998–99, an increase in this proportion was witnessed because only reputed and large companies with good track records accessed the new issue market. Moreover, these companies received a sound response in the absence of good issues in the market. The share of the premium in the total amount mobilised by equity issues reached a peak of 78.8 per cent in 1999–2000. This was due to a craze for the

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TABLE 6.10 Share of Equity Issues with Premium in the Total Equity Issues of Non-government Public Limited Companies

Year	Total Equity Issues		Equity Issues with Premium		Per Cent of Equity Issues with Premium to Total Equity Issues	
	Number	Amount (Rs. in Crore)	Number	Amount (Rs. in Crore)	Number (In Per Cent)	Amount (In Per Cent)
1990–91	246	1,285.7	41	128.1	17	10.0
1991–92	367	1,916.2	56	227.5	15.3	13.2
1992–93	868	9,952.6	324	5,184.1	37.3	51.9
1993–94	983	9,959.7	372	4,464.9	37.7	44.2
1994–95	1,548	17,414.4	628	8,420.8	40.6	48.4
1995–96	1,591	11,877.4	461	4,856.4	28.8	40.5
1996–97	801	6,101.4	126	1,462.1	15.6	23.9
1997–98	89	1,162.4	29	653.5	32.5	56.2
1998–99	33	2,562.7	19	1,325.8	57.6	51.7
1999–00	69	2,752.5	48	2,169.3	63	83
2000–01	128	2,607.6	52	1,227.3	39	75
2001–02	6	860.4	3	654.3	53	88
2002–03	5	6.27	5	391.3	65	90
2003–04	35	2470.9	24	1,613	73	98
2004–05	51	11,451.8	46	11,049	89	98
2005–06	128	20,899	118	18,793	93	99
2006–07	114	29,756	109	19,733	95	66
2007–08	120	79,739	113	79,352	94	99
2008–09	45	14,272	40	14,176	89	99
2009–10	72	54,875	71	54,866	99	99

Source: SEBI, Bulletin.

TABLE 6.11 Classification of Equity Issues

(Percentage Share in Total Amount Raised)

Particulars	2001–02	2002–03	2003–04	2004–05	2005–06	2006–07	2007–08	2008–09
(A) Public Issues, of which	86.00	89.00	96.00	87.20	85.07	88.93	62.64	22
IPOs	16.00	25.00	15.00	43.82	39.94	85.07	48.94	14
FPOs	70.00	64.00	81.00	43.38	45.13	3.86	13.70	8
(B) Rights	14.00	11.00	4.00	12.80	14.93	11.07	37.36	78
Total (A+B)	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100

Source: SEBI, *Handbook of Statistics on the Indian Securities Market.*

initial public offerings of companies in the information technology sector. There was a sharp decline in this trend in 2000–01 and 2001–02.

In 2001–02, there were only six equity issues by the private sector. Out of these six issues, three issues were with a premium. However, in the year 2003–04, the number of equity issues with premium increased sharply.

During the years 2004–05 and 2005–06, the number of equity issues with premium increased tremendously. The proportion of equity issues with premium to total number of equity issues was 89 per cent and 93 per cent during these two years. Equity issues constituted 99.1 per cent of the total resource mobilisation through public issues during 2005–06 and were 99.9 per cent during 2006–07. Buoyant stock markets, strong macro economic fundamentals, a higher than expected GDP growth, strong exports growth, good corporate earnings, and higher mergers and acquisitions created favourable sentiments for equity issues. During 2008–09, there were no preference and debenture issues and 82 per cent of the issues floated by the private sector were rights issues (Tables 6.8 and 6.9). Rights issues dominated the market in 2008–09 (Table 6.11).

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TABLE 6.15 Resources Raised by Banks and Financial Institutions in the Public Sector from the Primary Market and Their Share in Amount Raised Through Prospectus and Rights and Total Resources Mobilisation

Year	*Amount Mobilised by Banks and Financial Institutions (Rs. in Crore)*	*Total Amount Mobilised Through Prospectus and Rights (Rs. in Crore)*	*Total Resource Mobilisation from Primary Market (Rs. in Crore)*	*Per Cent Share of Banks and Financial Institutions in (3)*	*Percentage of Banks and Financial Institutions in (4)*
(1)	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*
1992–93	356	20,589	23,286	1.7	1.5
1993–94	3,843	23,992	37,044	16.0	10.4
1994–95	425	27,730	41,974	1.0	1.0
1995–96	3,465	20,540	36,193	16.9	9.8
1996–97	4,352	15,412	33,872	28.2	12.8
1997–98	1,476	4,657	37,737	31.7	3.9
1998–99	4,352	9,365	59,044	46.5	7.4
1999–2000	255	7,704	68,963	3.3	0.4
2000–01	1,472	6,362	74,199	23	2.0
2001–02	1,070	7,112	71,988	15	1.5
2002–03	2,989	4,867	71,815	61	4.2
2003–04	4,076	7,851	71,091	52	5.7
2004–05	5,726	21,892	1,05,297	26	5.4
2005–06	5,413	26,940	1,23,305	20	4.4
2006–07	997	31,600	1,42,567	3.2	0.7
2007–08	17,553	83,707	2,33,358	21.0	7.5
2008–09	–	14,671	2,17,416	–	–

Source: RBI, *Annual Report*, various issues.

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- Investors lapped up the PSU bank shares because of their confidence in the basic worth of the stock.
- Investors perceived that the banks entering the market had cleaned up their acts. A series of reforms, the most important being the adherence to provisioning norms and a healthy bottom line—even if it was achieved with the help of government largesse—had convinced the investor of the attractive possibilities of capital appreciation.
- Investors perceived that with the divestment of government stake, banks had achieved a greater degree of autonomy from government control.

However, resource mobilisation by banks and financial institutions registered a substantial decline in the years 1999–2000 and 2001–02. But, they emerged as the biggest class of issuers in the years 2002–03 and 2003–04.

Banks and Financial institutions dominated the primary market till 2005–06 (Table 6.16). Banks mobilised Rs. 30,151 crore through private placements to meet their capital adequacy requirements.

Banks and financial institutions did not tap the public issues market during 2008-09. They used the private placement route to raise funds. (Table 6.15 and 6.16)

MUTUAL FUNDS

Mutual funds are seen as institutions for providing small investors with avenues of investment in the capital market. Most of the investors do not have the resources, knowledge, skill, experience, and time for directly accessing the capital market. Mutual fund is an investment intermediary which mobilises the savings of the small investor, invests these savings with expertise in a well-balanced and well-diversified portfolio of stocks, thereby, reducing risk and earning a higher rate of return on investment.

Mutual funds are not new in India. The Unit Trust of India (UTI), set up in 1964 under an act of parliament, was the first mutual fund in India. In 1987, with the expansion of the capital market, the government felt the need to allow public sector banks and financial institutions to float mutual funds. During 1987–92, seven new mutual funds were established in the public sector. A change in the government policy in 1993

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TABLE 6.16 Resource Mobilisation by Top Eight Industries

Rs. in Crore

	2002–03		2003–04		2004–05		2005–06		2006–07		2007–08		2008–09	
	No.	*Amount*	*No.*	*Amount*	*No.*	*Amount*	*No.*	*Amount*	*No.*	*Amount*	*No.*	*Amount*	*No.*	*Amount*
Banking/FIs	13	3,443	11	5,428	12	11,311	12	12,439	5	2,190	6	30,951	0	0
Infotech	3	227	9	804	5	5,095	15	902	12	2,077	10	691	1	42
Paper and Pulp	1	217	0	0	1	60	4	182	1	15	1	35	0	0
Health Care	2	73	1	14	2	109	10	651	2	208	3	542	3	144
Cement and Construction	1	30	0	0	2	169	11	1,020	13	2,747	27	18,905	3	80
Chemical	–	–	8	2,085	4	128	2	128	5	147	8	661	4	218
Electronics	–	–	5	341	2	61	2	54	9	480	4	684	0	0
Power					2	5,854	2	2,164	1	30	4	13,709	2	958
Finance									9	2,765	7	1,773	3	1,996

Source: Bulletin, various issues

led to the entry of private corporates and foreign institutional investors into the mutual fund segment, taking the tally of mutual funds to 37 by end-March 2004. The total assets under the management of all the mutual funds (including UTI) as of March 2004 has grown to nearly Rs. 1,50,000 crore from Rs. 25 crore in 1964. This asset base is spread over in more than 300 schemes.

Table 6.17 shows an increasing trend in the total resources mobilised by mutual funds from 1987–88 to 1992–93. The contributory factors were setting up of new banks and financial institution-sponsored mutual funds in the late 1980s, tailor-made schemes introduced by them, and high assured rate of return offered by some mutual funds.

Resource mobilisation declined from 1993–94 and more sharply in 1995–96 and 1996–97. Even though new private sector mutual funds entered the market during this time, there was a decline in resource mobilisation by mutual funds. The subdued stock market conditions coupled with a perceived lack of transparency in the functioning of mutual funds, delayed refunds, poor accountability, and lack of efficient services were the causes of poor performance of many mutual funds resulting in low or even negative returns thereby. This eroded the investors' interest. Consequently, resource mobilisation by mutual funds (other than UTI) was low; in the case of UTI, there were large reverse flows in view of substantial repurchases.

In 1998–99, private sector mutual funds accounted for two-thirds of the total resource mobilisation. In the case of UTI, resource mobilisation was quite low due to the redemption pressure faced by it in respect of the US-64 scheme.

Conditions improved for this industry in the subsequent years as several tax incentives were announced for mutual fund investors in the Union Budget for 1999–2000. The tax concessions were offered in the equity-oriented schemes which, coupled with bullish trends in the secondary market, led to higher collections by mutual funds in the subsequent years. There was a halt in the growth of mobilisation of resources during 2008–09 due to redemption pressure and a steep fall in stock prices because of global financial crisis (Table 6.17). The net resources mobilised by private sector mutual funds and the UTI turned negative. With improvement in market sentiments, the net resources mobilised turned positive during 2009–10.

The Indian capital market is getting institutionalised as investors after burning their fingers by directly investing in the primary market are preferring mutual funds as their investment vehicle.

RESOURCE MOBILISATION FROM INTERNATIONAL MARKETS

As mentioned earlier, funds can be raised in the primary market from the domestic market as well as from international markets. After the reforms were initiated in 1991, one of the major policy changes was allowing Indian companies to raise resources by way of equity issues in the international markets. Earlier, only debt was allowed to be raised from international markets. In the early 1990s, foreign exchange reserves had depleted and the country's rating had been downgraded. This resulted in a foreign exchange crunch and the government was unable to meet the import requirements of Indian companies. Hence, allowing companies to tap the equity and bond market in Europe seemed a more sensible option. This permission encouraged Indian companies to become global.

- GDRs are listed on the European stock exchanges or on the Asian stock exchanges such as the Dubai and Singapore stock exchanges

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TABLE 6.17 Trends in Mutual Funds Resource Mobilisation

(Rs. in Crore)

Period	Gross Mobilisation				Redemption				Net in Flow				
	Private Sector	Public Sector	UTI	Total	Private Sector	Public Sector	UTI	Total	Private Sector	Public Sector	UTI	Total	Assets at the End of Period
1999–00	43,726	3,817	13,698	61,241	28,559	4,562	9,150	42,271	15,166	–745	4,548	18,790	1,07,946
2000–01	75,009	5,535	12,413	92,957	65,160	6,580	12,090	83,829	9,850	–1,045	323	9,128	90.587
2001–02	147,798	12,082	4,643	1,64,523	1,34,748	10,673	11,927	1,57,348	13,050	1,409	–7,284	7,175	1,00,594
2002–03	2,84,095	23,515	7,096	3,14,706	2,72,026	21,954	16,530	3,10,510	12,069	1,561	–9,434	4,196	1,09,299
2003–04	5,34,649	31,548	23,992	5,90,190	4,92,105	28,951	22,326	5,43,381	42,545	2,597	1,667	46,808	1,39,616
2004–05	7,36,463	56,589	46,656	8,39,708	7,28,864	59,266	49,378	8,37,508	7,600	–2,677	–2,722	2,200	1,49,600
2005–06	9,14,703	1,10,319	73,127	10,98,149	8,71,727	1,03,940	69,704	10,45,370	42,977	6,379	3,424	52,779	2,31,862
2006–07	15,99,873	1,96,340	1,42,280	19,38,439	15,20,836	1,88,719	1,34,954	18,44,508	79,039	7,621	7,326	93,985	3,26,292
2007–08	37,80,753	3,46,126	3,37,498	44,64,376	36,47,449	3,35,448	3,27,678	43,10,575	1,33,304	10,677	9,820	1,53,802	5,05,152
2008–09	42,92,751	7,10,472	4,23,131	54,26,354	43,26,768	7,01,092	4,26,790	54,54,650	–34,018	9,380	–3,658	–28,296	4,17,300
2009–10	76,98,483	14,38,688	8,81,851	1,06,19,023	76,43,555	14,26,189	8,66,198	99,35,942	54,928	12,499	15,653	83,080	6,13,979

Source: SEBI Bulletin, July, 2010.

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Indian companies have raised resources from international capital markets through Global Depository Receipts (GDRs)/American Depository Receipts (ADRs), Foreign Currency Convertible Bonds (FCCBs), and External Commercial Borrowings (ECBs). The last are used as a residual source, after exhausting external equity as a main source of finance for large value projects.

Factors Leading to an Increase in the Popularity of International Markets

Since 1993, many of the firms have chosen to use the offshore primary market instead of the domestic primary market for raising resources. The factors that can be attributed to this behaviour are as follows.

- The time involved in the entire public issue on the offshore primary market is shorter and the issue costs are also low as the book building procedure is adopted.
- Offshore issues allow foreign ownership to cross the ceiling.
- Foreign institutional investors (FIIs) prefer Euro issues as they do not have to register with the SEBI nor do they have to pay any capital gains tax on GDRs traded in the foreign exchanges. Moreover, arbitrage opportunities exist as GDRs are priced at a discount compared with their domestic price.
- Indian companies can collect a larger volume of funds in foreign exchange from international markets than through domestic markets.
- The increasing popularity of Euro bonds market among international borrowers. Euro bonds are underwritten by an international syndicate of banks and placed in countries other than the one in whose currency the bond is denominated. There are no regulatory restrictions as they fall outside the purview of any single country's regulatory framework. Moreover, they are not subject to stringent disclosure norms as compared to dollar denominated bonds in the US.
- The projections of the GDP growth are very strong and consistent which have created a strong appetite for Indian paper in the overseas market.
- An overseas issuance allows the company to get exposure to international investors, thereby, increasing the visibility of Indian companies in the overseas market.

The investors in international markets are hedge funds, long equity funds, and self-managed pension funds.

Indian firms can raise long-term funds from the international markets through equity instruments such as GDRs/ADRs or through FCCBs—a debt instrument convertible into equity on a future date. Long-term loans raised from the international markets are known as External Commercial Borrowings (ECBs).

Global Depository Receipts (GDRs)

GDRs are essentially equity instruments issued abroad by authorised overseas corporate bodies against the shares/bonds of Indian companies held with nominated domestic custodian banks. An Indian company intending to issue GDRs will issue the corresponding number of shares to an overseas depository bank. Thus, the issue of GDR creates equity shares of the issuing company which are kept with a designated bank. GDRs are freely transferable outside India and dividend in respect of the share represented by the GDR is paid in Indian rupees only. They are listed and traded on a foreign stock exchange. Trading takes place between professional market makers on an OTC (over the counter) basis. A GDR may represent one or more shares of the issuing company. The shares correspond to the GDR in a fixed ratio. GDRs are fungible, which means the holder of GDRS can instruct the depository to convert them into underlying shares and sell them in the domestic market. A holder of a GDR can, at any time, convert it into the number of shares that it represents. Till conversion, the GDRs do not carry any voting rights and once conversion takes place, the underlying shares are listed and traded on the domestic exchange. Now the GDR holders can instruct their depository to vote on their behalf.

Most of the Indian companies have their GDR issues listed on the Luxembourg Stock Exchange and the London Stock Exchange. Indian GDRs are primarily sold to institutional investors and the major demand is in the UK, US, Hongkong, Singapore, France, and Switzerland. Rule 144A of the Securities and Exchange Commission (SEC) of the US permits companies from outside the US to offer their GDRs to qualified institutional buyers.

American Depository Receipts (ADRs)

ADRs are negotiable instruments, denominated in dollars, and issued by the US Depository Bank. A non-US company that seeks to list in the US, deposits its shares with a bank and receives a receipt which enables the company to issue American Depository Shares (ADSs). These ADSs serve as stock

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Box 6.4 Sponsored ADS Issues

In a sponsored ADS issue, a company's shareholders submit their domestic shares to the company which are then issued to foreign investors in the form of ADSs. The shares submitted for the sponsored ADS issue are extinguished and replaced with ADRs. A sponsored ADS issue is different from the regular ADS issue. When companies issue sponsored ADS, there is no new issue of equity shares. Indian investors, promoters, or FIIs can tender their shares when a company announces an ADR issue and the allotment is done proportionately. Companies which have large amounts of cash and a high percentage of floating stock (shares owned by non-promoters), issue sponsored ADS to increase their visibility in territories where their products are sold.

ICICI Bank converted 38.4 million equity shares (5.2 per cent of its equity) into American Depository Shares (ADSs) at USD 12.11 each at a premium of 18 per cent to the closing domestic price on March 11, 2005. ICICI Bank was the first bank to go in for a sponsored ADS issue.

Infosys Technologies, India's second largest software services firm, offered in May 2005, ADS conversion (conversion of existing shares into US-listed stock) at USD-67 per ADS (American Depository Shares). This sponsored secondary offering consisted of 14 million ADSs representing 14 million equity shares with a green-shoe option of 2 million shares. Infosys offered this conversion to boost the size of US float to about 14 per cent of its capital and also to give domestic investors an opportunity to reap the big premium on the NASDAQ. Of the 16 million shares on offer, 20 per cent (3.2 million) shares were allotted to the Japanese market through a public offer without listing (POWL). This was the first POWL issue by any Indian company. POWL means offering the Infosys stock without an official listing procedure to Japanese institutions and retail investors.

Process for Issuing Sponsored ADR/GDR by an Indian Company

- Board Approval
- Tendering of the shares by the shareholders
- Conversion to ADRs/GDRs
- Sale of ADRs/GDRs to overseas investors
- Repatriation of proceeds to India within one month
- Distribution of proceeds to the shareholders

certificates and are used interchangeably with ADRs which represent ownership of deposited shares. There is no legal or technical difference between an ADR and a GDR. As they are listed on the New York Stock Exchange (NYSE) and the NASDAQ (National Association of Securities Dealers Automated Association), ADR issues offer access to the US institutional and retail markets while GDR issues offer access only to the US institutional market. ADR listing requires comprehensive disclosures and greater transparency as compared to a GDR listing.

GDRs can be converted into ADRs by surrendering the existing GDRs and depositing the underlying equity shares with the ADR depository in exchange for ADRs. The company has to comply with the SEC requirements to materialise this exchange offer process. However, the company does not get any funds by this conversion. The trend is towards the conversion of GDRs into ADRs as ADRs are more liquid and cover a wider market.

ADRs are accessible to only good companies with high transparency and good governance practices which also benefit the local investor; this gets reflected in a higher P/E ratio. Companies are attracted towards raising ADRs as they are free to decide the deployment of funds either in the US or in India. Companies can also make their presence felt in the global arena which would result in increased liquidity of the company's stock. This would also further broaden the mergers and amalgamations financing capabilities of the company. Moreover, an ADR issue creates a currency for issue of dollar-denominated stock option to employees, thereby enabling the company to hire and retain the best human resources. A considerable amount of resources has been raised from the international capital market through GDRs/ADRs.

Good companies through good corporate practices and governance have been successful in getting themselves listed on the LSE, the NASDAQ, and the NYSE. There are 12 Indian companies listed on the New York Stock Exchange (NYSE) and two on NYSE Euronext. The US government has made listing norms more stringent in the wake of a recent spate of accounting scandals. With the introduction of stringent Sarbanes Oxley Act in the US, many Indian companies have found it difficult to raise funds through ADRs. Many small and mid-size Indian companies opted to raise funds at the Alternate Investment Market (AIM) at London. Firms listed at AIM can trade on other global exchanges. Satyam Computers went for a cross-listing in early 2008 by joining NYSE Euronext besides NYSE.

Organising Euro Issues

The Euro issues market comprises GDRs/ADRs and FCCBs. Both FCCBs and FCEBs being debt instruments are covered under ECBs. A company which wants to tap international markets for raising resources has to prepare its accounts for the last three to five years in a revised format according to the generally accepted accounting principles (GAAP) prevalent either in the UK or US for the GDR/ADR issue. The company has to appoint a merchant banker for organising the Euro issue. The merchant banker occupies a pivotal place as he formulates the marketing strategy, designs the issue structure, and arranges syndicate members, underwriters, and a team of intermediaries. After finalising the offer document, he conducts

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road shows wherein interviews with the fund managers and potential investors are held and there is widespread distribution of pamphlets, brochures, and reports of the issuing company. These road shows help in knowing the investor response to the issue. The issue price is based on this response and the price of the securities on the domestic stock exchange. The issue price is decided a few hours before the opening of the issue. In the initial years, Indian GDRs were priced at a discount over the prevailing domestic price. The phenomenon of pricing at a discount ended in November 1993 when Mahindra and Mahindra (M&M) placed its GDR at par with the domestic price.

Guidelines Relating to International Issues

ADRs/GDRs are considered to be a part of foreign direct investment (FDI). Therefore, such issues would need to conform to the existing FDI policy and only in areas where FDI is permissible. Indian companies raising money from ADRs/GDRs through registered exchanges are now free to access the ADR/GDR markets automatically, without the prior approval of the Ministry of Finance, Department of Economic Affairs. Prior permission from the Government of India is essential for the issue of FCCBs. A company seeking to raise funds abroad through these instruments should have a consistently good track record of at least three years. The foreign equity participation directly or indirectly is restricted to 51 per cent of the issued and subscribed capital of a company.

Banks, financial institutions, and registered non-bank financial institutions were made eligible for Euro issues in June 1996 subject to the condition that the proceeds from such issues would not be invested in stock market and real estate. There is no restriction now on the number of Euro issues floated in a year by a company or a group of companies.

The end use of the GDR proceeds and external commercial borrowings have been prescribed and modified from time to time. As GDRs/ADRs are full risk equity, end-use restrictions on GDR/ADR issue proceeds have been removed. The proceeds so raised have to be kept abroad till actually required in India. Pending repatriation or utilisation of the proceeds, the Indian company can invest the funds in

1. Deposits with or Certificate of Deposit or other instruments offered by banks who have been rated by Standard and Poor, Fitch, IBCA or Moody's, etc. and such rating not being less than the rating stipulated by Reserve Bank from time to time for the purpose (current rating applicable is AA(-) by Standard and Poor/Fitch IBCA or Aa3 by Moody's);
2. Deposits with branch/es of Indian Authorised Dealers (ADs) outside India; and
3. Treasury bills and other monetary instruments with a maturity or unexpired maturity of one year or less.

Indian companies are free to utilise, without any prior approval, 100 per cent of the proceeds for overseas investment.

The ADR/GDR proceeds can be utilised for first stage acquisition of shares in the disinvestment process of Public Sector Undertakings/Enterprises and also in the mandatory second stage offer to the public in view of their strategic importance. Voting rights on shares issued under the scheme shall be as per the provisions of Companies Act, 1956 and in a manner in which restrictions on voting rights imposed on ADR/GDR issues shall be consistent with the Company Law provisions. RBI regulations regarding voting rights in the case of banking companies will be applicable to all shareholders exercising voting rights.

In his budget speech 1998–99, the finance minister announced a special stock option scheme for Indian software companies linked with ADR/GDR offerings to enable them to provide incentive to retain their highly skilled professionals.

In March 2001, the government allowed two-way fungibility for Indian GDRs/ADRs by which converted local shares could be reconverted into GDRs/ADRs subject to sectoral caps. Under this scheme, a stock broker in India, registered with SEBI, can purchase shares of an Indian company from the market for conversion into ADRs/GDRs based on instructions received from overseas investors. Re-issuance of ADRs /GDRs would be permitted to the extent of ADRs/GDRs which have been redeemed into underlying shares and sold in the Indian market.

With this, the reverse fungibility of ADRs and GDRs has gathered momentum. With the reconversions, there was no headroom in case of the ICICI bank's counter in September 2002. Headroom denotes the number of domestic shares which are available for reconversion into ADRs or GDRs.

Funds raised through FCCBs can be used for restructuring of external debt and not more than 25 per cent of the FCCB issue proceeds may be used for general corporate restructuring, including working capital requirements. Unlisted companies are barred from issuing shares or debt overseas through FCCBs, without a prior or simultaneous listing in the domestic stock markets.

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TABLE 6.18 Number and Quantum of Euro Issues

Year	*Total (Rs. in Crore)*
1992–93	702 (2)
1993–94	7,898 (27)
1994–95	6,743 (31)
1995–96	1,297 (5)
1996–97	5,594 (16)
1997–98	4,009 (7)
1998–99	1,148 (3)
1999–2000	3,487 (6)
2000–01	4,197 (13)
2001–02	2,384 (5)
2002–03	3,426 (11)
2003–04	3,098 (18)
2004–05	3,353 (15)
2005–06	11,352 (48)
2006–07	17,005 (40)
2007–08	26,556 (26)
2008–09	4,788 (13)
2009–10	15,967
Total	1,23,004 (286)

Note: Figures in Parentheses indicate number of issues.
Source: RBI, *Handbook of Statistics on Indian Economy*, 2008–09.

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External Commercial Borrowings (ECBs)

External Commercial Borrowings are borrowings raised from the international markets by corporates. These overseas borrowings are governed by an ECB policy which is administered by the finance ministry along with the RBI. Indian companies can access funds on a first-come-first-serve basis within an overall limit set in the ECB guidelines.

External Commercial Borrowings supplement domestically available resources for expansion of existing capacity as well as for fresh investment. Indian companies have preferred this route to raise funds as the cost of borrowing is low in the international markets. ECBs need sound risk management–both interest rate and forex risk. Any default has wider repercussions in terms of increasing the risk premium for the subsequent borrowers from India.

Reliance Petroleum raised USD 125 million in the form of ECBs in August 1996. This issue assumes significance as it was the only company which raised resources from the international market without any guarantee from a bank or a financial institution. The issue carried a very low coupon rate of 7.84 per cent.

In October 1996, the first floating rate ECB issue was introduced by Global Telesystems. The company raised 60 million Swiss francs (around USD 48 million) in the form of fully convertible bonds. The company offered an interest rate of 175 basis points over the LIBOR (London Inter-Bank Offer Rate).

SIDBI raised USD 20 million for 38 years–one of the largest tenored ECBs raised in the country–in 2005. Reliance Petroleum, Adani Power, and Essar Oil each raised USD 500 million during 2007–08.

ECBs are a key component of India's overall external debt which includes, external assistance, buyers' credit, suppliers' credit, NRI deposits, short-term credit, and rupee debt. ECB refer to commercial loans (in the form of bank loans, buyers' credit, suppliers' credit, securitised instruments (such as floating rate notes, and fixed-rate bonds) availed from non-resident lenders with minimum average maturity of three years. It also includes credit from official export credit agencies and commercial borrowings from the private sector window of multilateral financing institutions.

ECBs can be accessed under two routes, the automatic route and the approval route.

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Automatic Route ECBs for investment in the real sector–the industrial sector, especially the infrastructure sector in India are under the automatic route, i.e., they do not require RBI/government approval. The maximum amount of ECBs which can be raised by an eligible borrower under the automatic route is USD 500 million or its equivalent during a financial year.

Eligible Borrowers Under the Automatic Route

1. Corporates registered under the Companies Act except financial intermediaries (such as banks, financial institutions, housing finance companies, and NBFCs) are eligible borrowers. Individuals, Trusts and Non-profit making Organisations are not eligible to raise ECB.
2. Non-government Organisations (NGOs) engaged in micro-finance activities are eligible to avail ECB. Such NGO (i) should have a satisfactory borrowing relationship for at least three years with a scheduled commercial bank authorised to deal in foreign exchange and (ii) would require a certificate of due diligence on 'fit and proper' status of the board/committee of management of the borrowing entity from the designated Authorised Dealer (AD).

Borrowers can raise ECBs from internationally recognised sources such as international banks, international capital markets, multilateral financial institutions (such as IFC, ADB, and CDC), export credit agencies; and suppliers of equipment, foreign collaborators, and foreign equity holders.

Amount and Maturity

1. Corporate borrowers may avail ECB up to USD 50 million or equivalent with minimum average maturity of three years.
2. Corporate borrowers may avail ECB above USD 50 million and up to USD 500 million or equivalent with minimum average maturity of five years.
3. The maximum amount of ECB which can be raised by a corporate is USD 500 million during a financial year.
4. NGOs engaged in micro-finance activities can raise ECB up to USD 5 million during a financial year.
5. ECB up to USD 20 million can have call/put option provided the minimum average maturity of three years is complied before exercising call/put option.
6. Borrowers in infrastructure sector may avail ECB up to USD 500 million for Rupee expenditure for permissible end-uses per financial year.

Approval Route ECBs that do not come under the automatic route are now considered by an empowered committee of the Reserve Bank for approval.

Eligible borrowers under the approval route are the following.

1. Financial institutions dealing exclusively with infrastructure or export finance such as IDFC, ILFS, Power Finance Corporation, Power Trading Corporation, IRCON, and EXIM Bank.
2. Banks and financial institutions which had participated in the textile or steel sector restructuring package as approved by the government are now permitted to the extent of their investment in the package and assessment by the RBI based on prudential norms. Any ECB availed for this purpose so far will be deducted from their entitlement. These financial sector players will also not be able to provide either guarantee or letters of credit.
3. Non-banking financial companies (NBFCs) may avail ECB with minimum average maturity of five years from multilateral financial institutions, reputable regional financial institutions, official export credit agencies, and international banks to finance import of infrastructure equipment for leasing to infrastructure projects.
4. Housing finance companies may avail foreign currency convertible Bonds (FCCB) by satisfying the following minimum criteria: (i) the minimum net worth of the financial intermediary during the previous three years shall not be less than Rs. 500 crore, (ii) a listing on the BSE or NSE, (iii) minimum size of FCCB is USD 100 million, (iv) the applicant should submit the purpose/plan of utilisation of funds.
5. Entities in the service sector, viz., hotels, hospitals, and software companies have been permitted to avail ECB.
6. Cases falling outside the purview of the automatic route limits.

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End-use

1. ECB can be raised only for investment (such as import of capital goods, new projects, modernisation/expansion of existing production units) in real sector—industrial sector including small and medium enterprises (SME) and infrastructure sector—in India. Infrastructure sector is defined as (i) power; (ii) telecommunication; (iii) railways; (iv) road including bridges; (v) sea port and airport; (vi) industrial parks; (vii) urban infrastructure (water supply, sanitation, and sewage projects); and (viii) mining, exploration, and refining.
2. ECB proceeds can be utilised for overseas direct investment in Joint Ventures (JV)/Wholly Owned Subsidiaries (WOS) subject to the existing guidelines on Indian Direct Investment in JV/WOS abroad.
3. Utilisation of ECB proceeds is permitted in the first stage acquisition of shares in the disinvestment process and also in the mandatory second stage offer to the public under the Government's disinvestment programme of PSU shares.
4. NGOs engaged in micro-finance activities may utilise ECB proceeds for lending to self-help groups or for micro-credit or for bonafide micro-finance activity including capacity building.
5. ECB proceeds can be utilised by the telecom companies for payment for obtaining license/permit for 3G Spectrum.
6. Utilisation of ECB proceeds is not permitted for on-lending or investment in capital market or acquiring a company (or a part thereof) in India by a corporate.
7. Utilisation of ECB proceeds is not permitted in real estate. The term 'real estate' excludes development of integrated township.
8. End-uses of ECB for working capital, general corporate purpose, and repayment of existing Rupee loans are not permitted.

ECB proceeds should be parked overseas until their actual requirement in India. Such proceeds can be invested in the following liquid assets (a) deposits or certificate of deposit offered by banks rated not less than AA (-) by Standard and Poor/Fitch IBCA or Aa3 by Moody's; (b) deposits with overseas branch of an AD bank in India; and (c) Treasury bills and other monetary instruments of one year maturity having minimum rating as indicated above. The borrowers have been extended the flexibility to either keep these funds off-shore as above or keep it with the overseas branches/subsidiaries of Indian banks abroad or to remit these funds to India for credit to their Rupee accounts with AD Category I banks in India, pending utilisation for permissible end-uses Prepayment of ECBs upto USD 200 million is permitted without prior approval of the RBI, subject to compliance with the stipulated minimum average maturity as applicable for the loan.

The all-in-cost (rate of interest and other fees and expenses in foreign currency) ceilings over the six month LIBOR is 300 basis points for ECBs with three years and upto a five-year maturity period and 500 basis points for ECBs with a maturity of more than five years. Thus, if the six-month LIBOR is 3.5 per cent, the total permissible cost will be 8.5 per cent. The enhanced ceilings will enable top-rated companies to roll over their existing debt. Refinancing of an outstanding ECB by raising fresh loans at a lower cost is permitted subject to the condition that the outstanding maturity of the original loan is maintained. The designated AD has the general permission to make remittances of instalments of principal, interest, and other changes in conformity with ECB guidelines issued by the government/the RBI from time to time.

The ECBs were a preferred route to raise borrowed funds by large and mid-sized companies as the rate of interest was in the international markets. During the year 2007–08, Indian companies borrowed around USD 31 billion via ECBs. With rising foreign loan rates and a sharp depreciating rupee, Indian companies will now turn to domestic market for loan.

Foreign Currency Convertible Bonds (FCCBs)

FCCBs are bonds issued by Indian companies and subscribed to by a non-resident in foreign currency. They carry a fixed interest or coupon rate and are convertible into a certain number of ordinary shares at a preferred price. They are convertible into ordinary shares of the issuing company either in whole, or in part, on the basis of any equity-related warrants attached to the debt instruments. These bonds are listed and traded abroad. Till conversion, the company has to pay interest in dollars and if the conversion option is not exercised, the redemption is also made in dollars. Thus, foreign investors prefer convertible bonds whereas Indian companies prefer to issue GDRs. The interest rate is low but the exchange risk is more in FCCBs as interest is payable in foreign currency. Hence, only companies with low debt equity ratios and large forex earnings potential opt for FCCBs.

Foreign Currency Convertible Bonds

- Carry an equity component being a debt instrument.
- Give the investor a choice to convert his bond into fixed number of shares at a predetermined price or to receive a fixed yield to maturity.
- In adverse market conditions, the widening gap between bond price conversion and market price of stocks is a major worry.

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Corporates can raise FCCBs at a coupon rate of 1.5 per cent which is lower than the domestic rate. The yield-to-maturity in case of these bonds is around 6–7 per cent and it is to be paid only at the end of the tenure.

The scheme for issue of FCCBs and ordinary shares was notified by the government in 1993 to allow companies easier access to foreign capital markets. Under the scheme, bonds upto USD 50 million are cleared automatically, those up to USD 100 million by the Reserve Bank, and those above that by the finance ministry. The minimum maturity period for FCCBs is five years but there is no restriction on the time period for converting the FCCBs into shares.

The interest rate in FCCBs is much lower than bond issuances or loan syndications. The equity component in a FCCB is an attractive feature for investors. Higher the premium for conversion of equity, higher will be the yield on the FCCB. FCCBs straddle both the worlds of equity and debt. FCCBs are less dilutive than equity and are cheaper than debt. In case of FCCBs, equity dilution is not immediate and happens gradually as the bonds get converted into underlying local shares in a phased manner. Initial outflow on interest payments is extremely low since the coupon rate lies between 0 and 1.5 per cent.

When the stock markets become buoyant, FCCBs are a more preferred route to raise foreign currency funds than pure ECBs. Indian companies have issued around USD 20 billion to 50 billion of FCCBs over the past few years to meet their growth plans.

Foreign Currency Exchangeable Bonds (FCEBs)

Foreign currency exchangeable bond is a bond offered by an issuing company and subscribed to by investors living outside India and exchangeable into equity shares of another company, which is called the offered company, in any manner, either wholly or partly or on the basis of any equity-related warrants attached to debt instruments. For example, Tata Sons, a promoter of all key Tata group companies, issues exchangeable bonds to raise funds for Tata Motors.

The Central Government notified the FCEB scheme for facilitating issue of Foreign Currency Exchangeable Bonds by Indian Companies. This scheme was operationalised with effect from September 23, 2008.

- FCEB is a foreign currency bond issued by an Indian company which is a part of the promoter group of offered company and exchangeable into equity shares of the offered company

Foreign Currency Exchangeable Bond means a bond expressed in foreign currency, the principal, and interest in respect of which is payable in foreign currency, issued by an Issuing Company and subscribed to by a person who is resident outside India, in foreign currency and exchangeable into equity share of another company (offered company), in any manner, either wholly, or partly or on the basis of any equity related warrants attached to debt instruments. The FCEB may be denominated in any freely convertible foreign currency.

Eligible Issuer The Issuing Company shall be part of the promoter group of the Offered Company and shall hold the equity share/s being offered at the time of issuance of FCEB.

Offered Company The Offered Company shall be a listed company, which is engaged in a sector eligible to receive Foreign Direct Investment and eligible to issue or avail of Foreign Currency Convertible Bond (FCCB) or External Commercial Borrowings (ECB).

Entities Not Eligible to Issue FCEB An Indian company, which is not eligible to raise funds from the Indian securities market, including a company which has been restrained from accessing the securities market by the SEBI, shall not be eligible to issue FCEB.

Eligible Subscriber Entities complying with the Foreign Direct Investment policy and adhering to the sectoral caps at the time of issue of FCEB can subscribe to FCEB. Prior approval of Foreign Investment Promotion Board, wherever required under the Foreign Direct Investment policy, should be obtained.

Entities Not Eligible to Subscribe to FCEB Entities prohibited to buy, sell, or deal in securities by the SEBI will not be eligible to subscribe to FCEB.

End-use of FCEB Proceeds

Issuing Company

1. The proceeds of FCEB may be invested by the issuing company overseas by way of direct investment including in Joint Ventures or Wholly Owned Subsidiaries abroad, subject to the existing guidelines on overseas investment in Joint Ventures/Wholly Owned Subsidiaries.
2. The proceeds of FCEB may be invested by the issuing company in the promoter group companies.

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Promoter Group Companies

Promoter Group Companies receiving investments out of the FCEB proceeds may utilise the amount in accordance with end-uses prescribed under the ECB policy.

End-uses Not Permitted The promoter group company receiving such investments will not be permitted to utilise the proceeds for investments in the capital market or in real estate in India.

All-in-cost The rate of interest payable on FCEB and the issue expenses incurred in foreign currency shall be within the all-in-cost ceiling as specified by Reserve Bank under the ECB policy.

Pricing of FCEB At the time of issuance of FCEB, the exchange price of the offered listed equity shares shall not be less than the higher of the following two:

1. The average of the weekly high and low of the closing prices of the shares of the offered company quoted on the stock exchange during the six months preceding the relevant date; and
2. The average of the weekly high and low of the closing prices of the shares of the offered company quoted on a stock exchange during the two week preceding the relevant date.

Average Maturity Minimum maturity of FCEB shall be five years. The exchange option can be exercised at any time before redemption. While exercising the exchange option, the holder of the FCEB shall take delivery of the offered shares. Cash (Net) settlement of FCEB shall not be permissible.

Parking of FCEB Proceeds Abroad

The proceeds of FCEB shall be retained and/or deployed overseas by the issuing promoter group companies in accordance with the policy for the ECB.

It shall be the responsibility of the issuing company to ensure that the proceeds of FCEB are used by the promoter group company only for the permitted end-uses prescribed under the ECB policy. The issuing company should also submit audit trail of the end-use of the proceeds by the issuing company/ promoter group companies to the Reserve Bank duly certified by the designated Authorised Dealer bank.

Operational procedure—Issuance of FCEB shall require prior approval of the Reserve Bank under the Approval Route for raising ECB. The reporting arrangement for FCEB shall be as per extant ECB policy.

FCEBs would help the promoter to meet the financing requirements within the group firms especially in cases of acquisitions of foreign firm by a promoter group company. FCEBs have also not taken off so far.

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Conclusion

The primary market was in a depressed state for a long time. Some unsustained spells of buoyancy were witnessed in 1994–95 (financial sector IPOs), 1999–2000 (IT boom), and the latest in 2002. During the financial years 1994 and 1995, more than 1,000 IPOs were floated in the Indian primary market. In the year 2001–02, only six equity issues aggregating Rs. 860 crore were floated by the private sector.

The primary market was subdued due to lack of investors' confidence. Many fraudulent promoters took advantage of the free pricing regime and duped investors. The SEBI failed to take timely action against these promoters leading to a lack of confidence among investors. They shied away from the primary market. The level of investors' confidence, in turn, is dependent on the performance of the secondary markets. The secondary markets were also coloured with stories of scams which again eroded investors' confidence. Certain other factors which led to subdued conditions in the primary market were strict disclosure standards and entry point norms, prescribed by the SEBI, which led to a decline in the number of issues by the new companies.

The blue-chip companies tapped the international markets via the GDR/ADR route to raise financial resources. Corporates, financial institutions, and banks preferred the private placement route. The private placement route became more popular than the public issue route. In private placements, it was the debt instruments which gained more popularity as investors preferred safety over higher returns. This led to a rise in the debt–equity ratio of many private sector companies.

The primary market revived during 2004–05 as many good quality scrips from private sector companies were subscribed to, enthusiastically, by the investors. Moreover, the government's disinvestment

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programme created a favourable climate whereby small investors once again entered the market. In November 2005, along with private provident funds (PFs), superannuation and gratuity funds were also allowed by the finance ministry to invest 5 per cent of their new inflow in stocks The total size of superannuation and gratuity funds is around 10–15 per cent of the Rs. 2,50,000 crore provident fund sector. Since November 2005, a dozen superannuation and gratuity funds have, for the first time, invested in equity markets. Besides purchasing shares in the secondary market, these retirement funds are also investing in IPOs, follow on equity offerings of companies and some of the equity-linked mutual funds. They can directly invest in only those shares where debt instruments floated by the company have an investment grade, from atleast two rating agencies. The government liberalised the guidelines relating to private provident funds in August 2008, to facilitate more retirement savings to flow into the stock market and help evolve the corporate debt market. Private provident funds can now invest upto 15 per cent of the corpus in the stocks and 40 per cent of the funds in private sector debt instruments. These debt instruments will have to be rated investment grade by just one credit rating agency as opposed to the earlier requirement of two. The revised guidelines will be effective from April 1, 2009. The pension sector should also be opened up so that long-term domestic money can enter the primary and secondary market.

The bearish phase in the stock markets has had an impact on companies, going for raising funds, through public issues. Indian companies need to have a relook at their business and growth plans in the context of global fund crisis.

India has a household saving rate of about 35 per cent of the GDP, which approximately amounts to Rs. 6 lakh crore a year. Moreover, the Indian investor is looking for profitable and safe investment avenues. Indian retail investors are usually more interested in buying from the primary market. Small investors are more concerned with gains on the listing date which has converted the primary market into a speculative one. If the merchant bankers appropriately price the issue, this will go a long way in sustaining the revival of the primary market. It is the good faith of the small investors, regulator, and promoter which can help these issues become a success.

KEY TERMS

New Issues Market, Prospectus, Rights Issues, Preferential Allotment, Private Placement, Free-Pricing, Book Building, Green-shoe Option, Global Depository Receipts, American Depository Receipts, Foreign Currency Convertible Bonds, External Commercial Borrowings.

SUMMARY

1. The primary market is a market for new issues. Funds are mobilised in the primary market through (a) prospectus, (b) rights issues, (c) preferential allotment, and (d) private placement.
2. Issues are offered to the public through prospectus and the public subscribes directly.
3. IPO is an offering of either a fresh issue of securities or an offer for sale of existing securities or both by an unlisted company for the first time to the public.
4. A seasoned public offering (SPO) is an offering of either a fresh issue of securities or an offer for sale to the public by an already listed company through an offer document.
5. Rights issue is the issue of new shares in which existing shareholders are given preemptive rights to subscribe to the new issue on a pro-rata basis.
6. A preferential issue is an issue of shares or of convertible securities by listed companies to a select group of persons under Section 81 of the Companies Act, 1956 which is neither a rights issue nor a public issue.
7. The direct sale of securities by a company to some select people or to institutional investors is called private placement. Private placement refers to the direct sale of newly-issued securities by the issuer to a small number of investors through merchant bankers. The public sector garnered huge resources from the private placement market. In terms of instruments, debt instruments, mainly bonds and debentures of different maturities, were preferred the most. Private placements are now regulated. Companies wanting to list their privately placed bonds have to make disclosures as per the Companies Act and the SEBI guidelines.
8. There are three categories of participants in the primary market. They are the issuers of securities, investors in securities, and intermediaries.
9. There are different intermediaries to an issue such as merchant bankers or book running lead managers (BRLMs), syndicate members, registrars to the issue, bankers to the issue, auditors of the company, and solicitors.
10. In 1992, the Capital Issues (Control) Act, 1947 was repealed and all controls relating to raising of resources from the market were removed. Hence, now the promoters (issuers of securities) do not require the consent of any authority either for making the issue or for pricing it.
11. Book building is a recognised mechanism for capital raising. Book building is a mechanism through which an offer price for IPOs based on the investors' demand is determined. The aim of the process is to have the issue presold and preclude chances of under-subscription/devolvement. The cost and time for making public issues is lowered; the procedures are also simplified. The SEBI reintroduced the moving price band concept in the book built IPOs. The price band can be revised and this revision has to be informed to the stock exchanges. The SEBI lowered the mandatory participation of QIBs in the book built IPOs from 60 per cent to 50 per cent.
12. Reverse book building is a process wherein the shareholders are asked to bid for the price at which they are willing to offer their shares. It is just similar to reverse auctions.
13. A green-shoe option means an option of allocating shares in excess of the shares included in the public issue and operating a post-listing price stabilising mechanism for a period, not exceeding 30 days, in accordance with the provisions of Chapter VIIIA of the DIP Guidelines. A stabilising agent (SA) steps in and buys the shares from the market when the share price falls below the offer

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price. He has the discretion to decide the timing, the quantity, and the price at which to buy shares for stabilising the post-listing price.

14. The on-line issue of shares is issued via the electronic network of the stock exchanges. The guidelines for online issue of shares are incorporated in a new chapter in the SEBI (Disclosure and Investor Protection) Guidelines, 2000.
15. Three distinct trends in resource mobilisation from the primary market through the prospectus and the rights issues. It indicates an increasing trend from 1991–92 to 1994–95, a decreasing trend from 1995-96 onwards, with unsustained spells of revival in 1998–99 and an increasing trend since 2003–04.
16. The average share of the private sector in resources mobilised through prospectus and rights was around 45 per cent in 1990s.
17. Large issues account for more than 90 per cent of the total issues. In 2003–04, large issues accounted for more than 97 per cent of the total issues and equity issues-dominated bond issues.
18. Banks and financial institutions raised large amount of resources from the primary capital market. They emerged as the biggest class of issuers in the years 2002–03 and 2003–04.
19. The Indian capital market is getting institutionalised as investors, after burning their fingers, by directly investing in the primary market, and preferring mutual funds as their investment vehicle.
20. Indian companies have raised resources from international capital markets through Global Depository Receipts (GDRs), American Depository Receipts (ADRs), Foreign Currency Convertible Bonds (FCCBs), and External Commercial Borrowings (ECBs).
21. GDRs are essentially equity instruments issued abroad by authorised overseas corporate bodies against the shares/bonds of Indian companies held with nominated domestic custodian banks.
22. ADRs are negotiable instruments, denominated in dollars, and issued by the US Depository Bank.
23. FCCBs are bonds issued by Indian companies and subscribed to by a non-resident in foreign currency. They carry a fixed interest or coupon rate and are convertible into a certain number of ordinary shares at a preferred price.
24. ECBs can be accessed under two routes, namely, automatic route and approval route.
25. Resources mobilised by way of Global Depository Receipts (GDRs) registered a sharp increase. Companies are attracted towards raising ADRs as they are free to decide the deployment of funds either in the US or in India.
26. As Indian companies tap foreign capital markets to raise funds, similarly, foreign companies can now issue their shares to Indian nationals in India.

MINI CASE

Ritu is a first year MBA student who is always missing her Garam Masala Chai and Samosas made by Sevakram's Mobile Restaurant in her hometown of Bhopal. She approaches Sevakram with a business partnership proposal to open a similar mobile restaurant in Amdavad near her college. Sevakram is horrified. He is not willing to invest in a city that is unfamiliar to him and is more than a thousand kilometers away. However, he has known Ritu for many years as she had patronised his restaurant for years and had never asked for payment credit and had always paid cash. Thus, he offers her his secret formulas in return for 5 per cent of gross revenues that she can make creating products using his formulas. Ritu gladly accepts the deal.

She creates samples of Chai, samosas, cold sandwiches, and idlis using Sevakram's secret formulas and serves them to her classmates. Her classmates love the Chai and eatables. She tells them that she plans to drop out of the MBA course and start a business selling Chai and these eatables across the whole country. She convinces ten of her classmates to contribute Rs. 1,000.00 each at 10 per cent simple annual interest with the principal due after two years and one free Chai and eatables every week till she pays back the loan.

With the seed money that she has now she rents a ultra small mobile kiosk and names it Ritu's Tea House and hires a couple of friends to sell these eatables from her kiosk. Meanwhile, she focuses on creating these products and streamlining the production process at her apartment. She delivers these products thrice a day to her kiosk. Ritu's Tea House even though a small kiosk is a big success in her university campus. Three months later, her 10 friends contribute an additional Rs. 50,000.00 to start another kiosk and a commercial kitchen where she can create these eatables. She hires production staff and logistics staff and six months later, she has paid off all her loans and has two very successful kiosks, a commercial kitchen with trained staff and a small logistics department who delivers on bicycles, and a very happy Sevakram with his 5 per cent royalties and a happy set of friends who have had a return of 10 per cent in nine months and 40 sets of free eatables.

QUESTIONS FOR DISCUSSION

1. Ritu has approached you, a financial consultant, to help her out with additional finances. She wants to open 18 more kiosks in the campus since the campus has many colleges and hostels and 20 kiosks will comfortably survive without cannibalising each others' sales. What will be your recommendation?
2. Fifteen months later Ritu approaches you again for help, with additional funding. All her 20 kiosks are a runaway success and her commercial kitchen is running at full capacity. She has a small managerial team of three people who are now managing the kitchen and the logistics. In a range of 5 km outside the campus, there are enough commercial businesses to support at least 100 kiosks. Ritu wants to hire a real-estate manager to negotiate kiosk areas in the commercial and retail buildings, she wants to buy two delivery trucks for her logistics department, and she needs funding to create and run the additional 100 kiosks. What will be your recommendation?
3. Two years later Ritu has again approached you for your help. Ritu's Tea Houses' revenues this year will exceed Rs. 3 crore Ritu, now an MBA dropout, is very satisfied with her success but she has not achieved her vision of having Ritu's Tea House in every city, town, and village of the country. She wants to know if she should now become like a Sevakram and franchise her business model to other franchisees or should she keep growing the way she has grown in the past four years? Discuss the funding needs and intermediaries that will be involved in both the approaches.

REVIEW QUESTIONS

1. How are funds mobilised in the primary market?
2. What are the reasons for growth of the private placement market in India?
3. Why do blue-chip companies opt to raise funds through GDRs/ADRs?
4. Describe the primary market scenario in India.
5. What is a green-shoe option? What are the advantages and disadvantages of exercising this option?
6. What is an IPO? State the entry norms laid by the SEBI for making an IPO. What are the requirements that need to be fulfilled by an unlisted company wishing to go public?
7. What are the requirements to be fulfilled by an issuer making a follow-on public offer?
8. Which companies are eligible for raising funds through fast-track route?
9. Describe the process of trading of rights entitlement.
10. What is a preferential issue? State the norms issued by SEBI for preferential allotment. Why do companies prefer to allot preferential shares?
11. State the guidelines relating to Qualified Institutions Placement.
12. State the guidelines relating to External Commercial Borrowings.

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13. What are the salient features of the Indian Depository Receipts (IDR) rules? Also mention the SEBI norms to be adhered by the IDR issuer.
14. What is book building? Describe the book building process. List the benefits and limitations of book-building.
15. What is ASBA? Explain the ASBA process.
16. What is the role of the Anchor investor in the Indian primary market.

Answer in Brief

1. Distinguish between:
   a. IPO and FPO
   b. Public issues and Right issues
   c. Public issues and Private Placement
   d. Rights issue and Preferential issue
   e. Qualified Institutions Placement and Private Placement
   f. Qualified Institutions Placement and GDR
   g. GDRs and ADRs
   h. Fixed pricing and book building process.
2. What are the different intermediaries to an issue?
3. State the pre-issue and post-issue activities of a merchant banker.
4. What do you understand by the moving price band concept?
5. Define
   a. Retail Individual Investor
   b. Qualified Institutional Buyers (QIBs)
   c. Non-Institutional Investor (NII)
   d. Promoter and Promoter Group
6. What is a Sponsored ADS issue? When do companies issue Sponsored ADS?
7. State the routes under which ECBs can be accessed?
8. What is reverse book building? Describe the process for reverse book building.
9. Which entities are exempted from entry norms laid down by the SEBI for raising funds through an IPO?
10. Why do promoters offer rights issue?
11. How is the pure auction method of book building different from the regular book building?
12. How are FCEBs different from FCCBs?

Choose the Right Answer

1. _____ issue does not bring in any fresh capital.
   (a) Equity (c) Debenture
   (b) Preference (d) Bonus
2. Where the offer or invitation to subscribe for shares or debentures is made to 50 or more persons, then such an offer or invitation is known as _____ offering.
   (a) public (c) preferential
   (b) private (d) rights
3. Prospectus is not issued in _____.
   (a) public issue (c) rights issue
   (b) private placement
4. An issuer need not file an offer document in case of _____.
   (a) public issue (c) rights issue
   (b) preferential allotment
5. A _____ issue is an issue of securities by listed companies to a select group of persons under Section 81 of the Companies Act, 1956.
   (a) rights (c) public
   (b) preferential
6. In book building, the spread between the floor and the cap of the price band should not be more than _____ per cent.
   (a) 10 (c) 30
   (b) 20 (d) 50
7. In book building, a bid is usually open for a minimum of _____ working days and not more than _____working days.
   (a) five, seven (c) seven, ten
   (b) three, seven (d) three, five
8. Allocation to retail investors high networth individuals (non-institutional investors) and qualified institutional buyers (QIBs) is in the ratio of _____ respectively.
   (a) 25:50:25 (c) 35:15:50
   (b) 50:25:25 (d) 50:15:35
9. An issuer can launch an IPO within_____.
   (a) three months (c) nine months
   (b) six months (d) one year
10. Rights issue shall be kept open for atleast_____ days and not more than _____ days.
    (a) 15, 30 (c) 20, 40
    (b) 30, 60 (d) 10, 20
11. An issue of a minimum size of Rs._____crore is a mega issue.
    (a) 50 (c) 150
    (b) 100 (d) 300
12. The maximum amount of ECBs which can be raised by an eligible borrower under the automatic route is USD_____million.
    (a) 100 (c) 500
    (b) 300 (d) 1000

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7

Disinvestment of Public Sector Undertakings

Chapter Objectives

This chapter will enable you to develop an understanding of the following:

1. *What is disinvestment*
2. *Why disinvestment of PSUs in India*
3. *The PSU sell-off methods*
4. *Proceeds realised from disinvestment*
5. *Evaluating the disinvestment programme*
6. *Disinvestment of PSUs in different countries*

INTRODUCTION

Central public sector undertakings (PSUs) are organisations established by the government of India as government companies under the Companies Act or as statutory corporations under specific statutes of parliament.

After independence, the government realised that the process of industrialisation needed enormous amount of capital which was beyond the financial capability of the private sector. PSUs were set up in the early 1950s to ensure a rapid economic and industrial growth, create the necessary infrastructure for economic development, create employment opportunities, promote balanced regional development, and assist the development of small-scale and ancillary industries. The central government's direct involvement and involvement through holding companies was to the extent of 95 per cent of the total share capital of all the central public sector undertakings. Fifty-eight industries were reserved exclusively for the public sector in the 1950s. In 1991, the number of industries reserved was brought down to 18 and now it is 4.

PSUs do not have an autonomy as most of their decisions relating to capital expenditure, acquisitions and investments have to be approved by the Public Investment Board (PIB), Cabinet Committee on Economic Affairs (CCEA) and the central government. The control on PSUs is also exercised through the Comptroller and Auditor General (CAG), Central Vigilance Commission (CVC), and the CBI. These controls exist because PSUs are ultimately responsible to parliament.

There are 35 PSUs in the BSE-200 index accounting for almost two-fifths of the market capitalisation, with an aggregate market capitalisation of Rs. 3,84,600 crore. Further, a third of India's mega companies (market capitalisation of USD 5 billion) are PSUs. And, many of them are not only market leaders in their areas of operation but figure in the global fortune 1000 list as well.

PSUs have supported the creation of a pool of managerial and technical talent and a large middle-class population. They have also fulfilled their social obligations to the community at large by providing education, medical, recreational and vocational facilities to the people in the vicinity of their township.

Most of the PSUs are subsidied by the central government and hold monopoly positions in the Indian market. Public sector undertakings of India are a heterogenous mix of infrastructure companies, manufacturing companies and companies engaged in trade and services.

According to the ET–CMIE PSU survey, there are about 380 central public sector units, both listed as well as unlisted at the stock exchanges. They include 31 banks, 17 hire purchase firms, 10 coal and lignite companies, 17 investment services firms, 27 units engaged in trading, and 13 business consultancy firms such as the India Trade Promotion Organisation, Central Mine Planning and Design Institute, and Water and Power Consultancy Services. They had a combined net worth of Rs. 3,45,790 crore, a combined income of Rs. 6,28,600 crore and a dividend payment of more than Rs. 10,000 crore for the year 2000–01. The Oil and Natural Gas Corporation (ONGC) had the largest net worth of more than Rs. 30,000 crore, highest profits of Rs. 5,229 crore, and the highest dividend payment, Rs. 1,729 crore for the year 2000–01. Among the smallest central PSUs are Borrea Coal, Richardson Cruddas, Nagaland Pulp and Paper, Brushware, and Katras Jherriah Coal with revenues under Rs. 10 lakh. The PSU with highest borrowing (excluding banks and financial institutions) was the Food Corporation of India with borrowings of Rs. 22,240 crore and revenues of around Rs. 28,000 crore for the year 2000–01.

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In addition to the above, there are 210 state PSUs, about half of them being loss-making units. State PSUs are small in comparison with central PSUs. Tamil Nadu has the highest number of PSUs—55, followed by Kerala with 28 units and Gujarat with 24. The combined net worth of the 210 state PSUs was around Rs. 23,280 crore, combined revenues of Rs. 33,000 crore and net loss of Rs. 286 crore as of 2000–01. Together, the state PSUs declared a dividend of around Rs. 100 crore to their state governments in 2000–01. Gujarat's Sardar Sarovar Nigam has a net worth of Rs. 8,041 crore, followed by Karnataka's Krishna Bhagya Jala Nigam worth Rs. 2,207 crore. The largest state-run unit in terms of revenue was Karnataka Power Transmission with a revenue of Rs. 5,565 crore in 2000–01. In terms of profit, the Gujarat State Electricity Corporation topped the list with a net profit of Rs. 91 crore on a revenue of just Rs. 350 crore and in terms of loss, the Dakshin Haryana Bijli Vitran Nigam had an accumulated loss of Rs. 264.3 crore. State-run PSUs, with accumulated losses of Rs. 4,600 crore, are a big drain on the respective governments.

Disinvestment

- Privatisation implies a change in ownership and management while disinvestment may or may not lead to a change of management

The disinvestment of public sector undertakings means the sale of public sector equity leading to a dilution of the government's stake. In India, the term 'disinvestment' is used rather than 'privatisation.' Privatisation implies a change in ownership resulting in a change of management while disinvestment may or may not lead to a change of management. A well-designed disinvestment programme helps in the long-term growth process through increased foreign investment, technology transfer and the subsequent enhancements in productivity. The process of disinvestment was initiated by the government of India during 1991–92 as part of a package of PSU reform. The disinvestment of government stake from PSUs follows from the Industrial Policy Statement of 1991–92. Around Rs. 2,00,000 crore are locked in PSUs.

Almost half of the PSUs in the country are loss-making enterprises and a big drain on the national exchequer. The public sector was consuming far too much capital and current revenues and the government itself was facing a resource crunch owing to mounting fiscal deficit. The then finance minister, Manmohan Singh, realised that competition would intensify due to reforms and the cash-starved PSUs would be badly affected. So the idea of equity sale privatisation was first mooted in 1991 by him as a means of raising resources and improving the performance of PSUs. Moreover, the process of liberalisation began in the 1990s. The private sectors had enough resources to get into the sectors dominated by PSUs. The government also identified certain sectors such as hotel and food which could be best left to the private sector.

Objectives of Disinvestment

- Broad-base equity
- Put national resources and assets to optimal use
- Enhance the productivity of PSUs

Objectives The privatisation programme was flagged off in October 1991 without clear-cut objectives. The stated objective was to raise resources to finance fiscal deficit. It was proclaimed that the step meant widespread holding which again meant increased efficiency. Moreover, there was no well-defined strategy laid down to achieve these unclear objectives. This was evident by the way the government offloaded, in the very first year, small lots of 2 per cent and 3 per cent of a company's equity capital which left major control still in the government's hands. This revealed the unstated objective of the government which was to retain control over the management. The government later on stated that the objectives of disinvestment were to broad base equity, improve management, enhance availability of resources for these public sector enterprises and finance fiscal deficit. In the Disinvestment Policy 2000–01, the government, for the first time, seemed prepared to reduce its stake in the non-strategic PSUs even below 26 per cent if necessary.

In 2001, the government introduced a special provision for setting aside a quota of shares for small investors and workers. The government set out the following policies in respect of PSUs: Bring down government equity in all non-strategic PSUs to 26 per cent or lower if necessary; restructure and revive potentially viable PSUs; close down PSUs which cannot be revived; and fully protect the interest of workers.

The government has stressed that the proceeds from disinvestment would be used for meeting expenditure in the social and infrastructure sectors, restructuring of PSUs, and restructuring public debt.

To maximise returns to the government, the approach has been shifted from the disinvestment of small lots of shares to strategic sale of blocks of shares to strategic investors.

The disinvestment minister reviewed the disinvestment policy on December 9, 2002 and stated the objective of disinvestment as to put national resources and assets to optimal use and in particular to unleash the productive potential inherent in our public sector enterprises. The disinvestment policy aimed at modernisation and upgradation of public sector enterprises, creation of new assets, generation of employment, and retiring of public debt.

From April 2009, disinvestment of central public sector enterprises (CPSEs) will be considered on a case-by-case basis for approval by the government as CPSEs differ in terms of capital structure, financial strength and status in compliance with mandatory listing requirements.

The Government, on November 5, 2009, approved the following action plan for disinvesting government equity in profit-making CPSEs:

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1. Already listed profitable CPSEs not meeting the mandatory public shareholding of 10 per cent, are to be made compliant.
2. All CPSEs having positive net worth, no accumulated losses and have reported net profits for the three preceding consecutive years are to be listed through public offerings out of government shareholding or issue of fresh equity by the company or a combination of both.
3. The proceeds from disinvestment would be channelised into National Investment Fund (NIF) and would be available in full during April 2009 to March 2012 for meeting the capital expenditure requirements of selected social sector programmes decided by the Planning Commission/Department of Expenditure.

The proceeds from the disinvestment in Power Grid Corporation (PGC) and Rural Electrification Corporation (REC) were channelised to NIF. The NIF corpus of Rs. 1814.45 crore is managed by UTI Assets Management Company Ltd, SBI Funds Management Company (Pvt) Ltd, and Jeevan Bima Satyog Asset Management Company Ltd under the 'discretionary mode' of the Portfolio Management Scheme (PMS) governed by SEBI guidelines.

DISINVESTMENT MACHINERY

Initially, in 1991–92, the government resorted to bundling options wherein shares were offered only in bundles of 'very good,' 'good,' and 'average' companies. This resulted in disinvestment at very low prices. The government then realised that framing proper strategies for disinvestment was essential.

The Government of India appointed a committee under the chairmanship of the former RBI Governor, C. Rangarajan, in 1993. It recommended that a disinvestment committee be established on a statutory basis in view of the multiple ministries involved, its impact on economic reform, and the need to monitor use of the proceeds of such disinvestment. In 1996 when the Congress was voted out of power, the United Front government set up a disinvestment commission. It was constituted under the chairmanship of G. V. Ramakrishna. It was set up for advising the government on disinvestment in general and for drawing up a long-term disinvestment programme for the PSUs referred to the commission. The commission identified four objectives as part of its long-term strategy: to strengthen PSUs, where appropriate, in order to facilitate disinvestment; to protect employees' interest; to broad base ownership; and to augment receipts for the government.

The Disinvestment Commission broadly classified the PSUs into two categories for disinvestment—the core group and the non-core group. Those in the core group were defined as having considerable market presence and hence PSU disinvestment would be limited to a maximum of 49 per cent. The non-core group industries were defined as units where private sector players have already made huge investments with the aim of enhancing the intrinsic value of PSU shares. The commission recommended that the core and non-core PSUs should be restructured prior to disinvestment. It identified about 100 PSUs and classified them as *navratnas* and *mini-ratnas*. Nine well-performing PSUs under the core category were identified by the government for granting autonomy, which meant giving them freedom to incur capital expenditure, raise resources, and enter technology contracts. These PSUs, popularly known as '*navratnas*', are BHEL, BPCL, HPCL, IPCL, IOC, NTPC, ONGC, SAIL, and VSNL.

The Disinvestment Commission advocated 'strategic sales' of particular PSUs or sale of equity blocks to a single buyer accompanied by transfer of management to the private investor. The government showed its willingness to hand over control through strategic sales to any private party acquiring 25 per cent in the company. The commission has the mandate to offload upto 74 per cent government equity in the non-core and non-strategic areas. There is no change in the government's present shareholding in strategic areas. The government has identified arms, ammunition, and the allied items of defence, equipment, defence aircraft and warships, atomic energy, and railway transport as strategic areas.

The Disinvestment Commission submitted 12 reports recommending disinvestment of 58 PSUs out of the 71 referred to it. These reports contained specific recommendations including disinvestment through strategic sale in 29 PSUs, trade sale in 8 PSUs, offer of share through GDR and domestic route for 5 PSUs, no disinvestment for 1 PSU, disinvestment deferred in 11 PSUs, and closure of 4. The government decided to disinvest in 45 PSUs out of the recommended 58. The tenure of the Disinvestment Commission ended on November 30, 1999.

The Disinvestment Commission was reconstituted in July 2001 with R. H. Patil as chairman. The task of this Disinvestment Commission is to advise the government on non-strategic PSUs and their subsidiaries excluding IOC, ONGC, and GAIL. The Disinvestment Commission submitted its thirteenth report in January 2002 and made recommendations in respect of the following four PSUs: Neyveli Lignite Corporation Limited (NLC); Manganese Ore (India) Limited (MOIL); Real India Technical and Economic Services Limited (RITES); and Projects and Equipment Corporation Limited (PEC).

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The recommendations are being examined by the government.

The government constituted the Department of Disinvestment (DOD) on December 10, 1999. It is a nodal body set up to streamline and speed up disinvestment and establish a systemic policy approach to it. It has been made responsible for all matters relating to the disinvestment of central government equity from central PSUs. The Ministry of Disinvestment is to take decisions on its recommendations on the modalities of disinvestment including restructuring.

PSU Self-off Methods

- Bidding
- Sale of shares in the market
- GDR route
- Crossholdings
- Strategic sale

THE PSU SELL-OFF METHODS

The government has adopted various methods to sell off shares in PSUs.

- *Bidding:* In 1991–92, the bidding method was adopted. When the government invites bids for a portion of its stake in a public sector undertaking, it is essentially conducting an auction. The Department of Public Enterprises (DPE) invites closed bids from government financial institutions and mutual funds. The tendering process is driven by a reserve price based on valuation models such as net asset value, earnings potential, and previous realisations if available. These were determined after consultations with merchant bankers such as IDBI and SBI Caps. The government sets a price below which it is unwilling to sell its stake. This price is referred to as the reserve price. In 1991–92, the government resorted to bundling option wherein shares were offered only in bundles of 'very good,' 'good,' and 'average'. The realised amount exceeded the targeted amount in the very first year of the disinvestment programme due to acceptance of low bids for share bundles. However, this strategy instead of helping the government to divest shares in loss-making enterprises at reasonable prices, resulted in disinvestment at very low prices. The share bundles included certain PSU shares such as MTNL, ITI, VSNL, CMC, and Cochin Refineries which would have otherwise commanded a high premium if sold individually. The practice of bundling shares was abandoned thereafter. The government, in subsequent years, sold shares for each company separately. The emphasis of the government in the initial years was on disinvestment of equity, retaining the controlling block.
- *Sale of Shares in the Market:* During 1991–99, shares of companies like IOC, BPCL, HPCL, GAIL, and VSNL were sold in the market. The shares of these blue chip companies were sold at price–earnings ratios of ranging between 4.5 and 6.0. The sale of shares through public issue not only brings down the government's equity holding in the company but there is also the advantage that the money so realised can be used for expansions. The offer of sale of shares in the primary market increases public ownership in these PSUs through retail participation resulting in better price discovery, increasing the floating stock of the company and deepening the capital market. The IPO route is suitable during strong secondary market conditions. Moreover, retail investors get an opportunity to subscribe to the offer and help develop capital markets. The wealth created by PSUs through public resources can be shared equitably with the public at large. However, a public issue does not result in a change in management style and functioning of the companies. The control of the companies continues to be vested with the government resulting in a lower P/E ratio.
- *Global Depository Receipts (GDR) Route:* The government decided to tap the overseas market for disinvestment due to sluggish capital market conditions. In March 1997, the VSNL disinvestment took place through the GDR issue which was priced at USD 13.93 and was over-subscribed 10 times. The second GDR issue of VSNL in February 1999 was priced at a lower price of USD 9.25. MTNL and GAIL were the other GDR issues. The government sold 18 per cent equity in GAIL in 1999–2000 and raised Rs. 1,095 crore through the disinvestment of 155 million shares represented by 22.5 million GDRs. The disinvestment through offloading of minority shares through domestic, ADR, or GDR markets was not productive.
- *Cross-holdings:* After widely missing the targets on the PSU disinvestment front, the government adopted an innovative route to meet the disinvestment target in 1998–99. Cash-rich oil companies were asked to subscribe to each other's shares. This swapping of shares within oil sector PSUs took place just before the close of 1998–99. This cross-holding of Indian Oil Corporation (IOC) buying 10 per cent government stake in ONGC and 5 per cent stake in GAIL, ONGC buying 10 per cent in IOC and 5 per cent in GAIL, and GAIL buying 2.5 per cent stake in ONGC helped the government gather Rs. 4,867 crore at the end of the year. The lock-in period of these shares came to an end in September 2004.

- Strategic sale is sale of equity blocks of a PSU to a single buyer (private investor) resulting in change of ownership and management

- *Strategic Sale:* The Disinvestment Commission in 1996 advocated 'strategic sales' of particular PSUs or sales of equity blocks to a single buyer accompanied by the transfer of management to the private investor. The government also felt the need for privatisation as opposed to just disinvestment. It preferred to privatise the PSUs through the strategic sale route. A strategic sale is indicative of

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TABLE 7.1 Price–Earnings Ratio

Sale of Shares 1991–99		*Strategic Disinvestment 2000–02*	
Company	*P/E Ratio*	*Company*	*P/E Ratio*
IOC	4.9	Balco	19
BPCL	5.7	CMC	12
HPCL	5.9	HTL	37
GAIL	4.4	MFIL	Very High as EPS was Negative
VSNL	6.0 (In Monopoly Days)	LJMC	Same as Above
		PPL	Same as Above
		JESSOP	Same as Above
		IBP	63
		VSNL	11 [Inclusive of Income from Dividend and so on After the End of Monopoly]
		HZL	26
		Maruti	89
		IPCL	58

Source: Business World, June 24, 2002, p. 26.

the government's sincerity about disinvestment. It also enables a higher valuation since it takes into account intrinsic valuation, not just the prevailing market price. Moreover, private investors introduce new technologies, induct fresh investments, and improve efficiency. Under strategic sale, the government transfers part of its holding to a strategic partner who would control the operation and financial policy of the enterprise. The strategic partner is chosen through an elaborate bidding process. The transfer of ownership is subject to certain restrictions imposed through covenants. However, strategic sale may inhibit competition and limit the ability of the government to realise the full value of the assets. The first strategic sale was of Modern Food where the government offloaded 74 per cent of its equity to Hindustan Lever for Rs. 105.45 Crore. The strategic sale of Balco, CMC, HTL, MFIL, PPL, JESSOP, IBP, LJMC, VSNL, HZL, Maruti, and IPCL was done at a higher price–earnings ratio ranging between 11 and 89. VSNL's price–earnings ratio of around 11 was higher by around 6 than in case of public issue. In strategic sale, the money goes to the government exchequer instead of the company. The government has adopted the competitive bidding route to ensure the success of the disinvestment programme. The group or the corporate securing the bid then has to make an open offer for acquiring shares from the public at six months' average price as per SEBI's takeover code. The recourse to strategic sale has made the process of disinvestment more beneficial from the revenue point of view. Between 1991 and 1997, the sale of minority shares in blue chip PSUs such as ONGC, IOC, GAIL, and VSNL fetched a price–earnings ratio of 4.4 to 6. With strategic sales, the price–earnings ratio spurted to between 11 and 89. The amount so realised was Rs. 11,335 crore, from the disinvestment of a mere 1.02 per cent of the government equity of Rs. 885 crore.

The Ministry of Disinvestment has set certain guidelines for evaluating PSUs. It has suggested four methods to arrive at the reserve price of a PSU. These are: the discounted cash flow (DCF) method, the balance sheet method, the market multiple method, and the asset valuation method.

Methods Used to Arrive at the Reserve Price of a PSU

- Discounted cash flow
- Balance sheet
- Market multiple
- Asset valuation

The DCF method discounts the expected future cash flows of the PSU to arrive at its present value. The balance sheet method values a company on the basis of the value of its underlying assets. This method does not project the future cash flow. The market multiple method uses information on how the market is evaluating comparable firms. The asset valuation method estimates the cost of replacing the tangible assets of the business and the costs so arrived at as the value of the firm. The asset valuation method overlooks the value of intangibles such as goodwill, brands, distribution network, and customer relationships which are important to determine the intrinsic value of the enterprise. The asset valuation method is more suitable in case of liquidation than in the case of companies sold as running concerns. The DCF method is superior to the other three as it projects future cash flows and the earning potential of the firm, takes into account intangibles such as brand equity, marketing and distribution networks, the level of competition likely to be faced in the future, risk factors to which the enterprise is exposed as well as the value of its core assets. Sometimes, it is better to use a combination of methods in case of PSUs having sizeable tangible assets such as surplus land, which are unrelated to its core business.

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Strategic Sales Techniques

In the years 2000–01 and 2001–02, 14 PSUs were disinvested (Refer Annexure 7.1). The disinvestment ministry had evolved innovative methods to make them attractive for sale. In case of Balco and VSNL, the government retained cash and the real estate of the company and sold the remaining assets while in the case of India Tourism Development Corporation (ITDC) and the Shipping Corporation of India (SCI), it spun off various assets as separate and individual entities. The government financially restructured the ailing Paradeep Phosphates before the sale, to make it more attractive to prospective buyers.

Two sell-offs in 2002, that of Maruti Udyog Limited (MUL) and Indian Petrochemical Corporation Limited (IPCL), were unique in the 11-year history of disinvestment. In the case of Maruti, the government decided to sell 50 per cent holding in three phases. The first phase entailed Rs. 400 crore rights issue in which the government would renounce its entitlement in favour of its equal foreign partner, Suzuki Motor Corporation, for a consideration of Rs. 1,000 crore. Suzuki's stake was to go upto 54.5 per cent after the issue and the Rs. 400 crore were to flow into the company's coffers. Suzuki also paid Rs. 1000 crore as control premium. In the second phase, the Government of India would sell 36 lakh shares in an initial public offer (IPO) and earn a minimum of Rs. 828 crore as Suzuki had underwritten these shares at a price of Rs. 2,300 (face value Rs. 100). The government's remaining stake was to be sold in the last phase. Suzuki was only picking up 4.5 per cent additional stake under the rights issue to become a majority owner and it would be obliged to buy the remaining stake only if the government was unable to get a predetermined minimum price for its share in the two subsequent public issues. In 2003, the government divested 27.5 per cent by way of initial public offering (IPO) which was a huge success. The issue was oversubscribed ten times and opened with a premium of 25.2 per cent.

In the IPCL case, the government of India sold off one of its units prior to the sale to prevent the creation of a monopoly in the petrochemical sector. The sale of one unit (the Baroda unit to IOC) prior to disinvestment made IPCL more attractive for the buyer—Reliance—as the unit was the oldest and the least profitable. The government held a 59.95 per cent stake in the petrochemicals giant and to dilute its holdings it decided to sell its 51 per cent holding in two phases. In the first phase, the government invited financial bids in April 2002 from prospective bidders—Reliance Industries, IOC—the Chatterjee Group Combine and Nirma for a 26 per cent stake in the oil giant. On May 18, 2002, Reliance Industries Limited (RIL) became the strategic buyer as it had submitted the highest bid of Rs. 231 per share for a total consideration of Rs. 1491 crore. RIL further bought 20 per cent from the market to take its holding to 46 per cent. The second phase involved selling 25 per cent of its stake in tranches of 10 per cent or less every year, either in the market or to a strategic buyer.

PROCEEDS REALISED FROM DISINVESTMENT

The government has collected disinvestment proceeds of around Rs. 49,214 crore from the sale of 50 PSUs in the last 15 years. There have been only four years (1991–92, 1994–95, 1998–99, and 2003–04) during which the actual receipts have exceeded the targeted receipts. The success has been due to acceptance of extremely low bids in 1991–92 for share bundles which included premium shares offloading in 1994–95 of a large chunk of shares in attractive PSU giants such as BHEL, GAIL, and Bharat Petroleum and through cross-holdings wherein cash-rich PSUs were forced to buy back equity of other PSUs.

During 1993–94, disinvestment was held in March 1994 and the bids were opened in April 1994. Thus, the proceeds so realised were accounted as capital receipts of 1994–95. The actual mobilisation under the disinvestment programme fell short of the targeted amount in the budget for three successive years—from 1995–96 to 1997–98—due to sluggish capital market conditions. Hence, the government adopted the GDR route to mobilise resources under this programme.

The Supreme Court judgement in December 2001 validating the previous fiscal's (FY 2001) sale of aluminium major Balco to Sterlite Industries, gave impetus to the limping disinvestment process. Moreover, the disinvestment ministry headed by Arun Shourie was able to sell off PSUs at a hefty premium by adopting the competitive bidding route. The successful bidders were supposed to make an open offer to investors other than the government. These helped in creating a bullish environment in the PSU segment. The PSU stocks which were trading at a discount started trading at price–earnings multiples comparable to private sector blue chips. The BSE PSU index rose 531.27 points or 57.44 per cent between December 31, 2001 and March 31, 2002. The BSE Sensex was up only by 207.02 points or 6.34 per cent in the same period.

Buoyed by this spurt in market prices of PSU shares, the Department of Disinvestment mooted a proposal on July 8, 2002, for mopping up Rs. 25,000 crore by making public offers in five major PSUs. These include BSNL, IOC, GAIL, NTPC, and ONGC. The government owns 100 per cent stake in BSNL and NTPC, 82 per cent in IOC and ONGC, and 67 per cent in GAIL.

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PSU Disinvestment: Summary of Receipts from Disinvestment: 1991–92 to 30–9–2009

TABLE 7.2 Actual Disinvestment From April 1991 Onwards and Methodologies Adopted

Year	*No. of cos in which Equity Sold*	*Target Receipt for the Year (Rs. in Crore)*	*Actual Receipts (Rs. in Crore)*	*Methodology*
1991–92	47@	2,500	3,038	Minority Shares Sold by Auction Method in Bundles of 'Very Good,' 'Good,' and 'Average' Companies.
1992–93	35$	2,500	1,913	Bundling of Shares Abandoned. Shares Sold Separately for Each Company by Auction Method.
1993–94	–	3,500	0	Equity of 7 Companies Sold by Open Auction But Proceeds Received In 1994–95.
1994–95	13	4,000	4,843	Sale Through Auction Method, in which NRIs, and Other Persons Legally Permitted to Buy, Hold, or Sell Equity, Allowed to Participate.
1995–96	5	7,000	361	Equities of Four Companies Auctioned and Government Piggy Backed in the IDBI Fixed Price Offering for the Fifth.
1996–97	1	5,000	380	GDR (VSNL) in International Market.
1997–98	1	4,800	902	GDR (MTNL) in International Market.
1998–99	5	5,000	5,371	GDR (VSNL)/Domestic Offerings with the Participation of FIIs (Concor, Gail). Cross-purchase by 3 Oil Sector Companies, i.e., GAIL, ONGC, and Indian Oil Corporation.
1999–2000#	4	10,000	1,860	GDR: GAIL, VSNL: Domestic Issue, Balco: Restructuring MFIL: Strategic Sale, and Others.
2000–01	4	10,000	1,871	Strategic Sale of Balco, LJMC; Takeover: KRL (CRL), CPCL (MRL), BRPL.
2001–02$#	9	12,000	5,632	Strategic Sale of CMC–51%, HTL–74%, VSNL–25%, IBP–33.58%, PPL–74%, and Sale by Other Modes: ITDC & HCLI; Surplus Reserves: STC and MMTC.
2002–03	6	12,000	3,348	Strategic Sale: HZL–26%, MFIL–26%, IPCL–25%, HCL, ITDC, Maruti: Control Premium from Renunciation of Rights Issue, ESOP:HZL, CMC.
2003–04	9	14,500	15,547	Maruti-IPO (27.5%) Jessop and Co. (Strategic Sale–72%), HZL (Call Option of SP 18.92%), Public Offers—IPCL (28.95%), CMC (26%), IBP (26%), DRDG (20%), GAIL (10%), ONGC (10%), ICI (9.2%).
2004–05	3	4,000	2,764.87	NTPC (IPO). NTPC (5.25% Offer for Sale), IPCL (5% to Employees and ONGC (0.01%).
2005–06	1	–	1569.68	By Sale of MUL Shares to Public Sector.
2007–08	3	–	4,181.39	Sale of Rs. 2,366.94 Crore MUL Shares to Public Financial Institutions and Sale of Power Grid Corporation (PGC)—Rs. 994.82 Crore and Rural Electrification Corporation (REC)—Rs. 819.63 Crore.
2008–09	–	–	–	–
2009–10	2	–	4,259.80	Sale of Rs. 2012.85 Crore of NHPC Limited and Rs. 2,247.05 Crore Shares of OIL India Limited.
Total #	56	96,800	57,682.93	

* Total number of companies in which disinvestment has taken place so far.

@ 31 in one tranche and 16 in other. $ in 3 tranches

Figures (inclusive of amount expected to be realised, control premium, dividend/dividend tax and transfer of surplus cash reserves prior to disinvestment etc.)(Rs. 31 crore taxes from Balco).

Source: Department of Disinvestment.

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TABLE 7.3 Disinvestment of Public Sector Undertakings and Ratio of Disinvestment Proceeds to Gross Fiscal Deficit

Year	Target (Rs. in Crore)	Actual (Rs. in Crore)	Per Cent of Actual to Target	Per Cent of Disinvestment Proceeds to GFD
1991–92	2,500	3,038	121.5	8.0
1992–93	2,500	1,913	76.5	4.7
1993–94	3,500	–	–	–
1994–95	4,000	4,843	121.1	8.4
1995–96	7,000	362	5.2	0.6
1996–97	5,000	380	7.6	0.6
1997–98	4,800	902	18.8	1.0
1998–99	5,000	5,371	107.4	4.7
1999–2000	10,000	1,820	18.2	1.7
2000–01	10,000	1,869	18.7	1.7
2001–02	12,000	5,632	46.9	4.3
2002–03	12,000	3,348	27.9	–
2003–04	13,200	15,547	118	18.12
2004–05	4,000	2,684	67.1	4.32

Source: Public Enterprise Survey.

In the last four years, i.e., from 1999–2000 to 2002–03, the government failed to meet its disinvestment targets. The NDA government set a target of Rs. 13,200 crore in 2003–04.

The disinvestment was set-off with the initial public offering (IPO) from India's largest car maker Maruti Udyog Limited (MUL) which hit the primary market on June 12, 2003. The government divested 25 per cent of its 45.8 per cent stake in MUL by selling 7.22 crore shares of the face value of Rs. 5 per share at a floor price of Rs. 115 per share through the book-building route. The total size of the issue was Rs. 830 crore with a green-shoe option to sell another 72 lakh shares. The issue was offered in 75 cities and 150 centres through 100 per cent book building process wherein 60 per cent of the issue was allocated to qualified institutional buyers (QIBs), 15 per cent to non-institutional investors, and 25 per cent to retail investors to subscribe upto 1,000 shares. The issue was over-subscribed almost 10 times and the cut-off price was fixed at Rs.125 per share. The MUL IPO created a history of sorts by listing at Rs. 157, a 26 per cent premium to its issue price of Rs. 125 per share. After touching an intra-day high of Rs. 170.3, the scrip ended at Rs. 164 at over 31 per cent premium to the offer price. This spectacular success of the MUL IPO demonstrated the merits of a disinvestment strategy where the strategic sale of a government company is then followed by selling residual shares to the public. The government garnered Rs. 993.35 crore through this sale. Post-offer, the government's stake came down to 18.3 per cent from 45.8 per cent.

On March 27, 2002, the government had offloaded its 26 per cent equity in Hindustan Zinc to Sterlite Industries for Rs. 445 crore. In November 2003, Sterlite Industries acquired the government's residual stake of 18.92 per cent for Rs. 323.88 crore.

The disinvestment programme of the government received a set-back with the Supreme Court ruling on September 16, 2003 that disinvestment in HPCL and BPCL required parliamentary sanction as these former MNCs were nationalised through an act of parliament. The planned disinvestment of Nalco, HPCL, and BPCL were deferred. The growing Indian economy, good corporate results and a slow down in the US market attracted the foreign institutional investors towards Indian Stock Markets which led to a rally in the stock market. Moreover, the IPOs of UCO Bank and Vijaya Bank got good response from the market which motivated the government to offload its stakes by selling shares to the public. The government decided to divest its holdings in six PSUs namely IPCL, CMC, IBP, Dredging Corporation of India Limited (DCIL), ONGC, and GAIL, in March 2004. In IPCL, CMC and IBP, the government completely divested its holdings, while in others it sold only a part. The government reserved 25 per cent of all the offerings for retail investors and offered them shares at a 5 per cent discount to the cut-off price. The process of disinvestment in these six PSUs began by February end and was completed by mid-March, 2004.

The IPCL issue opened on February 20, 2004 at a floor price of Rs. 170 per share which was also the cut-off price. The government offloaded 29 per cent stake by offering 5.94 crore shares. The IPCL issue was over-subscribed 4.9 times with over two lakh applications. The government raised Rs. 1,219.24 crore through the IPCL issue.

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IBP and CMC issues opened on February 23, 2004. In IBP, IOC had brought majority stake of 53.58 per cent at Rs. 1400 per share in 2001. The government offloaded 57.58 lakhs IBP shares of Rs. 10 each at a floor price of Rs. 620. Initially, the IBP offer received a lukewarm response due to the sustained offloading of stock but with the disinvestment minister Arun Shourie announcing a probe, IBP got over-subscribed by 2.80 times, receiving around 85,000 applications. The government raised Rs. 352.53 crore by divesting its 26 per cent stake at a cut-off price of Rs. 620.

In CMC, the government had sold 51 per cent of the paid-up capital to Tata Sons for Rs. 152 crore, i.e., at Rs. 197 per share in October 2001. This price was higher than the reserve price of Rs. 108.8 crore. The government decided to offload the remaining 26 per cent stake in CMC at a floor price of Rs. 475 per share. The issue was over-subscribed 11 times with the retail portion being over-subscribed six times. The government collected Rs. 188.69 crore through its offer of 39.76 lakh shares at a cut-off price of Rs. 485 per share.

The government's offer for sale of 56 lakh shares of Dredging Corporation of India (DCI) hit the market on February 26, 2004. The government offloaded 20 per cent of its stake in the company at a cut-off price of Rs. 400. The floor price was in the range of Rs. 385 to Rs. 400 and the offer was over-subscribed by more than nine times. Maximum bidding was seen at the ceiling of the price band set by the government and hence the cut-off price was set at Rs. 400. The DCI IPO received bids for 86.62 lakh shares as against the offer size of 56 lakh shares. The government raised Rs. 223.44 crore through this sale and post offer its stake came down to 78.6 per cent.

The IPO of GAIL India issue opened on February 27, 2004. The government offered 8.45 crore shares at a floor price of Rs. 185 by disinvesting 10 per cent of its ownership to the public. In less than two days, the IPO of Gail India got over-subscribed 2.41 times. The government raised Rs. 1643.63 crore through this issue at a cut-off price of Rs. 195.

The government's offer for sale of 10 per cent of its stake in Oil and Natural Gas Corporation (ONGC) opened on March 5, 2004. This was the largest IPO in the history of the Indian primary market. Moreover, it was the biggest success among the six PSU IPOs. One of the factors attributing to its success was the issue price which was fixed in a range of Rs. 680 to Rs. 750. The price–earning multiple worked out to around 9.7 which was quite low when compared to its global peers and this attracted retail investors. Moreover, the SEBI allowed merchant bankers and lead managers to issue participatory notes to large investors domiciled overseas for ONGC shares which led to a high demand for the scrip. The offer for sale of 14.26 crore shares was over-subscribed 5.9 times attracting bids worth over Rs. 60,000 crore. ONGC made history by mopping up the targeted Rs. 10,000 crore in less than 20 minutes of its opening.

The government met its target of disinvestment after a gap of four years. These six offers for sale helped the government to surpass the disinvestment target of Rs. 13,200 crore by Rs. 2,347 crore. Through these six offers, the government was successful in broadening the retail investor base. The strong response to ONGC issue demonstrates that the Indian stock markets can successfully execute global size offerings and Indian investors do respond enthusiastically to good paper.

The Manmohan Singh government (UPA) after assuming power came up with an offer for sale of 5.25 per cent stake in state power producer, National Thermal Power Corporation which were sold in 2004–05 (Table 7.2).

The government sold 8 per cent of MUL's shares in early 2006 at Rs. 678.40 per share for Rs. 1567.60 crore to eight public sector banks and financial institutions. The sale fetched a price higher than the prevailing market price due to the French auction model—bidders pay the price that they bid. The government sold-off its remaining stake of 10.27 per cent stake in MUL to banks, financial institutions and private mutual funds through the differential pricing method during 2008–09.

The cabinet committee on Economic Affairs approved on April 9, 2010, the government's proposal to disinvest a portion of government of India's shareholding in Steel Authority of India Ltd (SAIL) and Engineers India Limited (EIL) to the extent of 10 per cent each through offer for sale.

EVALUATING THE DISINVESTMENT PROGRAMME

The government had no clear-cut objectives set for the disinvestment programme. In the initial years of implementation, the government talked of disinvestment without losing control and when the programme flopped, it talked more in terms of privatisation than disinvestment.

The disinvestment programme was used as a tool to finance fiscal deficit. It was more a tool for raising resources to finance revenue expenditure than one to redefine the role of the government in the economy. The government did not have a proper privatisation policy. The government was never clear about what business it meant to remain in and from where it needed to move out. There was a lack of political will and a sense of urgency, which led to sales being repeatedly stopped and restarted. Every sale undertaken by the government was a subject of controversy. There were differences of opinion on the methods or pricing

The Disinvestment Programme

- A tool to finance fiscal deficit
- Some of the best performing units sold at low prices
- PSUs not structured nor marketed properly before sale
- Absence of political consensus for disinvestment

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Countries such as Japan, France, Italy, and Germany have raised almost USD 285 billion through 120 public offerings. The model of disinvestment through public offers is referred to as 'Share Issue Privatisation (SIP).' SIPs have raised over USD 400 billion for governments in every continent in the past two decades. Moreover, this model has helped develop capital markets and promote an equity culture among domestic investors. The disinvestment proceeds were utilised to trim budget deficits, enhance institutional and structural competence, and to improvise on the social costs emerging as a result of disinvestment.

Conclusion

A similar and sincere restructuring exercise needs to be undertaken for Indian PSUs and a similar public-offer-sale route should be adopted. This can be used as a tool to revive the sluggish primary capital market conditions. In view of mounting fiscal deficits, the disinvestment of PSUs has become inevitable.

There should be a clear-cut methodology laid down for each PSU because a common disinvestment methodology cannot be very effective. For instance, there are some PSUs which are loss-making but are of immense value due to their production capacities and/or distribution network. In such cases, a better price can be obtained from strategic sale rather than sale in open market to retail investors while in some PSUs, retail interest may be necessary to drive the trading volumes. Moreover, offering good PSU stock to the retail segment can improve market sentiments and broad base the shareholding. Finally, the speed of the disinvestment process is a critical variable for its success. The increase in competition and drying up of the resources of the government can weaken even strong PSUs. A delay in disinvestment can not only weaken these PSUs but also reduce the value that can be realised through their sale.

A smooth and successful disinvestment programme of central PSUs can raise the probabilities of successful disinvestment of state PSUs.

KEY TERMS

Disinvestment, Privatisation, Fiscal Deficit, Strategic Sale.

SUMMARY

1. Central public sector undertakings (PSUs) are organisations established by the Government of India as government companies under the Companies Act or as statutory corporations under specific statutes of parliament.
2. The disinvestment of public sector undertakings means the sale of public sector equity leading to a dilution of the government's stake.
3. The objectives of disinvestment are to broad base equity, improve management, enhance availability of resources for these public sector enterprises and finance fiscal deficit.
4. The government has adopted various methods to sell off shares in PSUs: bidding, sale of shares in the market, global depository route, cross-holdings, strategic sale.
5. The Ministry of Disinvestment has suggested four methods to arrive at the reserve price of a PSU. These are: the discounted cash flow method, the balance sheet method, the market multiple method, and the asset valuation method.
6. The government has collected disinvestment proceeds of around Rs. 47,500 crore from the sale of 49 PSUs in the last 14 years.
7. The government's current emphasis is the on sale of equity shares in the market. The government collected Rs. 14,222 crore in the year 2003–04 by selling its equity stake in seven PSUs.
8. Countries such as Japan, France, Italy, and Germany have raised almost USD 285 billion through 120 public offerings. The disinvestment proceeds were utilised to trim budget deficits, enhance institutional and structural competence and to improvise on the social costs emerging as a result of disinvestment.

REVIEW QUESTIONS

1. State the reasons for the government's decision to disinvest its stake in the public sector enterprises.
2. Why is the Indian disinvestment programme surrounded with many controversies?
3. Do you think that the disinvestment programme has achieved its stated objectives? Discuss.
4. Which were the different methods adopted to sell off PSUs? Which method is the most superior? Why?

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ANNEXURE 7.1 PSU Disinvestments: 2000–02

Company	Stake Sold (%)	Total Price (Rs. in Crore)	Methodology
Balco	51	826.50	Strategic Sale to Sterlite Industries After Taking Out Cash Reserves.
Modern Foods	100	149.00	Complete Sale to Hindustan Lever in Two Phases After Minor Restructuring.
CMC	51	152.00	The Tatas Purchased the Company After they Alone were Left in the Fray.
HTL	74	55.00	Simple Sale of a Company that was Not Doing Too Well.
Lagan Jute Machinery	74	2.53	The Loss-making Entity was Sold as an Ongoing Concern.
ITDC	100	179.55	Nine of its Properties were Demerged and Sold as Separate Entities.
Hotel Corporation	100	242.51	Three of its Properties were Demerged and Sold as Separate Entities.
IBP	33.58	1,153.68	The Stake was Purchased by IOC at a Fairly High Premium.
VSNL	25	3,689.00	Simple Sale to the Tatas After Taking Out Cash and Delinking its Real Estate.
Paradeep	74	151.70	An Incomplete Financial Restructuring was Undertaken Before Selling It.
Phosphates Jessop & Co.	72	18.18	Post-restructuring, The Loss-making Entity was Sold as an Ongoing Concern.
Hindustan Zinc	26	445.00	Sterlite Industries Took it Over in a Simple Sale Transaction.
IPCL	26	1,491.00	To Stop Creation of a Monopoly, One of its Units was Sold off Beforehand.
Maruti Udyog	50	2,424.00**	For the First Time, A Part of the Money will Flow Back into the Company.

* Includes cash taken out of the company prior to disinvestment in the form of dividends and dividend tax.
** Minimum expected realisation to the government in a 3-phase disinvestment.
Source: Business World, June 3, 2002, p. 26.

ANNEXURE 7.2 PSU Disinvestments: 2003–04

Name	Open Date	Close Date	Cut-off Price (In Rs.) Floor Price (Rs.)	General	Retail	Stakes Offered (%)	Govern-ment Stake Post Issue (%)	Issue Size (Shares in Crores)	Amount Raised (Rs. in Crore)
MUL	June 12, 2003	June 19, 2003	115	125	125	25	20.8	7.22	82.3
IPCL	February 20, 2004	February 27, 2004	170	170	161.5	29	5.0	7.19	1,219.24
IBP	February 23, 2004	March 1, 2004	620	620	589.0	26	Nil	0.57	352.53
CMC	February 23, 2004	February 28, 2004	475	485	460.75	26.25	Nil	0.39	188.69
Dredging Corp.	February 26, 2004	March 4, 2004	385–400	400	380.00	20	78.6	0.56	223.44
Gail	February 27, 2004	March 5, 2004	185	195	185.25	10	57.4	8.45	1,643.63
ONGC	March 5, 2004	March 13, 2004	680–750	750	712.50	10	74.1	14.29	10,512.00
Total									14,221.83

Source: Capital Market.

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8

The Secondary Market

Chapter Objectives

This chapter will enable you to develop an understanding of the following:

1. *Functions of the secondary market*
2. *Post-reforms stock market scenario*
3. *Organisation structure of stock exchanges*
4. *Listing of securities, trading and settlement arrangements*
5. *Internet trading*
6. *Stock market index*
7. *Stock exchanges such as the Bombay Stock Exchange, the National Stock Exchange, the Over The Counter Exchange of India, the Inter-connected Stock Exchange of India, the Indonext and Regional Stock Exchanges*
8. *Measures to boost liquidity in the secondary market: Investment by FIIs, buy back of shares, market making system, rolling settlement and margin trading*
9. *Impact of reforms and measures on secondary market activities*

INTRODUCTION

The secondary market is a market in which existing securities are resold or traded. This market is also known as the stock market. In India the secondary market consists of recognised stock exchanges operating under rules, by-laws and regulations duly approved by the government. These stock exchanges constitute an organised market where securities issued by the central and state governments, public bodies, and joint-stock companies are traded. A stock exchange is defined under Section 2(3) of the Securities Contracts (Regulation) Act, 1956, 'as any body of individuals whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities'.

Functions of the Secondary Market

- To facilitate liquidity and marketability of the outstanding equity and debt instruments.
- To contribute to economic growth through allocation of funds to the most efficient channel through the process of disinvestment to reinvestment.
- To provide instant valuation of securities caused by changes in the internal environment (company-wide and industry-wide factors). Such valuation facilitates the measurement of the cost of capital and the rate of return of the economic entities at the micro level.
- To ensure a measure of safety and fair dealing to protect investors' interests.
- To induce companies to improve performance since the market price at the stock exchanges reflects the performance and this market price is readily available to investors.

Development of the Stock Market in India

The origin of the stock market in India dates back to the end of the eighteenth century when long-term negotiable securities were first issued. The real beginning, however, occurred in the middle of the nineteenth century, after the enactment of the Companies Act in 1850 which introduced the feature of limited liability, and generated investor interest in corporate securities.

The Native Share and Stock Brokers' Association, now known as the Bombay Stock Exchange (BSE) was formed in Bombay (now Mumbai) in 1875. This was followed by the formation of association/exchanges in Ahmedabad in 1894, Calcutta (now Kolkata) in 1908, and Madras (now Chennai) in 1937. In order to promote the orderly development of the stock market, the central government introduced a comprehensive legislation called the Securities Contracts (Regulation) Act, 1956.

The Calcutta Stock Exchange (CSE) was the largest stock exchange in India till the 1960s. In 1961, there were 1,203 listed companies across the various stock exchanges of the country. Of these, 576 were listed on the CSE and 297 on the BSE. However, during the later half of the 1960s, the relative importance of the CSE declined while that of the BSE increased sharply.

Table 8.1 below shows the phenomenal growth in the operations of the stock markets in India till the nineties.

Till the early 1990s, the Indian secondary market comprised regional stock exchanges with the BSE heading the list. The Indian stock market was plagued with many limitations, such as the following.

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TABLE 8.1 Pattern of Growth of Stock Exchanges

	1946	*1961*	*1971*	*1975*	*1980*
No. of Stock Exchanges	7	7	8	8	9
No. of Listed Companies	1,125	1,203	1,599	1,852	2,265
Market Capitalisation (Rs. in Crore)	971	1,292	2,675	3,273	6,750
	1990–91	*1999–2000*	*2004–05*	*2007–08*	
No. of Stock Exchanges	22	23	23	19	
No. of Listed Companies	2,471	5,815	4,731*	4,887	
Market Capitalisation* (Rs. in Crore)	90,836	1,12,842	16,98,428	51,38,014	
Turnover (Rs. in Crore)	36,011	20,670,310	16,20,498**	51,29,895	

Note: * relates to the BSE, ** relates to the BSE and the NSE.
Source: SEBI, Annual Report, various issues.

- Uncertainty of execution prices.
- Uncertain delivery and settlement periods.
- Front running, trading ahead of a client based on knowledge of the client order.
- Lack of transparency.
- High transaction costs.
- Absence of risk management.
- Systemic failure of the entire market and market closures due to scams.
- Club mentality of brokers.
- Kerb trading—private off-market deals.

POST-REFORMS MARKET SCENARIO

After the initiation of reforms in 1991, the Indian secondary market now has a four-tier form as follows:

- Regional stock exchanges
- The National Stock Exchanges (BSE and NSE)
- The Over the Counter Exchange of India (OTCEI)
- The Inter-Connected Stock Exchange of India (ISE)

The NSE was set up in 1994. It was the first modern stock exchange to bring in new technology, new trading practices, new institutions and new products. The OTCEI was set up in 1992 as a stock exchange, providing small- and medium-sized companies the means to generate capital.

In all, there are, at present, 21 stock exchanges in India—15 regional stock exchanges, the BSE, the NSE, the OTCEI and the Interconnected Stock Exchange (ISE) of India. The ISE is a stock exchange of stock exchanges. The 15 regional stock exchanges are located at Ahmedabad, Bangalore, Bhuvaneshwar, Kolkata, Cochin, Coimbatore, Delhi, Guwahati, Indore, Jaipur, Kanpur, Ludhiana, Chennai, Pune and Vadodara. They operate under the rules and by laws and regulations approved by the government and the SEBI.

The MCX Stock Exchange (MCX-SX) was granted recognition on September 16, 2008 by the SEBI. The United Stock Exchange of India Limited (USE) is the latest entrant in the stock markets. It commenced operations in July 2010. It is the fourth currency futures exchange after BSE, NSE and MCX-SX. All 21 Indian public sector banks, leading private sector banks, public sector undertaking and corporates are shareholders of the exchange.

Table 8.2 shows the secondary market structure in India.

Regulation of Stock Exchanges

The stock markets in India are regulated by the central government under the Securities Contracts (Regulation) Act, 1956, which provides for the recognition of stock exchanges, supervision and control of recognised stock exchanges, regulation of contracts in securities, listing of securities, transfer of securities and many other related functions. The Securities and Exchange Board of India Act, 1992, provides for the establishment of the Securities and Exchange Board of India (SEBI) to protect investors' interest in securities and promote and regulate the securities market.

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TABLE 8.2 Secondary-market Structure

Secondary Market Structure	*As on March 31, 2001*	*As on March 31, 2005*	*As on March 31, 2006*	*As on March 31, 2008*	*As on March 31, 2009*	*As on March 31, 2010*
Stock Exchanges (Cash Market)	23	22	22	20	20	20
Stock Exchanges (Derivatives Market)	2	2	2	2	2	2
Brokers (Cash Segment)	9,782	9,129	9,335	9,487	9,628	9,772
Corporate Brokers (Cash Segment)	3,808	3,733	3,961	4,190	4,308	4,424
Sub-brokers (Cash Segment)	9,957	13,684	23,479	44,074	60,947	75,577
Brokers (Derivatives)	519	994	1,120	1,442	1,587	1,705
Foreign Institutional Investors	527	685	882	1,319	1,626	1,713
Custodians	14	11	11	15	16	17
Depositories	2	2	2	02	02	02
Depository Participants	335	477	526	654	714	758
Merchant Bankers	233	128	130	155	134	164
Bankers to an Issue	69	59	60	50	51	48
Under Underwriters	57	59	57	35	19	5
Debenture Trustees	37	35	32	28	30	30
Credit Rating Agencies	4	4	4	05	05	–
Venture Capital Funds	35	50	80	106	132	158
Foreign Venture Capital Investors	1	14	39	97	129	143
Registrars to an Issue and Share Transfer Agents	186	83	83	76	71	74
Portfolio Managers	39	84	132	205	232	243
Mutual Funds	39	39	38	40	44	47
Approved Intermediaries (Stock Lending Schemes)	10	3	3	02	02	02
STP (Centralised Hub)	46	–	–	01	01	01
STP (Service Providers)	–	–	–	02	02	02
Regulators (DCA, DEA, RBI and SEBI)	4	4	4	04	04	04

Source: SEBI Bulletin, September 2009.

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ORGANISATION, MANAGEMENT AND MEMBERSHIP OF STOCK EXCHANGES

The organisational forms of the various recognised stock exchanges in India were as follows:

(i) Bombay, Ahmedabad and Indore	Voluntary non-profit-making association of persons
(ii) Kolkata, Delhi, Bangalore, Cochin, Kanpur, Guwahati, Ludhiana and Chennai	Public limited company
(iii) Coimbatore and Pune	Company limited by guarantee
(iv) The Over the Counter Exchange of India	A company under Section 25 of the Companies Act, 1956

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The regional stock exchanges were managed by a governing body consisting of elected and nominated members. The trading members, who provide broking services, owned, controlled and managed the exchanges. The governing body was vested with wide-ranging powers to elect office-bearers, set up committees, admit and expel members, manage properties and finances of the exchange, resolve disputes and conduct day-to-day affairs of the exchange.

The OTCEI and the NSE are demutualised exchanges wherein the ownership and management of the exchange are separated from the right to trade on exchange. The National Stock Exchange was the only tax-paying company incorporated under the Companies Act and promoted by leading financial institutions and banks.

Brokers are members of the stock exchange. They enter trades either on their own account or on behalf of their clients. They are given a certificate of registration by the SEBI and they have to comply with the prescribed code of conduct. Over a period of time, many brokers with proprietary and partnership firms have converted themselves into corporate entities. Both NSE as well as OTCEI have laid down strict standards for the admission of members, which relate to capital adequacy, track record, education, experience and so on, to ensure quality broking services.

Brokers are important intermediaries in the stock markets as they bring buyers and sellers together, and aid in price discovery. There are three classes of brokers, namely, proprietary, partnership and corporate. In the old exchanges, most of the brokers are proprietary in nature, whereas in the new exchanges, they are corporate members. Several structural changes have taken place in the Indian broking industry over the past few years. Consolidation and reconstructuring have assumed considerable importance in this segment. As on March 31, 2010, there were 9,772 brokers and 4,424 brokers in the cash segment registered with the SEBI. The CSE has the highest number of brokers followed by the NSE, the OTCEI and the BSE.

A stock broker is required to pay an annual registration fee of Rs. 5,000, if his turnover per year does not exceed Rs. 1 crore. If it does, he has to pay Rs. 5,000 plus one-hundredth of 1% of the turnover in excess of Rs. 1 crore. About 5 years from the date of initial registration, he has to pay Rs. 5,000 for a block of 5 financial years. The exchange also levies transaction charges.

The brokerage on transactions varies from broker to broker. The maximum brokerage that can be levied is 2.5% of the contract price, exclusive of statutory levies such as SEBI-turnover fee, service tax and stamp duty. He is also required to pay the exchange, the transaction charges at the rate of 0.0035% (Rs. 3.5 per Rs. 1 lakh) of the turnover. Trading members are also required to pay securities-transaction tax (STT) on all delivery-based transaction, at the rate of 0.125% (payable by both buyer as well as seller), and, in case of non-delivery transactions, at the rate of 0.025%, for equities payable by the seller alone). Stamp duties are also payable by him as per the rates prescribed by the relevant states.

Brokers can now offer direct market-access (DMA) facility to institutional clients that allow clients a direct access to the exchange-trading system, through the broker's infrastructure, without any manual intervention by the broker. This enables brokers to have a direct control of clients over orders, faster execution of client orders, reduced risk of errors associated with manual-order entry, greater transparency, increased liquidity, lower-impact costs for large orders, better audit trails and better use of hedging and arbitrage opportunities through the use of decision-support tools/algorithms for trading.

Consolidation is taking place in the broking industry. Small brokerages are shutting shop as the big broking entities have cornered a big chunk of the broking business.

Demutualisation of Stock Exchanges

All the stock exchanges in India, except the NSE and the OTCEI, were broker-owned and broker-controlled. In other words, it was the brokers who traded, collectively owned and managed these exchanges. The ownership and managerial rights of the brokers often led to a conflict of interests, wherein the interest of brokers was preserved over those of the investors. Instances of price rigging, recurring payment crisis on stock exchanges and misuse of official position by office bearers, have been unearthed in the last few years. As a result, both rolling settlement as well as demutualisation of stock exchanges were announced to preserve their integrity.

Demutualisation is the process by which any member-owned organisation can become a shareholder-owned company. Such a company could either be listed on a stock exchange or be closely held by its shareholders.

Stock exchanges in India were either Section-25 companies under the Companies Act or an association of persons. Hence, stock exchanges were exempt from all taxes. The NSE, the OTCEI and the ICSE were set up as demutualised stock exchanges. The NSE was set up as a demutualised entity and is owned by financial institutions. Although the ISE was set up as demutualised, it was not a profit-making organisation,

Demutualisation

- Separation of ownership rights and trading rights
- Stock exchange is a corporate tax paying entity
- Safeguards the interest of investors
- Brings out greater transparency in the functioning of the stock exchanges

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which means that even if the profit gets generated, it cannot be distributed among owners, like in the NSE. Like the ISE, the OTCEI has been set up with a not-for-profit motive. It was the first demutualised exchange in the country, set up with a share capital of Rs. 10 crores and promoted by prominent Indian financial institutions. Table 8.3 provides a comparison of the NSE model and international models of demutualised exchanges.

Through demutualisation, a stock exchange becomes a corporate entity, changing from a non-profit-making company to a profit- and tax-paying company. Demutualisation separates the ownership and control of stock exchanges from the trading rights of its members. This reduces the conflict of interest between the exchange and the brokers and the chances of brokers using the stock exchanges for personal gains. With demutualisation, stock exchanges have access to more funds for investment in technology, mergers with and acquisition of other exchanges, and for strategic alliances with other exchanges. Members of the stock exchange also benefit by demutualisation as their assets become liquid and they get a share of the profits made by the exchange through dividends. Demutualisation makes operations of the stock exchange transparent, which facilitates better governance.

Demutualisation process is similar to a company-going public—owners will be given equity shares. The exchange offers equity capital, either through dilution of existing promoters stake or by the fresh issue of capital. The process seeks to give majority control (51%) of the exchange to investors who do not have trading rights. This is to allow a better regulation of the exchange. Once listed as a public company, the exchange will be governed by the corporate-governance codes to ensure transparency.

There has been a global trend towards demutualisation, wherein 17 stock exchanges including NASDAQ, and those of Australia, Singapore, Hong Kong, London and Tokyo have already been demutualised, and another 15 are in the process of demutualisation. The Amsterdam and Australian Stock Exchanges have become publicly listed companies. In Asia, the Singapore Stock Exchange (SGX) and the Singapore Monetary Exchange have merged.

In November 2002, SEBI approved the uniform model of corporatisation and demutualisation of stock exchanges, recommended by the Kania Committee. The committee recommended that stock exchanges in India, which were set up as associations of persons, should be converted into companies, limited by shares. The three stakeholders of the exchange—the shareholders, brokers and the investing public—should equally represent the board. The trading and ownership rights, currently coded in the broker's membership card, should be separated. A broker will get trading rights after paying a certain fee, fixed by the exchange. The ownership right, however, will reside with the shareholders of the corporatised exchange. The shares of an exchange can also be listed on other exchanges.

The Securities Contracts (Regulation) Act was amended on October 12, 2004, through an ordinance, making it compulsory for the exchanges to convert into corporate entities and delink their broker members from the management. The ordinance restricts brokers' representation in the governing-body board of stock exchanges to 25%. It also reduces their shareholding in the exchange to 49% from the existing 100%.

Moreover, 51% of the stake of an exchange should be held by the public, other than shareholders having trading rights. Brokers' trading rights will be distinct from their ownership and management right in all exchanges. The segregation is expected to safeguard the interest of investors and bring about a greater transparency and efficiency of stock exchanges. The ordinance also allows inter-exchange trading among brokers, which would promote a trading platform for small- and mid-cap companies.

With corporatisation, the assets owned by the exchanges become the personal property of the brokers. Brokers demanded a one-time exemption from all taxes, including capital-gain tax in respect of all the property of the exchange. The budget for 2003–04 announced an exemption from the payment of capital-gain tax for exchanges on corporatisation.

In order to speed up the process of demutualisation and corporatisation of stock exchanges, the finance minister in the Finance Budget 2005–06, announced a one-time exemption from the stamp duty that is payable on transfer of assets.

The SEBI made it mandatory for stock exchanges to dilute 51% ownership in favour of public. In India, three stock exchanges—the Bombay Stock Exchange (BSE), the Ahmedabad Stock Exchange

Box 8.1 NASDAQ

The National Association of Securities Dealers (NASD) demutualised the NASDAQ stock exchange in the year 2000 by way of a two-phase private placement of shares to dilute the stake of NASD in Nasdaq to 27 per cent. It raised a total of USD 516 million in the first phase and later raised another USD 240 million by offering convertible debentures in a private offering which could be converted to a 9.8 per cent stake in Nasdaq. Today, the exchange has over 2,900 investors.

Source: Capital market.

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TABLE 8.3 Comparison of the NSE Model and International Models of Demutualised Stock Exchanges

Comparators	*International Model*	*NSE Model*
Legal Structure	Company	Company
For Profit/Not-for-profit	For Profit Company	Owned by shareholders which are financial institutions which also have broking firm as subsidiaries
Ownership Structure	Owned by shareholders which includes brokers	
Listing	Several stock exchanges are listed on themselves after initial public offer.	Not a listed company. No Initial public offer made.
Ceilings on Shareholding	Mostly 5% of voting rights for a single shareholder	No ceiling
Segregation of Ownership, Trading Rights and Management	These are segregated. To become a member of the demutualised stock exchange, it is not necessary to own a share in the company. Thus, members may or may not be shareholders and members who own shares may sell off their trading rights and all shareholders are not necessarily members	These are segregated. The trading rights and ownership are segregated. The broking firms are not shareholders
Board Structure	The governing board comprises directors who are elected by shareholders. Some of the directors are brokers but majority do not have a stock-broking background	The board comprises representatives of shareholders, academics, chartered accountants, and legal experts. Of these, three directors are nominated by the SEBI and three directors are public representatives approved by the SEBI
Fiscal Benefits	As mutual entities, stock exchanges enjoyed fiscal benefits prior to demutualisation, but when converted into for-profit companies these are taxed	The NSE was set up as a demutualised for-profit company and is taxed. So the question of fiscal benefit prior to demutualisation does not arise
Transfer of Assets	Assets were transferred from the mutual entity to the for-profit demutualised company and shares were given to the members in lieu of the ownership in the old entity. There was no cash consideration paid. Since an Initial Public Offer (IPO) was also made in many cases, the valuation of the shares were done by the market and no separate valuation exercise was required as for example in the case of the LSE where a bonus issue was made	The question of transfer of assets did not arise because the NSE was set up by the institutions as a demutualised company itself
Enactment of Legislation to Give Effect to Demutualisation	In several countries, a separate legislation was necessary as in the case of Australia, Hong Kong, Toronto and Singapore. In several others, no legislation was necessary as in the case of the UK	Not applicable as the NSE was set up as a demutualised company

Source: Report of the SEBI Group on Corporatisation and Demutualisation of Stock Exchanges.

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(ASE) and the Madhya Pradesh Stock Exchange (MPSE), did not have a corporate structure as they functioned as associations of persons. They were first corporatised and then demutualised. The BSE completed the process of demutualisation in June 2007.

All stock exchanges except the Coimbatore Stock Exchange have completed their corporatisation and demutualisation process, and are functioning as for-profit companies, limited by shares, and at least 51% of their equity-share capital is held by public other than shareholders having trading rights therein. Various investors like public-sector banks, public-sector insurance companies, public-sector undertakings (PSUs), industrial-development corporations, corporates and individuals have subscribed to the equity-share capital of the stock exchanges.

In view of the special nature of stock exchanges, the SEBI laid out norms in regard to the shareholding pattern, for recognised stock exchanges in respect of which the scheme for corporatisation or demutualisation has been approved by the Board under Section 4B of the Act.

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1. The minimum stake of a single shareholder in a recognised stock exchange, directly or indirectly, cannot exceed 5% of the total equity, and that at least 51% of the total equity in such exchanges should be held by public. The holding limit of a single shareholder was enhanced to 15% in respect of six categories of shareholders, which are public financial institutions, stock exchanges, depositories, clearing corporations, banks and insurance companies.
2. Any shareholder holding more than 1% of the exchange's total equity cannot hike the stake, post-implementation of these norms.
3. No shareholder having trading rights in a recognised stock exchange shall, prior to issuance of the confirmation under Regulation 7, transfer his shares in such recognised stock exchange to any person otherwise than in accordance with Chapter II.
4. The private placement would be in line with the rules in the Companies Act.

These norms prevent any single entity from acquiring a substantial stake and, say, in the functioning of stock exchanges. Also, they enable foreign investors to acquire shares in stock exchanges and encourage competition among exchanges. The government has permitted 49% (26% by FDI and 23% by FII) foreign investment in stock exchanges. Strategic investments in stock exchanges are required for the revival and growth of stock exchanges, so that they can compete globally. SGX and Deutsche Börse AG hold 5% stake each in the BSE. In NSE, entities such as the NYSE Group, Goldman Sachs, General Atlantic and Softbank Asian Infrastructure Fund have a stake of 5% each.

LISTING OF SECURITIES

Listing of Securities

- Permits trading
- Unlocks the value of the company
- Creates wealth effect

A company has to list its securities on the exchange so that they are available for trading. A company can seek listing on more than one stock exchange. Earlier, it was compulsory to list on the regional stock exchange that is nearest to its registered office, but now it is not mandatory. A security listed on one exchange is permitted for trading on the other.

A company seeking listing of its securities on the stock exchange is required to file an application, in the prescribed form, with the Exchange before issue of Prospectus by the company, where the securities are issued by way of a prospectus or before issue of Offer for Sale, where the securities are issued by way of an offer for sale. The prospectus should state the names of the stock exchanges, where the securities are proposed to be listed. It has to enter into a listing agreement with the stock exchange. As per Section 73 of the Companies Act, 1956, a company seeking listing of its securities on a stock exchange is required to submit a letter of application to all the stock exchanges where it proposes to have its securities listed, before filing the prospectus with the registrar of companies. Section 21 of the Securities Contract (Regulation) Act, 1956, deals with the listing of the public companies. Section 19 of the Securities Contract (Regulation) Rules, 1957, deals with the requirements and documents to be submitted with respect to the listing of securities on a recognised stock exchange. The documents that need to be submitted are: Memorandum and articles of association and, in case of a debenture issue, a copy of the trust deed, prospectus or statements in lieu of prospectus, offers for sale and circulars or advertisements offering any securities for subscription or sale during the last 5 years, balance sheets and audited accounts for the last 5 years, or in the case of new companies, for such shorter period for which accounts have been made up; a statement showing dividends and cash bonuses, if any, paid during the last 10 years (or such shorter period as the company has been in existence, whether as a private or public company) and dividends or interest in arrears, if any; certified copies of agreements or other documents relating to arrangements with or between vendors and/or promoters, underwriters and sub-underwriters, and brokers and sub-brokers; a statement containing particulars of the dates of, and parties to all material contracts, agreements (including agreements for technical advice and collaboration), concessions and similar other documents (except those entered into in the ordinary course of business carried on or intended to be carried on by the company), together with a brief description of the terms, subject matter and general nature of the documents; a brief history of the company since its incorporation giving details of its activities including any reorganisation, reconstruction or amalgamation, changes in its capital structure (authorised, issued and subscribed) and debenture borrowings, if any; particulars of shares and debentures issued (i) for consideration other than cash, whether in whole or part, (ii) at a premium or discount or (iii) in pursuance of an option; and a statement containing particulars of any commission, brokerage, discount or other special terms including an option for the issue of any kind of the securities granted to any person. The SEBI issues guidelines/circulars prescribing certain norms to be included in the listing agreement and to be complied by the companies.

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In case the exchange does not admit the company's securities for listing, the company cannot proceed with the allotment of shares. However, the company may file an appeal before SEBI under Section 22 of Securities Contract (Regulation) Act, 1956 (SCRA, 1956), and also to the Securities Appellate Tribunal (SAT).

A company delisted by a stock exchange and seeking relisting at the same exchange is required to make a fresh public offer and comply with the extant guidelines of the exchange. Provisions in the listing agreement attempt to ensure liquidity and investor protection in the stock market. There were 5,900 securities listed on exchanges and around 6,94,000 unlisted companies in India at the end of March 2009. Unlisted companies follow provisions under the Companies Act which are less stringent. Because the compliance cost of listing are high, companies do not prefer to get listed on the stock exchanges. The compliance costs for listed companies include expenses for carrying out legal formalities, costs for communicating quarterly and annual financial reports to shareholders, printing and posting costs of reports, listing fee to the exchanges and reporting board decisions to exchanges.

A company can seek listing if at least 10% of the securities, subject to a minimum of 20-lakh securities, have been offered to the public for subscription. In addition, the size of the net offer to the public (i.e., the offer price multiplied by the number of securities offered to the public, excluding reservations, firm allotment and promoters' contribution) is not less than Rs. 100 crores and the issue is made only through book-building method with 60% of the issue size allocated to the qualified institutional buyers (QIBs). Alternatively, a company has to offer at least 25% of the securities to the general public.

A company needs to obtain 'in-principle' approval for listing from the exchanges having nationwide trading terminals where it is listed, before issuing further shares or securities. Where the company is not listed on any exchange having nationwide trading terminals, it needs to obtain such 'in-principle' approval from all the exchanges in which it is listed before issuing further shares or securities. Moreover, the equity-listing agreement has been amended to prohibit listed companies from issuing shares with superior rights as to voting or dividend vis-à-vis the rights on the equity shares that are already listed.

The basic norms for listing of securities are uniform for all exchanges. They are specified in the listing agreement entered into between the company and the concerned exchange and their compliance is monitored by the exchanges. The stock exchanges levy annual listing fees from the listed companies; this constitutes their major source of income.

The following eligibility criteria have been prescribed effective August 1, 2006 for listing of companies on BSE, through Initial Public Offerings (IPOs) and Follow-on Public Offerings (FPOs):

Companies have been classified as large-cap companies and small-cap companies. A large-cap company is a company with a minimum issue size of Rs. 10 crores and market capitalisation of not less than Rs. 25 crores. A small-cap company is a company other than a large-cap company.

1. In respect of Large-Cap Companies: The minimum post-issue paid-up capital of the applicant company shall be Rs. 3 crores; issue size shall be Rs. 10 crores; and the market capitalisation of the company shall be Rs. 25 crores (market capitalisation shall be calculated by multiplying the post-issue paid-up number of equity shares with the issue price).
2. In respect of Small-Cap Companies: The minimum post-issue paid-up capital of the Company shall be Rs. 3 crores; the issue size shall be Rs. 3 crores; the market capitalisation of the Company shall be Rs. 5 crores; the income/turnover of the Company shall be Rs. 3 crores in each of the preceding three 12-month period; and number of public shareholders after the issue shall be 1,000. A due diligence study may be conducted by an independent team of Chartered Accountants or Merchant Bankers appointed by BSE, the cost of which will be borne by the company. The requirement of a due diligence study may be waived if a financial institution or a scheduled commercial bank has appraised the project in the preceding 12 months.

The BSE issued new listing norms in August 2002 for companies listed on other exchanges and seeking listing on the BSE. These companies should have a minimum issued and paid-up equity capital of Rs. 3 crores, minimum net worth of Rs. 20 crores, profit-making track record of 3 years, minimum market cap at two times its paid-up capital, and a dividend track record for three consecutive years with a minimum dividend of at least 10%. Besides, there should be a two-year track record of being listed on a regional exchange. At least 25% of the issued capital should be with a non-promoter and no single shareholder should hold more than 0.5% of the capital.

After a security is issued to the public and listed on a stock exchange, the issuing company has to make continuous disclosures relating to financial results, material information which would have a bearing on the performance of the company, and information in the form of a statement on the actual utilisation of funds and actual profitability as against the projected utilisation of funds and projected profitability, on a

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quarterly basis to the stock exchanges. To improve transparency, the SEBI made it mandatory for listed companies to provide their half-yearly results and disclose their balance sheets—audited or un-audited—every 6 months to the stock exchanges. Listed companies will also be permitted to submit accounts under the international financial reporting standards (IFRS), which calls for greater disclosures.

The SEBI issued new norms for listing and raising of funds by small and medium enterprises (SMEs) on November 9, 2009. According to the norms, Companies listed on the SME exchanges would be exempted from the eligibility norms applicable for IPOs and FPOs prescribed in the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 (ICDR). SEBI has prescribed a minimum IPO application size of Rs. 1 lakh in order to have informed, financially sound and well-researched investors with a certain risk-taking ability. The minimum trading lot under the SME platform would be Rs1 lakh. For listing on the main boards of NSE and BSE, an upper limit of Rs. 25 crores paid-up capital has been prescribed for a company wanting to be listed on the SME platform/exchange and having a minimum paid-up capital of Rs. 10 crores. In other words, Rs. 25 crores would be the maximum capital permissible to be raised under the SME platform. If the paid-up capital is more than Rs. 25 crores, trading will be on the main platform. The entire public offer of small and medium companies will have to be underwritten. The offer document will have to be filed with SEBI and the exchange. No observations would be issued by SEBI on the offer documents filed by the merchant bankers.

An exchange can take some disciplinary actions, including suspension/delisting of securities if a company fails to comply with the requirements. Delisting of securities means removal of securities of a listed company from the stock exchange where it was registered. As a result of this, the company ceases to be traded at that stock exchange. There are two methods for delisting: compulsory and voluntary.

A stock exchange may compulsorily delist the shares of a listed company under certain circumstances such as non-compliance with the listing agreement for a minimum period of 6 months, failure to maintain the minimum trading level of shares on the exchange, insider trading, manipulation of share prices, unfair market practices by promoters/directors, inability to meet current debt obligations or to adequately finance operations due to sickness, or has not paid interest on debentures for the last 2–3 years, or has become defunct, or there are no employees, or liquidator appointed. Under compulsory delisting, the promoter of the company shall be liable to compensate the shareholders of the company by paying them the fair value of the securities held by them and acquiring their securities, subject to their option to remain security holders with the company. In such a case, there is no provision for an exit route for the shareholders except that the stock exchanges would allow trading in the securities under the permitted category for a period of 1 year after delisting.

The SEBI has issued the delisting guidelines for voluntary delisting from any stock exchange other than the regional stock exchange. The companies need to obtain prior approval of the holders of the securities sought to be delisted, by a special resolution at a General Meeting of the company. The shareholders will be provided with an exit opportunity by the promoters or those who are in the control of the management.

Companies can get delisted from all stock exchanges following the substantial acquisition of shares. The regulations state that if the public shareholding goes down to 10% or less of the voting capital of the company, the acquirer making the offer, has the option to buy the outstanding shares from the remaining shareholders at the same offer price. However, under the existing SEBI takeover code, the exit price is based on the average of the preceding 26-week high and low prices.

An exit-price mechanism called 'reverse book-building method' is used to arrive at the price at which the shares will be bought from the shareholders. However, an exit opportunity need not be given in cases where securities continue to be listed in a stock exchange having nationwide trading terminals.

Dual Listing of shares of companies is not allowed in India. Dual Listing allows a company to be listed on stock exchanges of two countries. This enables an investor to buy/sell shares in one country and sell/buy them in another country where they are listed. For example, Royal Dutch Shell and Unilever are listed on the stock exchanges of the United Kingdom and the Netherlands, and Rio Tinto Group is listed on the stock exchanges of Australia and the United Kingdom. Dual Listing is required when two companies in two countries enter into an agreement to operate their businesses as if they were a single enterprise (without an outright merger), while retaining their separate legal entity and the existing stock exchange listings. Bharti Airtel and the South Africa-based Telco, MTN sought dual listing of their shares where Bharti shares could be listed on the Johannesburg Stock Exchange and MTN on NSE or BSE. But the Indian government policy does not allow dual listing. There are many issues which need to be resolved to enable dual listing. Domestic trading in shares denominated in foreign currency is not permitted; and to enable this, the Foreign Exchange Management Act and the Companies Act need to be amended. Moreover, the Indian rupee needs to be fully convertible. In addition, the domestic company's and the foreign company's composition of Boards should be identical and the stock exchanges of both the countries should have similar rules and regulations.

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Central Listing Authority

The listing fees constitutes the major source of income of stock exchanges. The greater the number of companies listed on an exchange, the higher their listing fees. To attract companies to get listed, exchanges are tempted to ease listing standards. Moreover, listing requirements vary from one exchange to another. This results in issuers wasting resources to comply with listing requirements of a number of exchanges simultaneously. Hence, a conflict of interest arises when stock exchanges regulate the companies that contribute to their revenues through listing fees. This conflict may become more serious in the near future as the process of demutualisation of stock exchanges is underway. With demutualisation, the core objective of stock exchanges would be profit maximisation; this would lead to further dilution in listing requirements to maintain or increase listing fees.

To resolve these issues, a central listing authority is needed in the country who would not only frame listing regulations but also take on the task of ensuring compliance of listing requirements. In the UK, the London Stock Exchange (LSE) takes care of trading while a listing authority takes care of the listing activity. The government has proposed the introduction of a Central Listing Authority (CLA). The CLA would regulate prelisting procedures including clearing of prospectus. It would also apply post-listing measures to monitor the purpose for which funds are used. This would prevent diversion of funds for alternate use. In the pre-liberalisation era, the Controller of Capital Issues (CCI) monitored the pricing of issues as well as the end use of funds by companies.

Under the proposed structure, the regional listing of shares will continue and the stock exchange would be responsible for monitoring violations of listing agreement. Merchant bankers would be responsible for disclosures made in the prospectus. The department of company affairs would, as usual, regulate unlisted companies.

To make corporates more accountable for their actions and to prevent any further scandals, the SEBI has set up the CLA for which it has spelled out norms.

The SEBI (Central Listing Authority) Regulations, 2003

These regulations were notified on August 22, 2003 and are stated below:

- Before making an issue of securities, and before making an application to the stock exchange for listing of its securities, the issuer must obtain a letter precedent to listing from the CLA. The applicant shall also specify the exchange or the exchanges where the applicant is desirous of listing its securities.
- The draft offer document will be filed only with the CLA. The SEBI may offer its observations, if any, to the CLA.
- The CLA may call for information from the stock exchanges and the intermediaries in connection with the processing of the applications for letter precedent to listing.
- The CLA may impose conditions while granting the letter precedent to listing and also lay down further conditions subsequent to the grant of the letter. The letter is to be valid for 90 days, by which time the subscription list for public and rights issues should have opened and in the case of other kinds of issues the securities should have been listed on the stock exchanges. Subject to certain conditions, the CLA may, in its discretion, extend the validity period of the letter precedent to listing.
- The CLA may withdraw the letter precedent to listing after giving an opportunity of being heard to the applicant in the following circumstances.
  - Where the applicant changes the terminal conditions of the issue or where any material development has taken place which has a bearing on the issue.
  - Where the applicant has either suppressed material facts or misrepresented the facts in its application to the CLA.
  - Where the applicant has failed to comply with the conditions imposed by the CLA.
  - Where the CLA is of the opinion that withdrawal of the letter precedent to listing is in the larger interests of the investors and the securities markets.
- Against decision of the CLA, an appeal may be filed before the SAT.

The CLA shall be entitled to withdraw the letter precedent to listing if and only if the securities have not been listed and in case they have been listed, then CLA shall inform the SEBI and the stock exchanges for taking such steps as may be deemed fit including delisting of the securities.

Regulation 17 provides that in the extent of non-compliance with any of the CLA regulations or any of the terms of the listing agreement or in the event of any failure on part of the applicant to furnish the

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required information to the CLA, the same shall be punishable with penalty as specified in Section 15A or Section 15B of the SEBI Act, 1992.

Regulation 2 (1)(h) of the SEBI (CLA) Regulations, 2003 defines a 'letter precedent to listing' to mean a letter issued by the CLA under Regulation 12 permitting the applicant to make a listing application to any exchange including an application for re-listing and listing of an already listed security at an exchange other than the exchange where it is presently listed.

The SEBI provides operational and functional support to the CLA in matters relating to appointment of the CEO and providing infrastructure and manpower to the CLA as and when required.

The CLA is headed by Shri M. N. Venkatachalaiah, former Chief Justice of India. The aim of the CLA is to ensure uniform and standard practices for listing the securities on stock exchanges.

Risk Management to be shifted below Central Listing Authority, and Trading rules and regulations below risk management. Then circuit breakers and then trading arrangements.

RISK MANAGEMENT

The SEBI has laid down risk management policies to mitigate market, operational and systemic risks. Designing effective risk management policies leads to enhancement of investor protection and market development.

On the instructions of the SEBI, the stock exchanges have developed a comprehensive risk management system to promote a safe and efficient market. Stock exchanges have laid down trading rules and regulations for broker-members, set up market surveillance systems to curb excess volatility, created trade/settlement guarantee fund to ensure timely settlements even if a member defaults to deliver securities or pay cash, and set up a clearing corporation to guarantee financial settlement of all trades and thereby reduce credit risk in the settlement system. The Clearing Corporation matches the transactions, reconciles sales and purchases and daily settlements. It is also responsible for the risk management of its members and conducts inspection and surveillance. It also collects margins and capital from members and monitors their net worth requirement. Its major role is to ensure the fulfilment of every contract either by becoming a counter-party itself to every trade or by guaranteeing the performance of all trades. This risk management system was absent in the pre-reforms period and the setting up of the system is one of the landmark achievements of financial market reforms.

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Trading Rules and Regulations

Strict rules and regulations have been framed to prevent unfair trading practices and insider trading. The trading rules relate to the margin system, intra-day trading limit and exposure limit. Brokers are levied various types of margins such as daily margins, mark-to-market margins, ad hoc margins and volatility margins to check price volatility.

Stock exchanges impose different types of margins on brokers for individual stocks, depending on the exposures taken by these brokers in these stocks, both on a proprietary basis and on behalf of clients, vis-à-vis the overall market exposure in the scrips. Several of these margins are paid upfront by brokers.

These margins are collected to prevent operators from taking market positions in excess of their buying capacities and are used to settle dues to the exchange/clearing corporation/traders in the event of any fund shortage faced by the broker. The margins vary from operator to operator depending on the size of the positions taken in the market. There is a real-time monitoring of the intra-day trading limits and gross exposure limits by the stock exchanges. There is an automatic deactivation of trading terminals in case of breach of exposure limits. The collection of margins from institutional clients is on T+1 basis.

As a large section of the market makes margin payments by routing trades through brokers who pay lower margins, the SEBI stipulated that the stock brokers/sub-brokers of one exchange cannot deal with the brokers/sub-brokers of the same exchange either for proprietary trading or for trading on behalf of the clients without prior permission. It has also stipulated that a stock broker/sub-broker of an exchange can deal with only one broker/sub-broker of another exchange for proprietary trading offer, intimating the names of such stock broker/sub-broker to his parent stock exchange.

If the markets become volatile, the exchanges impose different types of margins such as value-at-risk (VaR) to minimise the risk of default by either counter-party. The system of collecting margins is devised in such a manner that higher exposures attract higher margins. Besides the normal margin, scrips with unusually high trading volumes attract special margins or a special ad hoc margin to keep defaults at bay.

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The SEBI has shifted the margining system from net basis to gross basis (sale and purchase) with effect from September 3, 2001, and introduced a 99% VaR-based margin for all scrips in the compulsory rolling system with effect from July 2, 2001. VaR measures the worst-expected potential loss from an unlikely adverse event in a normal, everyday market environment. Prior to VaR, trade positions were reported at book value only and no considerations were made for market changes. This margin is kept in a manner that covers price movements for more than 99% of the time. Usually, three sigma (standard deviation) is used for the measurement.

The intra-day trading limits, that is, limit to volume is specified and no broker's trading volume can exceed this limit. If a broker wishes to exceed the limit he has to deposit the additional capital with the exchange. The upper limit for the gross exposure of a broker is fixed at 20 times his capital to ensure market safety. Besides these, there are capital adequacy norms for members, indemnity insurance and online-position monitoring by exchanges.

To ensure fair trading practices, the SEBI has formulated Insider Trading Regulations prohibiting insider trading by making it a criminal offence. To enhance transparency of the takeover process and to protect the interests of the minority shareholders, there are now separate regulations relating to acquisitions and takeovers.

Circuit Breakers

To contain the excessive volatility in prices, the SEBI introduced, in 1995, scripwise daily circuit breakers/price bands. The circuit breakers bring about a halt/suspension in trading, automatically for a specified period, if the market prices vary unusually on either side, that is, move out of a pre-specified band. Circuit breakers do not halt trading but no order is permitted if it falls out of the specified price range.

Circuit breakers allow participants to gather new information and assess the situation. This helps in controlling the panic. It helps exchange-clearing houses to monitor their members. However, the introduction of circuit breakers precipitates matters during volatile moves and leads to chaos as participants rush to execute their orders before an anticipated trading halt.

In the United States, the system of circuit breakers was introduced in 1987 to halt a sharp fall in share prices. In India, circuit breakers are used to halt both sharply rising as well as declining prices. Price bands, which were originally fixed at 8%, were relaxed in case of 100 scrips in January 2000, when a further variation of 4% in the scrip beyond 8% was allowed after a cooling-off period of 30 minutes. In June 2000, the price

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Box 8.2 Index-wide Circuit Breakers

The BSE and the NSE implement the index-based market-wide circuit breaker system on a quarterly basis. The market-wide circuit breakers would be triggered by movement of either the Sensex or the NSE S&P CNX Nifty whichever is breached earlier.

- In case of a 10 per cent movement of either of these indices, there would be a one-hour market halt if the movement takes place before 1 p.m. In case, the movement takes place at or after 1 p.m. but before 2:30 p.m., there will be a trading halt for one-half hour. In case the movement takes place at or after 2.30 p.m., there will be no trading halt at the 10 per cent level and the market will continue trading.
- In case of a 15 per cent movement of either index, there will be a two-hour market halt if the movement takes place before 1 p.m. If the 15 per cent trigger is reached on or after 1 p.m. but before 2 p.m., there will be a one-hour halt. If the 15 per cent trigger is reached on or after 2 p.m. the trading will halt for the remainder of the day.
- In case of a 20 per cent movement of the index, the trading will be halted for the remainder of the day.

The percentages are calculated on the closing index value of the quarter. These percentages are translated into absolute points of index variations (rounded off to the nearest 25 points in case of the Sensex and 10 points in case of the Nifty). At the end of each quarter, these absolute points of index variations are revised and made applicable for the next quarter.

As an additional measure of safety, individual scrip-wise price bands have been fixed by the NSE as below:

- Daily price bands of 2% (either way) on a set of specified securities
- Daily price bands of 5% (either way) on a set of specified securities
- Daily price banks of 10% (either way) on specified securities
- Price bands of 20% (either way) on all remaining securities (including debentures, warrants, preference shares etc. which are traded on CM segment of NSE),
- No price bands are applicable on: scrips on which derivative products are available or scrips included in indices on which derivatives products are available.

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band was relaxed by 8% from 4% in case of scrips under rolling settlement. These price bands were removed for all stocks in the rolling mode from July 2, 2001, and for the entire market from January 2, 2002. An index-based, market-wide circuit-breaker system at three stages of the index movement, either way at 10%, 15% and 20% is now applied. To enhance safety, individual scripwise price bands of 20% either way have been prescribed for all securities except those available for trading in the derivatives segment, and new listings.

For the first time since their introduction in July 2001, the Sensex and Nifty attracted the index-wide circuit filters and trading on BSE and NSE was halted two times (for a total of 3 hours) on May 17, 2004. Monday, May 17, witnessed the biggest intra-day fall (842.37 points or 17.59%) and the second-biggest, single-day fall (564.71 points or 11.14%) of the Sensex. The market reacted adversely to the statements of some leaders of the new Congress-led United Progressive Alliance (UPA) government regarding policy matters including disinvestment in the PSUs, liberalisation of foreign-direct investment (FDI) norms and the sale of non-performing assets by banks and financial institutions. On November 26, 2008, markets hit lower circuits on the news of global financial crisis. For the first time on Monday, May 18, 2009, markets hit two upper circuits (first circuit at over 10% and the next at 20%) when a clear mandate for the Congress-led UPA was announced. May 18, 2009 was the reverse of May 17, 2004. Trading was halted within seconds of opening of the markets when the 30-share Sensex surged 14.70% or 1,789.88 points to 13,963.30 and the 50-unit S&P CNX Nifty gained 531.65 points or 14.48% to 4203.30.

TRADING ARRANGEMENTS

Electronic Trading Systems

- Ensures transparency
- Increases information efficiency
- Increases operational efficiency
- Improves depth and liquidity of the market
- Provides a single trading platform

The open outcry system, prevalent a few years ago on regional stock exchanges, has been replaced by an online, screen-based electronic trading system. The NSE and the OTCEI had adopted screen-based trading right from inception. With almost all the exchanges going electronic, trading has shifted from the floor to the brokers' office where trades are executed through a computer terminal. All stock exchanges together have 8,000 terminals spread across the country. In a screen-based trading system, a member can feed into the computer the number of securities and the prices at which he would like to transact and the transaction is executed as soon as it finds a matching order from a counter party. The electronic trading system is superior to the open outcry system of the past. It ensures transparency, as it enables participants to see the full market during real time. It increases information efficiency by allowing a faster incorporation of price-sensitive information into prevailing prices and thereby helps in an efficient price discovery. This also results in the operational efficiency as there is a reduction in time, cost, risk of error, and fraud and elimination of a chain of brokers and jobbers, which result in low transaction costs. This system has enabled a large number of participants, in every part of the country, to trade in full anonymity with one another simultaneously, thereby improving the depth and liquidity of the market. This has led to the integration of different trading centres spread all over the country into a single trading platform.

The SEBI has permitted the setting up of trading terminals abroad as well as Internet trading. Now, investors in any part of the world can route the order through the Internet for trading in Indian scrips. Internet trading is more cost effective than using trading terminals.

There are two types of trading systems—order-driven trading system and quote-driven trading system. In the order-driven system, orders from all over the country are entered into an electronic system and matched directly and continuously without the involvement of a jobber or a market maker. In the quote-driven system, there are market makers who continuously offer two-way quotes—buy-and-sell quotes—and are willing to buy and sell any quantity. The BSE provides both these systems while the NSE provides only the order-driven system.

There are two types of orders: limit orders and market orders. Limit orders are those trades which will be only executed at the price specified by the investor. Usually, retail investors and fund houses place limit orders. Market orders are those trades which are executed at the latest quoted bid or offer price on the trading screen.

There are certain orders (buy or sell) which already exist in the trade book at the time of trade matching which are known as passive orders. While active orders are incoming orders that are matched against the passive orders, stock exchanges charge different transaction fees for both passive and active orders.

The SEBI allowed trading members (Brokers) to offer Direct Market Access (DMA) to institutional clients such as foreign institutional investors (FIIs), mutual funds and insurance companies in April 2008. These institutional clients can directly execute their buy-and-sell orders without any manual intervention by their brokers. The benefits of DMA are:

1. It prevents the practice of front-running by brokers who are trading ahead of the client based on the knowledge of the client order. Brokers profit from the price changes which take place when large institutional orders are placed. With DMA, the secrecy of the orders can be maintained as the orders are routed directly through the computer system.

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2. It enables a faster execution of orders with a minimal risk of errors from the manual order entry.
3. It reduces malpractices and price manipulation, enhances transparency and increases liquidity as the orders are visible to the entire market rather than to a particular person/group.
4. It results in lower impact costs for large orders. Moreover, institutional client can break large orders into smaller ones, thereby reducing the bid-ask spread. In addition, it results in saving, in the form of low brokerage charges.
5. It enables **algorithmic trading** wherein the traders instal computers running complex mathematical algorithms and place buy-and-sell orders automatically in the trading system through DMA. Algorithmic trading or program trading is a software program built on certain mathematical models, which enables traders to detect an arbitrage opportunity between the cash and the futures market and place orders on exchanges in real time. It enhances efficiency in trading, reduces transaction costs and prevents information leakage. Foreign broking firms such as Merrill Lynch, Goldman Sachs, JPMorgan, Citigroup and Credit Suisse offer these trading services.

Algorithmic trading is popular in developed countries but it has not taken off in a big way in India because of lack of liquidity beyond the top 15–20 actively traded scrips and both the exchanges' systems not being equipped to handle very heavy orders of trades, when the market is unusually active.

Trading and Settlement

After the reforms, the trading-and-settlement cycle was trimmed from 14 days to 7 days. Later on, securities were traded and settled under a uniform weekly-settlement cycle. In a trading cycle, trades accumulated till the end of a specified period and the positions were settled in the form of payment of cash and delivery of securities. The carry-forward system prevailed for a long period at stock exchanges, as it increased the volume of trading and thereby added to the liquidity of the system. However, it also increased the speculation which, in turn, increased the volatility in prices and defaults by brokers, thereby impeding the price-discovery process. Hence, an alternative system called 'rolling settlement' was introduced in a phased manner.

Under the T+5 basis rolling-settlement system, the trading cycle comprises 1 day and transactions in these securities are settled 5 days after the trade date. The rolling settlement on a T+5 basis was introduced in 10 scrips in January 2000, extended to another 153 scrips in May 2000 and then to 414 securities in July 2001; and thereafter, all scrips were covered under this system. From April 2002, the rolling settlement was on a T+3 basis but since April 2003 it is on a T+2 basis (transactions in securities are settled 2 days after the trade date). Effective implementation and success of the rolling settlement requires electronic fund-transfer facility and dematerialisation.

Dematerialisation of Securities

To eliminate various problems such as theft, fake/forged transfers, transfer delays and the paperwork associated with physical certificates, an electronic book entry form of holding and transferring securities has been introduced. Investors have the option to hold securities in either physical or dematerialised form. In order to expedite the process of dematerialisation, the SEBI has mandated the compulsory settlement of trade in demat form in certain select scrips. Securities issued through an IPO can be settled only in a dematerialised form. Henceforth, all IPOs will be issued in the dematerialised form. Two depositories—the National Securities Depository Limited (NSDL) and the Central Depository Service Limited (CDSL)—offer trading facility in the dematerialised form. The dematerialisation process is almost complete and more than 99% of the turnover settled by delivery is in the dematerialised form.

Steps involved in online trading

1. An investor/trader needs to sign the 'member–client agreement' if dealing directly with a broker or a 'broker–sub-broker–client tripartite agreement' if dealing with a sub-broker in order to execute trades on his behalf from time to time. An investor/trader has also to furnish details such as permanent account number (PAN), which has been made mandatory for all the investors participating in the securities market;,his name, date of birth, photograph, address, educational qualifications, occupation, residential status (Resident Indian/NRI/others); bank and depository account details; and if registered with any other broker, then the name of that broker and the concerned stock exchange and the Client Code Number in the client registration form. All brokers have been mandated to use

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Box 8.3 To Trade Online Using e-broking Facility

- Register yourself with the online trading portals listed on the site.
- You must be a registered iconnect user.
- On placing an order for buy/sell of securities through the listed, online trading portal, click on 'Pay Through'—Bank listed on the
- online portal which will direct you to a login screen of your account.
- Once the details of your Login ID and password are entered, you are required to verify the transaction details and confi rm the
- transaction by entering your transaction ID and password. An email confi rmation will follow regarding the status of your transaction once your order is executed.
- Your account status will be updated on a real time basis.

Source: Business Today, February 13, 2005.

the assigned limits designated by the broker to the clients. Even if the client order exceeds the assigned limits, the order gets re-routed to the broker's server for authorisation or rejection. The broker can change the parameters on-line. His software allows real time market information display, client information display, bank account management, and a transaction history display.

In April 2000, the market was bullish and a large number of players ventured into online (Internet) trading. As many as 79 members took permission for Internet trading. However, after the Ketan Parekh scam, barely 10 members remained online. The market is dominated by *ICICI Direct.com* with a market share of about 50 per cent and *India Bulls.com* with a market share of 26 per cent.

ICICI has emerged as a market leader because it can provide strong connectivity between the trading account, demat account, and bank accounts. Moreover, ICICI's huge off-line presence in various financial services segments and penetration aids in drawing as well as servicing customers. ICICI Direct leads the pack with 1,70,000 trading customers. It executes an average of 1,600 trades a day; this puts it in the same league as the tenth largest online brokerage in the US. *Sharekhan.com* and *5 paise.com* have faded away while *Kotak Street.com* and *HDFC Securities* are hanging on.

Around 44 lakh investors had registered to trade online as on March 31, 2008. There has been a sharp increase in volumes after the rolling settlement was introduced. The online trading volumes rose from Rs. 7,288 crore in 2000–01 on the National Stock Exchange to Rs. 6,68,399 crore in 2007–08. Around 11.68 per cent of the total trading volume was routed and executed through internet during 2007–08.

Online trading has driven down the transaction costs substantially and increased the liquidity options available to an investor to enter or exit from the stock at his own wish. The Internet has provided a wide range of information to the investor which has enabled him to take calculated risks.

The US has the largest number of cyber investors—approximately 15 million. Online trading has grown tremendously in the US where roughly 40 per cent of retail stock brokerage business is conducted through the Internet. Schwab, a US-based company, is the world's largest discount and web brokerage firm with 5.8 million investor accounts holding more than USD 500 billion in assets.

Compare this with Indian online trading statistics. Online trading represents about 18 per cent of the total traded volumes on the NSE and the BSE.

The stumbling blocks for such low online trading volumes are as follows.

- Erratic bandwidth and erratic net connectivity coupled with low personal computer (PC) penetration.
- Low security and inadequate cyber laws.
- Lack of automation in the banking sector especially among public sector banks. Not many banks offer online transaction of money.
- Incremental and ongoing investment in technology and brand building are required. This is owing to lack of funding for Internet-based business.
- Stipulation from the SEBI—Know Your Customer (KYC)—which requires that companies actually meet their customers before allowing them to trade on their site. This requires a large off-line structure which most of the companies do not have.
- A big time lag of 5–10 minutes between the placing of an order and its execution. The high volatility prevailing in the market leads to fluctuations in prices.
- High cost of transactions as online brokers charge brokerage as steep as 0.20–0.25 per cent for non-delivery based transaction and between 0.50–0.75 per cent for delivery based transaction.
- Absence of streaming data on the investor's computer. The broker gets streaming data on his computer while the client does not. Clients get a browser-based web application which works on a request reply model, most suited for document presentation,

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- An online investor pays more margin for trading than the off-line investor and his funds are also tied up for more trading days.
- The high development, acquisition, maintenance and service costs. The cost of servicing one internet client may range between Rs. 5,000 to Rs. 8,000 annually.

There is great potential for the growth of Internet trading in India. What is required is a regulatory authority to control this market; availability of high bandwidth, and an online infrastructure. Investor interest in Internet trading has to be sustained and this requires innovations and new products. Broking firms should devise distinct marketing and service strategies.

STOCK MARKET INDEX

Functions of an Index

- To serve as a barometer of the equity market
- To serve as a benchmark for portfolio of stocks
- To serve as underlying for futures and options contracts

The stock market index is the most important indices of all as it measures overall market sentiment through a set of stocks that are representative of the market. The stock market index is a barometer of market behaviour. It reflects market direction and indicates day-to-day fluctuations in stock prices. The market index reflects expectations about the behaviour of the economy as a whole. It is a precursor of economic cycles. The function of a stock index is to provide investors with information regarding the average share price in the market. A well-constructed index captures the overall behaviour of the market and represents the return obtained by a typical portfolio investing in the market. An ideal index must represent changes in the prices of scrips and reflect price movements of typical shares for better market representation. Stock index is a barometer of a nation's economic health as market prices reflect expectations about the economy's performance. Stock markets tend to be buoyant when the economy is expected to do well. The bell wether Sensex, if it touches the psychologically golden 15,000 mark, indicates that the country's financial and economic growth is surging ahead.

Stock indices are termed as leading economic indicators as they indicate what is going to happen in the economy in the future. The returns generated in the stock market are based on future expectations. The future streams of expected returns from the companies are discounted to arrive at their present value known as market price.

A good market index incorporates a set of scrips which have high market capitalisation and high liquidity. Market capitalisation is the sum of the market value of all the stocks included in the index. The market value is derived by multiplying the price of the share by the number of equity shares out-standing. Liquidity is reflected in the ability to buy or sell a scrip at a price close to the current market price. In other words, the bid–ask spread is minimum.

The index on a day is calculated as the percentage of the aggregate market value of the set of scrips incorporated in the index on that day to the average market value of the same scrips during the base period. For example, the BSE Sensex is a weighted average of prices of 30 select stocks and S&P CNX Nifty of 50 select stocks.

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Categories of Holding Excluded from the Definition of Free-float

- Holdings by founders/directors/ acquirers/bodies with controlling interest.
- Government hold-ing as promoter/acquirer
- Holdings through the FDI route
- Strategic stakes by private corporate bodies/individuals
- Crossholdings by associate/group companies
- Equity held by Employee Welfare Trusts
- Locked-in shares

Methodologies for Calculating the Index

Market Capitalisation Weighted

1. **Full market capitalisation method:** In this method, the number of shares outstanding multiplied by the market price of a company's share determines the scrip's weightage in the index. The shares with the highest market capitalisation would have a higher weightage and would be most influential in this type of index. Examples: S&P 500 Index in USA and S&P CNX Nifty in India.
2. **Free-float market capitalisation method:** Free-float is the percentage of shares that are freely available for purchase in the markets. It excludes strategic investments in a company such as the stake held by government, controlling shareholders and their families, the company's management, restricted shares due to IPO regulations, and shares locked under the employee stock ownership plan. In this methodology, the weight of a scrip is based on the free-float market capitalisation. Free-float market capitalisation reflects the investible market capitalisation which may be much less than the total. Closely held companies would have a much lower weightage and companies with high free-float, i.e., higher investible shares, would be rewarded. Companies which provide high shareholder value but have less free-float would be marginalised.

Free-float market capitalisation method is superior to full market capitalisation method in several ways.

- Free-float is rational in the sense that it factors in the constituent shares to the extent they are available for trading in the market. For instance, ONGC has a free-float of less than 15 per cent and hence it has a weight of under 5 per cent in the free-float weighted sensex.

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- The free-float methodology helps in designing a broad-base index wherein the concentration of top few companies and their influence on index movement is reduced. It avoids the undue inf uence of closely held large capitalisation stocks on the index movement and prices.
- An index-based on free-float methodology, is useful to active fund managers as it enables them to benchmark their fund returns vis-a-vis an investible index.
- It avoids multiple counting of company shares through cross holding.

Passive investing (index investing) in the developed market is around 10 per cent. The free-float index helps fund managers in better tracking and replication as the weight of scrips in the index is based on their float available in the market, which helps them in investing in those scrips. The free-float methodology has become popular the world over. Since June 2001, the entire range of FTSE (Financial Time Stock Exchange) indices are fully free-float adjusted. S&P's indices around the world are free-float. All Dow Jones indices except Dow Jones Industrial Average are free-float adjusted.

The BSE has taken a lead on free-floating the indices. It made a beginning by launching on July 11, 2001, the country's first free-float index, 'BSE-TECK Index,' an index for technology, entertainment, communication, and other knowledge-based sectors. The BSE has introduced this methodology in the case of the BSE sensex since September 1, 2003. Now the BSE sensex is a free-float sensex.

Free-float Factors The BSE has adopted the international practice of assigning a free-float factor to each company. Free-float factors are assigned according to a banding structure consisting of ten bands into which each company falls, based on its percentage of shares in free-float. The banding structure means that the actual free-float of a company is not taken as it is but rounded off to the higher multiple of 5 or 10 depending upon the banding structure adopted. The exact free-float of a company is rounded-off to the higher multiple of 10. For example, if the free-float factor of a company is, say, 16 per cent, a free-float factor of 0.2, i.e., 20 per cent is applied. If the free-float factor changes, adjustment to the index is made only if the new free-float crosses either the lower band or the higher band by 2 percentage points. The free-float factor is then multiplied with the full market capitalisation of the company to arrive at the free-float capitalisation. Based on the percentage of a company's free-float capitalisation to the total free-float capitalisation of the sensex, weights are assigned to each company.

Free-float Index

- Reflects investible market capitalisation
- Avoids influence of few companies on index movement
- Helps active fund managers to bench-mark their returns
- Helps passive fund managers in tracking and replicating

In order to reduce the frequency of index adjustments arising out of a change in free-float of a company, the BSE refined the banding structure and increased the number of bands from 10 to 20. In the 20 band system, a company having a free-float of 60.1 per cent would be assigned a free-float factor of 0.65 and another company having a free-float of 67 per cent would be assigned a free-float factor of 0.7. A Free-float factor of say 0.55 means that only 55 per cent of the market capitalisation of the company will be considered for index calculation.

3. **Modified capitalisation weighted:** This method seeks to limit the influence of the largest stocks in the index which otherwise would dominate the entire index. This method sets a limit on the percentage weight of the largest stock or a group of stocks. The NASDAQ-100 Index is calculated by using this method.

Free-float Bands:

% Free-float	*Free-float Factor*	*% Free-float*	*Free-float Factor*
>0 – 5%	0.05	>50 – 55%	0.55
>5 – 10%	0.10	>55 – 60%	0.60
>10 – 15%	0.15	>60 – 65%	0.65
>15 – 20%	0.20	>65 – 70%	0.70
>20 – 25%	0.25	>70 – 75%	0.75
>25 – 30%	0.30	>75 – 80%	0.80
>30 – 35%	0.35	>80 – 85%	0.85
>35 – 40%	0.40	>85 – 90%	0.90
>40 – 45%	0.45	>90 – 95%	0.95
>45 – 50%	0.50	>95 – 100%	1.00

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Price Weighted Index In this method, the price of each stock in the index is summed up which is then equated to an index starting value. An arbitrary date is set as the base and the Laspeyre's Price Index which measures price changes against a fixed base period quantity weight is used. In case of a stock-split, the market price of the stock falls and this results in less weightage in the index. The Dow Jones Industrial Average and Nikkie 225 are price-weighted indices.

Equal Weighting In this method, each stock's percentage weight in the index is equal and hence, all stocks have an equal influence on the index movement. The value line index at Kansas City Board of Trade (KCBT) is an equal weighted index.

Global Stock Market Indices

The Dow Jones Industrial Average It is the most widely watched and quoted index because of its long existence. The Dow has 30 constituents and it follows the methodology of price-based weightage. Changes to stocks included in the Dow are infrequent: three stocks were added/dropped in 1991, four in 1997, and four in 1999. The addition of Microsoft and Intel in 1999 was the first inclusion of Nasdaq market stocks to the Dow 30.

The Nasdaq Composite Index This index is the market capitalisation weightages of prices for all the stocks listed in the Nasdaq stock market. The Nasdaq Composite began on February 8, 1971, with a base of 100.

The Nasdaq 100 Index Nasdaq 100 comprises the largest computer, software and telecom stocks by market capitalisation on the Nasdaq. For a company to be included in the Nasdaq 100, it must have a minimum average trading volume of 1,00,000 shares per day and must have been trading on a major exchange for at least a year or two.

The S&P 500 Index This index comprises 500 biggest publicly traded companies in the US by market capitalisation. Most money managers treat the S&P 500 as a proxy for the US stock market. The S&P 500 tries to cover all major areas of the US economy. To be included, a company must be profitable, the prospective company must not be closely held (at least 50 per cent of its stock should be public) and must have a large trading volume for its shares (not less than a third of its total shares).

The FTSE 100 The FTSE 100 consists of the largest 100 companies by full market value listed on the London Stock Exchange. The FTSE 100 is the benchmark index to indicate the performance of the European market. It is a market-capitalisation-weighted index that also considers the free-float weightages of individual stocks before including them in the index.

The MSCI Indices Include the MSCI EAFE (Europe, Australasia, and Far East), MSCI Europe, MSCI World, MSCI (EMF), and MSCI Pacific Basin Indices.

The MSCI World Index is a free-float adjusted market capitalisation index that is designed to measure global developed market equity performance. As of April 2002, the MSCI World Index consisted of the following 23 developed market country indices: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Singapore, Portugal, Spain, Sweden, Switzerland, the United Kingdom and the United States.

The MSCI EAFE Index is a free-float market capitalisation index that is designed to measure developed market equity performance. As of April 2002, it consisted of 21 developed market country indices, excluding the US and Canada.

The MSCI EMF (Emerging Markets Free) Index is a free-float adjusted market capitalisation index that is designed to measure equity performance in the global emerging markets. As of April 2002, the MSCI EMF Index consisted of the following 26 emerging market country indices: Argentina, Brazil, Chile, China, Colombia, the Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, the Philippines, Poland, Russia, South Africa, Taiwan, Thailand, Turkey and Venezuela.

Major Indices in India

Major Indices
- Sensex
- S&P CNX Nifty

There are two major indices in India: BSE Sensex and NSE Nifty. The BSE Sensitive Index of equity share prices was launched in 1986. It comprises 30 shares and its base year is 1978–79. The major criterion for selection of a scrip in the Sensex is large market capitalisation. Besides this criterion, other criteria

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like listed history, track record, industry/sector representation, number of trades, average value of shares traded per day as a percentage of total number of outstanding shares, are considered for inclusion in the Sensex. The scrip selection is also based on a balanced representation of the industry, leadership position in the industry, continuous dividend-paying record, and track record of promoters. Since its beginning in 1986, it was revised for the first time on the 50th *Independence Day*, August 15, 1997, by replacing 15 scrips. During this revamp, the scrips of banks and financial institutions with a weightage of 14.6 per cent were included on the index for the first time. It was revised again in October 1998 to replace some old economy stocks such as Arvind Mills, Great Eastern Shipping, Steel Authority of India, and IPCL with some new economy stocks such as Infosys, NIIT, Castrol, and Novatris. The sensex was revamped again on March 11, 2000, which came into effect on April 10. Certain scrips, such as Indian Hotels, IDBI, Tata Chemicals, and Tata Power were replaced by Satyam Computers, Zee Telefilms, Dr Reddy's Laboratories, and Reliance Petroleum. The new economy stocks now have a 50 per cent weightage in the index. The BSE Sensex was revised again on January 7, 2002, when the motorcycle major Hero Honda Motors displaced Mahindra and Mahindra and HCL Technologies displaced NIIT. The BSE included the MUL scrip in place of L&T Ltd from May 19, 2004. On July 7, 2007, Mahindra and Mahindra displaced Hero Honda Motors. On July 28, 2008, Ambuja Cement Ltd and Cipla Ltd were replaced by Sterlite Industries Ltd and Tata Power Company Ltd. The Sun Pharmaceutical Industries replaced Satyam Computers on January 12, 2009. The recent revamp was on June 29, 2009 when Ranbaxy Laboratories was replaced by Hero Honda Motors. The index constituents were revised by the BSE 20 times between January 1, 1986 and June 30, 2009. Today, only eight of the original club of 30 remain, the others have been supplanted by companies whose scrips are far more indicative of the happenings in the market.

The Reliance Industries Ltd (RIL) has the highest weightage of 13.75% in index market capitalisation, followed by Infosys Technologies Ltd with 9.5%, and ICICI Bank Ltd with 7.58%. The BSE Sensex represents 44% of the BSE market capitalisation and 14 most-important listed and traded sectors. The BSE Sensex scrips, on average, account for 52% of the trading volumes on a daily basis and 35% of total trades executed on the exchange.

Another index which has become very popular in a short span of time is the S&P CNX NIFTY. The NSE began equity trading in November 1994, and its volumes surpassed that of the BSE in a very short span of time. The NSE and CRISIL undertook a joint venture, wherein they jointly promoted India Index Services and Products, a specialised organisation to provide stock index services. This organisation developed scientifically devised indices of stock prices in the NSE in technical partnership with Standard and Poor (S&P). The NSE introduced this index to reflect the market movements more accurately, provide fund managers with a benchmark for measuring portfolio performance and develop a reference rate for introducing index-based derivative products. The S&P CNX Nifty launched on July 8, 1996, comprises 50 scrips which are selected on the basis of low impact cost, high liquidity and market capitalisation. The impact cost is the percentage marking from the (bid + ask)/2 suffered in executing a transaction. The 'Bid' is the buyer's price—the price at which there is a ready buyer for the stock which he intends to sell. The 'Ask' (or offer) is the price at which there is a seller ready to sell his stock and this is the price the buyer needs to know when he is buying a stock.

- Impact cost is the cost of executing a transaction on a stock exchange. It varies with the size of the transaction

Lower the impact cost, higher the liquidity of a stock and vice versa. Suppose a scrip trades at a bid price of Rs. 99 and an asking price of Rs. 101, the ideal price is Rs. 100. If a buy order for 1,000 shares goes through at Rs. 102, then the market impact cost is 2%. If a buy order for 2,000 shares goes through at Rs. 104, then the market impact cost at 2,000 shares is 4%. For a stock to be included in the S&P CNX Nifty, it must trade in the total portfolio of Rs. 2 crores at an impact cost of less than 1.5 per cent on 85% of the trading days. Nifty represents about 44% of the total market capitalisation on the NSE. The S&P CNX Nifty is a widely used indicator. Index funds and index futures and options, launched at the NSE, are based on the S&P CNX Nifty.

Both BSE as well as the NSE use the weighted average method of averaging whereby each stock is given a weight in proportion to its market capitalisation. Suppose an index contains two stocks, A and B. If A has a market capitalisation of Rs. 3,000 crores and B has a market capitalisation of Rs. 1,000 crores, then a 75 % weightage is attached to the movements in A and a 25% weightage to the movements in B.

Besides these two indices, the other popular indices are the Economic Times Ordinary Share Price Index, Financial Express Ordinary Price Index and the RBI Index of Security Prices. These indices comprise 72, 100, and 338 scrips, respectively. The major regional stock exchanges such as Kolkata, Chennai, Delhi and Ahmedabad have their own indices. The other major indices are the OTCEI index, the CMIE (Centre for Monitoring Indian Economy) index, the CRISIL CNX indices (mid-cap 200, PSE index, IT index and MNC index) and the Business Line (all India) Index.

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STOCK EXCHANGES

The Bombay Stock Exchange

Trading in securities has been in vogue in India for a little over 200 years. Trading in securities dates back to 1793, most of them being transactions in loan securities of the East India Company. Rampant speculation was a common feature even during those times. The broking community prospered as there was a rise in prices which led to a share mania during 1861–65. This bubble burst in 1865 when the American Civil War ended. The brokers realised that investor confidence in the securities market could be sustained only by organising themselves into a regulated body with defined rules and regulations. This realisation resulted in formation of 'The Native Share and Stock Brokers' Association,' which later came to be known as the Bombay Stock Exchange (BSE). In 1875, these brokers assembled at a place now called Dalal Street. The BSE was set up as a voluntary, non-profit-making association of broker members. It emerged as a premier stock exchange after the 1960s. The increased pace of industrialisation caused by the two world wars, protection to the domestic industry and the government's fiscal policies aided the growth of new issues, which, in turn, helped the BSE to prosper. The BSE dominated the Indian capital market by accounting for more than 60% of the all-India turnover.

Until 1992, the BSE operated like a closed club of select members. With the securities scam outburst in 1992 and the SEBI taking over the reins of the stock market, the BSE had to bring about changes in its operational policies. Until March 1995, the BSE had an open outcry system of trading. However, when faced with a stiff competition from the NSE, the country's first modern, computerised and professionally managed stock exchange set up in 1994, the BSE had to change its system of trading and operations. On March 14, 1995, the BSE turned to electronic trading whereby the brokers trade using computers. This system is known as the BSE On-line Trading System (BOLT). Screen-based trading was initially confined to 818 major scrips. Trading in all the 5,000 scrips of the BSE was transferred to BOLT on July 3, 1995. The introduction of BOLT helped in improving trading volumes, significantly reducing the spread between buy-and-sell orders, better trading in odd-lot shares, fixed-income instruments and dealings in the renunciation of rights shares.

In 1995, BOLT was limited to Mumbai, whereas the NSE was operating at the national level. As a result, the BSE was losing countrywide business. The BSE, therefore, submitted a proposal for allowing the installation of terminals connected to BOLT in centres outside Mumbai. After rejecting the proposal four times, on October 29, 1996, the SEBI finally allowed the BSE to use its BOLT system nationwide.

Today, BOLT is spread over 330 cities with 15,471 TWSs (trader work stations). Later, the BSE set up a central depository system to dematerialise shares and promote demat trading.

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BSE Milestones

1840–50	About half-a-dozen brokers converge under a banyan tree near what is now called Horniman Circle.
1860–65	In the prevailing share mania, the number of brokers rises to about 250, but in the aftermath of the price crash they are hard-pressed to find a place for their regular meeting.
1874	The broking community find a place in what is now called Dalal Street to conduct their dealings in securities without hindrance and an informal association of sorts comes into being.
July 9, 1875	The Native Share and Stock Broker Association with the aim of 'protecting the character, status and interests of native share and stock brokers,' with 3,128 members who pay an entrance fee of 1 rupee is set up. The genesis of the present-day BSE is clearly traceable to these humble beginnings. Premises are hired in 1874 so that the indignity of trading in public comes to an end.
1895–1930	The exchange moves into what is now known as the Stock Exchange Old Building in 1895. With more members and more trading spaces, after repeated expansion in 1920, 1928 and 1930, the BSE is vastly different from the one that existed in the last quarter of the 19th century.
1921	The establishment of a clearing house for settlement of transactions.
1923	K. P. Shroff, later to be known as the doyen of the Indian stock market, assumes the post of honorary president of the BSE, a position he retained till 1966. Together with Phiroze Jeejeebhoy, who later succeeded him, Shroff steers the exchange through stormy times and plays a major role in raising the BSE's status.

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1957	The government accords a permanent recognition under the Securities Contracts (Regulation) Act.
1973	The construction work for a new multi-storey office to house the BSE commences. It is named after its former president, Phiroze Jeejeebhoy.
1986	On January 2, BSE launches the first stock index with 30 scrips and the base year of 1978–79 with quotations from specified and non-specified group of companies listed on the five major bourses—Bombay, Calcutta, Delhi, Ahmedabad and Madras.
1994	Serial bomb blasts in BSE, but it begins to operate as usual despite damages to the premises.
1995	In March, BSE introduces the modified carry-forward system (the traditional *badla* had been banned since March 1993). In July, all scrips are transferred to BOLT. Now, more than 250 cities/towns are on BOLT trading.
1997	Screen-based trading commences.
1999	In March, Central Depository Services, promoted by the BSE, begins operations.
2000	In June, the BSE becomes the first exchange in the country to introduce trading in derivatives in the form of index futures on the Bell Wether Sensex.
2005	Launched enterprise market for SMEs—INDOnext on January 7, 2005 to provide small and medium enterprises easy and an efficient access to capital markets. INDOnext is a joint initiative of the BSE with 18 regional stock exchanges.
2009	Launch of Currency Derivatives, Interest Rate Futures and Mutual Fund Service System.

Source: www.bseindia.com

Carry Forward Deals, or *Badla*

The carry forward system, or *badla,* was a unique feature of Indian stock exchanges, particularly of the BSE. *Badla* was a unique selling proposition of the BSE. *Badla* provided the facility for carrying forward the transaction from one settlement to another. In simple terms, it was the postponement of the delivery of or payment for the purchase of securities from one settlement period to another. This facility of carry forward provided liquidity and breadth to the market. It was invented in the BSE and other exchanges copied the mechanism as it facilitated share financing, share lending, and carry forward simultaneously. It was a stock lending facility (since shares were needed to postpone a sell position) as well as a money market operation (since finance was needed to postpone a buy decision). By bringing in outside money to fund the carry forward of the long positions, *badla* acted as a bridge between the money market and the stock market. This system also helped in moderating extreme movement of stock prices, as it facilitated short selling in a rising market and long purchases in a declining market. It acted as a risk-hedging instrument wherein an investor could hedge against a likely fall or rise in prices by selling or buying in a carry forward market.

- *Badla* is the postponement of the delivery of or payment for the purchase of securities from one settlement period to another

Badla Mechanism

Badla was allowed in the specified group of shares of the BSE. This specified group was also known as the forward group as one could buy or sell shares in it without physical delivery. The carry forward session (*badla* session) was held on every Saturday at the BSE.

A contract for current settlement could be executed in any of the following three ways.

- Delivery against a sale contract given and delivery against a purchase contract received, and payment received/made at the contract rate.
- Squaring off of transactions wherein a reverse transaction of either buying or selling of shares squared up with the earlier outstanding position and the difference in prices settled.
- A contract in respect of which delivery was given or taken and which was not offset by an opposite transaction during the settlement period, could be carried forward to the next settlement period at the making up price, i.e. the closing quotation on the last trading day and the difference between the contract rate and the making up price settled. This postponement of the delivery of or payment for the purchase of securities from one settlement period to another was referred to as carry forward.

Badla involved four parties: the long buyer—a buy position in a stock without the capacity to take delivery of the same, the short seller—a sell position without having the delivery in hand, the financier and the stock lender.

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Types of *Badla* Transactions

Vyaj badla known as *mandi badla*

Teji badla known as *mal badla*

If the quantum of delivery sales exceeded the quantum of delivery purchases, financiers known as *vyaj badlawala* came forward to assist in completing the deal, took delivery in the current settlement, made the delivery in the next settlement to the buyers and, by doing so, helped in carrying forward the transaction. The difference between the current settlement rate and the sale rate for the next settlement which they received was the interest charges known as *seedha badla* and the transaction was known as *vyaj* or *mandi badla*. If the quantum of delivery purchases exceeded the quantum of delivery sales, share financiers known as *teji badlawala* would give delivery in the current settlement to the buyers at the settlement rate and take the delivery back in the next settlement from the seller at lower sale rates. The difference between the two rates earned by them was known as 'backwardation' or *ulta badla* and the transaction was known as *mal badla* or *teji badla*.

Badla charges were market-determined and varied from scrip to scrip and from settlement to settlement. *Badla* rates ranged from 15 per cent to 36 per cent on a yearly basis. The SEBI banned *badla* charges for carry forward sales (short position) if the net carry forward buy (long) positions exceeded short positions. If the market was overbought (net long), there would be more demand for funds and the carry forward rates would be high; the reverse would be true when the market was oversold (net short). An oversold market would result in high demand for securities and the stock lender would get returns.

These transactions were completely hedged and stock exchanges guaranteed settlements and conducted auctions of shares in case of defaults. However, these guarantees were not available in unofficial or parallel *badla* markets which existed in Kolkata and Mumbai. Kolkata had a 90 per cent unofficial *badla* market and as a result, it had to undergo a payment crisis in 2001.

Badla, or the carry forward facility, was quite popular, accounting for nearly 90 per cent of the trade at all stock exchanges.

Advantages

The *badla* system contributed to the increase in the volume of the trading activity at the BSE as it facilitated brokers to carry forward their positions and leverage. Moreover, as *badla* financiers were earning higher returns through this mechanism, they were lending a larger amount of funds, leading to an increase in trading activity. *Badla* along with other factors such as increased network, boom periods, and increased participation by retail investors was instrumental in the increase of volume of trading activity from Rs. 500 crore in 1991–92 to Rs. 9,000 crore in 2000. *Badla* was also a vehicle of speculation.

The 135-year-old *badla* system was banned in 1993 by the SEBI as it led to excessive speculation and increased market risk. It was also uncontrolled and unregulated which enhanced market risk and the prices of scrips could be manipulated under *badla* as brokers could easily corner liquid stocks. Moreover, brokers evaded margins and manipulated *badla* rates. Following the ban, however there was a steep decline in the volumes in the specified group following the ban. Therefore, it was revived and resumed again on the BSE in January 1996 on the recommendations of the G. S. Patel Committee. Later, in March 1997, the SEBI constituted the J. R. Varma Committee to review the revised carry forward system. The committee recommended a modified carry forward system (MCFS) which was accepted by the SEBI.

The MCFS was replaced by another carry forward mechanism—Borrowing and Lending of Securities Scheme (BLESS)—on January 27, 2001. This scheme was similar to Automatic Lending and Borrowing Mechanism (ALBM) of the NSE. The difference between ALBM/BLESS and *badla* was that while under ALBM/ BLESS one could withdraw the securities financed by paying a small margin of 15 per cent to 20 per cent, under *badla,* securities were kept with the clearing house and could not be withdrawn. Due to the facility of withdrawal of securities under BLESS/ALBM, a broker could create an exposure seven to eight times the amount invested in these deferral products.

In March 2001, after the Ketan Parekh scam came to light and the payment crisis in the Kolkata Stock Exchange, the SEBI completely banned *badla* and all deferral products—ALBM and BLESS—from July 2001. With this ban again, the volume of trading on BSE slumped from an average daily turnover of Rs. 5,220 crore in May 2001 to around Rs. 700 crore in July 2001—a decline of more than 70 per cent in a period of two months. This old system has been replaced by a new system—rolling settlement.

Listing Categories

Before *badla* was resumed in 1996, there were only two categories of securities listed on the BSE—the specified group of shares comprising the securities in which carry forward deals were allowed and the

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cash group shares in which no carry forward deals were permitted. Later, it was observed that the facility of carry forward was not being used in all the 94 scrips in the specified group. Hence, after *badla* was resumed, the size of the specified group was reduced to 32 scrips on April 3, 1996.

The BSE later decided to regroup the existing A and B group shares into three categories.

A Group This group consists of large turnover and high floating stock, with large market capitalisation. In other words, scrips included in this group are blue-chip companies. Carry-forward deals and weekly settlement were allowed in this group. At present, there are 150 scrips in this group.

B1 Group This group includes scrips of quality companies with an equity above Rs. 3 crores, with high growth potential and trading frequency. No carry-forward facility was allowed in this group. As on 12 December 2009, there were 205 scrips in this group.

B2 Group This group of scrips were just like those of B1 but with a fortnightly settlement. However, in September 1996, the BSE introduced a weekly settlement for all scrips listed on the exchange, thus doing away with the distinction between the B1 and B2 groups. This group consists of low trading volume scrips, with an equity below Rs. 3 crores, and surveillance measures initiated against most of them for suspected price manipulations.

Both B1 and B2 groups have been merged into one group known as B Group since April 1, 2008. All companies not included in group 'A', 'S' or 'Z' are clubbed under this category.

Subsequently, a Z group was introduced in 1999 with scrips of companies that do not meet the rules, regulations and stipulations laid down by the exchange. It is a buyer-beware company. There are some 300 scrips in the group. The companies that failed on a frequent basis to disclose quarterly results, to address investor grievances and make an arrangement with depositories to demat shares or even pay the exchange-listing fees are transferred by the exchange to this category. All Z-category stocks result in deliveries. The trading is on a trade-to-trade basis and no squaring up is permitted in intra-day trading as in other groups. The exchange authorities review their performance on a regular basis; and if a company satisfies the requirement, it is reverted back to its original group. As on December 12, 2009, there were 2,376 scrips in this group.

A new F group pertaining to the debt-market segment and G group pertaining to the government-securities market was started with effect from September 9, 1996.

The BSE set up the BSE INDONext market as a separate trading market on January 7, 2005 on its BOLT system as S group. As on December 12, 2009, there were 481 scrips in this group.

The scrips are transferred on a trade-to-trade basis from the regular segment to T group. Settlement of trades is done on the basis of gross obligations for the day. No netting is allowed and every trade is settled separately. As on December 12, 2009, there were 623 scrips in this group.

Scrips in the BSE-Indonext segment S, which are settled on a trade-to-trade basis as a surveillance measure, are transferred to the **TS** group. As on December 12, 2009, there were 52 scrips in this group.

There were 4,955 companies and 7,887 scrips were listed on BSE till November 2009.

BSE Indices

The first index launched by BSE was the BSE Sensitive Index (Sensex) in 1986. Since then, in the last 15 years, it has launche d 13 more indices. The BSE Sensex of equity-share prices was launched with the base year of 1978–79. It comprises 30 scrips. The BSE Sensex was followed by the BSE National in 1989.

This is a broader index comprising 100 scrips. The BSE introduced two new indices during 1993–94—the BSE 200 and the Dollex. The BSE 200 reflects the movements in the shares of 200 selected companies from its specified and non-specified lists. The Dollex is a dollar version of the BSE 200, which has 1989–90 as its base year. The BSE Dollex indices are Dollex 30, 100 and 200. The BSE introduced five sectoral indices from August 1999—the BSE IT Index, the BSE Capital Goods Index, the BSE FMCG Index, the BSE Health Care Index and the BSE Consumer Durables Index. In 2001, the BSE launched the BSE-PSU Index Dollex-30 and the BSE-Tech Index. Market capitalisation of all the indices is a free-float market capitalisation except for BSE-PSU Index. Subsequently, it introduced seven new sectoral indices which include auto, bank, metal, oil and gas, power, realty and tech. The other major indices introduced are small cap, midcap, BSE100, BSE 500 and BSE IPO.

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Box 8.4 Scrips Comprising the Sensex and their Free-float Factors

Scrip Code	Company	Beta Values	Weightage (%) in SENSEX as on November 30, 2009	Free-float Adj. Factor as on November 30, 2009
500410	ACC Ltd	0.78	0.65	0.55
500103	Bharat Heavy Electricals Ltd	0.95	3.03	0.35
532454	Bharti Airtel Ltd	0.74	3.14	0.35
532868	DLF Ltd	1.61	1.17	0.25
500300	Grasim Industries Ltd	0.64	1.29	0.75
500180	HDFC Bank Ltd	0.82	5.07	0.85
500182	Hero Honda Motors Ltd	0.47	1.35	0.5
500440	Hindalco Industries Ltd	1.2	1.2	0.65
500696	Hindustan Unilever Ltd	0.33	2.45	0.5
500010	Housing Development Finance Corporation Ltd	1.12	5.58	0.9
532174	ICICI Bank Ltd.	1.54	7.58	1
500209	Infosys Technologies Ltd	0.66	9.15	0.85
500875	ITC Ltd	0.55	5.38	0.7
532532	Jaiprakash Associates Ltd	1.8	1.37	0.55
500510	Larsen & Toubro Ltd	1.22	6.85	0.9
500520	Mahindra & Mahindra Ltd	0.98	1.69	0.75
532500	Maruti Suzuki India Ltd	0.63	1.78	0.5
532555	NTPC Ltd.	0.55	2.04	0.15
500312	ONGC Corporation Ltd	0.79	4.04	0.2
532712	Reliance Communications Ltd.	1.45	0.98	0.35
500325	Reliance Industries Ltd.	1.2	13.75	0.5
500390	Reliance Infrastructure Ltd	1.58	1.21	0.65
500112	State Bank of India	1.14	5.04	0.45
500900	Sterlite Industries	1.33	2.55	0.45
524715	Sun Pharmaceutical Inds Ltd	0.32	0.95	0.4
532540	Tata Consultancy Services Ltd	0.82	3.18	0.3
500570	Tata Motors Ltd	1.18	1.5	0.6
500400	Tata Power Co. Ltd	0.84	1.76	0.7
500470	Tata Steel Ltd	1.42	2.81	0.7
507685	WIPRO Ltd	0.83	1.45	0.2
	SENSEX	**1**		**2.28**

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Sensex Moves in the 1990s

Events	*Date*	*BSE Close*
Gulf War begins	January 17, 1991	1017.72
Rupee depreciation from Rs. 21 to Rs. 26	July 3, 1991	1312.87
Manmohan Singh Budget I	July 24, 1991	1485.76
High Index 91	November 19, 1991	1924.15
Low Index 92	January 1, 1992	1957.33
Manmohan Singh Budget II High Index 92	February 29, 1992	3017.68
Harshad Mehta period peak	April 23, 1992	4467.32
Scam exposed	April 26, 1992	3896.90
Babri Masjid demolition	December 10, 1992	2550.22
Manmohan Singh Budget III	February 27, 1993	2652.40
Low Index 93	April 26, 1993	2036.81
SEBI bans *badla*	December 13, 1993	3346.06
High Index 93	December 13, 1993	3454.81

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Events	*Date*	*BSE Close*
Low Index 94	January 5, 1994	3454.08
Manmohan Singh Budget IV	February 28, 1994	4286.20
First all-time high	September 12, 1994	4630.54
NSE starts operations	November 3, 1994	4269.86
High Index 95	January 2, 1995	3932.09
Manmohan Singh Budget V	March 15, 1995	3487.07
NSE turnover crosses BSE's	November 1, 1995	3488.50
Low Index 95	November 29, 1995	2922.16
Manmohan Singh Budget VI (Interim)	February 28, 1996	3494.09
BJP loses confidence vote	May 27, 1996	3653.10
High Index 96	June 14, 1996	4049.32
P. Chidambaram Budget I	July 22, 1996	3807.60
S&P upgrades outlook to positive	October 1, 1996	3226.80
Low Index 96	December 4, 1996	2745.06
Low Index 97	January 2, 1997	3225.24
P. Chidambaram Dream Budget II	February 28, 1997	3651.91
Fall of the Deve Gowda government	March 31, 1997	3360.89
RIL gives 1:1 bonus	June 26, 1997	4116.56
High Index 97	August 5, 1997	4548.02
Asian crisis	October 28, 1997	3934.33
Moody warns rating downgrade	January 8, 1998	3598.16
Vajpayee sworn in as PM	March 19, 1998	3820.87
High Index 98	April 21, 1998	4280.96
Pokhran nuclear blast	May 11, 1998	4022.20
US imposes sanctions	May 12, 1998	3945.13
Yashwant Sinha's Budget I	June 1, 1998	3642.68
Moody's two notch downgrade	June 19, 1998	3143.10
US 64 scare	October 5, 1998	2878.07
Low Index 98	October 20, 1998	2764.16
S&P lowers rating to BB	October 22, 1998	2764.16
Yashwant Sinha's Budget II	February 27, 1999	3399.63
Fall of the Vajpayee government	April 17, 1999	3326.98
Air attacks on Kargil begin	May 26, 1999	3973.30
US lifts sanctions	June 11, 1999	3969.36
Second all-time high	July 14, 1999	4710.25
Sensex touches 5,000 mark for the first time in technology boom Sensex marked from 4,000 to 5,000 in 106 trading days	October 8, 1999	4981.74
High of 1999	October 14, 1999	5075.34
Sensex touches 6,000 mark	February 11, 2000	5933.56
New all-time high	February 14, 2000	6150.69
Yashwant Sinha Budget III	February 29, 2000	5446.98
Crash in the NASDAQ composite	April 14, 2000	4880.71
Sensex touches its year's low	October 19, 2000	3491.55
UTI suspends the sale and repurchase of its flagship scheme	July 2, 2001	3312.95
US 64 *badla* banned and T+5 rolling settlement introduced	September 21, 2001	2600.12
On September 11, 2001, terrorists attack World Trade Centre in New York, Sensex touches eight-year low	September 21, 2001	2600.12
The government offloads 51 Per Cent stake in CMC and Tata Sons and 74 Per Cent stock in Hindustan Teleprinters to HFCL. Various other disinvestments take place and the PSU stocks raise the Sensex to a new eight-month high	February 13, 2002	3519.87

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Events	*Date*	*BSE Close*
Sensex blasts past 5,000 for second time in history.	November 3, 2003	5063.63
It was the highest in 43 months since April 13, 2000.		
The feel good belief in a rebounding economy and a powerful performance from four of its biggest stock push up the Sensex by 165 points the largest gain in a day since March 14, 2001. Sensex moves from 4,000 to 5,000 in just 55 trading days Expectations that the BJP-led National Democratic	January 14, 2004/ February 18, 2004	6194.11
Alliance (NDA) government would be re-elected Out polls predict that the NDA would return to power	April 23, 2004	5925.58
Sensex tumbles 230 points on the eve of the	May 11, 2004	5325.90
announcement of the election outcome on May 13, 2004		
The Sensex crashes 894.31 points or 16.5 Per Cent in two trading sessions on the shock defeat of the	May 17, 2004	4505.16
BJP-led NDA government		
Strong quarterly results and huge FII inflow	October 1, 2004	5527.75
The easing oil prices, stable fundamentals of the economy and FII inflow are the driving forces. After a nine-month gap, the Sensex close above the 6000 mark	November 16, 2004	6016.58
Historic high	March 8, 2005	6915.06
The best in 12 months under a new government since 1991–92 – a 31 Per Cent appreciation	May 26, 2005	6462.00
Crossed the five-digit mark	February 6, 2006	10,122
Crossed the 12000 mark	May 11, 2006	12,671
Crash of the Sensex	June 14, 2006	8,929
Crossed the 13000 mark	October 30, 2006	13,024
Crossed the 14000 mark	May 14, 2007	14,026.02
Crossed the 14500 mark	May 23, 2007	14,500.64
Crossed the 16000 mark	September 19, 2007	16335.20
Crossed the 17000 mark	September 27, 2007	17018.56
Crossed the 18000 mark	October 09, 2007	18,327.42
Crossed the 19000 mark	October 15, 2007	19095.75
Crossed the 20000 mark	December 26, 2007	20,018.17
Crossed the 21000 mark	January 08, 2008	21,077.53
Peak of the Sensex	January 10, 2008	21,206.77
Crash of the Sensex	October 27, 2008	7,697.39
On December 2, 2009	December 2, 2009	17,329.68
On July 13, 2010	July 13, 2010	18,106.50

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Gigantic Drops of the Sensex in a Day Of the eight major falls of Sensex in a day, three can be attributed to political developments and the rest to scams. Political stability and scams have, to a large extent, influenced the market investor sentiments—domestic and international.

Year	*Fall (Points)*	*Culprits*
April 28, 1992	570	Harshad Mehta Involved in a Scam
May 12, 1992	333	Full Effect of the Scam
May 9, 1992	327	National Housing Bank Involved in a Scam
March 31, 1997	303	Congress Withdraws Support to Deve Gowda's Government
April 17, 1999	246	Vajpayee's Government Falls
April 04, 2000	361	Dotcom Bubble Bursts
May 17, 2004	894.31	Defeat of the BJP-led NDA Government
October 24, 2008	1070	Sub Prime Crisis and Global Meltdown

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Bull Rally On October 17, 2003, the BSE Sensex closed at 4,930.53. This was the fastest rally of 2,006 points in the last decade. This 2,006-point rally came in 123 trading days, since April 25, 2003, when the Sensex was 2,924.12 points. However, the fastest rally, outside the current decade, was during the Harshad Mehta Scam when the Sensex gained 2,193 points in 31 trading days between February 7, and April 2, 1992. The biggest bull run was inspired by 'Big Bull' Harshad Mehta and expectations of foreign money coming into the local equity market. The Sensex moved up by 127% from 1,885 to 4,285 levels.

The second 1,150-plus point rally during March–August 2003 in the equity market was the largest half-year rally in more than a decade. The BSE Sensex then registered the biggest post-reform gain—a record rise of 83.37% during the year 2003–04. Unlike some previous rallies, this rally was a broad-based one, not driven by a few scrips of one or two sectors. Investors holding a diversified portfolio recorded an all-round gain. Moreover, there was also a considerable amount of FII interest in the Indian markets.

Between the last week of October 2004 and end-March 2005, a strong rally pushed the BSE Sensex to a historic high of 6,915.06 on March 8, 2005. Strong macroeconomic fundamentals, renewed buying interests by FIIs, an acceleration in the industrial activity, an improved financial performance of Indian companies, a moderation of domestic inflation, an easing of international crude-oil prices, an unprecedented pick-upon in bank credit and policy initiatives relating to the FDI in telecom and construction sections contributed to the upsurge in the Sensex.

The Sensex crossed the 8,000 level—a historic high on September 8, 2005. The Sensex closed on that day at 8,053—a rise of 106 points. The BSE Sensex crossed the 5-digit mark on February 6, 2006 when it touched 10,122. It touched 12,000 on April 20, 2006 and 12,671 on May 11, 2006, but it went into a free fall after May 12, 2006, lost 30% over a month, touched bottom at 8,799 on June 14, 2006 and drove investors into a panic.

The Sensex touched 11,015 on August 8, 2006 and 12,010 on September 15, 2006. It crossed the 13,000 mark on October 30, 2006 when the index rallied 117 points to close at 13,024. Investors' wealth in the 30 Sensex companies, measured in terms of the cumulative market value of these firms, soared to over Rs. 16,50,000 crores, from about Rs. 15,00,000 crores on April 20, 2006. Total investor wealth soared to over 34,00,000 crores on October 30, 2006. Strong economic growth, robust corporate results, a stable rupee, inflation and interest rates, lower crude-oil prices and high FII investment gave a fillip to market sentiments which drove the Sensex to amazing heights.

In 2006, the Sensex joined a select club of global indices such as the Dow Jones Industrial Average, the Nikkei and Hong Kong's Hang Seng which had crossed the 10,000 mark. India became the first BRIC country to join an exclusive club of developed markets whose market capitalisation of companies listed on the stock exchanges exceeds the GDP. A comparison of the market capitalisation with GDP is primarily made to assess the valuation levels of the markets. The total listed market capitalisation touched Rs. 34 lakh crores on October 16, 2006 exceeding the GDP figure of around Rs. 32 lakh crores during the financial year 2006.

The Sensex touched an all-time high of 21,206.77 on January 10, 2008, but then started declining on account of adverse global developments. Since the second quarter of 2009, the Sensex has been rising on account of improvements in the global financial markets scenario.

The BSE Sensex (Average) movements are shown in Figure 8.1.

Trends in Turnover on the BSE

The annual turnover, market capitalisation and the BSE Sensex increased sharply by 99 per cent in 1991–92 (Table 8.4). Share markets were unprecedentedly buoyant due to the liberalisation measures announced by the government to attract investments. Some important proposals announced in the Union Budget of 1992–93, such as the abolition of wealth tax on financial assets, abolition of the office of the CCI, free pricing era, and permission for Indian companies to raise funds abroad triggered volumes on the BSE. Irregularities in the securities transactions of banks and financial institutions also added to the speculative pressure in the stock markets. These irregularities were detected in 1992–93 when the scam broke out which -led to the streamlining of stock market operations by the BSE authorities, sharply reducing the turnover. In 1996–97, the turnover at BSE rose by 148 per cent. *Badla* was revived, which led to a massive rise in the turnover in the specified group of shares. Moreover, the extension of trading terminals outside Mumbai in September 1997 and rapid progress in trading in demat paperless form were some of the reasons for an increase in the turnover witnessed from 1996–97 to 1998–99.

During 1999–2000, the BSE turnover witnessed a sharp increase of 119 per cent. The market was driven by large FII inflows, improved corporate performance, sound macro-economic fundamentals, and upgrading of India's international credit ratings from stable to positive by international credit rating agencies. In 2000–01, the increase in turnover was 46 per cent. This was due to a slowdown in FII inflows, large

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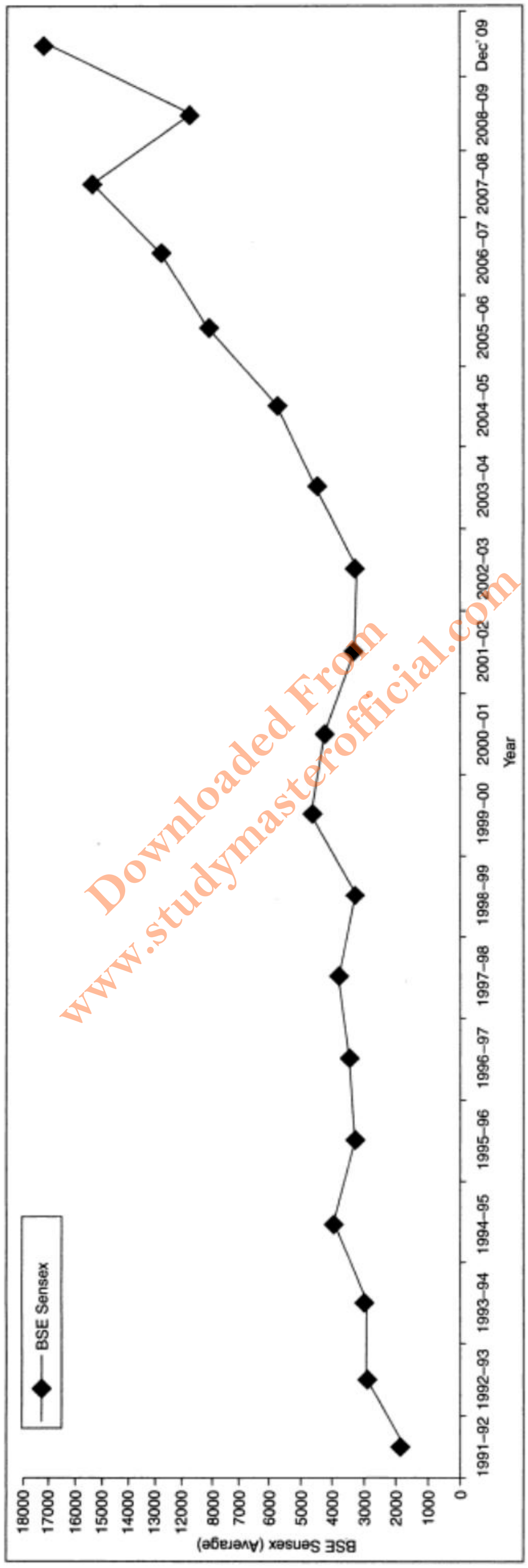


Figure 8.1 BSE Sensex (Average)

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sell-offs of new economy stocks on Nasdaq, an increase in international oil prices, payment crises at some stock exchanges, and liquidity problems with some cooperative banks.

The average share of A group in total volumes from 1990–91 to 1993–94 was around 78 per cent. In 1994–95, there was a sharp fall in its percentage as the SEBI banned *badla* in A group shares. Then, with the resumption of *badla* in January 1996, the proportion of A group increased. Moreover, in 1995–96, even though the number of companies in A group was reduced sharply from 94 to 32, the group's share in total volumes increased. This shows a very high concentration of a handful of companies in trading volumes at the exchange.

The number of listed companies rose from 2,471 in 1990–91 to 9,413 in 2002–03. However, the number of listed companies declined to 4,955 till November 2009, on account of delisting of securities. The market capitalisation is an indicator of the addition to the wealth of share owners. Its increase is a function of price change and supply change coming from new issues. In the first year of economic reforms, market capitalisation increased by 256%. This was the result of an increase in share prices due to an announcement of liberalisation measures and the listing of six PSU stocks for the first time on the stock exchange. In the subsequent year, 1992–93, market capitalisation declined due to irregularities in securities transactions. Share prices firmed up again in 1993–94 due to an increased flow of foreign funds, increased investor interest and speculative trading.

The secondary market turned distinctly depressed thereafter, as the BSE Sensex lost as many as 1382.30 points by March 31, 1995. In 1996–97, 1998–99, and 2000–01, even though the turnover increased, the market capitalisation declined. This indicated that the positive impact of wealth on consumption demand was lacking. The decline in market capitalisation was a result of decline in the new economy share prices and large sell-offs in the global market, news about financial status of US-64, payment crises at some stock exchanges and withdrawal of deferral products including *badla*. The secondary market turnover declined sharply both at the BSE and the NSE in 2001–02. Global recessionary conditions, international disturbances, and domestic industrial slowdown accounted for this sharp decline. The BSE Sensex touched the 2,600 mark on September 21, 2001 when terrorists attacked US cities. This 2,600 mark was an all-time, eight-year low, the lowest since September 8, 1993. BSE market capitalisation jumped to Rs. 17.5 lakh crores in March 2004, and India joined the US$400-billion Asian elite club. On October 30, 2006, the Sensex joined a select club of global indices which have crossed the 10,000 mark and continued to trade above that mark. The BSE Sensex touched an all-time high of 21,207 on January 10, 2008, but declined sharply thereafter on account of global financial turmoil. The impact of the sub-prime crisis and the turbulence in the global financial markets were felt on the stock markets in India. The depressed conditions in the domestic and global markets led to a steep fall in the Sensex by 60.9% and it touched a new low of 8,110.10 on March 9, 2009. The volatility of the BSE Sensex increased, the market capitalisation fell and the price–earning (P/E) ratio declined significantly. With improvements in the global liquidity and global financial markets, there has been an upward trend in the Sensex since the second quarter of 2009. The FIIs returned to the Indian markets and large purchases by them raised the BSE Sensex to 17,000 mark in November 2009. Moreover, the unexpected, good, corporate-earning announcements improved the market sentiments and investor confidence (Table 8.4).

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TABLE 8.4 Important Indicators of the Stock Exchange, Mumbai

Year	*Turnover (Rs. in Crore)*	*Per Cent Share of A Group in Total Volumes*	*No. of Listed Companies*	*Market Capitalisation of Listed Companies (Rs. in Crore)*	*Trend in Share Price BSE Sensex*	*Price Earning Ratio*	*Price Book Value Ratio*	*Yield Per Cent Per Annum*
1990–91	36,012 (22.6)	80.15	2,471	90,836 (39.3)	1,167.97 (49.5)	N.A.	N.A.	N.A.
1991–92	71,777 (99.3)	76.08	2,601	3,23,363 (256.0)	4,285.00 (266.9)	26.0	N.A.	N.A.
1992–93	45,696 (–36.3)	72.67	2,903	1,88, 146 (–41.8)	2,280.52 (–46.8)	35.5	6.18	0.82
1993–94	84,536 (85.0)	73.59	3,585	3,68,071 (95.6)	3,778.99 (65.7)	36.35	5.03	0.91
1994–95	67,749 (–19.9)	22.81	4,802	4,35,481 (18.3)	3,260.96 (–13.7)	41.24	5.64	0.75
1995–96	50,064 (–26.1)	53.63	5,603	5,26,476 (20.9)	3,366.61 (3.2)	19.92	3.46	1.25

(Continued)

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TABLE 8.4 (Continued)

Year	Turnover (Rs. in Crore)	Per Cent Share of A Group in Total Volumes	No. of Listed Companies	Market Capitalisation of Listed Companies (Rs. in Crore)	Trend in Share Price BSE Sensex	Price Earning Ratio	Price Book Value Ratio	Yield Per Cent Per Annum
1996–97	1,24,284 (148.3)	95.56	5,832	4,63,915 (–11.9)	3,360.89 (–0.2)	15.34	2.93	1.54
1997–98	2,07,644 (66.9)	94.88	5,853	5,60,325 (20.8)	3,892.89 (15.8)	14.51	2.73	1.53
1998–99	3,11,999 (50.3)	93.67	5,848	5,42,942 (–3.1)	3,739.96 (–3.9)	12.86	2.26	1.82
1999–2000	6,85,028 (119.6)	N.A.	5,889	9,12,842 (68.1)	5,001.28 (33.7)	19.76	3.4	1.23
2000–01	10,00,032 (46.00)	N.A.	5,955	5,71 ,553 (–37.4)	3,604.38 (–27.9)	23.9	3.6	1.3
2001–02	3,07,292 (–69)	N.A.	5,782	6,12,224 (+7)	3,469 (–3.7)	16.6	2.4	2.0
2002–03	3,14,073	N.A.	5,650	5,72,198	3,049	14.5	0	0
2003–04	5,03,053	N.A.	5,528	12,01,207	5,591	18.57	–	–
2004–05	5,18,715	N.A.	4,731	16,98,429	6,493	15.61	–	–
2005–06	8,16,074	N.A.	4,781	30,22,190	11,280	20.9	–	–
2006–07	9,56,185	N.A.	4,821	35,45,041	13,072	20.3	5.1	1.3
2007–08	15,78,857	N.A.	4,887	51,38,014	15,644	20.11	5.2	1.1
2008–09	11,00,074	N.A.	4,929	30,86,075	9,709	13.7	2.7	1.8
2009–10	13,78,809	N.A.	4,973	61,65,619	17,528	21.3	3.9	1.1

Note: Figures in brackets are percentage variations over the previous year.
N.A.: Not Available.
Source: The Stock Exchange, Mumbai.

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The P/E ratio is the market price of a share divided by the earnings per share. It signifies the price being paid by the buyer of equities for each rupee of annual earnings, whether distributed as dividends or retained in the company. A company's P/E ratio is crucial for judging whether the prevailing market price of a share is reasonable. The P/E ratio of the index is the market capitalisation of the 30 companies in the Sensex, divided by their earnings or net profits. A market's P/E ratio is an important indicator of the general state of the share market. Markets decide the P/E ratio based on a company's expected growth in earnings. Hence, when the expectation of growth increases and confidence shoots up, the scrip gains. One of the highest P/E levels was witnessed in April 1992, when the Sensex had a P/E of 56. In November 1994 it was 39, in July 1999 it was 17.51, in June 2000 it was 22.4 and in September 2003 it was 15.55. In November 2004, the stocks of Indian companies were quoted at 13 times their earnings. A declining trend was witnessed in P/E ratios due to lack of free-float, rising fiscal deficit, and a substantial rise in recent years in earnings of corporates. A similar trend was observed in the price–book-value ratio. The annualised yield based on 30 scrips included in the Sensex was the highest at 1.82% in 1998–99 and declined in the subsequent years and again increased to 2.0 in 2001–02. The price–earning ratio of the 30 scrips increased during the years 2005–06, 2006–07 and 2007–08, but declined during 2008–09. A similar trend was noticed in the price–book-value ratio.

Box 8.5 Price-to-book Value Ratio

Price-to-book value (P/BV) is the ratio of market price of a company's share over the book value of its equity, or the net worth. The net worth is the value of company's assets expressed in the balance sheet, i.e., the difference between the book value of assets and book value of its liabilities. The P/BV ratio offers a simple approach to find undervalued stocks. If a stock is trading for less than its book value, or has a P/BV ratio of less than 1, it means the investors perceive the company's assets as overstated or that the company is earning a low return on assets. This ratio may not always be a reliable guide for picking under valued stocks on account of various reasons: book value of an asset may not help when assets are ageing or the earnings power of the assets increase or decrease; book value can be changed by increasing or lowering the cash reserves; and this ratio is of less value to companies in the services sector with few tangible assets.

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TABLE 8.5 Top 50 Companies by Market Capitalisation and Turnover at BSE and NSE (Rs. in Crores)

Item	Market Capitalisation (End of Period)				Turnover			
	1991–92 (at BSE)	% to Total	2007–08 (at NSE)	% to Total	1991–92 (at BSE)	% to Total	2007–08 (at NSE)	% to Total
Manufacturing	86,232	58.6	7,11,980	22.51	41,572	83	4,30,484	19.72
Financial services	29,842	20.3	97,743	3.09	576	1.1	2,54,523	11.66
FMCG	26,359	17.9	1,27,532	4.03	3,478	6.9	26,700	1.22
IT	–	–	2,51,388	7.95	436	0.1	1,28,794	5.9
Petrochemicals	–	–	7,25,669	22.94	–	–	3,88,646	17.8
Infrastructure	–	–	5,39,261	17.05	–	–	5,00,458	22.93
Telecommunications	–	–	2,89,080	9.14	–	–	1,82,192	8.35
Banks	–	–	2,83,587	8.96	–	–	2,04,182	9.35

Note: FMCG: Fast moving consumer goods such as food, beverages and personal products.
IT: Information Technology.
Source: BSE, NSE, RBI, Report on Currency and Finance and various issues.

Table 8.5 reflects the significant changes in the relative importance of various companies. Traditionally, manufacturing companies such as cements and steel and the financial-services sector constituted the bulk of market capitalisation and of the turnover at the stock exchanges. However, in recent years, the relative importance of the traditional sectors has declined, while that of information technology (IT), pharmaceuticals and FMCG sectors has increased.

This change was a result of the government policy, which lifted the controls on the private sector and then opened up the economy to foreign companies. Hence, many capital-intensive industries such as steel, fertilisers and chemicals, which worked well in a closed economy, could not withstand the international competition. Moreover, new companies and businesses emerged which offered good returns.

Conclusion

The oldest stock exchange of India faced rough weather when the National Stock Exchange (NSE) was set up in 1994. It was opined that the BSE would not be in a position to face stiff competition from this new and modern stock exchange. However, the BSE revamped its operations quickly, adopted modern technology, and gave tough competition to the NSE. This competition among the exchanges has made the Indian capital market more mature.

The BSE is still in the process of reforming itself. The involvement of BSE brokers and its elected members in a series of scams has affected its image and small and institutional investors have more or less lost faith in it. It completed the process of demutualisation and corporatisation in May 2007. The Singapore stock exchange (SGX) and the Deutsche Borse (DB) are BSE's strategic partners holding 5 per cent stake each in the exchange. They have a combined investment of Rs. 380 crore at Rs. 5200 per share.

The BSE's network outside Mumbai has not expanded significantly. The BSE lacks in liquidity and needs to draw in more players like market makers to create liquidity. The BSE and NSE had commenced derivatives trading in 2000 but NSE dominates the derivatives market. Thus, BSE needs to revamp its strategic plan to compete with NSE.

THE NATIONAL STOCK EXCHANGE OF INDIA

The stock markets witnessed many institutional changes in the 1990s. One of them was the establishment of the NSE, a modern stock exchange which brought with it the best global practices.

The NSE was incorporated in November 1992 with the following objectives.

- To establish a nationwide trading facility for equities, debt instruments, and hybrids.
- To ensure all investors all over the country equal access through an appropriate communication network.
- To provide a fair, efficient, and transparent securities market to investors through an electronic trading system.
- To enable shorter settlement cycles and book-entry settlement system.
- To meet the current international standards of securities markets.

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TABLE 8.6 NSE—At a Glance

	CAPITAL MARKET (EQUITIES) SEGMENT		
1	Settlement Guarantee Fund	March 31, 2009	Rs. 4,843.50 Crores
2	Investor Protection Fund	September 30, 2009	Rs. 299.91 Crores
3	Number of Securities Available for Trading	October 31, 2009	1,672
4	Record Number of Trades	May 19, 2009	1,12,60,392
5	Record Daily Turnover (Quantity)	May 19, 2009	19,225.95 Lakhs
6	Record Daily Turnover (Value)	May 19, 2009	Rs. 40,151.91 Crores
7	Record Market Capitalisation	January 07, 2008	Rs. 67,45,724 Crores
8	Record Value of S&P CNX Nifty Index	January 08, 2008	6,357.1
9	Record Value of CNX Nifty Junior Index	January 04, 2008	13,209.35
	CLEARING & SETTLEMENT		
1	**Record Pay-in/Pay-out (Rolling Settlement):**		
	Funds Pay-in/Pay-out (N2007200)	October 23, 2007*	Rs. 4,567.70 Crores
	Securities Pay-in/Pay-out (Value) (N2009088)	May 21, 2009*	Rs. 9,523.33 Crores
	Securities Pay-in/Pay-out (Quantity) (N2009088)	May 21, 2009*	4,385.75 Lakhs
	*Settlement Date		
	DERIVATIVES (F&O) SEGMENT		
1	Settlement Guarantee Fund	March 31, 2009	Rs. 23,655.86 Crores
2	Investor Protection Fund	September 30, 2009	Rs. 52.89 Crores
3	Record Daily Turnover (Value)	July 29, 2009	Rs. 116,508 Crores
4	Record Number of Trades	January 07, 2009	18,74,697
	CURRENCY DERIVATIVES SEGMENT		
1	Record Daily Turnover (Value)	November 27, 2009	Rs. 10,599.48 Crores
2	Record Number of Trades	November 27, 2009	51,656
3	Record Number of Contracts	November 27, 2009	22,60,014
4	Investor Protection Fund	September 30, 2009	Rs. 0.01 Crores
	WHOLESALE DEBT SEGMENT		
1	Number of Securities Available for Trading	October 31, 2009	3,978
2	Record Daily Turnover (Value)	August 25, 2003	Rs. 13,911.57 Crores

Source: www.nseindia.com

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The NSE incorporated a separate entity—NSE IT Ltd in October 1999, to service the securities industry in addition to the management of IT requirements of the NSE. It also set up NSE Infotech Services Ltd to focus on IT. It caters to the IT needs of NSE and all its group companies exclusively. The data and info-vending products of the NSE are provided through a separate company DotEx International Ltd, a wholly owned subsidiary of the NSE.

The commodity exchange platform—NCDEX—was jointly set up by the NSE with financial institutions. In order to provide clearing-and-settlement services to NCDEX, it promoted a company—National Commodity Clearing Limited (NCCL) in 2006. In 2008, it set up a national-level electricity exchange—Power Exchange India (PXI) Ltd, again the first of its kind in the country.

The NSE is ranked third in terms of number of equity shares traded and is the eighth largest derivatives exchange in the world.

Membership Pattern on the NSE

The management of the NSE is in the hands of professionals, as distinct from the trading members, to avoid any conflict of interest. If the applicant is an individual/partnership firm/corporate, then the individual/at least two partners of the applicant firm/at least two directors of the applicant corporate must be graduates, possess at least 2-year experience in securities market, not debarred by the SEBI and not engaged in any fund-based activity. A trading member is admitted to any of the following combinations of market segments: (a) wholesale debt market (WDM) segment, (b) capital market (CM) and the futures and options (F&O) segments, (c) CM segment and the WDM segment or (d) all the three segments (refer Table 8.7).

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NSE Milestones

Month/Year	*Event*
November 1992	Incorporation.
April 1993	Recognition as a stock exchange.
June 1994	WDM segment goes live.
November 1994	CM segment goes live through VSAT.
March 1995	Establishment of Investor Grievance Cell.
April 1995	Establishment of NSCCL, the first Clearing Corporation.
July 1995	Establishment of Investor Protection Fund.
October 1995	Became the largest stock exchange in the country.
April 1996	Commencement of clearing and settlement by NSCCL.
April 1996	Launch of S&P CNX Nifty.
June 1996	Establishment of Settlement Guarantee Fund.
November 1996	Setting up of National Securities Depository Ltd, the first depository in India, co-promoted by NSE.
November 1996	'Best IT Usage' award by Computer Society of India.
December 1996	Commencement of trading/settlement in dematerialised securities.
December 1996	Dataquest award for 'Top IT User.'
December 1996	Launch of CNX Nifty Junior.
November 1997	'Best IT Usage' award by Computer Society of India.
May 1998	Promotion of joint venture, India Index Services & Products Limited (IISL) (along with CRISIL) for index services.
May 1998	Launch of NSE's Web-site: www.nseindia.com.
July 1998	Launch of 'NSE's Certification Programme in Financial Markets.' (NCFM).
August 1998	'CYBER CORPORATE OF THE YEAR 1998' award.
April 1999	'CHIP Web Award' by CHIP magazine.
October 1999	Setting up of NSE. IT Ltd.
January 2000	Launch of NSE Research Initiative.
February 2000	Internet Trading in CM segment.
June 2000	Commencement of Derivatives Trading (in Index Futures).
September 2000	Launch of Zero Coupon Yield Curve.
June 2001	Commencement of Trading in Index Options.
July 2001	Commencement of Trading in Options on Individual Securities.
November 2001	Commencement of Trading in Futures on Individual Securities.
December 2001	Launch of NSE VAR for Government Securities.
January 2002	Launch of Exchange Traded Funds (ETFs).
May 2002	NSE wins the Wharton–Infosys Business Transformation award in the organisation-wide transformation category.
October 2002	Launch of Government Securities Index.
January 2003	Launch of Retail Debt of Government Securities.
June 2003	Launch of Exchange Traded Interest Rate derivatives on Notional 91-day T-bills and Notional 10-year bonds.
August 2003	Launch of Futures and Options on CNX IT Index.
June 2004	Launch of STP Interoperability.
August 2004	Launch of NSE electronic interface for listed companies.
March 2005	'India Innovation Award' by EMPI Business School, New Delhi.
June 2005	Launch of Futures & Options on BANK Nifty Index.
August 2006	Setting up of NSE Infotech Services Ltd.
December 2006	'Derivative Exchange of the Year,' by Asia Risk magazine.
January 2007	Launch of NSE–CNBC TV 18 media centre.

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Month/Year	*Event*
March 2007	NSE, CRISIL announce launch of India Bond Watch.com
March 2007	Launch of Gold BeES—Exchange Traded Fund (ETF).(First Gold ETF).
June 2007	Launch of Futures & Options on CNX 100 and CNX Nifty Junior contracts.
October 2007	Launch of Futures & Options on Nifty Midcap 50.
January 2008	Launch of Mini Nifty derivative contracts.
March 2008	Launch of long-term option contracts on S&P CNX Nifty Index.
May 2008	Launch of NOW or 'NEAT on Web'platform.
April 2008	Launch of DMA
April 2008	Launch of Securities Lending & Borrowing Scheme.
April 2008	Launch of India VIX—The Volatility Index.
June 2008	Setting up of Power Exchange India Ltd.
August 2008	Launch of Currency Derivatives for the first time in India, currency futures are traded on a stock-exchange platform.
October 2008	Operationalisation of Power Exchange India Ltd. It provides a common electronic platform for trading of electricity.
August 2009	Launch of Interest Rate Futures.
November 2009	Launch of Mutual Fund Service System.

Source: www.nseindia.com

TABLE 8.7 Distribution of SEBI Registered Trading Members on NSE as on March 31, 2009

Particulars	*C M*	*WDM*	*CM & WDM*	*CM, WDM and F&O*	*CM and F&O*	*CD*	*Total*	*PCMs*
Corporates	95	6	9	47	941	40	1,138	20
Individuals	10	–	–	–	34		44	0
Firms	12	–	–	–	33		45	0
Total	**117**	**6**	**9**	**47**	**1,008**	**40**	**1,227**	**20**

CM=Capital Market, WDM=Wholesale Debt Market, F&O=Futures & Options, PCM=Professional Clearing Members, CD = Currency Derivatives
Source: www.nse-india.com
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Indices

The NSE Fifty was rechristened as the S&P CNX Nifty on July 28, 1998. This index is widely used as it reflects the state of the market sentiments for 50 highly liquid scrips. The base period for the S&P CNX Nifty is November 3, 1995. The S&P CNX Nifty is computed using a float-adjusted, market capitalisation-weighted methodology. It accounts for 58.64% of the total market capitalisation of CM segment of NSE and 51.39% of the traded value of all the stocks on the NSE as at end-March 2008. It is used as a benchmarking fund portfolios, index-based derivatives and index funds.

The CNX Nifty Junior is a mid-cap index introduced in January 1997 to cater to the growth companies in the economy. The base period is November 3, 1996. Companies include those which are traded with an impact cost of less than 2.5% on 85% of the trading days. It accounts for 9.60% of the market capitalisation of CM segment of NSE as at end-March 2008.

A new index called the S&P CNX Defty (dollar-denominated S&P CNX Nifty) was introduced on November 26, 1997. It shows returns on the S&P CNX Nifty index in dollar terms. The S&P CNX Defty serves as a performance indicator to FIIs, offshore funds and others. It is also used as an effective tool for hedging Indian equity exposure. This new index is available online.

The other popular indices are the Nifty mid-cap 50, the CNX mid-cap 50, the S&P CNX Sectoral Indices, such as IT, Bank, FMCG, Public Sector Enterprises (PSE), MNC, Services, Energy, Pharma, Infrastructure, PSU Bank and Realty.

NSE launched on January 29, 2008 an environment, social and corporate governing (ESG) index, the first of its kind, to measure practices based on quantitative as opposed to subjective factors.

These indices are maintained, monitored and updated by India Index Services and Products Limited (IISL). A joint venture between the NSE and CRISIL, IISL is the only specialised organisation in the country to provide stock-index services. It introduced the country's first infotech, sector-specific index in September 1998.

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National Securities Clearing Corporation Limited

Functions of NSCCL

- Clears all trades
- Determines obligations of members
- Arranges for pay-in and pay-out of funds/securities
- Receives funds/securities
- Processes for shortages in funds/securities
- Guarantees settlement
- Collects and maintains margins/collateral/base capital/other funds
- Counter party to all settlement obligations of the members

In April 1995, the NSE set up the National Securities Clearing Corporation Limited (NSCCL), a wholly owned subsidiary, to undertake clearing and settlement at the exchange. It commenced operations from April 1996. It operates with a well-defined settlement cycle, aggregates trades over a trading period, nets the positions to determine the liabilities of the members, and ensures movement of funds and securities to meet respective liabilities. Its central functions are clearing and settlement of trades and risk management.

The NSCCL assumes the counter-party risk of each member and guarantees settlement. Settlement guarantee is a guarantee provided by the clearing corporation for the settlement of all trades even if a party defaults to deliver securities or pay cash. The NSCCL started the settlement guarantee fund for the capital market in June 1996 with an initial corpus of Rs. 300 crore (Table 8.9). This fund stood at Rs. 2,700 crore at the end of March 2006. It cushions itself from any residual risk. Members contribute to this fund which is utilised for the successful completion of settlement. A separate settlement guarantee fund (SGF) is maintained for the futures and options (F&O) segment.

There are four entities linked with the Clearing Corporation (NSCCL) in the clearing and settlement process.



- **Custodian/Clearing members:** Clearing members have to make available funds and/or securities in the designated accounts with clearing bank/depositories to meet their obligations on the settlement date. Custodian is a clearing member but not a trading member. They settle trades assigned to them by trading members. The NSCCL notifies the relevant trade details to custodians on the trade day who affirm back. If a custodian confirms to settle that trade, he is assigned that particular obligation by the NSCCL. There are 11 custodians empanelled with the NSCCL.
- **Clearing banks:** They are a key link between the clearing members and clearing corporation. Every clearing member is required to open a dedicated clearing account with one of the designated clearing banks. The NSCCL, in association with clearing banks, provides working capital funding to clearing members. A clearing bank has to enter into an agreement with the NSCCL and the clearing member and open clearing accounts with depositories. The clearing member has to approach its bank, which would extend the funding requirements in consultation with the NSCCL.
- **Depositories:** They hold securities in dematerialised form for the investors in their beneficiary accounts. Every clearing member is required to maintain a clearing pool account with the depositories. The depository runs on electronic file to transfer securities from accounts of the custodians/clearing member to that of the NSCCL and vice versa.
- **Professional Clearing Members (PCMs):** They are a special category of members with clearing rights but with no trading rights and who perform functions similar to those of custodians. PCMs clear and settle trade for their clients who may be individuals or institutions.

The NSCCL carries out the clearing and settlement process with the help of clearing banks and depositories which results in an actual movement of funds and securities on the prescribed pay-in and pay-out day.

NSCCL Products and Services

- Clearing and settlement
- Guarantee
- Risk management
- Direct payment to clients
- Constituent SGL account
- Mutual fund service system

The clearing members bring in the securities in designated accounts with the two depositories—the CM pool account in the case of the NSDL and designated settlement accounts in the case of the CDSL and funds in the designated accounts with clearing banks. The clearing banks, on receiving electronic instructions from the NSCCL, debit accounts of clearing banks and credit accounts of the clearing corporation. This is termed as pay-in of funds and securities (Table 8.8).

The NSCCL, after providing for shortages of funds/securities, sends electronic instructions to the depositors/clearing banks to credit accounts of clearing members and debit accounts of the clearing corporation. Thus, the settlement cycle is complete once the pay-out of funds and securities is done.

The settlement cycle and settlement statistics are shown in Tables 8.8 and 8.9.

Margin Requirements

The NSCCL imposes stringent margin requirements as part of its risk containment measures. For imposing margins, the stocks are categorised as follows:

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THE INDIAN FINANCIAL SYSTEM

Markets, Institutions and Services

BHARATI V. PATHAK



THIRD EDITION

The Indian financial system is a complex amalgamation of various institutions, markets, regulations and laws, analysts, transactions, claims and liabilities. This book not only thoroughly engages with these important aspects of financial system as its bedrock, but also helps students, academicians and professionals to survive and thrive in today's competitive business environment. This edition has been substantially revised, with new chapters, incorporation of the latest amendments and changes, and important discussions on topics like risk management, systematic investment plans, reverse mortgage loans and financial inclusion.

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