Chapter-2 SWAPS

- A swap is a derivative contract between two parties that involves the exchange of pre-agreed cash flows of two financial instruments.
- Introduced in the late 1980s, swaps are a relatively new type of derivative. Even though relatively new, their simplicity, coupled with their extensive applications, makes them one of the most frequently traded financial contracts.
- Corporate finance professionals may use swap contracts to hedge risk and minimize the uncertainty of certain operations. For example, sometimes projects can be exposed to exchange rate risk and the Company’s CFO may use a currency swap contract as a hedging instrument.

- Parties in swaps are usually companies and financial organizations and not individuals, because there is always a high risk of counterparty default in swap contracts.
- Some financial institutions usually participate as the market makers of swap markets. The institutions, which are also known as swap banks, facilitate the transactions by matching counterparties.

Types of Swaps

1 Interest rate swap

Counterparties agree to exchange one stream of future interest payments for another, based on a predetermined notional principal amount. Generally, interest rate swaps involve the exchange of a fixed interest rate for a floating interest rate.

2 Currency swap

Counterparties exchange the principal amount and interest payments denominated in different currencies. These contracts swaps are often used to hedge another investment position against currency exchange rate fluctuations.

3 Commodity swap

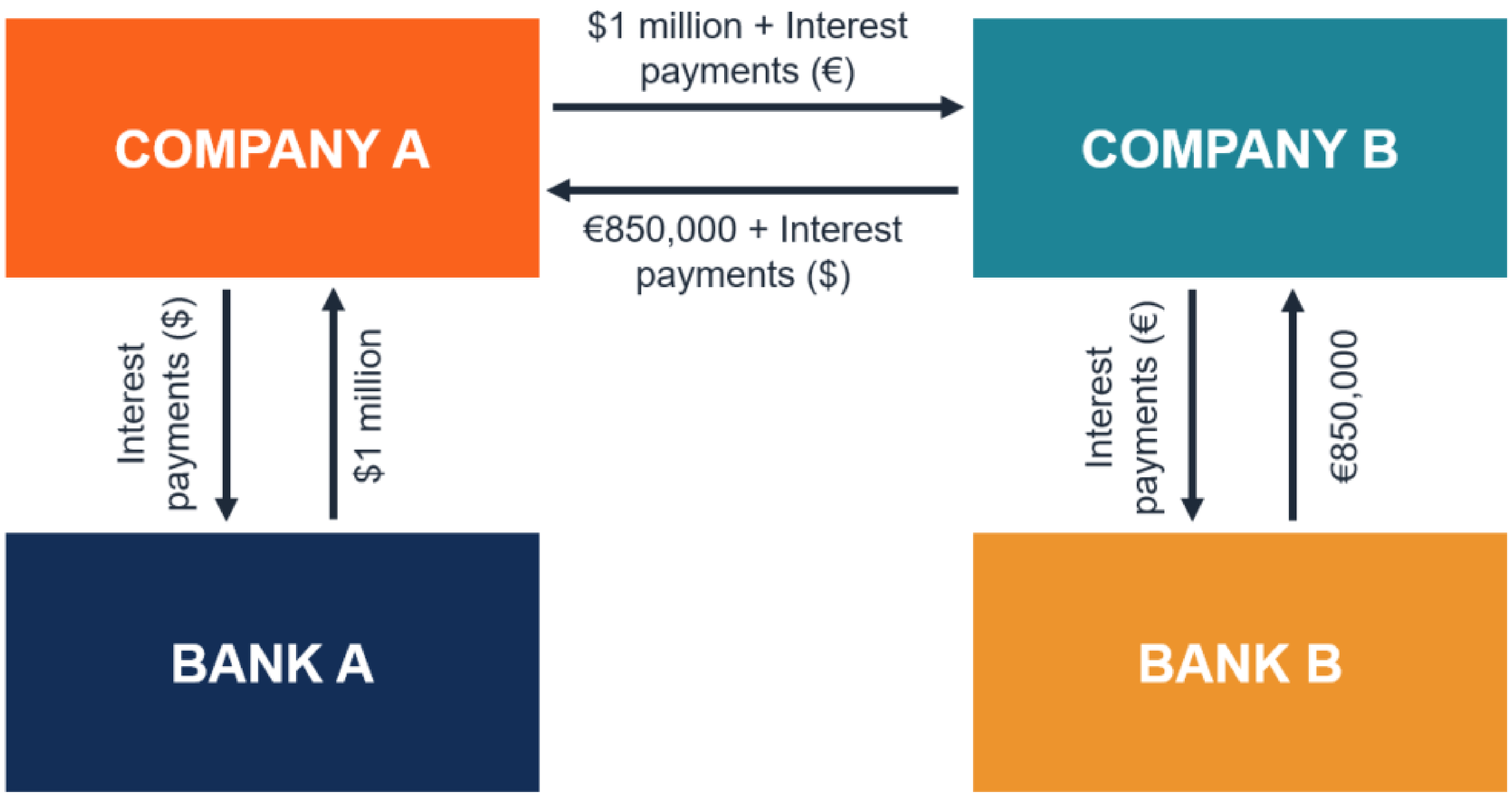
These derivatives are designed to exchange floating cash flows that are based on a commodity’s spot price for fixed cash flows determined by a pre-agreed price of a commodity. Despite its name, commodity swaps do not involve the exchange of the actual commodity.

4 Credit default swap

A CDS provides insurance from the default of a debt instrument. The buyer of a swap transfers to the seller the premium payments. In case the asset defaults, the seller will reimburse the buyer the face value of the defaulted asset, while the asset will be transferred from the buyer to the seller. Credit default swaps became somewhat notorious due to their impact on the 2008 Global Financial Crisis.

Currency Swap

- A currency swap contract (also known as a cross-currency swap contract) is a derivative contract between two parties that involves the exchange of interest payments, as well as the exchange of principal amounts in certain cases, that are denominated in different currencies. Although currency swap contracts generally imply the exchange of principal amounts, some swaps may require only the transfer of the interest payments.


COMPANY A
$1 million + Interest payments (€)
€850,000 + Interest payments ($)
COMPANY B
Interest payments ($)
$1 million
Interest payments (€)
€850,000
BANK A
BANK B

- In order to understand the mechanism behind currency swap contracts, let’s consider the following example. Company A is a US-based company that is planning to expand its operations in Europe. Company A requires €850,000 to finance its European expansion.
- On the other hand, Company B is a German company that operates in the United States. Company B wants to acquire a company in the United States to diversify its business. The acquisition deal requires US$1 million in financing.
- Neither Company A nor Company B holds enough cash to finance their respective projects. Thus, both companies will seek to obtain the necessary funds through debt financing. Company A and Company B will prefer to borrow in their domestic currencies (that can be borrowed at a lower interest rate) and then enter into the currency swap agreement with each other.

- The currency swap between Company A and Company B can be designed in the following manner. Company A obtains a credit line of $1 million from Bank A with a fixed interest rate of 3.5%. At the same time, Company B borrows €850,000 from Bank B with the floating interest rate of 6-month LIBOR. The companies decide to create a swap agreement with each other.
- According to the agreement, Company A and Company B must exchange the principal amounts ($1 million and €850,000) at the beginning of the transaction. In addition, the parties must exchange the interest payments semi-annually.

Company A must pay Company B the floating rate interest payments denominated in euros, while Company B will pay Company A the fixed interest rate payments in US dollars. On the maturity date, the companies will exchange back the principal amounts at the same rate ($1 = €0.85).

Types of Currency Swap Contracts

- **Fixed vs. Float:** One leg of the currency swap represents a stream of fixed interest rate payments while another leg is a stream of floating interest rate payments.
- **Float vs. Float (Basis Swap):** The float vs. float swap is commonly referred to as basis swap. In a basis swap, both swaps' legs both represent floating interest rate payments.
- **Fixed vs. Fixed:** Both streams of currency swap contracts involve fixed interest rate payments.

A financial swap is **a derivative contract where one party exchanges or "swaps" the cash flows or value of one asset for another**. For example, a company paying a variable rate of interest may swap its interest payments with another company that will then pay the first company a fixed rate.

- For example, when conducting a currency swap between USD to CAD, a party that decides to pay a fixed interest rate on a CAD loan can exchange that for a fixed or floating interest rate in USD. Another example would be concerning the floating rate. If a party wishes to exchange a floating rate on a CAD loan, they would be able to trade it for a floating or fixed rate in USD as well.
- The interest rate payments are calculated on a quarterly or semi-annually basis.

Fixed vs. Float Example

- Suppose Company X carries a $100 million loan at a fixed rate of 6.5%. Company X expects that the general direction of interest rates over the near or intermediate-term is down. Company Y, carrying a $100 million loan at London Interbank Offered Rate (LIBOR) + 3.50% (floating rate loan), has the opposite view; it believes interest rates are on the rise. Company X and Company Y wish to swap. With the fixed-for-floating swap Company X will pay the floating rate, and thus benefit if in fact interest rates drop, and Company Y will assume payments for the fixed-rate loan. Company Y will stand to benefit if interest rates rise. Swap transactions are facilitated by a swap dealer, who will act as the required counterparty for a fee.

Interest Rate Swaps

- The most popular types of swaps are plain vanilla interest rate swaps. They allow two parties to exchange fixed and floating cash flows on an interest-bearing investment or loan.
- Businesses or individuals attempt to secure cost-effective loans but their selected markets may not offer preferred loan solutions. For instance, an investor may get a cheaper loan in a floating rate market, but they prefer a fixed rate. Interest rate swaps enable the investor to switch the cash flows, as desired.

- Assume Paul prefers a fixed rate loan and has loans available at a floating rate (LIBOR+0.5%) or at a fixed rate (10.75%). Mary prefers a floating rate loan and has loans available at a floating rate (LIBOR+0.25%) or at a fixed rate (10%). Due to a better credit rating, Mary has the advantage over Paul in both the floating rate market (by 0.25%) and in the fixed rate market (by 0.75%). Her advantage is greater in the fixed rate market so she picks up the fixed rate loan. However, since she prefers the floating rate, she gets into a swap contract with a bank to pay LIBOR and receive a 10% fixed rate.
- Paul borrows at floating (LIBOR+0.5%), but since he prefers fixed, he enters into a swap contract with the bank to pay fixed 10.10% and receive the floating rate.


Lender
Lender
LIBOR + 0.5%
10%
LIBOR
LIBOR
Paul
Mary
10.10%
10%
Bank
0.10%
Investopedia

Benefits: Paul pays (LIBOR+0.5%) to the lender and 10.10% to the bank, and receives LIBOR from the bank. His net payment is 10.6% (fixed). The swap effectively converted his original floating payment to a fixed rate, getting him the most economical rate. Similarly, Mary pays 10% to the lender and LIBOR to the bank and receives 10% from the bank. Her net payment is LIBOR (floating). The swap effectively converted her original fixed payment to the desired floating, getting her the most economical rate. The bank takes a cut of 0.10% from what it receives from Paul and pays to Mary.

1. Fixed-to-Floating

For example, consider a company named TSI that can issue a bond at a very attractive fixed interest rate to its investors. The company's management feels that it can get a better cash flow from a floating rate. In this case, TSI can enter into a swap with a counterparty bank in which the company receives a fixed rate and pays a floating rate.

2. Floating-to-Fixed

A company that does not have access to a fixed-rate loan may borrow at a floating rate and enter into a swap to achieve a fixed rate. The floating-rate tenor, reset, and payment dates on the loan are mirrored on the swap and netted. The fixed-rate leg of the swap becomes the company's borrowing rate.

3. Float-to-Float

Companies sometimes enter into a swap to change the type or tenor of the floating rate index that they pay; this is known as a basis swap. A company can swap from three-month LIBOR to six-month LIBOR, for example, either because the rate is more attractive or it matches other payment flows. A company can also switch to a different index, such as the federal funds rate, commercial paper, or the Treasury bill rate.

Unit-3 Risk Management

Meaning of Risk

Risk refers to the possibility that an uncertain event or situation may occur and affect the achievement of an individual's or organisation's objectives. Risk may result in a **loss, adverse outcome or deviation from the expected result**. However, in modern business, risk may also create opportunities for gain.

For example, a company investing in a new market faces the risk of financial loss if the market does not perform as expected. At the same time, the investment may provide an opportunity for higher profits and growth.

Definition: Risk implies future uncertainty about deviation from expected earnings or expected outcome. Risk measures the uncertainty that an investor is willing to take to realize a gain from an investment.

Types of Risk

- **Financial risk** refers to a company's ability to manage its debt and financial leverage, the risk that a company may default on its debt payments
- **Business risk** refers to the company's ability to generate sufficient revenue to cover its operational expenses, a risk that the company will be unable to function as a profitable enterprise.

Meaning of Risk Management

Risk management is a systematic process of identifying, analysing, assessing, responding to and monitoring risks that may affect the achievement of organisational objectives.

The purpose of risk management is not to eliminate every risk, because complete elimination is usually impossible and may prevent an organisation from taking beneficial opportunities. Instead, it aims to ensure that risks are understood and managed within acceptable limits.

Risk Management Definition:

Risk management is the identification, evaluation, and prioritization of risks followed by coordinated and economical application of resources to minimize, monitor, and control the probability or impact of unfortunate events or to maximize the realization of opportunities.

Nature of Risk Management

The **nature of risk management** refers to the basic characteristics and features that explain how risk management functions within an organisation. The important features are:

1. **Continuous Process:** Risk management is a continuous process because new risks may arise as business conditions, technology, markets and regulations change.
2. **Systematic Process:** It follows a systematic approach of identifying, analysing, evaluating, treating and monitoring risks.

3. **Future-Oriented:** Risk management focuses on possible future events and their potential impact on the organisation.

4. **Proactive in Nature:** It aims to identify and manage risks before they result in significant losses rather than dealing with risks only after they occur.

5. **Organisation-Wide Approach:** Risk management covers all major areas of an organisation, including finance, operations, marketing, human resources, technology and strategy.

6. **Decision-Oriented:** Risk information helps managers make informed decisions by considering both potential opportunities and threats.

7. **Dynamic in Nature:** The nature and level of risk change with changes in economic conditions, technology, competition, government policies and business strategies.

8. **Integrated Process:** Risk management should be integrated with strategic planning, budgeting, investment decisions and day-to-day business operations.

9. **Preventive and Protective:** It attempts to prevent the occurrence of avoidable risks and protect the organisation from the financial impact of unavoidable risks.

10. **Based on Risk–Return Relationship:** Risk management recognises that higher expected returns are generally associated with higher levels of risk and seeks to maintain an appropriate balance between risk and return.

11. **Stakeholder-Oriented:** Effective risk management protects the interests of shareholders, employees, customers, creditors, investors and other stakeholders.

12. **Value-Oriented:** The ultimate purpose of risk management is not simply to eliminate all risks but to manage them effectively so that the organisation can achieve its objectives and create long-term value.

Objectives of Corporate Risk Management

The main objectives of corporate risk management are:

1. **To identify risks:** To identify potential risks that may negatively affect the company's operations, financial position and objectives.

2. **To assess and analyse risks:** To evaluate the probability and potential impact of identified risks on the organisation.

3. **To minimise financial losses:** To reduce the possibility and magnitude of financial losses arising from business activities.

4. **To protect corporate assets:** To safeguard the company's physical, financial, technological and human resources from potential threats.

5. **To ensure business continuity:** To enable the organisation to continue its critical operations even during unexpected events or crises.

6. **To improve decision-making:** To provide management with relevant information about risks so that better and more informed decisions can be taken.

7. **To ensure compliance:** To help the organisation comply with applicable laws, regulations, accounting standards and corporate governance requirements.
8. **To protect reputation:** To prevent events that may damage the company's goodwill, public image and stakeholder confidence.
9. **To reduce uncertainty:** To reduce the impact of uncertainty on business operations and future performance.
10. **To support achievement of corporate objectives:** To manage risks in such a way that the organisation can achieve its strategic, financial and operational goals.
11. **To protect stakeholders' interests:** To safeguard the interests of shareholders, employees, customers, creditors and other stakeholders.
12. **To create and preserve corporate value:** The ultimate objective is to manage risks effectively while supporting sustainable growth and long-term value creation.

Scope of Corporate Risk Management

The scope of corporate risk management covers all activities undertaken by an organisation to identify, evaluate, control and monitor risks. The following points explain its major areas:

1. Planning and Implementing the Risk Management Process

Risk management begins with developing a systematic plan for managing risks. The organisation establishes risk-management policies, procedures and responsibilities and implements them throughout the organisation. The process is regularly reviewed and improved according to changes in the business environment.

2. Risk Identification and Analysis

The organisation identifies different risks that may affect its objectives, such as financial, operational, strategic, legal, technological and reputational risks. After identifying the risks, their causes, probability of occurrence and possible consequences are analysed to understand their potential impact.

3. Assessment and Prioritisation of Risk

All risks do not have the same level of importance. Therefore, the organisation assesses risks on the basis of their **likelihood and potential impact**. High-priority risks that can cause significant financial or operational damage are addressed first, while lower-priority risks are monitored appropriately.

4. Establishing and Quantifying the Risk-Handling Capabilities of the Organisation

An organisation must determine its ability to deal with different types and levels of risk. This involves assessing its financial resources, insurance coverage, internal controls, human resources, technology and emergency arrangements. Quantifying risk helps management determine how much risk the organisation can **accept, reduce, transfer or avoid**.

5. Reporting of Risk

Effective risk management requires timely and accurate reporting of important risks to management and the Board of Directors. Risk reports provide information about the nature, level, potential impact and treatment of risks. Proper reporting enables management to take corrective action and make informed decisions.

6. Inclusion of External Risk in Corporate Governance

Corporate risk management should consider risks arising from the external environment, such as changes in government policies, economic conditions, competition, technological developments, climate change, geopolitical events and regulatory changes. Such risks should be incorporated into corporate governance and strategic decision-making.

7. Taking Insurance Policies and Health and Safety Measures

Organisations can transfer certain risks through appropriate insurance policies. For example, companies may take property, fire, liability, employee-related, cyber and business interruption insurance. In addition, health and safety measures should be implemented to protect employees, customers and other stakeholders from accidents, injuries and workplace hazards.

8. Conducting Audits for Compliance with Ethical Standards and Policies

Risk management also includes checking whether employees and management are following the organisation's ethical standards, policies, rules and procedures. Internal and compliance audits help identify unethical practices, fraud, conflicts of interest and violations of organisational policies and applicable regulations.

9. Creating Risk Awareness within the Organisation

Employees at all levels should understand the risks associated with their responsibilities. Organisations should conduct training programmes, workshops and awareness campaigns to develop a **risk-aware culture**. Employees should be encouraged to report potential risks and follow established risk-control procedures.

Conclusion

Thus, the scope of corporate risk management is not limited to preventing financial losses. It covers **risk planning, identification, analysis, assessment, prioritisation, risk treatment, reporting, governance, insurance, compliance, safety and risk awareness**. An effective risk-management system enables an organisation to protect its resources, improve decision-making and achieve its objectives with greater confidence.

Role of a Risk Manager

A **Risk Manager** is responsible for identifying, assessing, controlling and monitoring risks that may affect an organisation. The major roles of a risk manager are:

1. **Identifying Risks**
   The risk manager identifies potential risks that may affect the organisation, including financial, operational, strategic, legal, technological, environmental and reputational risks.
2. **Analysing and Assessing Risks**
   The risk manager analyses the likelihood and potential impact of identified risks and determines their level of seriousness.

3. **Prioritising Risks**
   Since an organisation cannot manage all risks with equal attention, the risk manager prioritises risks according to their probability and potential impact.

4. **Developing Risk Management Strategies**
   The risk manager develops appropriate strategies to **avoid, reduce, transfer or accept** different types of risks.

5. **Implementing Risk Management Policies**
   The risk manager helps formulate and implement risk-management policies, procedures and internal controls across different departments.

6. **Managing Insurance**
   The risk manager identifies insurable risks and recommends suitable insurance policies to protect the organisation against potential financial losses.

7. **Monitoring and Reviewing Risks**
   Risks are continuously monitored because their nature and level may change over time. The risk manager regularly reviews existing controls and recommends improvements.

8. **Ensuring Legal and Regulatory Compliance**
   The risk manager helps ensure that the organisation complies with applicable laws, regulations, contractual obligations and internal policies.

9. **Risk Reporting**
   The risk manager prepares risk reports for senior management and the Board of Directors, highlighting major risks, their potential impact and measures taken to control them.

10. **Crisis and Business Continuity Management**
    The risk manager develops contingency and business continuity plans to help the organisation respond effectively to unexpected events such as natural disasters, cyberattacks or major operational failures.

11. **Creating Risk Awareness**
    The risk manager creates awareness among employees about potential risks and encourages them to follow appropriate risk-control procedures.

12. **Coordinating with Different Departments**
    The risk manager works with finance, human resources, operations, IT, legal and other departments to ensure that risks are identified and managed throughout the organisation.

13. **Supporting Management in Decision-Making**
    The risk manager provides management with relevant risk information so that major decisions regarding investments, expansion, financing and business strategies can be taken after considering potential risks.

14. **Developing a Risk-Aware Culture**
    The risk manager promotes a culture in which employees understand that managing risk is the responsibility of **everyone in the organisation**, rather than only the risk-management department.

Risk Management Process

The **risk management process** is a systematic series of steps through which an organisation identifies, analyses, evaluates, responds to and monitors risks. The major steps are as follows:

1. Planning of Risk Management

Risk management begins with **planning how risks will be managed** within the organisation. At this stage, management determines the objectives, scope, methods, responsibilities and resources required for risk management.

The organisation establishes a **risk management policy and framework** and decides who will be responsible for identifying, analysing, reporting and controlling risks. It also determines the criteria for measuring the probability and impact of risks. Proper planning ensures that risk management becomes an organised and continuous activity rather than an occasional exercise.

2. Identification of Risk

Risk identification involves finding out **what risks may arise, where they may arise and how they may affect the organisation**. It is important to identify risks at an early stage because unidentified risks cannot be properly managed.

Various approaches can be used for risk identification:

a. Source Analysis

Under source analysis, the organisation identifies the **sources or causes of risk**. These may be internal or external.

- Internal sources: employees, machines, systems, processes and financial decisions.
- External sources: government policies, economic conditions, competitors, natural disasters, technology and market changes.

Example: Dependence on a single supplier can be identified as a source of supply-chain risk.

b. Problem Analysis

Problem analysis starts with identifying existing or potential **problems and weaknesses** within the organisation. The organisation then examines what risks may arise from these problems.

Example: Poor internal controls may create risks of fraud, errors and financial losses.

c. Objective-Based Risk Analysis

Under this approach, risks are identified by examining the organisation's **objectives**. Management considers what events could prevent the organisation from achieving its strategic, financial or operational objectives.

Example: If an organisation's objective is to increase sales, changes in customer preferences or intense competition may create risks to achieving that objective.

d. Scenario-Based Risk Identification

In this approach, different possible **future scenarios** are developed and the risks associated with each scenario are identified.

Example: A company may consider scenarios such as a sudden increase in raw-material prices, a cyberattack, economic recession or a major supply-chain disruption and identify the risks associated with each situation.

e. Common Risk Checking / Taxonomy-Based Risk Identification

This method uses a **predefined classification or taxonomy of common risks** to ensure that important risk categories are not overlooked. Risks may be classified into financial, operational, strategic, legal, technological, environmental, reputational and other categories.

A risk checklist or risk taxonomy helps organisations conduct a more comprehensive risk-identification exercise.

3. Qualitative Risk Analysis

Qualitative risk analysis involves assessing risks using descriptive or ranking methods rather than assigning precise monetary values.

Each identified risk is generally evaluated according to:

- **Probability/Likelihood** – How likely is the risk to occur?
- **Impact/Consequence** – How serious will its effect be if it occurs?

Risks may then be classified as **low, medium, high or critical**. A risk matrix is commonly used to prioritise risks.

Example:

Probability	**Impact**	**Risk Level**
Low	Low	Low
Medium	Medium	Moderate
High	High	Critical

The main purpose of qualitative analysis is to **prioritise risks** and determine which risks require immediate attention.

4. Quantitative Risk Analysis

Quantitative risk analysis measures the potential effect of risks in numerical terms. It is generally used for significant risks where management requires more precise information for decision-making.

It may involve estimating:

- Probability of occurrence
- Expected financial loss
- Potential revenue loss
- Cost of risk control
- Impact on cash flows

- Value at Risk (VaR)
- Expected monetary value
- Possible range of financial outcomes

Example: If there is a 20% probability of a loss of ₹50 lakh, the expected monetary loss can be estimated as:

Expected Loss = Probability × Potential Loss
= 20% × ₹50 lakh
= **₹10 lakh**

Quantitative analysis helps management compare risks in financial terms and decide how much should be spent on controlling or transferring them.

5. Risk Response Planning or Plan of Action

After analysing and prioritising risks, the organisation decides **what action should be taken in response to each major risk**.

The major risk-response strategies are:

- **Risk Avoidance:** Eliminating the activity that creates the risk.
- **Risk Reduction/Mitigation:** Taking measures to reduce the probability or impact of the risk.
- **Risk Transfer:** Transferring the financial consequences of risk to another party, such as through insurance or contractual arrangements.
- **Risk Acceptance:** Accepting the risk when its potential impact is within the organisation's risk tolerance.
- **Risk Sharing:** Sharing the risk with another organisation or business partner.

A proper action plan should specify **what action will be taken, who will be responsible, available resources, deadlines and expected results**.

6. Monitoring and Control of the Implementation of the Plan of Action

Risk management does not end after preparing a response plan. The organisation must continuously **monitor whether the planned actions are actually being implemented and whether they are effective**.

Monitoring and control involve:

- Tracking identified risks.
- Checking whether risk-response measures are implemented.
- Evaluating the effectiveness of controls.
- Identifying new or emerging risks.
- Updating the risk register.
- Reporting significant changes to management.

- Taking corrective action when required.
- Reviewing and improving the risk-management process.

Example: If a company introduces cybersecurity controls to reduce cyber risk, the risk manager must regularly check whether these controls are working effectively and whether new cyber threats have emerged.

Personal Risk Management vs. Corporate Risk Management

Basis	**Personal Risk Management**	**Corporate Risk Management**
Meaning	Personal risk management refers to the process of identifying and managing risks that may affect an individual's financial security and well-being.	Corporate risk management refers to the systematic process of identifying, assessing and managing risks that may affect a company's operations, profitability and objectives.
Main Objective	Its main objective is to protect an individual's income, wealth, assets and financial security.	Its main objective is to protect the organisation from potential losses and support the achievement of its business objectives.
Scope	It generally covers risks related to an individual's personal, financial and family life.	It covers a wide range of financial, operational, strategic, legal, technological and market-related risks.
Major Risks	An individual may face risks such as health, life, property, employment, investment and inflation risks.	A company may face financial, operational, market, credit, liquidity, cyber, compliance, strategic and reputational risks.
Decision Maker	Personal risk-management decisions are generally taken by the individual or family members.	Corporate risk-management decisions are generally taken by the Board of Directors, senior management and risk-management teams.
Risk Assessment	Risk assessment is usually based on an individual's income, financial position, family responsibilities and future needs.	Risk assessment is based on financial analysis, business conditions, market trends, internal controls and the company's strategic objectives.
Insurance	Individuals may use life, health, motor, property and other personal insurance policies to transfer risks.	Companies may use property, liability, cyber, business interruption and other commercial insurance to manage specific risks.
Investment	Individuals manage investment risks by diversifying their savings among different investment options.	Companies manage investment and financial risks through appropriate capital allocation,

Basis	**Personal Risk Management**	**Corporate Risk Management**
		diversification and financial risk-management strategies.
Regulation	Personal risk management is generally subject to fewer regulatory requirements.	Corporate risk management is subject to various laws, regulations and corporate governance requirements, particularly for listed companies.
Risk Capacity	An individual's ability to absorb financial losses is generally limited by personal income and available wealth.	A company's ability to absorb losses depends on its size, capital structure, liquidity, profitability and financial strength.
Risk Monitoring	Individuals generally monitor their risks periodically according to their personal circumstances.	Companies usually monitor risks continuously through formal policies, internal controls, audits, risk committees and reporting systems.
Impact of Risk	The impact of unmanaged risk is mainly felt by the individual and their family.	The impact of unmanaged corporate risk may affect shareholders, employees, customers, creditors, investors and other stakeholders.

Attitude Towards Risk Management

Risk attitude refers to the way an individual or organisation **perceives, approaches and responds to risk**. Different organisations may react differently to the same level of risk depending on their objectives, financial strength, experience and risk-taking capacity.

The major types of risk attitudes are:

1. Risk-Averse Attitude

A **risk-averse organisation** prefers to avoid or minimise risk. It gives greater importance to safety and stability than to earning higher returns.

- It prefers safer investments and business decisions.
- It may accept lower returns in exchange for greater certainty.
- It uses insurance and strong internal controls to reduce exposure to risk.
- It carefully evaluates major decisions before taking action.

Example: A company may prefer investing surplus funds in low-risk government securities rather than highly volatile investments.

2. Risk-Neutral Attitude

A **risk-neutral organisation** does not consider risk as the primary factor while making decisions. It mainly focuses on the **expected return or expected outcome**.

- It compares alternatives mainly on the basis of expected benefits.
- It may accept risk if the expected return is attractive.
- It does not necessarily avoid risk simply because uncertainty exists.

Example: A company may select a project with a higher expected financial return even though it involves a moderate level of risk.

3. Risk-Seeking or Risk-Taking Attitude

A **risk-seeking organisation** is willing to accept higher levels of risk in the expectation of achieving higher returns or growth.

- It actively looks for opportunities involving greater uncertainty.
- It may enter new markets or introduce innovative products.
- It is willing to accept possible losses for the possibility of substantial gains.
- Such organisations generally have a higher tolerance for uncertainty.

Example: A start-up may invest heavily in an innovative technology with an uncertain market outcome because of the possibility of rapid growth.

Comparison of Risk Attitudes

Basis	**Risk-Averse**	**Risk-Neutral**	**Risk-Seeking**
Approach	Avoids or minimises risk	Evaluates risk mainly through expected outcomes	Willingly accepts higher risk
Main concern	Safety and stability	Expected return	Higher return and growth
Risk tolerance	Low	Moderate	High
Decision style	Conservative	Rational and outcome-oriented	Aggressive and opportunity-oriented
Typical strategy	Risk avoidance and reduction	Balanced evaluation	Risk-taking and innovation

Philosophy of Risk Management

The **philosophy of risk management** refers to the basic principles, beliefs and approach adopted by an organisation towards identifying, understanding and managing risks. It determines **how an organisation thinks about risk and how it responds to uncertainty** while achieving its objectives.

The major elements of the philosophy of risk management are:

1. Risk Cannot Be Completely Eliminated

The basic philosophy recognises that **risk is an unavoidable part of business activity**. An organisation cannot eliminate every risk, but it can identify, assess and manage risks effectively.

2. Risk Should Be Managed, Not Simply Avoided

The objective of risk management is not to avoid every risky activity. Some risks may provide opportunities for higher returns and growth. Therefore, organisations should take **calculated and informed risks** within acceptable limits.

3. Balance Between Risk and Return

Every business decision involves a relationship between **risk and expected return**. Generally, opportunities offering higher returns may involve greater risks. Risk management aims to achieve an appropriate balance between the two.

4. Proactive Rather Than Reactive Approach

An effective risk-management philosophy emphasises **anticipating risks before they occur**. Organisations should identify emerging threats and take preventive measures rather than waiting for losses to occur.

5. Risk Management Should Be Integrated with Business Decisions

Risk management should not be treated as a separate activity. It should be incorporated into **strategic planning, investment decisions, budgeting, financing, operations and other managerial decisions**.

6. Risk Management Is Everyone's Responsibility

Risk management is not the responsibility of only the risk manager or senior management. **Employees at all levels** should understand the risks associated with their activities and contribute to controlling them.

7. Risk Should Be Managed Within Risk Appetite

An organisation should clearly determine the amount and type of risk it is willing to accept, known as its **risk appetite**. Decisions should be taken within these established limits.

8. Cost of Risk Management Should Be Considered

The organisation should compare the **cost of controlling a risk with the potential loss** that the risk may cause. Excessive spending on controlling a very small risk may not be economically justified.

9. Continuous Monitoring and Improvement

Risk management is a **continuous process**. Risks change due to economic conditions, technology, competition, regulations and other factors. Therefore, risk-management policies and controls must be regularly reviewed and improved.

10. Protection and Creation of Value

The ultimate philosophy of risk management is to **protect existing organisational value and support the creation of new value**. Effective risk management helps an organisation achieve its objectives while dealing with uncertainty.

11. Ethical and Transparent Approach

Risk management should be based on **ethical behaviour, transparency, accountability and good corporate governance**. Concealing risks or providing misleading information can increase the potential damage to the organisation.

12. Opportunity as Well as Threat

Modern risk management considers both the **negative and positive effects of uncertainty**. While threats need to be controlled, favourable opportunities arising from uncertainty can also be identified and exploited.

Organisation of Risk Management

The organisation of risk management can be divided into different functional sections to ensure that risks are properly identified, assessed, treated, monitored and documented. The following sections explain the major areas:

1. Risk Identification and Assessment Section

This section is responsible for **identifying and evaluating the risks** faced by the organisation. It systematically examines internal and external factors that may affect the achievement of organisational objectives.

Its major activities include:

- Identifying financial, operational, strategic, legal, technological, environmental and reputational risks.
- Studying the **sources and causes** of different risks.
- Estimating the likelihood of occurrence of each risk.
- Assessing the possible financial, operational and reputational impact of risks.
- Classifying risks as low, medium, high or critical.
- Preparing and maintaining a **risk register** containing details of identified risks.
- Identifying new and emerging risks arising from changes in the business environment.

The main purpose of this section is to ensure that significant risks are identified **before they cause serious damage** to the organisation.

2. Risk Response Strategy Section

Once risks have been identified and assessed, this section determines **how the organisation should respond to each significant risk**. The response is selected according to the nature, severity and cost of the risk.

The major risk-response strategies are:

- **Risk Avoidance:** Eliminating an activity that creates an unacceptable level of risk.
- **Risk Reduction/Mitigation:** Taking measures to reduce the probability or impact of the risk.

- **Risk Transfer:** Transferring the financial consequences of a risk to another party, such as through insurance or contractual arrangements.
- **Risk Acceptance:** Accepting the risk when it falls within the organisation's risk appetite.
- **Risk Sharing:** Sharing the risk with another organisation or business partner.

The section also prepares a **risk-response plan** specifying the actions to be taken, persons responsible, resources required and expected completion dates.

3. Implementation, Control and Monitoring Section

This section ensures that the risk-response strategies are **actually implemented and remain effective**.

Its major functions include:

- Implementing approved risk-control measures.
- Assigning responsibility for specific risk-management activities.
- Establishing internal controls and procedures.
- Monitoring the level of risk on a regular basis.
- Comparing actual risk exposure with acceptable risk limits.
- Identifying new or changing risks.
- Checking whether risk-response measures are producing the desired results.
- Taking corrective action when controls are ineffective.
- Reporting significant changes in risk levels to senior management and the Board.

For example, if a company identifies **cybersecurity risk**, the implementation and monitoring section may ensure that firewalls, data backups, access controls and employee training are properly implemented and regularly reviewed.

4. Documentation and Record Maintenance Section

Proper documentation is an essential part of risk management because it provides a **permanent record of identified risks, decisions, actions and results**.

This section is responsible for maintaining:

- Risk-management policies and procedures.
- Risk registers.
- Risk assessment reports.
- Risk-response and action plans.
- Insurance policies and related documents.
- Internal control procedures.
- Incident and loss records.
- Risk-monitoring reports.

- Audit reports and compliance records.
- Minutes and reports of Risk Management Committee meetings.
- Records of corrective and preventive actions.

Proper documentation helps management **track the history of risks, evaluate the effectiveness of risk responses and provide evidence of compliance** with organisational policies and regulatory requirements.

Importance of Proper Record Maintenance

Good documentation ensures:

- **Accountability** – responsibility for managing risks can be clearly established.
- **Transparency** – risk-related decisions can be properly explained and reviewed.
- **Continuity** – future managers can understand previously identified risks and responses.
- **Compliance** – records can support regulatory, legal and audit requirements.
- **Improvement** – past incidents and experiences can be used to improve future risk-management practices.

Chap-4 Financial Intermediaries

- A financial intermediary is an entity that facilitates a financial transaction between two parties. Such an intermediary or a mediator could be a firm or an institution. Some examples of financial intermediaries are banks, insurance companies, pension funds, investment banks, and more.
- One can also say that the primary objective of the financial intermediaries is to channel savings into investments. These intermediaries charge a fee for their services.

- Financial intermediaries have emerged as a useful tool for the efficient market system as they help channelize savings into investment. However, they can also be a cause of concern, as the sub-prime crisis shows. Often, there is a need to regulate the activities of these intermediaries.

Financial Intermediaries in India can be classified into 3 main categories:

1. Banking Institutions
2. Non-Banking Financial Intermediaries
3. Financial Markets

1. Banking Institutions

Banking Institutions include:

1. Reserve Bank of India
2. Commercial Banks
3. Term Lending Institutions/ Development Banks

Reserve Bank of India

- Reserve Bank of India (RBI) is the Central Bank of India. RBI was established on 1 April 1935 by the RBI Act 1934. Key functions of RBI are, banker’s bank, the custodian of foreign reserve, controller of credit and to manage printing and supply of currency notes in the country.
- Reserve Bank of India (RBI) is the central bank of the country. RBI is a statutory body. It is responsible for the printing of currency notes and managing the supply of money in the Indian economy.
- Initially, the ownership of almost all the share capital was in the hands of non-government shareholders. So in order to prevent the centralisation of the shares in few hands, the **RBI was nationalised on January 1, 1949.**

Functions of Reserve Bank

A. **Traditional Banking Functions**
B. **Supervisory Functions**
C. **Promotional or Development Functions**

A. Traditional Banking Functions

1. Issue of Notes —The Reserve Bank has a monopoly for printing the currency notes in the country. It has the sole right to issue currency notes of various denominations except one rupee note (which is issued by the Ministry of Finance). The Reserve Bank has adopted the **Minimum Reserve System** for issuing/printing the currency notes. *Since 1957, it maintains gold and foreign exchange reserves of Rs. 200 Cr. of which at least Rs. 115 cr. should be in gold and remaining in the foreign currencies.*

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- **2. Banker to the Government–**The second important function of the Reserve Bank is to act as the Banker, Agent and Adviser to the Government of India and states. It performs all the banking functions of the State and Central Government and it also tenders useful advice to the government on matters related to economic and monetary policy. It also manages the public debt of the government.
- **3. Banker's Bank:-** The Reserve Bank performs the same functions for the other commercial banks as the other banks ordinarily perform for their customers. RBI lends money to all the commercial banks of the country.

- **4. Controller of the Credit:-** The RBI undertakes the responsibility of controlling credit created by commercial banks. RBI uses two methods to control the extra flow of money in the economy. These methods are quantitative and qualitative techniques to control and regulate the credit flow in the country. **When RBI observes that the economy has sufficient money supply and it may cause an inflationary situation in the country then it squeezes the money supply through its tight** monetary policy **and vice versa.**
- 5. Exchange Rate Management- The RBI is responsible for preparing domestic policies that maintain the value of rupee and helps in achieving the stability of exchange rate. In order to achieve the stability, it brings both the demand and the supply of foreign currency closer to each other. This is done under the provisions of the Foreign Exchange Management Act, 1999 (hereinafter referred as "FEMA"). The RBI also has the power to prohibit and regulate the deals in relation to foreign exchange and give power to other institutions through issuing license for acting as authorized agents for foreign exchange in the market.

- **6. Custodian of Foreign Reserves:-**For the purpose of keeping the foreign exchange rates stable, the Reserve Bank buys and sells foreign currencies and also protects the country's foreign exchange funds. RBI sells the foreign currency in the foreign exchange market when its supply decreases in the economy and vice-versa. **Currently, India has a Foreign Exchange Reserve of around US$ 487 bn. 6.**
- **Other Functions:-**The Reserve Bank performs a number of other developmental works. These works include the function of clearinghouse arranging credit for agriculture (which has been transferred to NABARD) collecting and publishing the economic data, buying and selling of Government securities (gilt edge, treasury bills etc)and trade bills, giving loans to the Government buying and selling of valuable commodities etc. It also acts as *the representative of the Government in the **International Monetary Fund (I.M.F.)** and represents the membership of India.*

B. Supervisory Functions

1. CRR & SLR Ratios
2. Capital Adequacy ratio
3. Priority sector for advances
4. Norms for debit card, credit card, ATM card
5. Interest on savings account
6. Submission of various statements

Effective supervisory and regulatory functions of RBI helped India to maintain economic growth during 2008 global financial meltdown.

C. Promotional Functions of RBI

Promotional functions are concerned with creating institutional set up leading to all round economic development such as:

1. **Agricultural Credit Department for the development of agriculture sector**
2. **Assistance for the establishment of Co-operative Marketing societies**--- For this purpose RBI has formed National Co-Operative Development & Housing Board which manages two funds -- National Co-operative Development Fund & National Co-operative Warehousing Fund

3. Industrial Development Oriented Function – for satisfying the long term and short term fund needs of industry through below mentioned financial institution, various direct and indirect financial assistance are provided.

- IDBI
- ICICI
- SIDBI
- SFCs
- IFCI
- SIDC

4. Development of Infrastructure Facilities

2. Commercial Banks

On the basis of ownership commercial banks are classified into

A. **Public Sector Banks –** Currently there are 12 public sector banks operating in India.

B. **Private Sector Banks –** There are many private like ICICI, HDFC, AXIS, YES and so on.

Forms of Bank Advances:

- Cash Credit
- Loan
- Bank Overdraft
- Purchase & Discounting of bills

Defects of Bank Lending

- Security based lending
- Big companies with greater amount of assets for security can avail loan.
- Limitation of cash credit limit
- Difficult to plan advances due to CC limitation
- No attention to priority sector advances
- Increased investment in inventory and receivables due to liberal credit
- Multiple credit on single security

The above credit limitations created the need for regulation of bank credit.

Recommendations by Tandon Committee

- Change is essential
- Cash credit and financial indiscipline
- Norms for inventory management
- Maximum Permissible Bank Finance –MPBF
- Forms of bank finance
- Use of bills of exchange
- Furnishing information
- Classification of borrowers

Recommendations by Chore Committee

- Surplus cash to be used as working capital and to that extent reduce dependence on bank credit.
- The present form of cash credit, loan and bill discounting should be continued.
- The division of bank credit into loan and cash credit should be discontinued.
- The bank credit more than MPBF under second method should be converted into term loan and facility of repayment by instalments should be given and 2% additional interest rate should be charged.
- While appraising the financial requirements of the borrower separate limits of bank finance should be set for normal requirement and seasonal requirement.
- If the borrower needs more than MPBF then, additional fund should be provided in the form of bank loan by opening loan account and additional 2% interest should be charged.
- The customer should forecast its quarterly requirement of bank finance and inform the bank in advance. If excess amount is withdrawn (-10% to +10%) then penalty interest rate should be charged.

- If request is made for alteration in inventory norms the matter should be strictly scrutinized.
- Delay in sanctioning credit should be reduced for customers who furnish information and make repayment on time.
- Investment in receivables should be financed by bills instead of cash credit.

3. Term Lending Institutions or Development Banks

- The prime objective is to provide long term finance for industrialization.
- Need for term lending FIs after independence:

❖Less savings so less capital formation

❖Underdeveloped capital markets

❖Problem of raising finance through equity issue

❖Scope of entrepreneurship was narrow

So for achieving fast economic growth there was a need to set up financial institutions that can satisfy the long term financial need of entrepreneurs.

Institutional Structure

National Level Institutions

- IFCI
- ICICI
- IDBI
- IIBI
- SIDBI
- NABARD

State Level Institutions

- SFCs
- SIDC

Forms of Financial Assistance by FIs

Direct Financial Assistance

- Rupee term loan
- Foreign currency term loan
- Purchase of equity shares and debentures
- Lease finance
- Instalment purchasing
- Rediscounting Bill of Exchange
- Short term capital
- Seed Capital

Indirect Financial Assistance

- Deferred payment guarantee
- Guarantee for Foreign currency term loan
- Underwriting

2. Non Banking Financial Intermediaries:

1. Insurance Corporations
2. UTI
3. Post offices
4. Provident Funds
5. Investment companies
6. Hire Purchase Companies
7. Leasing Companies
8. Housing Finance Companies
9. Venture capital Funds
10. NRI Funds

1. Insurance Corporations

- **LIC**-1956-nationalizing 250 private sector insu. cos-
- Limited to only life insurance
- Designs different policies according to requirement of people
- Premium income is the regular income
- Inspite of payment of claims high surplus fund is left which is then invested in govt. security, shares and bonds of public sector and private sector companies and grants term loans.
- Promoted LIC Housing Finance Ltd. as its subsidiary to provide housing finance and LIC Mutual Funds to mobilise savings.

- **GIC**-1971 govt took hold of GIC and nationalized it in 1973
- General insurance like fire, marine, vehicle, accident, health, theft, flood insurance.
- Its four subsidiaries are National Insurance co., New India Assurance Ltd., Oriental Fire & General Insurance Ltd., The United India Insurance Co. Ltd.
- General Insurance policies are issued for 1 year and lump sum premium. Policy lapses after 1 year or is to be renewed. Claim is paid only on happening of event.
- Surplus funds are invested in govt. security, shares and bonds of public sector and private sector companies and grants term loans.

2. UTI

- Established under UTI Act 1963- started functioning in 1964
- Objective
- Source of Fund
- Investment Policy
- Forms of Assistance – Loans- Investment in securities
- **Advantages of UTI**

1. Investment of small savings made possible
2. Diversification
3. Expert knowledge
4. Satisfies investors by offering varied schemes
5. Liquidity
6. Industrial Development
7. Capital Market Development

- **Disadvantages of UTI**

1. Government Interference
2. Market Risk
3. Success depends on Fund Manager

3. Post Office

- Run as govt Dept serves the purpose of financial intermediary
- Mobilises savings and creates a pool of savings for investment
- Safest form of investment
- Central and state govt utilizes funds to finance public expenditure and for implementation of fiscal policy.
- Savings schemes of post office

1. PO savings bank deposit
2. Recurring deposit account scheme
3. Monthly income plan
4. Senior citizen account
5. PPF plan
6. Time deposits
7. NSCs & KVPs

4. Provident Fund

- Like other non banking financial intermediary PF also mobilises savings and creates fund for investment in govt securities and industrial securities.
- Provides economic protection in old age and in case of death to family members.
- A sizable amount gets created at the time of retirement due to power of cumulation.
- Different provisions of PF for employees of different sectors.
- PF may be contributory (CPF) or general (GPF).
- CPF-Employee + Employer’s Contribution
- GPF-Employee + Pension Scheme to govt employees. No contribution by employer.

5. Investment Companies

- They are registered co.s under the Company’s Act 1956.
- It undertakes activities such as

1. Providing capital to new enterprises by purchasing its securities
2. Promotion of new companies
3. Underwriting capital issues
4. Acceptance of public deposits
5. Term lending

6. Hire Purchase Finance Companies

- It is a type of credit sales
- One of the three methods of credit sales: Trade credit, instalment method and hire purchase method.
- In hire purchase business the manufacturer has to maintain a sizable inventory of costly items and on other hand sale proceeds comes in instalments.
- So seller needs financial help from external sources to store inventory and meet investment in receivables.
- Hire purchase finance companies finance hire purchase business by way of term loans.
- Hire purchase company may use its own funds and do not depend on external sources.

- HPC may acquire term loan against inventory.
- HPFC may purchase (Factoring) or discount receivables of HPC.
- HPFC may directly provide loan to purchaser.
- Commodity instalment credit- a method in which purchaser is allowed to select and purchase the product of his own choice, opens account in name of purchaser, collects the price in instalments but pays to the seller in lumpsum.
- HPFC can be commercial banks, FIs, SFCs, invest. Comp,etc.

7. Leasing Finance Cos.

- Leasing of assets for certain companies is a better option than raising ownership funds which dilutes control and debt funds that creates permanent burden of interest payment and other issues related to capital structure.
- Two parties Lessor (Fin. Co.) and Lessee (equipment Purchaser)
- Latest technology advantage can be enjoyed without incurring capital expenditure.
- There was a mushroom growth of leasing companies but it declined because of amenment in tax allowance.

Advantages of Leasing

- Acquisition of assets without raising capital.
- Productivity & competitive strength increases due to adoption of latest technology.
- A different source of finance than other traditional sources.
- In case issue of further capital is not advisable, this is a better alternative.
- Leasing increases the debt capacity by generating income to pay interest.
- Liability of rent exp is fixed and certain.
- Lease rentals reduces tax liability as rents are deductible from income.
- No interference and more flexibility in asset utilization.
- Less risk of obsolescence.

Disadvantages

- No charge can be created on fixed assets so no security value.
- At the end of useful life, advantage of scrap value is not available.
- Higher lease rentals can make the asset more costly.

8. Housing Finance Companies

- Housing is a basic need and housing development is the need of the time in India.
- Sincere efforts have been made at the Govt. & Non Govt. level for its development.
- To provide external financing assistance to the individuals and co-operative housing societies many FIs have been established in public, private and co-operative sector.
- These institutions collect funds by issuing equity shares, bonds, public deposits and bank loans and provide long term loans to individuals and co-operative housing societies for the construction of houses.

HFIs

- HUDCO
- State Housing Finance Societies
- HDFC
- LIC Housing Finance Ltd.
- Commercial Banks
- National Housing Bank

9. Venture Capital

- VC emerged in India around 1987. VC Funds are established for investment in projects with a probability pf high risk and high returns.
- Venture means risk and venture capital fund means fund for investment in risky enterprise.
- VC funds means investment in risky projects that are new and untried in market. Also technocrat projects which involves huge investment and risk also falls in high risk category.
- The earnings capacity of such projects is very high and that too within a very short span of two to three years.
- Therefore VC is a high risk high return business.

Scope of VC

- To provide seed capital to technocrat for launching a new project.
- To provide additional capital at different stages of development.
- To provide bridge finance.
- To provide equity share capital by investing in equity shares.
- To provide debt capital for leveraged buyout of other company.
- To provide capital to new entrepreneurs for operations in foreign countries.
- To provide capital to existing companies for diversification, expansion and reconstruction.

Advantages of VC

- Provides fund to risky enterprises which fails to attract funds from traditional sources.
- Contributes to economic development and creation of new job opportunities.
- Encourages new technocrats who have high profit making ideas but no funds to implement such ideas.
- Encourages entrepreneurship by providing seed capital to such technocrats.
- Encourages research and development of indigenous technology.
- It makes commercialization of new research findings possible.
- It encourages knowledge and technology intensive new enterprises.
- It encourages R & D activities by making risk capital available.

Disadvantages of VC

- There is high risk of loosing capital if project fails.
- Simply providing capital is not enough but managerial skills and marketing guidance if not provided effectively chances of failure increases.
- Appointment of VC fund company on company board may increase interference.

10. NRI FUNDS

- Millions of Indian people reside in foreign countries for service, profession or business. They are known as NRI.
- If their savings are attracted to India, it not only adds to foreign exchange reserves but can be used productively for our economic development.
- So central government and RBI have instructed commercial banks in India to open NRI account with attractive terms.

Types of NRI Account

A. NRI Rupee account

1. Non Resident Rupee Account
2. Non Resident External Account
3. Non Resident Non repatriable Rupee Deposit Account
4. Non Resident Special Rupee Account Scheme

B. NRI Foreign Currency Account

- NRI and corporate bodies owned by them can open the account with Indian banks.
- These accounts can be opened in Dollar, Pound sterling, Deutche mark or Japanese yen.
- Indians residing abroad can remit funds to deposit in these accounts.
- Interest is paid in currency in which account is opened.
- There is no risk of foreign exchange fluctuations as repatriation is done in original currency.
- Rate of Int is decided by RBI and is tax free-the principal amount is free from wealth tax.

3. Financial Markets

- Money Market
- Capital Market
- Foreign Exchange Market

Money Market

Money Market is a segment of the financial market in India where borrowing and lending of short-term funds take place. The maturity of money market instruments is from one day to one year. In India, this market is regulated by both RBI (the Reserve bank of India) and SEBI (the Security and Exchange Board of India). The nature of transactions in this market is such that they are large in amount and high in volume. Thus, we can say that the entire market is dominated by a small number of large players.

Objectives of the money market in India

The following are the important objectives of an Indian money market

- Facilitate a parking place to employ short-term surplus funds.
- Aid room for overcoming short-term deficits.
- To enable the Central Bank to influence and regulate liquidity in the economy through its intervention in this market.
- Help reasonable access to users of short-term funds to meet their requirements quickly, adequately and at reasonable costs.

Segments of the Indian money market

- The Indian money-market has the following two segments. The existence of the unorganized market, though illegal, yet operates. However, we that is out of the scope of the present article. So we will concentrate exclusively on the organized money-markets in India. Wherever, in the blog article or elsewhere in the site we refer money-markets, it is in organized money-market only.
- **1. Unorganized money-market**
- The unorganized money market is an old and ancient market, mainly it is made of indigenous bankers and money lenders, etc.
- **2. Organized money-market**
- The organized money market is that part which comes under the regulatory ambit of RBI & SEBI. Governments (Central and State), Discount and Finance House of India (DFHI), Mutual Funds, Corporate, Commercial or Cooperative Banks, Public Sector Undertakings, Insurance Companies, and Financial Institutions and Non-Banking Financial Companies (NBFCs) are the key players of the organized Indian money market.

Structure of organized money market of India

The organized money market in India is not a single market. It is a combination of markets of various instruments.

The following are the **instruments** that are integral parts of the Indian money market system.

1. Call money or notice money

- Call money, notice money, and term money markets are sub-markets of the Indian money market. These markets provide funds for very short-term. Lending and borrowing from the call money market for 1 day.
- Whereas lending and borrowing of funds from notice money market are for 2 to 14 days. And when there are borrowing and lending of funds for the tenor of more than 14 days, it refers to “Term Money”.

2. Treasury bills

- The Bill market is a sub-market of this market in India. There are two types of the bill in the money market. They are treasury bills and commercial bill. The treasury bills are also known as T-Bills, T-bills are issued by the Central bank on behalf of Government, whereas Commercial Bills are issued by Financial Institutions.
- Treasury bills do not yield any interest, but it is issued at discount and repaid at par at the time of maturity. In T-bills there is no risk of default; it is a safe investment instrument. Maturity period of T-bills can be 91 days, 182 days and 364 days.

3. Commercial bills

- Commercial bill is a money market instrument which is similar to the bill of exchange; it is issued by a Commercial organization to raise money for short-term needs. In India, the participants of the commercial bill market are banks and financial institutions.

4. Certificate of deposits

- Certificate of Deposits also known as CDs. It is a negotiable money market instrument. It is like a promissory note. Rates, terms, and amounts vary from institution to institution. CDs are not supposed to trade publically neither it is traded on any exchange.
- In general institutions issue certificate of deposit at discount on its face value. The banks and financial institutions can issue CDs on a floating rate basis.

5. Commercial paper

- The commercial paper is another money market instrument in India. We also call commercial paper as CP. CP refers to a short-term unsecured money market instrument. Big corporations with good credit rating issue commercial paper as a promissory note. There is no collateral support for CPs. Hence, only large firms with considerable financial strength can issue the instrument.

6. Money market mutual funds (MMMFs)

- The *money-market mutual funds* were introduced by RBI in 1992 and since 2000 they are brought under the regulation of *SEBI*. It is an open-ended mutual fund which invests in short-term debt securities. This kind of *mutual fund* solely invests in instruments of the money market.

7. Repo and the reverse repo market

- Repo means “Repurchase Agreement”. It exists in India since December 1992. REPO means selling a security under an agreement to repurchase it at a predetermined date and rate. Those who deal in government securities they use the repo as an overnight borrowings.

Capital market

- Capital Market is a commonly used term. Capital market is a market for both debt and equity securities in India. It is the market where business enterprises, including companies and governments, can raise long-term funds. In other words, it can be said that the capital market is a market where the money is provided to the borrowers for more than a year.

- The Indian capital market includes both the stock or the share market and the bonds market. Share or stock market is the market where equities are traded, whereas, the bond market is the market where debt securities are traded.

- The Capital Market is regulated by Securities and Exchange Board of India (*SEBI*) that overlook the market ensuring that the investors are protected against fraud apart from other duties. The regulatory bodies lay down specific rules and regulations that must be adhered to safeguard the investors' interest.

1. EQUITY SHARES

An equity share, normally known as ordinary share is a part ownership where each member is a fractional owner and initiates the maximum entrepreneurial liability related with a trading concern. These types of shareholders in any organization possess the right to vote.

Features of Equity Shares Capital

- Equity share capital remains with the company. It is given back only when the company is closed
- Equity Shareholders possess voting rights and select the company’s management
- The dividend rate on the equity capital relies upon the obtainability of the surfeit capital. However, there is no fixed rate of dividend on the equity capital.

CHARACTERSTICS OF EQUITY SHARES

- 1. Maturity
- 2. Claims / right to income
- 3. Claim on assets
- 4. Right to Control or Voting Right
- 5. Pre-emptive Right
- 6. Limited liability

Advantages of Equity Shares Capital

- Equity Shares does not create a sense of obligation and accountability to pay a rate of dividend that is fixed.
- Equity Shares can be circulated even without establishing any extra charges over the assets of an enterprise.
- It is a perpetual source of funding and the enterprise has to pay back; exceptional case – under liquidation.
- Equity shareholders are the authentic owners of the enterprise who possess the voting rights.
- **Disadvantages of Equity Shares Capital**
- The enterprise cannot take either the credit or an advantage if trading on equity when only equity shares are issued.
- Highly risky
- Interference in management.
- When the firm earns more profits, then, higher dividends have to be paid which leads to raising in the value of the shares in the marketplace and its edges to speculation as well.

2.Preference Shares

- Preference shares are a long-term source of finance for a company. They are neither completely similar to equity nor equivalent to debt. The law treats them as shares but they have elements of both equity shares and debt. For this reason, they are also called ‘hybrid financing instruments’. These are also known as preferred stock, preferred shares, or only preferred in a different part of the world. There are various types of preference shares used as a source of finance.
- Features of preference shares
- 1. Maturity
- 2. Claim on income
- 3. Claim on assets
- 4. Control
- 5. Hybrid from securit

DEBENTURE

- Debenture is used to issue the loan by government and companies. The loan is issued at the fixed interest depending upon the reputation of the companies. When companies need to borrow some money to expand themselves they take the help of debentures.

Important features of Debentures

1. Debentures are instruments of debt, which means that debenture holders become creditors of the company
2. They are a certificate of debt, with the date of redemption and amount of repayment mentioned on it. This certificate is issued under the company seal and is known as a Debenture Deed
3. Debentures have a fixed rate of interest, and such interest amount is payable yearly or half-yearly
4. Debenture holders do not get any voting rights. This is because they are not instruments of equity, so debenture holders are not owners of the company, only creditors
5. The interest payable to these debenture holders is a charge against the profits of the company. So these payments have to be made even in case of a loss.

Advantages

- One of the biggest advantages of debentures is that the company can get its required funds without diluting equity. Since debentures are a form of debt, the equity of the company remains unchanged.
- Interest to be paid on debentures is a charge against profit for the company. But this also means it is a tax-deductible expense and is useful while tax planning
- Debentures encourage long-term planning and funding. And compared to other forms of lending debentures tend to be cheaper.
- Debenture holders bear very little risk since the loan is secured and the interest is payable even in the case of a loss to the company
- At times of inflation, debentures are the preferred instrument to raise funds since they have a fixed rate of interest

Disadvantages of Debentures

- The interest payable to debenture holders is a financial burden for the company. It is payable even in the event of a loss
- While issuing debentures help a company trade on equity, it also makes it to dependent on debt.
- Redemption of debentures is a significant cash outflow for the company which can imbalance its liquidity
- During a depression, when profits are declining, debentures can prove to be very expensive due to their fixed interest rate

Types of Debentures

1. Secured Debentures: These are debentures that are secured against an asset/assets of the company. This means a charge is created on such an asset in case of default in repayment of such debentures. So in case, the company does not have enough funds to repay such debentures, the said asset will be sold to pay such a loan. The charge may be fixed, i.e. against a specific assets/assets or floating, i.e. against all assets of the firm.
2. Unsecured Debentures: These are not secured by any charge against the assets of the company, neither fixed nor floating. Normally such kinds of debentures are not issued by companies in India.
3. Redeemable Debentures: These debentures are payable at the expiry of their term. Which means at the end of a specified period they are payable, either in the lump sum or in installments over a time period. Such debentures can be redeemable at par, premium or at a discount

4. Fully Convertible Debentures: These shares can be converted to equity shares at the option of the debenture holder. So if he wishes then after a specified time interval all his shares will be converted to equity shares and he will become a shareholder.

5. Partly Convertible Debentures: Here the holders of such debentures are given the option to partially convert their debentures to shares. If he opts for the conversion, he will be both a creditor and a shareholder of the company.

6. Irredeemable Debentures: Such debentures are perpetual in nature. There is no fixed date at which they become payable. They are redeemable when the company goes into the liquidation process. Or they can be redeemable after an unspecified long time interval.

7. Non-Convertible Debentures: As the name suggests such debentures do not have an option to be converted to shares or any kind of equity. These debentures will remain so till their maturity, no conversion will take place. These are the most common type of debentures.

Gilt Edged Securities

- A Government Security (G-Sec) is a tradeable instrument issued by the Central Government or the State Governments. It acknowledges the Government's debt obligation. Such securities are short term (usually called treasury bills, with original maturities of less than one year) or long term (usually called Government bonds or dated securities with original maturity of one year or more). In India, the Central Government issues both, treasury bills and bonds or dated securities while the State Governments issue only bonds or dated securities, which are called the State Development Loans (SDLs). G-Secs carry practically no risk of default and, hence, are called risk-free gilt-edged instruments.

Nature

- Indicate government debt
- Institutional investor
- Issued by notification of RBI
- Primary dealers act as brokers
- Used in open market operations of RBI
- Issued to meet the deficit of budget
- Secondary market
- Safety and liquidity
- Redemption on maturity
- Useful in maintaining SLR

Public deposits

- Public deposits refer to the unsecured deposits invited by companies from the public mainly to finance working capital needs. A company wishing to invite public deposits makes an advertisement in the newspapers.

- Any member of the public can fill up the prescribed form and deposit the money with the company. The company in return issues a deposit receipt. This receipt is an acknowledgement of debt by the company. The terms and conditions of the deposit are printed on the back of the receipt. The rate of interest on public deposits depends on the period of deposit and reputation of the company.

- A company can invite public deposits for a period of six months to three years. Therefore, public deposits are primarily a source of short-term finance. However, the deposits can be renewed from time-to-time. Renewal facility enables companies to use public deposits as medium-term finance.

Types of Public Deposit

From view point of security

- PD creating a charge on assets
- PD against personal guarantee of any director of the company
- Unsecured deposits

From view point of control

- PD free from control – no restriction- secured PDs
- PD subject to control – restrictions imposed- unsecured PDs

Regulation of PDs

- Proposal in a form supplied by company
- Announcement of acceptance of PDs
- Receipt of deposit
- Maintain a register of deposits
- File a return of deposits with RBI and company registrar
- Brokerage as prescribed by RBI
- Time limit of deposits- 6 to 36 months
- Ceiling of deposits- 25% of net worth, additional 10% from employees & shareholders.

Advantages of PDs to company

- Less costly
- Absence of interference
- Raising capital without security
- Freedom for use of funds
- Ease of returning deposits
- Bank intermediatory avoided
- Permission of SEBI not essential
- Serves as long term capital
- Attractive rate of interest

Advantages of PDs to depositors

- Attractive rate of interest
- Protection of investors by legal provisions
- Receipt of deposit
- Productive use of savings

Limitations

- Protection of depositor not full proof
- Threat to monetary policy of RBI
- Regional imbalance
- Fair weather friends
- Lack of knowledge of depositors
- Only large and sound companies can attract PDs

Foreign Exchange Market

- Every country has their respective currencies which they use in their trade and businesses, but what about in the foreign market? With the lack of versatility of the currencies, they become a hurdle in world trade. To solve this problem, the Foreign Exchange Market was introduced. This is a type of marketplace that will fix the exchange rate for the currencies.
- Without the foreign exchange market, the world economy would suffer terribly. Thus, it becomes important for us to consider this topic as a prior study. In this context, we will define the foreign exchange market, discuss the types, features, and participants in the same market.

Definition

- The foreign exchange market is over a counter (OTC) global marketplace that determines the exchange rate for currencies around the world. This foreign exchange market is also known as Forex, FX, or even the currency market. The participants engaged in this market are able to buy, sell, exchange, and speculate on the currencies.
- These foreign exchange markets are consisting of banks, forex dealers, commercial companies, central banks, investment management firms, hedge funds, retail forex dealers, and investors. In our prevailing section, we will widen our discussion on the 'Foreign Exchange Market'.

Types of Foreign Exchange Market

- Spot Markets
- Forward Markets
- Future Markets
- Option Markets
- Swaps Markets

Let us discuss these markets briefly:

- **Spot Market**

  In this market, the quickest transaction of currency occurs. This foreign exchange market provides immediate payment to the buyers and the sellers as per the current exchange rate. The spot market accounts for almost one-third of all the currency exchange, and trades which usually take one or two days to settle the transactions.

- **Forward Market**

  In the forward market, there are two parties which can be either two companies, two individuals, or government nodal agencies. In this type of market, there is an agreement to do a trade at some future date, at a defined price and quantity.

- **Future Markets**

  The future markets come with solutions to a number of problems that are being encountered in the forward markets. Future markets work on similar lines and basic philosophy as the forward markets.

- **Option Market**

  An option is a contract that allows (but is not as such required) an investor to buy or sell an instrument that is underlying like a security, ETF, or even index at a determined price over a definite period of time. Buying and selling 'options' are done in this type of market.

- **Swap Market**

  A swap is a type of derivative contract through which two parties exchange the cash flows or the liabilities from two different financial instruments. Most swaps involve these cash flows based on a principal amount.

Functions of Foreign Exchange Market

- **Transfer Function:** The basic and the most obvious function of the foreign exchange market is to transfer the funds or the foreign currencies from one country to another for settling their payments. The market basically converts one's currency to another.
- **Credit Function:** The FOREX provides short-term credit to the importers in order to facilitate the smooth flow of goods and services from various countries. The importer can use his own credit to finance foreign purchases.
- **Hedging Function:** The third function of a foreign exchange market is to hedge the foreign exchange risks. The parties in the foreign exchange are often afraid of the fluctuations in the exchange rates, which means the price of one currency in terms of another currency. This might result in a gain or loss to the party concerned.

Features of Foreign Exchange Market

1. **High Liquidity**

   The foreign exchange market is the most easily liquefiable financial market in the whole world. This involves the trading of various currencies worldwide. The traders in this market are free to buy or sell the currencies anytime as per their own choice.

2. **Market Transparency**

   There is much clarity in this market. The traders in the foreign exchange market have full access to all market data and information. This will help to monitor different countries' currency price fluctuations through the real-time portfolio.

3. **Dynamic Market**

   The foreign exchange market is a dynamic market structure. In these markets, the currency values change every second and hour.

4. **Operates 24 Hours**

   The Foreign exchange markets function 24 hours a day. This provides the traders the possibility to trade at any time.

Who are the Participants in a Foreign Exchange Market?

- **Central Bank:** The central bank takes care of the exchange rate of the currency of their respective country to ensure that the fluctuations happen within the desired limit and this participant keeps control over the money supply in the market.
- **Commercial Banks:** Commercial banks are the channel of forex transactions, which facilitates international trade and exchange to its customers. Commercial banks also provide foreign investments.
- **Traditional Users:** The traditional users consist of foreign tourists, the companies who carry out business operations across the globe.
- **Traders and Speculators:** The traders and the speculators are the opportunity seekers who look forward to making a profit through trading on short-term market trends.
- **Brokers:** Brokers are considered to be the financial experts who act as a sure intermediary between the dealers and the investors by providing the best quotations.

Chapter 5 Methods of Raising Finance

- Every business requires two types of capital. One is required as short term funds as working capital to finance its current assets and the second is long term fixed capital required to finance its fixed assets.
- The long term fixed capital can be raised by issuing shares, debentures or bonds. There are different methods of issuing shares and bonds.
- Some of the major methods of capital issue are as follows:

1. Public Issue
2. Rights issue
3. Private Placement
4. Book Building
5. Bonus shares
6. Term loan

1. Public Issue

- Under this method, the company issues a prospectus to the public inviting offers for subscription. The investors who are interested in the securities apply for the securities they are willing to buy. Advertisements are also issued in the leading newspapers. Under the Companies Act it is obligatory for a public limited company to issue a prospectus or file a statement in lieu of prospectus with the Registrar of Companies.
- Once subscriptions are received, the company makes allotment of securities keeping in view the prescribed requirements. The prospectus must be drafted and issued in accordance with the provisions of the Companies Act and the guidelines of SEBI. Otherwise it may lead to civil and criminal liabilities.
- Public issue or direct selling of securities is the most common method of selling new issues of securities. This method enables a company to raise funds from a large number of investors widely scattered throughout the country. This method ensures a wider distribution of securities thereby leading to diffusion of ownership and avoids concentration of economic power in a few hands.
- However, this method is quite cumbersome involving a large number of administrative problems. Moreover, this method does not guarantee the raising of adequate funds unless the issue is underwritten. In short, this method is suitable for reputed companies which want to raise large capital and can bear the large costs of a public issue.

Types of Offer

- **Initial Public Offer: For Unlisted Companies**
- An unlisted company is a public company that is neither listed on a stock exchange nor its shares are traded in any recognized stock exchange. It can also enter the primary market through Initial Public Offer. IPO is the first time when an unlisted company offers its shares to the public. Therefore, the process of IPO acts as a turning point for any unlisted company, as it helps in raising funds through public subscriptions. However, this process is much riskier than Further Public Offer as a company enters the market for the first time by issuing a prospectus.
- **Further Public Offer: For Listed Companies**
- When a listed company makes an offer for sale or comes out with a new issue of shares to the public to increase capital, it is known as Further Public Offer. FPO means a company which is already listed and has complied with the process of an IPO, is going to issue shares to the public. It is done to raise subsequent public investment. FPO is not as risky as an Initial Public Offer, as the investors are already aware of the company’s performance and have a fair idea about its growth opportunities.

Procedure of Public Issue

1. Permission of SEBI
2. Appointment of lead managers
3. Appointment of other intermediaries
4. Preparing draft prospectus-Red herring prospectus
5. Filing prospectus with company registrar
6. Printing of prospectus and share application form
7. Application to the recognized stock exchange for listing (within 10 days of filing prospectus)
8. Promotion of the issue-in order to get good response from investors

9. Statutory declaration of the issue- atleat 10 days prior to opening of issue
10. Opening of the issue- atleast 3 working days and not more than 10 days
11. Collection of application
12. Scrutiny of application
13. Classification of applicants- RIIs, NIIs,QIIs
14. Fixing the responsibility of underwriters
15. Allotment of shares
16. Listing of shares on recognized stock exchange

Shelf offer of securities

- A shelf offering is a Securities and Exchange Commission (SEC) provision that allows an equity issuer (such as a corporation) to register a new issue of securities without having to sell the entire issue at once. The issuer can instead sell portions of the issue over a three-year period without re-registering the security or incurring penalties.
- This lets a company adjust the timing of the sales of a new issue to take advantage of more favorable market conditions should they arise in the future.
- The company maintains any unissued shares as treasury stock, where they remain "on the shelf" until offered for public sale.
- It is also known as multiple issue prospectus or shelf prospectus.

Shelf Prospectus

- Before you learn about shelf prospectus meaning, you need to understand the meaning of a prospectus in financial terms. A prospectus is a legal document submitted by a company to SEBI that contains all the information regarding the securities issue. Every company must submit the prospectus before raising any funds. It provides a detailed outline of the company, the issue, the prices, dates, and features.
- Among the various types of a prospectus, a shelf prospectus is issued by a company that is planning multiple issues of bonds for raising funds from the public. A shelf prospectus can only be issued by a publicly listed company, and it is done by filing an information memorandum in Form PAS-2.
- A shelf prospectus can only be issued by a company if it is raising funds through non-convertible debt bonds. A non-convertible debt bond can't be converted into share capital. With the issue of a shelf prospectus, a company can issue securities to raise funds four times.
- The information mentioned in the shelf prospectus may vary based on the company and its fund requirements. However, most shelf prospectuses include information regarding the background of the company, financial summary, type of security, issue size, issue price, number of securities, risk profile, sector analysis, etc.

Who can issue a shelf prospectus?

- A shelf prospectus can be issued by the below-listed companies:
- Public Financial Institutions (PFIs) (companies in which the Indian government holds more than 51% of the shares)
- Non-banking Finance Companies (NBFCs)
- Public Sector Banks
- Publicly Listed Companies (companies that have their securities listed on stock exchanges such as National Stock Exchange (NSE), Bombay Stock Exchange (BSE), or the Calcutta Stock Exchange (CSE).

Criteria for companies to issue the Shelf Prospectus

- A company must be eligible to raise capital through bonds. Here are the criteria for companies that can issue a shelf prospectus:
- The company must have a valuation of Rs 5,000 crores and above.
- The company should submit an agreement with SEBI for the dematerialization of securities.
- The company must ensure that the bonds it is issuing have an AA- or above credit rating.
- There should not be any pending regulatory action against the promoters or the directors of the company.
- The company must be consistent in repaying the installments of debt.

Shelf Prospectus and financial securities

- Generally, a publicly listed company issues a shelf prospectus when it is trying to raise funds through bonds. However, a shelf prospectus is not limited to raising funds through bonds. Any company can issue a shelf prospectus if it is trying to raise funds by issuing more equity. Furthermore, issuing mutual funds also requires a detailed shelf prospectus. For mutual funds, a shelf prospectus offers information on the funds’ goals, risks, fees, investment strategies, etc. Before investing in a mutual fund, an investor can analyze the shelf prospectus to understand everything about the fund and then make informed investing decisions.

Benefits of Shelf Prospects

- A shelf prospectus is only approved by SEBI when it is sure that the securities being offered by the company are credible and won't create a high-risk profile for the investors. Since the approval of the shelf prospectus means that the securities are backed by a well-positioned company to offer good returns to investors, investors can consider investing in the securities. However, it is also good to analyze the shelf prospectus in detail before investing.
- The shelf prospectus offers every detail possible to the investor who is looking to invest in the securities. It ensures that the investors have all the information possible to do a detailed fundamental analysis of the company and ensure they are investing in low-risk securities. As, in the shelf prospectus, it is also mentioned why the company is issuing the securities, an investor can analyze the goal of the fundraising. For example, it is always better than a company raises funds to fund its future operations or for expansion rather than repaying its debts.

- The details included by a company in a shelf prospectus are reviewed and cross-checked by SEBI before it approves the issue. Investors too can ensure that they review and analyze every detail and only invest in a fundamentally sound company that can offer good returns over time by increasing its profitability.
- A shelf prospectus can prove to be the holy grail for an investor who wants to perform a fundamental analysis on a company to decide whether to invest in the securities issue. As a company also raises funds if they are in a bad financial position and want to repay its debt, it is always wise to review the draft prospectus thoroughly before deciding to invest. If you think that the company is profitable, has less debt, and is looking to use the raised capital for expanding, you can go ahead and invest in the new securities issue.

Difference between Public offer and shelf prospectus offer

1. After filing of prospectus securities are offered for subscription at a time.
2. The company acts a principal and sells through merchant bankers.
3. Size of issue and timing depends on demand and requirement of company.
4. For each offer separate prospectus is required to be filed with registrar.
5. Each public issue is required to be registered by a separate prospectus.
6. It is difficult to withdraw or cancel a issue once all preparations are made.
7. It involves more cost.

1. After filing of prospectus securities can be issued gradually.
2. Securities are sold by companies directly or on agency basis by one or more placement agents.
3. Issuing company determines the size, floor price and timing.
4. Multiple offers can be made within the validity period.
5. For subsequent offers memorandum of information is required to be filed.
6. As the issue is made at the best price and most favourable time, question of withdrawal does not arise.
7. Subsequent issues involve negligible cost.

Rights Issue

- A rights issue is an invitation to existing shareholders to purchase additional new shares in the company. This type of issue gives existing shareholders securities called rights. With the rights, the shareholder can purchase new shares at a discount to the market price on a stated future date. The company is giving shareholders a chance to increase their exposure to the stock at a discount price.

Features:

- Present shareholders of the company have the first legal right to subscribe to the shares of the new issue.
- The no. of rights that a shareholder gets is equal to the number of shares hold by him.
- The price of the new share (rights share) is determined by the company.
- Rights are negotiable. The holder of rights can sell them.
- Rights can be exercised only during a fixed period, which is usually about 30 days.

- **Advantage of the company:**

1. Company can raise additional capital at a cost less than that public issue.
2. Control over the company is maintained.
3. Company can plan expansion programme with additional capital.

- **Disadvantages to the company:**

  1. If the additional capital is not used properly the company becomes overcapitalized.
  2. It increase burden of dividend payments

- **Advantages to shareholders:**

    1. Existing share holder will get grater dividend in future.
    2. Dilution of control can be maintained.
    3. It creates the prosperity.

Disadvantages to shareholders

- If rights issue result overcapitalization, shareholder have to suffer because price and dividend decline.
- It increases the financial risk.

Private Placement or Qualified Institutional Placement

- Qualified Institutional Placement (QIP) is a method by which listed companies raise capital by issuing equities, or other equity convertible securities to qualified institutional buyers. It is a common method of private placement where the company does not dilute its management stake and also does not need to repeat elaborate paperwork like it did during its IPO.
- **Who are Qualified Institutional Buyers**

Qualified Institutional Buyers (QIB) are investors who follow the rules and regulations governed by SEBI. As per SEBI, QIBs are institutional investors who possess the necessary expertise and financial strength to carefully evaluate and invest in capital markets.

SEBI defines the following as Qualified Institutional Investors (QIBs):

- Any Mutual fund, venture capital fund, Alternative Investment Fund and foreign venture capital investor registered with SEBI
- Foreign institutional investor registered with SEBI
- Public financial institution defined in section 4A of the Companies Act, 1956
- Scheduled commercial bank
- Multilateral and bilateral development financial institution
- State industrial development corporation
- An insurance company registered with the Insurance Regulatory and Development Authority
- Provident fund with minimum corpus of twenty five crore rupees
- Pension fund with minimum corpus of twenty five crore rupees
- National Investment Fund
- Insurance funds set up and managed by army, navy or air force of the Union of India
- Insurance funds set up and managed by the Department of Posts, India

It is not necessary for these entities to register as QIBs with SEBI. If an entity falls under the above-specified categories, they can participate as QIBs in the primary issuance process.

Advantages of Private Placement

1) Generate Capital with Less Cost

Public issuing incurs significant underwriter fees and advertisement fees. The private issue can save most of these expenses of the company.

In a private issue, the company does not require expense in preparation of prospectus list, generate application forms, advertise the issue in various media channels, administrate the whole process, external consultant fees, etc.

2) Fewer Regulations

Private placements are less regulated when compare to a public offering. The company does not require to adhere to strict regulations of the Securities and Exchange Commission (SEC). The company will be able to have less hazel with the complex regulations when raising capital.

The company can negotiate the deal privately with its potential investors.

3) Long Term Investment

Private placements present more extended maturities than typical debt financing. This is ideal for when a business forecast potential long term growth opportunity where they could not see the return shortly.

Private placement investors are normally more patient than other investors, such as venture capitalists.

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4) The Company can Attract the Most Suitable Investors

In a private placement, an investment opportunity is offered to a small group of investors. Hence, there is a high chance of having the most suitable investors for the company, who knows about the business environment well and could provide business assistance.

Investors may be able to offer precious support to the company’s management on harmonizing the corporate strategy and company vision.

5) Privacy of the Investment Process

Private placement investments are negotiated confidentially because of less interference with the Securities and Exchange Commission’s (SEC) regulations. Public disclosure obligations are limited, compared to those found in the public issuing.

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6) Obtain Capital without Going Public

A private placement is a capital-raising method where the stocks are sold through a private offering. Stocks are not offered through a public offering in a private placement.

Private placements are one of the limited choices for risky ventures or start-up firms to raise capital. Private placements enable small businesses to maintain their private status of the company.

7) Speedy Process to Obtain Capital

The private placement process is faster on raising finance than the public issuing and other financing methods. There will be rigorous and complex processes applicable for the company if a company chooses to issue shares through public issues. On other hand, a company can raise capital using private placement within 1 or 2 months

Disadvantages of Private Placement

1) Limits the Number of Potential Investors

The private placement could be challenging for the company because of only a limited number of potential investors. Private placement may cause the company to spend more effort and expenses to attract investors than a public offering would require.

A private placement can result in a poor number of potential investors, who do not want to invest substantial amounts individually.

2) High Expectations of the Investors

Investors usually demand more return because of the risk they are taking by investing privately. The company management should support the demand of the investors and should work to achieve the relevant profit margin. This could be a challenging situation for a startup company.

3) Difficult to Find Suitable Investors

An investment opportunity is offered to a small group of investors in a private placement. Also, private placements are one of the limited choices for risky ventures or start-up firms to raise capital. These firms will not promise their investors to generate significant returns over the immediate years.

4) May Require to have a Good Credit Rating

Credit rating can be an advantage to find investors for private placement. However, this is time-consuming and will be an added cost to the capital generation process.

Book Building

- Book Building is the process by which an underwriter determines the price at which the shares must be sold in an Initial Public Offer (IPO). The process of price discovery requires the underwriter to call forth bids from various institutional investors such as fund managers and others. However, there always exists a risk of overpricing or undervaluing the shares.
- **Book Building Process**
- The issuing company hires an investment bank to act as an underwriter who decides the price range of the security.
- The investment bank then, invites large scale buyers, fund managers and others, to submit bids on the shares.
- The book is then built through the listing and evaluation of the aggregated demands for the issue from the submitted bids. The final price of the security is termed as the cut-off price.
- The underwriter publicises the details of the bids in order to maintain transparency in the entire process.
- Shares are allocated to the accepted bidders, thereafter.
- The prices determined in the book building process does not suggest that the price is the best price, nor is it mandatory for the company to use the said price in an IPO.

Advantages of Book Building

- Book building leads to price discovery and helps in finding the intrinsic value of the security being offered.
- The price of a security is determined in a more realistic way by taking into consideration the demand for security.
- The issuer gets the maximum price for the security.
- The issuer company can choose the quality investors.
- There is greater transparency in the allotment of shares to the investors.
- Book building process results in lower costs of issue. Especially, Book building helps the issuer save a lot of money on advertising and brokerage.

Bonus Shares

Bonus shares are an additional number of shares given by the company to its existing shareholders as "BONUS" when they are not in the position to pay a dividend to its shareholders despite earning decent profits for that quarter.

Only a company has the right to issue bonus shares to their shareholders, which has earned massive profit or large free reserves that cannot be utilized for any particular purpose and can be distributed as dividends.

However, these bonus shares are given to the shareholders according to their existing stake in the company.

For example:

If a company declares one for two bonus shares, it would mean that an existing shareholder would get two additional shares for one existing share.

Suppose a shareholder holds 2,000 shares of the company. When the company issues bonus shares, he will receive 1000 bonus shares, i.e. (2000 *1/2 = 1,000).

SEBI guidelines on issue of Bonus Shares

1. No bonus shares shall dilute other issues:

Issue of bonus shares shall not be made pending conversion of fully convertible debentures or partly convertible debentures unless sufficient number of shares is reserved for allotment to the holders of the said FCDs or PCDs after conversion.

2. Bonus issue from free reserves:

Bonus shares can be issued only out of free reserves built out of genuine revenue profits or share premium collected in cash.

3. Revaluation reserve not eligible:

Reserve created by revaluation of assets cannot be capitalized for issue of bonus shares.

4. Issue in lieu of dividend:

Bonus issue shall not be made in lieu of dividend.

5. Partly paid shares not eligible:

Partly paid shares, if any, will not be eligible for bonus shares. Such partly paid shares, if any, must be made fully paid before a bonus issue is contemplated.

6. No default of payment of interest, etc.:

The issuing company shall not have defaulted in the payment of interest or principal in respect of fixed deposits and interest payment on dentures or repayment of principal on redemption of debentures. The company must be certain that it has not defaulted in respect of payment of statutory dues of the employees, such as contribution of provident fund, gratuity, bonus, etc.

7. Time within which bonus issue shall be made:

A company which announces a bonus issue after the approval of its Board of Directors must implement the proposal within a period of six months from the date of such approval.

8. Bonus proposal cannot be withdrawn:

A company which has announced its proposal to issue bonus shares, cannot have the option to change its decision.

9. Provision in the articles:

There must be a suitable provision in the Articles of Association of the company for capitalisation of reserves. If not, the company must pass a special resolution and incorporate a suitable provision in the Articles of Association, before initiating action for a bonus issue.

10. Increase in authorized capital:

Where necessary, before action on a bonus issue is taken, the company shall increase its authorised capital so as to permit the proposed bonus issue.

11. Prohibition of issue of bonus shares by revaluation of assets:

The Department of Company Affairs has vide Circular No. 9/94 dated 6-9-1994, informed all companies (listed as well as unlisted) that no company shall venture to issue bonus shares out of reserves created by revaluation of fixed assets.

Term Loan

A term loan provides borrowers with a lump sum of cash upfront in exchange for specific borrowing terms. Term loans are normally meant for established small businesses with sound financial statements. In exchange for a specified amount of cash, the borrower agrees to a certain repayment schedule with a fixed or floating interest rate. Term loans may require substantial down payments to reduce the payment amounts and the total cost of the loan.

Term Loan Procedure

2·7. Term Loan :

We know that special financial institutions like IFCI, IDBI, SFCs SIDC and LIC, GIC etc. provide term loans, in the form of long term capital on easy terms and conditions, Before the project is completed and public issue of shares is made, the company needs funds for the purchase of land, machinery, equipments and construction of buildings. Such pre public issue financial requirements are met by term loans of financial institutions. These loans are very useful for the completion of the project.

Term Loan Procedure :

Any industrial unit seeking term loans from the financial institution has to undergo the following procedure :

1. An Application for Term Loan :

The company desiring loan has to make an application to the relevant institution. In the application it has to provide the following details:

1. Past track record of the promoters.
2. Details regarding industrial unit like name, address of registered office, type of business etc.
3. Details regarding projects like total production capacity, production processes, technical matters, location, management, land and building, plant and machinery, raw materials, disposal of affluent water, types of labour required and implementation programme.
4. Details of total cost of the project.
5. Sources of required funds.
6. Arrangement made for marketing.
7. Details regarding cash flows and profitability.
8. Economic and financial viability.
9. Licenses required from government.

2. Primary Scrutiny of the Application :

On receipt of the application an officer of the institution make primary scrutiny and appraisal of the application. He examines whether all the required details have been furnished or not. Incomplete application is returned to the applicant for completion. After primary scrutiny the officer prepares the flash report which is in the summary form of application. On the basis of flash report it is decided whether application is eligible for further processing or not.

3. An Apprisal of the Proposed Project :

On the basis of flash report if the application is found worth considering different aspects of the project like marketing, technical, financial, economic, managerial etc. are appraised. An appraisal of economic and financial viability is made. At the end of the appraisal a memorandum of appraisal is prepared and decision whether to accept the project for financing or to reject it is made.

4. Loan Sanctioning Letter :

If the project is accepted and the loan asked for is sanctioned, a loan sanctioning letter is written to the applicant which contains amount sanctioned, security to be provided and terms and conditions regarding repayment.

5. Acceptance of Terms and Conditions by the Applicant Company :

The loan seeker accepts the terms and conditions and sends the acceptance letter to the institution.

6. Loan Agreement :

On recepit of acceptance letter the institution prepares the draft of agreement and sends it to the applicant for its signature and seal. The agreement is stamped as per Indian stamp duty Act. Duly stamped and signed agreement is sent to the financial institution with necessary documents. The institution also puts its seal and signature. In this way a contract between the two comes into existence.

7. Payment of Loan :

After the loan is sanctioned it is paid not in lump sum amount but in a phased programme. Before the payment of loan the applicant company has to furnish certain information like the progress of the project, payment by promoters of their share, cash flow statement, compliance with legal formalities, fulfilment of conditions laid down by the institution etc. Looking to the progress of the project loan is disbursed in instalment.

8. Creating a Charge on the Assets :

Loans are provided against the security of an asset. Therefore, legal charge is created in the form of mortgage or pledge of ownership documents or hypothecation. As this is a time consuming process the first instalment may be paid against the personal guarantee of directors.

9. Monitoring of the Project :

In order to see that the project is completed within the scheduled time progress is monitored by the loan giving institution. Control over project is essential at two stages; one is the implementation stage and the other is commencement of production stage. At both the stages it controls the project by receiving certain information regarding the project.

Exercise