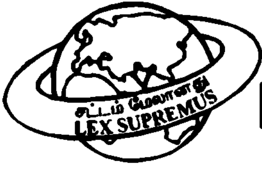

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FINANCIAL MARKETS AND INDIAN ECONOMIC ISSUES

B.Com. LL.B. (Hons.) Degree Course
SECOND YEAR - 3rd SEMESTER

STUDY MATERIAL

By

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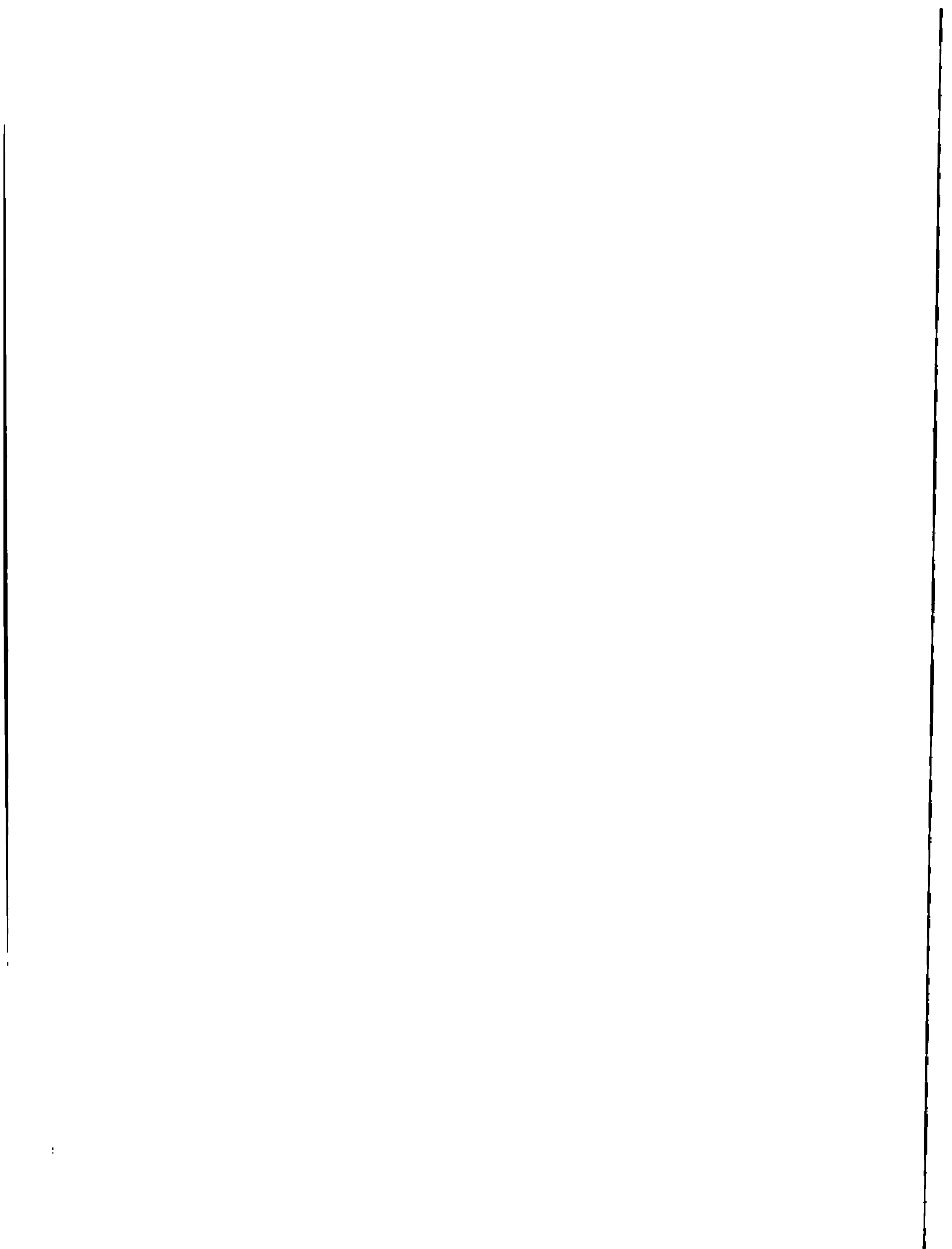


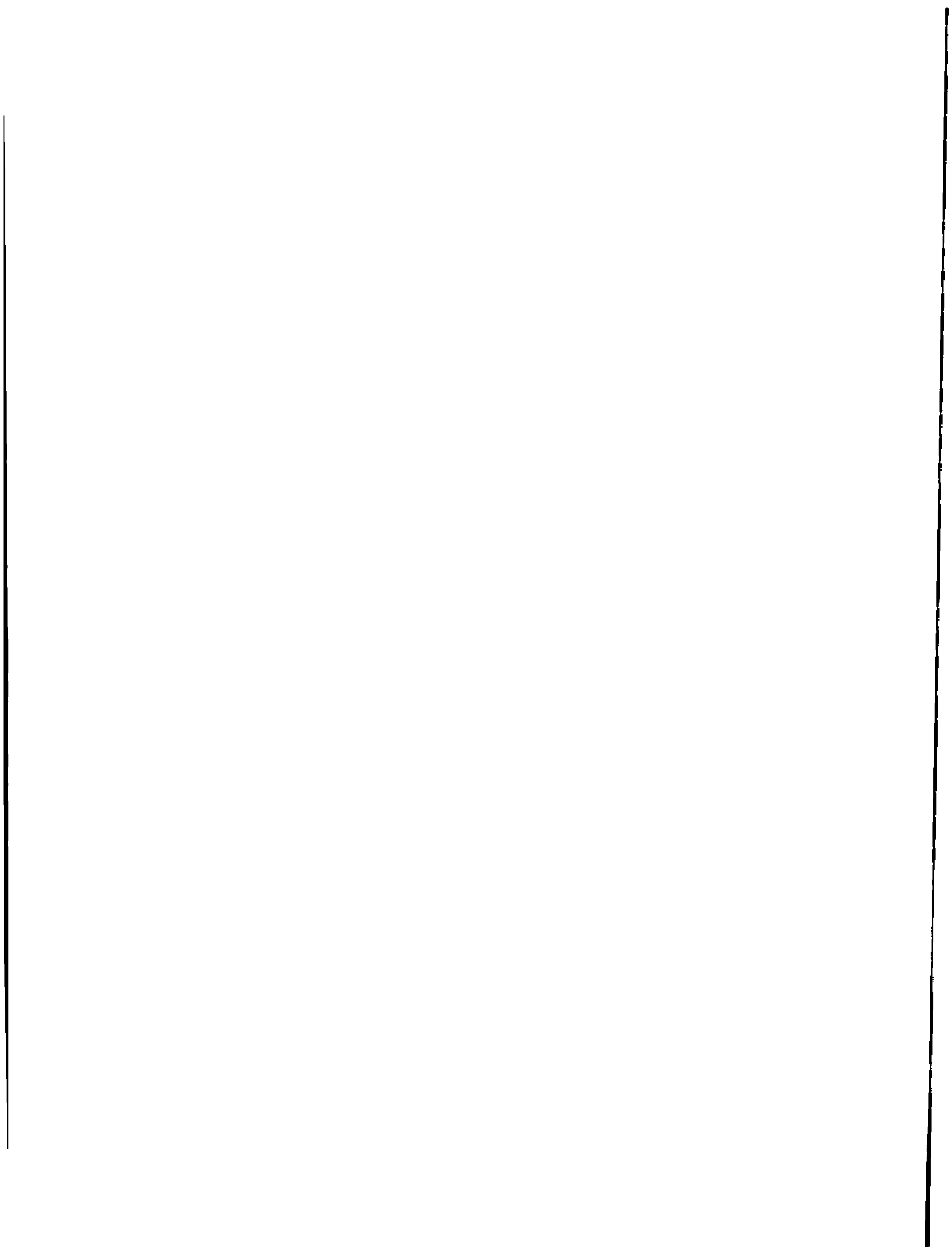
MESSAGE

Knowledge is power. Legal Knowledge is a potential power. It can be exercised effectively everywhere. Of all the domains of reality, it is Legal Knowledge, which deals with rights and liabilities, commissions and omissions, etc., empower the holder of such knowledge to have prominence over the rest. Law Schools and Law Colleges that offer Legal Education vary in their stature on the basis of their ability in imparting the quality Legal Education to the students. Of all the Law Schools and Colleges, only those that educate their students to understand the nuances of law effectively and to facilitate them to think originally, excel. School of Excellence in Law aims to be in top of such institutions.

The revolution in Information and Communication Technology dump lot of information in the virtual world. Some of the information are mischievous and dangerous. Some others are spoiling the young minds and eating away their time. Students are in puzzle and in dilemma to find out the right information and data. They do not know how to select the right from the wrong, so as to understand, internalise and assimilate into knowledge. Hence in the present scenario, the role of teachers gains much more importance in guiding the students to select the reliable, valid, relevant and suitable information from the most complicated, perplexed and unreliable data.

The teachers of the School of Excellence in Law have made a maiden attempt select, compile and present a comprehensive course material to guide the students in various subjects of law. The students can use such materials as guidance and travel further in their pursuit of legal knowledge. Guidance cannot be a complete source of information. It is a source that facilitates the students to search further source of information and enrich their knowledge. Read the materials, refer relevant text books and case laws and widen the knowledge.

Dr. P. Vanangamudi
Vice-Chancellor



PREFACE

Financial inclusion is about the broadening of financial services to those people who do not have access to financial services sector, the deepening of financial services for people who have minimal financial services, and greater financial literacy and consumer protection so that those who are offered the products can make appropriate choices. It means delivery of financial services, including banking services and credit at an affordable cost to the vast sections of disadvantaged and low income groups. The concept of financial inclusion has been prevailing in India from past 44 years. Beginning with the nationalization of commercial banks in 1969 and 1980, major step taken was the establishment of Regional Rural Banks in 1975 and banking sector reforms after 1991. A large numbers of studies have been made so far on financial inclusion in India, yet some gaps still persist. There are still problems of access to finance; credit, poverty and indebtedness have not been adequately examined. Just to open an account in the bank is not the only solution of the problem. Financial literacy is required for the overall achievement of the objective of financial inclusion. The present study is an attempt to find out regional disparity, indebtedness and status of financial inclusion in India. The present study covers the period from 2000 to 2010.

The prime objective of the present study is to give important clues to understand the nature, causes and determinants of financial inclusion in India. Financial inclusion is required to uplift the poor and disadvantaged people by providing them the customized financial products and services. This leads to inclusive growth encompassing the deprived and marginalized sections. Steps have been taken by the Government and Reserve Bank of India for expansion of banking services and linking of opportunities among various segments of financial sector like capital markets, insurance, etc. to achieve its aim of Inclusive Growth. This study intends to look at the changes occurred in conditions of India by considering the appropriate variables to test.

A significant step up in productivity since the start of this millennium boosted India's investment cycle, and led to high annualised growth rates – the fastest in the history of independent India. However, over the last few years, a deceleration in growth due to a higher emphasis on non-productivity boosting expenditure, coupled with turmoil in the international political and economic environment has weighed on India's performance.

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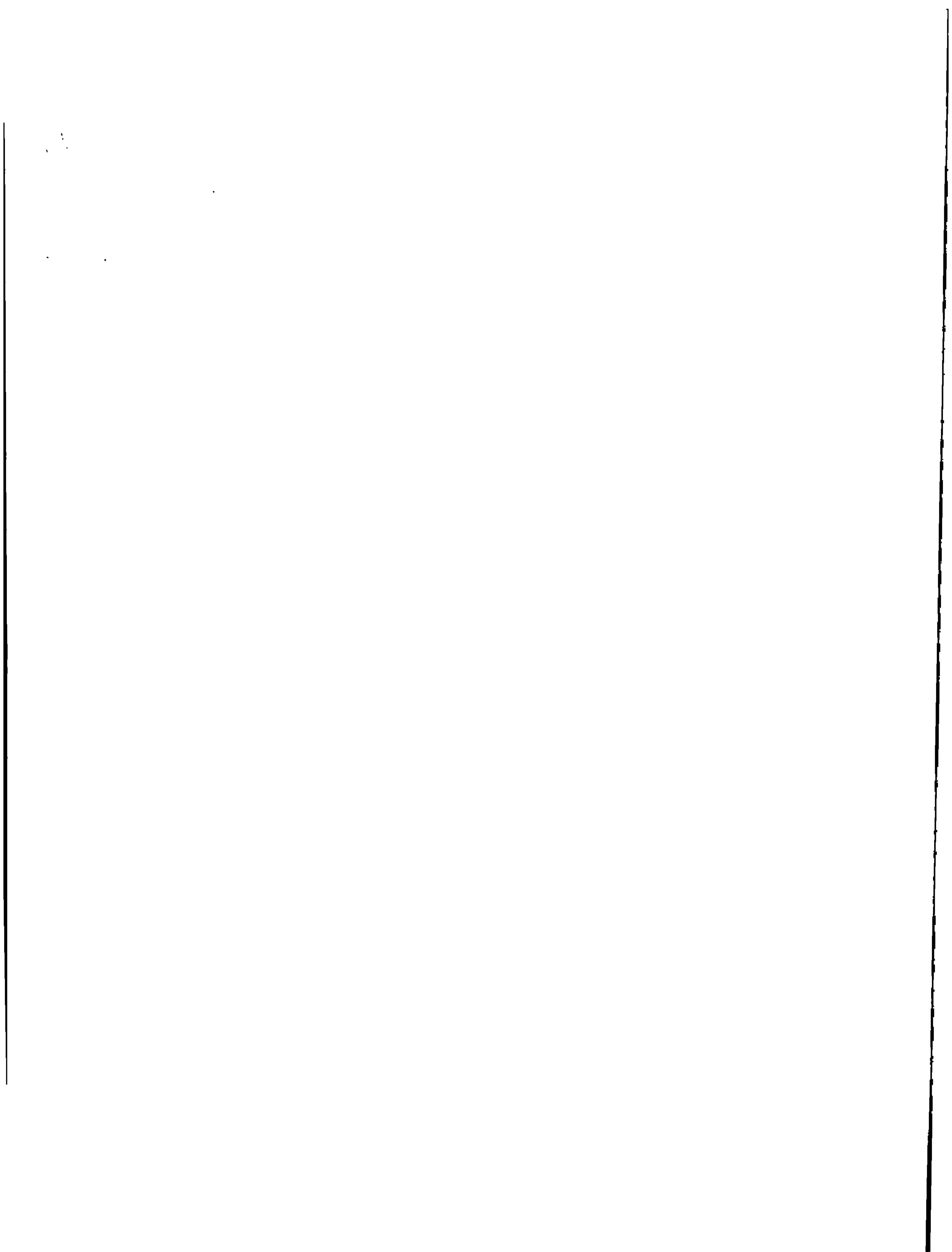


B.COM., LL.B., (HONS) SECOND YEAR – 3rd SEMESTER

FINANCIAL MARKETS AND INDIAN ECONOMIC ISSUES

COURSE OUTLINE

UNIT – I : INTRODUCTION

Meaning and importance of financial services – Types of financial services – Financial services and economic development – Financial Instruments – Financial markets - Players in financial services sector – Financial services sector problems and reforms.

UNIT – II : VENTURE CAPITAL AND MERCHANT BANKING

Venture Capital - Growth of venture capital in India – Leasing – types of leases – Leasing and borrowing – Credit rating – Factoring – types of factoring arrangements – Consumer finance –Is Merchant banking – functions - Issue management – Managing of new issues – underwriting – Stock exchange – Role of SEBI.

UNIT –III : MUTUAL FUNDS AND FOREIGN EXCHANGE MARKET

Mutual funds: Concepts and objectives – Functions and portfolio classification – Debt securitization – Demat services – Role of NSDL and CSDL – Meaning of exchange rate – Currency swap – Difference between forward contract and futures contracts – Money Laundering.

UNIT – IV: NATIONAL INCOME

Characteristics of Indian Economy – National Income Estimation – Trends – Inequalities of Income and Wealth – Limitations of National Income Estimation – Population – Causes – Trends – consequences – Population Policy 2000 – Poverty – Causes – Measurement – trends – Poverty Alleviation Programmes – Unemployment – Causes – Types – Trends – Programmes – HDI.

UNIT – V: PROBLEMS OF AGRICULTURE AND INDUSTRY

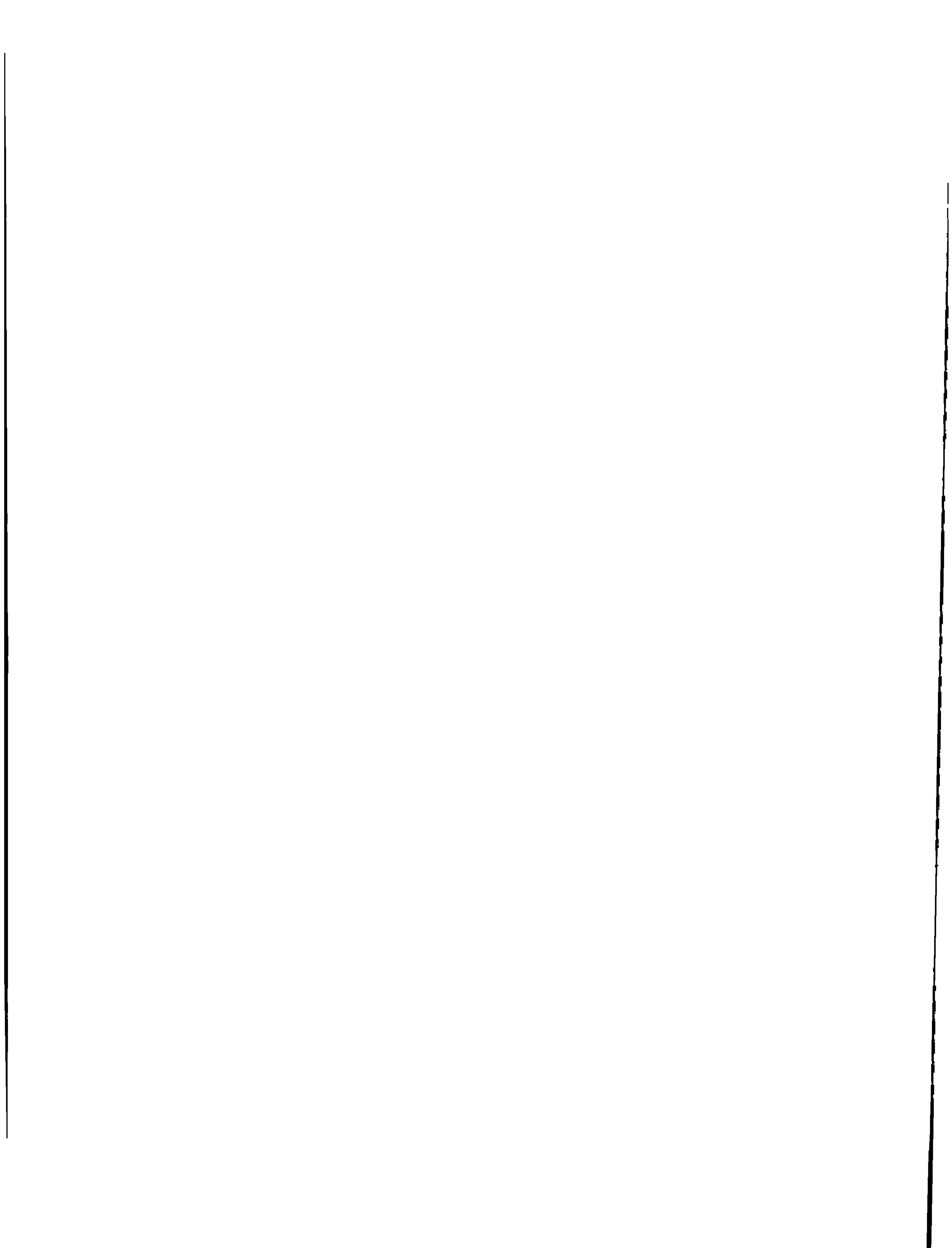
Features – Land Reforms – Green Revolution – Agricultural Marketing – Agricultural Credit – Problems of Agricultural Labour – Industry – Role – Problems – Industrial Policies – Industrial Disputes – Industrial Relations – Problems of Small Scale Industries – Measures – Industrial Policy – 1956.

Books Prescibed:

- I.M.Pandey – Financial Management
- S.N.Maheswari - Financial Management
- Dr.Radha – Financial Management
- Dr.N. Premavathy- Financial Management
- Ruddar Dutt and K.P.M. Sundaram- Indian Economy

BOOKS FOR REFERENCE:

- Economic and Political Weekly – Current Issues
- Indian Journal of Agriculture
- Indian Journal of Industries
- Sourthern Economists



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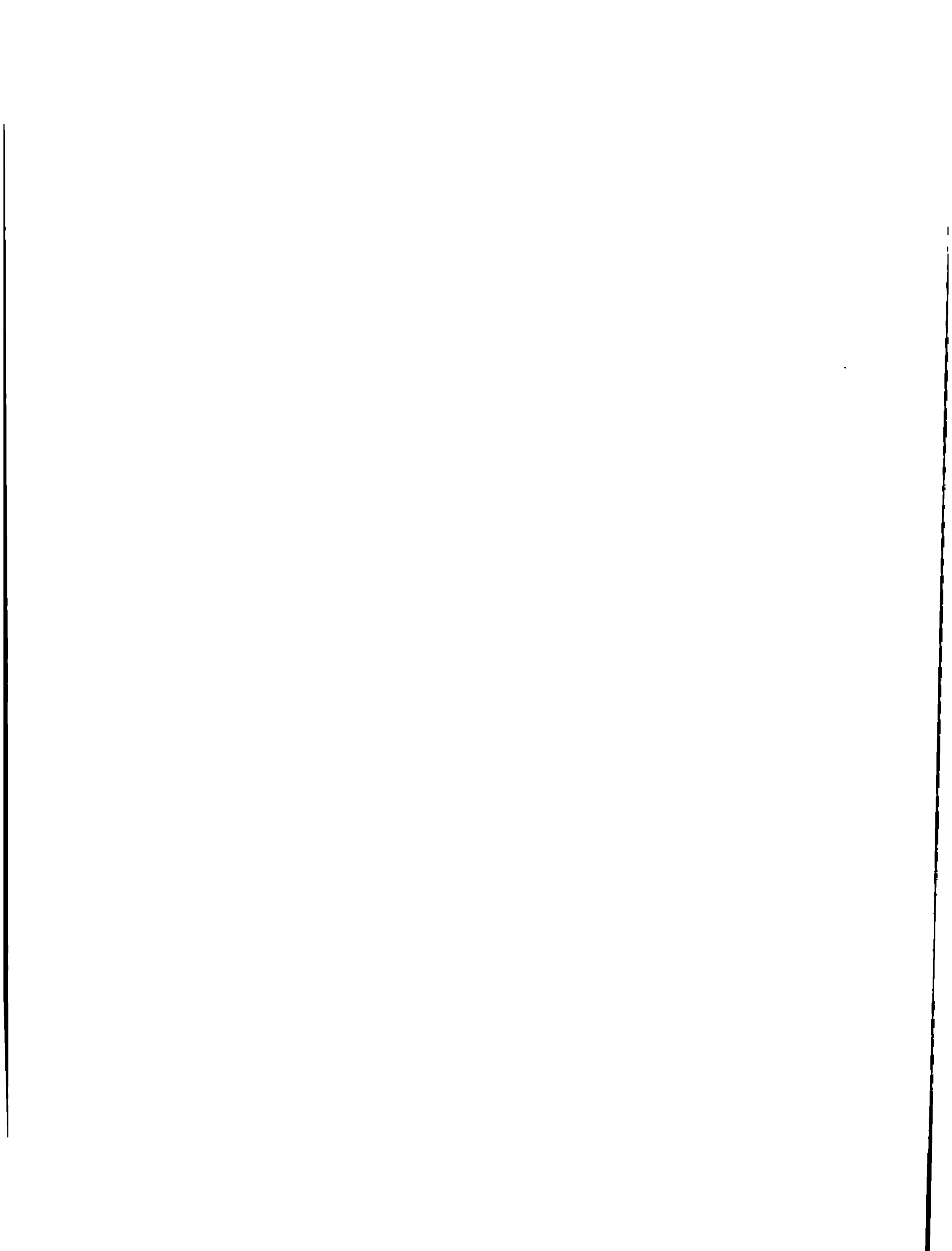


UNIT – I

CHAPTER – I

FINANCIAL SERVICES - INTRODUCTION

1.1.INTRODUCTION

A system that aims at establishing and providing a regular, smooth, efficient and cost effective linkage between depositors and investors is known as financial system. The functions of financial system are to channelise the funds from the surplus units to the deficit units. An efficient financial system not only encourages savings and investments, it also efficiently allocates resources in different investment avenues and thus accelerates the rate of economic development. The financial system of a country plays a crucial role of allocating scare resources to productive uses. Its efficient functioning is of critical importance to the economy.

1.2 CONCEPT OF FINANCIAL SYSTEM

Financial system is one of the industries in an economy. It is a particularly important industry that frequently has a far reaching impact on society and the economy. But if its occult trappings are stripped it is like any industry, a group of firms that combine factors of production (land, labour and capital) under the general direction of a management team and produce a product or cluster of products for sale in financial market. The product of the financial industry is not tangible rather it is an intangible service. Financial industry as a whole, produces a wide range of services but all these services are related directly or indirectly to assets and liabilities, that is, claims on people, organization, institutions, companies and government. These are the forms in which people accumulate much of their wealth. In simple terms we are referring to paper assets : shares, debentures, deposits, mortgages and other securities. Thus, financial system performs certain essential functions for the economy, including maintenance of payment system (through which purchasing power is transferred from one participant to another i.e. from buyer to seller), collection and allocation of the savings of society, and creation of a variety of stores of wealth to suit the preferences of savers. This brief sketch of functions of financial system gives us its gist. Performance of these functions pre-supposes the existence of financial assets, financial institutions (intermediaries) and financial markets. A combination of these three constitute financial system.

To interpret the financial system and evaluate its performance, it requires an understanding of its functions in an economy. Financial system in fact has the following functions:

a) Capital formation function

This is the process of diversion of the productive capacity of the economy to the making of capital goods which increase future productive capacity. Process of capital formation involve three distinct but inter-dependent activities : savings, finance and investment.

b) Allocative function

The financial system in process of capital formation has to decide as to how capital is to be used. Poor choice in deciding which economic projects are to be embarked upon, leads to wastage of resources. The better the quality of judgment exercised in allocation, the more rapid economic progress will be.

c) Service function

An effective financial system offers the economic segments services in form of providing opportunities to hold wealth in secured and convenient way so that they pay a positive rate of return. The availability of these services of the financial system contributes importantly, if in an intangible way, to the satisfaction of consumers.

Finance is the flowing blood in the body of financial system. It is a link between savings and investments by providing the mechanism through which savings (claims to resources) of savers are pooled and are put into the hands of those able and willing to invest by financial intermediaries. Financial intermediaries create assets that have property of liquidity or convertibility into a fixed amount of money on demand. Liquidity refers to cash, money and nearness to cash. Liquidity is the most significant aspect of financial intermediation while holding essentially illiquid assets themselves, intermediaries are able to create liquid assets to be held by the ultimate savers in the economy. Illiquid assets refer to credit creation. In Indian economy Central Bank (RBI in India) performs the function of cash creation where as financial institutions create credit. Flow of finance in the system takes place between two segments i.e. Surplus Unit and Deficit Unit as shown in Chart I. Surplus unit, having excess of income over current consumption can be public surplus unit or private surplus unit. The former have savings through normal budgetary channels and the retained earnings of public sector enterprises. The latter refer to household savings and non-corporate sector savings but corporate sector savings are dominating in volume. Corporate sector savings depend mainly on profitability and distribution policy of the enterprise. On the other hand size of household savings is a function of capacity, ability and willingness of the people to save which in return depends on numerous factors like psychological, social, economic. On the other end of flow of fund, we have deficit unit which seeks funds for investment or consumption purposes. Their investment and sometimes consumption pattern is outcome of their strategy about future earnings. This in turn is a function of existing stock of capital, state of industry and economy, government policies, potentials of opportunity for new investments. Government and business sector are the major borrowers whose investment normally surpass their savings.

The role of financial system is thus, to promote savings and their channalisation in the economy through financial assets that are more productive than the physical assets. The fund flows in an efficient financial system from less productive to more productive purpose, from unproductive/less productive activities to productive activities and from idle balance to active balances. Thus, ultimate objective is to add value through flow of fund in the system. This means that the operations of financial system are vital to the pace and structure of the growth of the economy. However we must not forget that some of the transfers are to households to acquire consumer goods and services and to government for assorted purposes, including collective consumption. This system plays a significant role in accelerating the rate of economic development which leads to improving general standard of living and higher social welfare.

There is another way to look at financial system. Financial system makes it easier to trade. People trade because they differ in what they have and in what they want. Trade may be *trade in lending* (giving up purchasing power now in exchange for purchasing power in the future), *trade in risk* (reducing economic burden of risks through insurance and forward transactions) and *trade in goods*. Trade benefits everyone. Thus, financial system is concerned with every one and every one is interacting with the system, consciously or unconsciously. Financial system makes trade easier through its *technology of payments* (whether through credit or cash), *technology of lending* (through financial market or direct lending) and *technology of risk* (taking up insurance policy or contracting in futures market). Technology basically refers to network of institutions, markets and instruments of financial system.

Financial system is changing very fast. Changes are due to two types of innovations. First category of innovation facilitates serving existing needs in new ways. An example is leasing, which enables the user to use the asset without buying it. Second category of innovation uses existing technology to serve new needs. Securitisation of financial assets is an example here. Funds extended in form of loans are tied up. To make use of such tied up funds these financial assets are securitised and liquid resources are raised to extend more loans.

Another dimension of financial system in an economy is the government. It is the government which lays down the rules of the game for financial system i.e. directs how the markets operate, which are permissible instruments and what are operating constraints of financial intermediaries. Intervention of government has two facets: one is *ensuring efficiency* in the system and second is providing *stability and building confidence.* A financial system is said to be efficient when the sum of all gains from lending, payment and trade in risk are as large as they can be. An immature financial system needs higher degree of intervention and vice-versa. Government also intervenes in financial system to provide its stability in absence of which the system breaks down and it can be disastrous. There has to be a limit to governmental intervention. Excessive intervention mars innovations. Innovations in financial system is the result of attempts to get out of the restrictive regulations. It is essential to appreciate role of financial system or sector in an economy. As the economy grows, the set up and operations of this systems changes. The major role as discussed earlier has been resources mobilization. An efficient financial system facilitate raising huge amount through even small contributions from large number of investors. A firm can raise Rs. 100 crore through issue of 10 crore shares being subscribed by investors with minimum contributions of Rs. 2000 being issue of minimum 200 shares of Rs. 10 each or through a mutual fund or financial institutions. Large amount can be mobilized from small investors. The instruments issued to raise fund may have maturity patterns which are different for the investor's need. To over come such situation secondary markets emerge as special part of financial system. To minimize the risk associated with investment, financial system offers a wide variety of investment opportuniting enabling investor to diversify their investment hence risk.

1.3 FINANCIAL CONCEPTS

An understanding of the financial system requires an understanding of the following concepts:

(i) Financial assets

(ii) Financial intermediaries

(iii) Financial markets

(iv) Financial rates of return

(v) Financial instruments

1.3.1 Financial Assets

In any financial transaction, there should be a creation or transfer of financial assets. Hence, the basic product of any financial system is the financial asset. A financial assets is one which is used for production or consumption or for further creation of assets. For instance, A buys equity shares and these shares are financial assets since they earn income in future.

In this context, one must know the distinction between financial assets and physical assets. Unlike financial assets, physical assets are not useful for further production of goods or for earning income. For example X purchases land and building, or gold or silver. These are physical assets since they cannot be used for further production. Many physical assets are useful for consumption only.

It is interesting to note that the objective of investment decides the nature of the asset. For instance if a building is bought for residence purpose, it becomes a physical asset. If the same is bought for hiring, it becomes a financial asset.

Classification of Financial Assets

Financial assets can be classified differently under different circumstances. One such classification is :

(i) Marketable assets

(ii) Non-marketable assets

Marketable Assets : Marketable assets are those which can be easily transferred from one person to another without much hindrance. Examples are shares of listed companies, Government securities, bonds of public sector undertakings etc.

Non-Marketable Assets : On the other hand, if the assets cannot be transferred easily, they come under this category. Examples are bank deposits, provident, funds, pension funds, National Savings Certificates, insurance policies etc.

Yet another classification is as follows:

(i) Money or cash asset

(ii) Debt asset

(iii) Stock asset

Cash Asset : In India, all coins and currency notes are issued by the RBI and the Ministry of Finance, Government of India. Besides, commercial banks can also create money by means of creating credit. When loans are sanctioned, liquid cash is not granted. Instead an account is opened in the borrower's name and a deposit is created. It is also a kind of money asset.

Debt Asset : Debt asset is issued by a variety of organizations for the purpose of raising their debt capital. Debt capital entails a fixed repayment schedule with regard to interest and principal. There are different ways of raising debt capital. Example are issue of debentures, raising of term loans, working capital advance, etc.

Stock Asset : Stock is issued by business organizations for the purpose of raising their fixed capital. There are two types of stock namely equity and preference. Equity shareholders are the real owners of the business and they enjoy the fruits of ownership and at the same time they bear the risk as well. Preference shareholders, on the other hand get a fixed rate of dividend (as in the case of debt asset) and at the same time they retain some characteristics of equity.

1.3.2 Financial Intermediaries

The term financial intermediary includes all kinds of organizations which intermediate and facilitate financial transactions of both individual and corporate customers. Thus, it refers to all kinds of financial institutions and investing institutions which facilitate financial transactions in financial markets. They may be in the organized sector or in the unorganized sector. They may also be classified into two :

(i) Capital market intermediaries

(ii) Money market intermediaries

Capital Market Intermediaries : These intermediaries mainly provide long term funds to individuals and corporate customers. They consist of term lending institutions like financial corporations and investing institutions like LIC.

Money Market Intermediaries : Money market intermediaries supply only short term funds to individuals and corporate customers. They consist commercial banks, co-operative banks, etc.

1.3.3 Financial Markets

Generally speaking, there is no specific place or location to indicate a financial market. Wherever a financial transaction takes place, it is deemed to have taken place in the financial market. Hence financial markets are pervasive in nature since financial transactions are themselves very pervasive throughout the economic system. For instance, issue of equity shares, granting of loan by term lending institutions, deposit of money into a bank, purchase of debentures, sale of shares and so on.

However, financial markets can be referred to as those centers and arrangements which facilitate buying and selling of financial assets, claims and services. Sometimes, we do find the existence of a specific place or location for a financial market as in the case of stock exchange.

Classification of Financial Markets

The classification of financial markets in India is shown in Chart II.

(a) Unorganised Markets

In these markets there are a number of money lenders, indigenous bankers, traders etc., who lend money to the public. Indigenous bankers also collect deposits from the public. There are also private finance companies, chit funds etc., whose activities are not controlled by the RBI. Recently the RBI has taken steps to bring private finance companies and chit funds under its strict control by issuing non-banking financial companies (Reserve Bank) Directions, 1998. The RBI has already taken some steps to bring the unorganized sector under the organized fold. They have not been successful. The regulations concerning their financial dealings are still inadequate and their financial instruments have not been standardized.

(b) Organised Markets

In the organized markets, there are standardized rules and regulations governing their financial dealings. There is also a high degree of institutionalization and instrumentalisation. These markets are subject to strict supervision and control by the RBI or other regulatory bodies.

These organized markets can be further classified into two. They are :

(i) Capital market

(ii) Money market

Capital Market : The capital market is a market for financial assets which have a long or indefinite maturity. Generally, it deals with long term securities which have a maturity period of above one year. Capital market may be further divided into three namely :

(i) Industrial securities market

(ii) Government securities market and

(iii) Long term loans market

I. Industrial securities market

As the very name implies, it is a market for industrial securities namely: (i) Equity shares or ordinary shares, (ii) Preference shares, and (iii) Debentures or bonds. It is a market where industrial concerns raise their capital or debt by issuing appropriate instruments. It can be further subdivided into two. They are :

(i) Primary market or New issue market

(ii) Secondary market or Stock exchange

Primary Market : Primary market is a market for new issues or new financial claims. Hence it is also called New Issue market. The primary market deals with those securities which are issued to the public for the first time. In the primary market, borrowers exchange new financial securities for long term funds. Thus, primary market facilitates capital formation.

There are three ways by which a company may raise capital in a primary market. They are :

(i) Public issue

(ii) Rights issue

(iii) Private placement

The most common method of raising capital by new companies is through sale of securities to the public. It is called public issue. When an existing company wants to raise additional capital, securities are first offered to the existing shareholders on a pre-emptive basis. It is called rights issue. Private placement is a way of selling securities privately to a small group of investors.

Secondary Market : Secondary market is a market for secondary sale of securities. In other words, securities which have already passed through the new issue market are traded in this market. Generally, such securities are quoted in the stock exchange and it provides a continuous and regular market for buying and selling of securities. This market consists of all stock exchanges recognized by the Government of India. The stock exchanges in India are regulated under the Securities Contracts (Regulation) Act, 1956. The Bombay Stock Exchange is the principal stock exchange in India which sets the tone of the other stock markets.

II. Government Securities Market

It is otherwise called Gilt-Edged securities market. It is a market where Government securities are traded. In India there are many kinds of Government Securities-short term and long term. Long term securities are traded in this market while short term securities are traded in the money market. Securities issued by the Central Government, State Governments, Semi-Government authorities like City Corporations, Port Trusts. Improvement Trusts, State Electricity Boards, All India and State level financial institutions and public sector enterprises are dealt in this market.

Government securities are issued in denominations of Rs.100. Interest is payable half-yearly and they carry tax exemptions also. The role of brokers in marketing these securities is practically very limited and the major participant in this market in the "commercial banks" because they hold a very substantial portion of these securities to satisfy their S.L.R. requirements.

The secondary market for these securities is very narrow since most of the institutional investors tend to retain these securities until maturity.

The Government securities are in many forms. These are generally:

(i) Stock certificates or inscribed stock

(ii) Promissory Notes

(iii) Bearer Bonds which can be discounted.

Government securities are sold through the Public Debt Office of the RBI while Treasury Bills (short term securities) are sold through auctions.

Government securities offer a good source of raising inexpensive finance for the Government exchequer and the interest on these securities influences the prices and yields in this market. Hence this market also plays a vital role in monetary management.

III. Long Term Loans Market

Development banks and commercial banks play a significant role in this market by supplying long term loans to corporate customers. Long term loans market may further be classified into :

(i) Term loans market

(ii) Mortgages market

(iii) Financial Guarantees market

Term Loans Market : In India, many industrial financing institutions have been created by thee Government both at the national and regional levels to supply long term and medium term loans to corporate customers directly as well as indirectly. These development banks dominate the industrial finance in India. Institutions like IDBI, IFCI, ICICI, and other state financial corporations come under this category. These institutions meet the growing and varied long-term financial requirements of industries by supplying long term loans. They also help in identifying investment opportunities, encourage new entrepreneurs and support modernization efforts.

Mortgages Market : The mortgages market refers to those centers which supply mortgage loan mainly to individual customers. A mortgage loan is a loan against the security of immovable property like real estate. The transfer of interest in a specific immovable property to secure a loan is called mortgage. This mortgage may be equitable mortgage or legal one. Again it may be a first charge or second charge. Equitable mortgage is created by a mere deposit of title deeds to properties as security whereas in the case of legal mortgage the title in the property is legally transferred to the lender by the borrower. Legal mortgage is less risky.

Similarly, in the first charge, the mortgager transfers his interest in the specific property to the mortgagee as security. When the property in question is already mortgaged once to another creditor, it becomes a second charge when it is subsequently mortgaged to somebody else. The mortgagee can also further transfer his interest in the mortgaged property to another. In such a case, it is called a sub-mortgage.

The mortgage market may have primary market as well secondary market. The primary market consists of original extension of credit and secondary market has sales and re-sales of existing mortgages at prevailing prices.

In India residential mortgages are the most common ones. The Housing and Urban Development Corporation (HUDCO) and the LIC play a dominant role in financing residential projects. Besides, the Land Development Banks provide cheap mortgage loans for the development of lands, purchase of equipment etc. These development banks raise finance through the sale of debentures which are treated as trustee securities.

Financial Guarantees Market : A Guarantee market is a center where finance is provided against the guarantee of a reputed person in the financial circle. Guarantee is a contract to discharge the liability of a third party in case of his default. Guarantee acts as a security from the creditor's point of view. In case the borrower fails to repay the loan, the liability falls on the shoulders of the guarantor. Hence the guarantor must be known to both the borrower and the lender and he must have the means to discharge his liability.

Though there are many types of guarantees, the common forms are : (i) Performance Guarantee, and (ii) Financial Guarantee. Performance guarantees cover the payment of earnest money, retention money, advance payments, non-completion of contracts etc. On the other hand financial guarantees cover only financial contracts.

In India, the market for financial guarantees is well organized. The financial guarantees in India relate to :

(i) Deferred payments for imports and exports

(ii) Medium and long term loans raised abroad

(iii) Loans advanced by banks and other financial institutions

These guarantees are provided mainly by commercial banks, development banks, Governments both central and states and other specialized guarantee institutions like ECGC (Export Credit Guarantee Corporation) and DICGC (Deposit Insurance and Credit Guarantee Corporation). This guarantee financial service is available to both individual and corporate customers. For a smooth functioning of any financial system, this guarantee service is absolutely essential.

Importance of Capital Market

Absence of capital market acts as a deferent factor to capital formation and economic growth. Resources would remain idle if finance are not funneled through capital market. The importance of capital market can be briefly summarized as follows :

(i) The capital market serves as an important source for the productive use of the economy's savings. It mobilizes the savings of the people for further investment and thus avoids their wastage in unproductive uses.

(ii) It provides incentives to saving and facilitates capital formation by offering suitable rates of interest as the price of capital.

(iii) It provides an avenue for investors, particularly the household sector to invest in financial assets which are more productive than physical assets.

(iv) It facilitates increase in production and productivity in the economy and thus enhance the economic welfare of the society. Thus, it facilitates "the movement of stream of command over capital to the point of highest yield" towards those who can apply them productively and profitably to enhance the national income in the aggregate.

(v) The operations of different institutions in the capital market induce economic growth. They give quantitative and qualitative directions to the flow of funds and bring about rational allocation of scarce resources.

(vi) A healthy capital market consisting of expert intermediaries promotes stability in values of securities representing capital funds.

(vii) Moreover, it serves as an important source for technological up gradation in the industrial sector by utilizing the funds invested by the public.

Thus, a capital market serves as an important link between those who save and those who aspire to invest these savings.

Money Market

Money market is a market for dealing with financial assets and securities which have a maturity period of upto one year. In other words, it is a market for purely short term funds. The money market may be subdivided into four. They are:

(i) Call money market

(ii) Commercial bills market

(iii) Treasury bills market

(iv) Short term loan market

Call Money Market : The call money market is a market for extremely short period loans say one day to fourteen days. So, it is highly liquid. The loans are repayable on demand at the option of either the lender or the borrower. In India, call money markets are associated with the presence of stock exchanges and hence, they are located in major industrial towns like Bombay, Calcutta, Madras, Delhi, Ahmedabad etc. The special feature of this market is that the interest rate varies from day to day and even from hour to hour and centre to centre. It is very sensitive to changes in demand and supply of call loans.

Commercial Bills Market : It is a market for bills of exchange arising out of genuine trade transactions. In the case of credit sale, the seller may draw a bill of exchange on the buyer. The buyer accepts such a bill promising to pay at a later date specified in the bill. The seller need not wait until the due date of the bill. Instead, he can get immediate payment by discounting the bill.

In India the bill market is under-developed. The RBI has taken many steps to develop a sound bill market. The RBI has enlarged the list of participants in the bill market. The Discount and Finance House of India was set up in 1988 to promote secondary market in bills. In spite of all these, the growth of the bill market is slow in India. There are no specialized agencies for discounting bills. The commercial banks play a significant role in this market.

Treasury Bills Market : It is a market for treasury bills which have 'short-term' maturity. A treasury bill is a promissory note or a finance bill issued by the Government. It is highly liquid because its repayment is guaranteed by the Government. It is an important instrument for short term borrowing of the Government. There are two types of treasury bills namely (i) ordinary or regular and (ii) adhoc treasury bills popularly known as 'adhocs'.

Ordinary treasury bills are issued to the public, banks and other financial institutions with a view to raising resources for the Central Government to meet its short term financial needs. Adhoc treasury bills are issued in favour of the RBI only. They are not sold through tender or auction. They can be purchased by the RBI only. Adhocs are not marketable in India but holders of these bills can sell them back to 364 days only. Financial intermediaries can park their temporary surpluses in these instruments and earn income.

Short-Term Loan Market : It is a market where short-term loans are given to corporate customers for meeting their working capital requirements. Commercial banks play a significant role in this market. Commercial banks provide short term loans in the form of cash credit and overdraft. Overdraft facility is mainly given to business people whereas cash credit is given to industrialists. Overdraft is purely a temporary accommodation and it is given in the current account itself. But cash credit is for a period of one year and it is sanctioned in a separate account.

Foreign Exchange Market

The term foreign exchange refers to the process of converting home currencies into foreign currencies and vice versa. According to Dr. Paul Einzing "Foreign exchange is the system or process of converting one national currency into another, and of transferring money from one country to another".

The market where foreign exchange transactions take place is called a foreign exchange market. It does not refer to a market place in the physical sense of the term. In fact, it consists of a number of dealers, banks and brokers engaged in the business of buying and selling foreign exchange. It also includes the central bank of each country and the treasury authorities who enter into this market as controlling authorities.

Functions : The most important functions of this market are :

(i) To make necessary arrangements to transfer purchasing power from one country to another.

(ii) To provide adequate credit facilities for the promotion of foreign trade.

(iii) To cover foreign exchange risks by providing hedging facilities.

In India, the foreign exchange business has a three-tiered structure consisting of:

(i) Trading between banks and their commercial customers.

(ii) Trading between banks through authorized brokers.

(iii) Trading with banks abroad.

Brokers play a significant role in the foreign exchange market in India. Apart from authorised dealers, the RBI has permitted licensed hotels and individuals (known as Authorised Money Changers) to deal in foreign exchange business. The FEMA helps to smoothen the flow of foreign currency and to prevent any misuse of foreign exchange which is a scarce commodity.

1.3.4 Financial Rates of Return

Most households in India still prefer to invest on physical assets like land, buildings, gold, silver etc. But, studies have shown that investment in financial assets like equities in capital market fetches more return than investments on gold. It is imperative that one should have some basic knowledge about the rate of return on financial assets also.

The return on Government securities and bonds are comparatively less than on corporate securities due to lower risk involved therein. The Government and the RBI determine the interest rates on Government securities. Thus, the interest rates are administered and controlled. The peculiar feature of the interest rate structure is that the interest rates do not reflect the free market forces. They do not reflect the scarcity value of capital in the country also. Most of these rates are fixed on an ad hoc basis depending upon the credit and monetary policy of the Government.

Generally the interest rate policy of the Government is designed to achieve the following:

(i) To enable the Government to borrow comparatively cheaply.

(ii) To ensure stability in the macro-economic system.

(iii) To support certain sectors through preferential lending rates.

(iv) To mobilize substantial savings in the economy.

1.3.5 Financial Instruments

Financial instruments refer to those documents which represent financial claims on assets. As discussed earlier, financial asset refers to a claim to the repayment of a certain sum of money at the end of a specified period together with interest or dividend. Examples are Bill of exchange, Promissory Note, Treasury Bill, Government Bond, Deposit Receipt, Share, Debenture, etc. Financial instruments can also be called financial securities. Financial securities can be classified into:

(i) Primary or direct securities.

(ii) Secondary or indirect securities.

Primary Securities : These are securities directly issued by the ultimate investors to the ultimate savers, e.g. shares and debentures issued directly to the public.

Secondary Securities : These are securities issued by some intermediaries called financial intermediaries to the ultimate savers, e.g. Unit Trust of India and mutual funds issue securities in the form of units to the public and the money pooled is invested in companies.

Again these securities may be classified on the basis of duration as follows :

(i) Short-term securities

(ii) Medium-term securities

(iii) Long-term securities

Short-term securities are those which mature within a period of one year. For example, Bill of Exchange, Treasury Bill, etc. Medium-term securities are those which have a maturity period ranging between one and five years like Debentures maturing within a period of 5 years. Long-term securities are those which have a maturity period of more than five years. For example, Government Bonds maturing after 10 years.

Characteristic Features of Financial Instruments

Generally speaking, financial instruments possess the following characteristic features:

(i) Most of the instruments can be easily transferred from one hand to another without many cumbersome formalities.

(ii) They have a ready market i.e., they can be bought and sold frequently and thus trading in these securities is made possible. (iii) They possess liquidity, i.e., some instruments can be converted into cash readily. For instance, a bill of exchange can be converted into cash readily by means of discounting and rediscounting.

(iv) Most of the securities possess security value, i.e., they can be given as security for the purpose of raising loans.

(v) Some securities enjoy tax status, i.e., investment in these securities are exempted from Income Tax, Wealth Tax, etc., subject to certain limits.

(vi) They carry risk in the sense that there is uncertainty with regard to payment of principal or interest or dividend as the case may be.

(vii) These instruments facilitate future trading so as to cover risks due to price fluctuations, interest rate fluctuations etc.

(viii) These instruments involve less handling costs since expenses involved in buying and selling these securities are generally much less.

(ix) The return on these instruments is directly in proportion to the risk undertaken.

(x) These instruments may be short-term or medium term or long-term depending upon the maturity period of these instruments.

1.4 DEVELOPMENT OF FINANCIAL SYSTEM IN INDIA

Some serious attention was paid to the development of a sound financial system in India only after the launching of the planning era in the country. At the time of Independence in 1947, there was no strong financial institutional mechanism in the country. There was absence of issuing institutions and non-participation of intermediary financial institutions. The industrial sector also had no access to the savings of the community. The capital market was very primitive and shy. The private as well as the unorganized sector played a key role in the provision of 'liquidity'. On the whole, chaotic conditions prevailed in the system. With the adoption of the theory of mixed economy, the development of the financial system took a different turn so as to fulfill the socio-economic and political objectives. The Government started creating new financial institutions to supply finance both for agricultural and industrial development and it also progressively started nationalizing some important financial institutions so that the flow of the finance might be in the right direction.

Nationalisation of Financial Institution

As we know that the RBI is the leader of the financial system. But, it was established as a private institution in 1935. It was nationalized in 1948. It was followed by the nationalization of the Imperial Bank of India in 1956 by renaming it as State Bank of India. In the same year, 245 Life Insurance Companies were brought under Government control by merging all of them into a single corporation called Life Insurance Corporation of India. Another significant development in our financial system was the nationalization of 14 major commercial banks in 1969. Again, 6 banks were nationalized in 1980. This process was then extended to General Insurance Companies which were reorganized under the name of General Insurance Corporation of India. thus, the important financial institutions were brought under public control.

Starting of Unit Trust of India

Another landmark in the history of development of our financial system is the establishment of new financial institutions to strengthen our system and to supply institutional credit to industries.

The Unit Trust of India was established in 1964 as a public sector institution to collect the savings of the people and make them available for productive ventures. It is the oldest and largest mutual fund in India. It is governed by its own statues and regulations. However, since 1994, the schemes of UTI have to be approved by the SEBI. It has introduced a number of open-ended and close-ended schemes. It also provides re-purchase facility of units of the various income schemes of UTI are linked with stock exchanges. Its investment is confined to both corporate and non-corporate sectors. It has established the following subsidiaries:

(i) The UTI Bank Ltd., in April 1994.

(ii) The UTI Investor Service Ltd., to act as UTI's own Registrar and Transfer agency.

(iii) The UTI Security Exchange Ltd.

Establishment of Development Banks

Many development banks were started not only to extend credit facilities to financial institutions but also to render advisory services. These banks are multipurpose institutions which provide medium and long term credit to industrial undertakings, discover investment projects, undertake the preparation of project reports, provide technical advice and managerial services and assist in the management of industrial units. These institutions are intended to develop backward regions as well as small and new entrepreneurs.

The Industrial Finance Corporation of India (IFCI) was set up in 1948 with the object of "making medium and long term credits more readily available to industrial concerns in India, particularly under circumstances where normal banking accommodation is inappropriate or recourse to capital issue method is impracticable". At the regional level, State Financial Corporations were established under the State Financial Corporation Act, 1951 with a view to providing medium and long term finance to medium and small industries. It was followed by the establishment of the Industrial Credit and Investment Corporation of India (ICICI) in 1955 to develop large and medium industries in private sector, on the initiative of the World Bank. It adopted a more dynamic and modern approach in industrial financing. Subsequently, the Government of India set up the Refinance Corporation of India (RCI) in 1958 with a view to providing refinance facilities to banks against term loans granted by them to medium and small units. Later on it was merged with the Industrial Development Bank of India. The Industrial Development Bank of India (IDBI) was established on July 1, 1964 as a wholly owned subsidiary of the RBI. The ownership of IDBI was then transferred to the Central Government with effect from February 16, 1976. The IDBI is the apex institution in the area of development banking and as such it has to co-ordinate the activities of all the other financial institutions. At the State level, the State Industrial Development Corporations (SIDCO)/State Industrial Investment Corporations were created to meet the financial requirements of the States and to promote regional development.

In 1971, the IDBI and LIC jointly set up the Industrial Reconstruction Corporation of India (IRCI) with the main objective of reconstruction and rehabilitation of sick industrial undertakings. The IRCI was converted into a statutory corporation in March 1985 and renamed as the Industrial Reconstruction Bank of India (IRBI). In 1997, the IRBI has to be completely restructured since it itself has become sick due to financing of sick industries. Now, it is converted into a limited company with a new name of Industrial Investment Bank of India (IIBI). Its objective is to finance only for expansion, diversification, modernization etc., of industries and thus it has become a development bank.

The Small Industries Development Bank of India (SIDBI) was set up as a wholly owned subsidiary of IDBI. It commenced operations on April 2, 1990. The SIDBI has taken over the responsibility of administrating the Small Industries Development Fund and the National Equity Fund.

Institution for Financing Agriculture

In 1963, the RBI set up the Agricultural Refinance and Development Corporation (ARDC) to provide refinance support to banks to finance major development projects such as minor irrigation, farm mechanization,, land development, horticulture, daily development, etc. However, in July 1982, the National Bank for Agriculture and Rural Development (NABARD) was established and the ARDC was merged with it. The whole sphere of agricultural finance has been handed over to NABARD. The functions of the Agricultural Credit Department and Rural Planning and Credit Cell of the RBI have been taken over by NABARD.

Institution for Foreign Trade

The Export and Import Bank of India (EXIM Bank) was set up on January 1, 1982 to take over the operations of International Finance wing of the IDBI. Its main objective is to provide financial assistance to exporters

and importers. It functions as the principal financial institution for coordinating the working of other institutions engaged in financing of foreign trade. It also provides refinance facilities to other financial institutions against their export-import financing activities.

Institution for Housing Finance

The National Housing Bank (NHB) has been set up on July 9, 1988 as an apex institution to mobilize resources for the housing sector and to promote housing finance institutions both at regional and local levels. It also provides refinance facilities to housing finance institutions and scheduled banks. It also provides guarantee and underwriting facilities to housing finance institutions. Again, it co-ordinates the working of all agencies connected with housing.

Stock Holding Corporation of India Ltd. (SHCIL)

Recently in 1987 another institution viz., Stock Holding Corporation of India Ltd. was set up to tone up the stock and capital markets in India. Its main objective is to provide quick share transfer facilities, clearing services, Depository services, support services, management information services and development services to investors both individuals and corporates. The SHCIL was set up by seven All India financial institutions viz., IDBI, IFCI, ICICI, LIC, GIC, UTI and IRBI.

Mutual Funds Industry

Mutual funds refer to the funds raised by financial service companies by pooling the savings of the public and investing them in a diversified portfolio. They provide investment avenues for small investors who cannot participate in the equities of big companies. Mutual funds have been floated by some public sector banks, LIC, GIC and recently by private sector also.

Venture Capital Institutions

Venture capital is another method of financing in the form of equity participation. A venture capitalist finances a project based on the potentialities of a new innovative project. Much thrust is given to new ideas or technological innovations. Indeed it is a long term risk capital to finance high technology projects. The IDBI venture capital fund was set up in 1986. The IFCI has started a subsidiary to finance venture capital viz., The Risk Capital and Technology Finance Corporation (RCTC). Likewise the ICICI and the UTI have jointly set up the Technology Development and Information Company of India Limited (TDICI) in 1988 to provide venture capital. Similarly many State Financial Corporations and commercial banks have started subsidiaries to provide venture capital. The Indus Venture Capital Fund and the Credit Capital Venture Fund Limited come under the private sector.

Credit Rating Agencies

Of late, many credit rating agencies have been established to help investors to make a decision of their investment in various instruments and to protect them from risky ventures. At the same time it has the effect of improving the competitiveness of the companies so that one can excel the other. Credit rating is now mandatory for all debt instruments. Similarly, for accepting deposits, non-banking companies have to compulsorily go for credit rating. Some of the credit rating agencies established re :

(i) Credit Rating and Information Services of India Ltd. (CRISIL)

(ii) Investment Information and Credit Rating Agency of India Ltd. (ICRA)

(iii) Credit Analysis and Research Ltd. (CARE)

(iv) Duff Phelps Credit Rating Pvt. Ltd. (DCR India)

The rating is confined to fixed deposits, debentures, preference shares and short term instruments like commercial paper. The establishment of various credit rating agencies will go a long way in stabilizing the financial system in India by supplying vital credit information about corporate customers.

Multiplicity of Financial Instruments

The expansion in size and number of financial institutions has consequently led to a considerable increase in the financial instruments also. New instruments have been introduced in the form of innovative schemes of LIC, UTI, Banks, Post Office Savings Bank Accounts, Shares and debentures of different varieties, Public Sector Bonds, National Savings Scheme, National Savings Certificates, Provident Funds, Relief Bonds, Indira Vikas Patra, etc. Thus different types of instruments are available in the financial system so as to meet the diversified requirements of varied investors and thereby making the system more healthy and vibrant.

Legislative Support

The Indian financial system has been well supported by suitable legislative measures taken by the Government then and there for its proper growth and smooth functioning. Though there are many enactments, some of them are very important. The Indian Companies Act was passed in 1956 with a view to regulating the function of companies from birth to death. It mainly aims at giving more protection to investors since there is a diversity of ownership and management in companies. It was a follow up to the Capital Issues Control Act passed in 1947. Again, in 1956, the Securities Contracts (Regulations) Act was passed to prevent undesirable transactions in securities. It mainly regulates the business of trading in the stock exchanges. This Act permitted only recognized stock exchanges to function.

To ensure the proper functioning of the economic system and to prevent concentration of economic power in the hands of a few, the Monopolies and Restrictive Trade Practices Act was passed in 1970. In 1973, the Foreign Exchange Regulations Act was enacted to regulate the foreign exchange dealings and to control Indian investments abroad and vice versa.

The Capital Issue Control Act was replaced by setting up of the Securities Exchange Board of India. Its main objective is to protect the interest of investors by suitably regulating the dealings in the stock market and money market so as to achieve efficient and fair trading in these markets. When the Government adopted the New Economic Policy, many of these Acts were amended so as to remove many unwanted controls. Bank and financial institutions have been permitted to become members of the stock market in India. They have been permitted to float mutual funds, undertake leasing business, carry out factoring services etc.

Besides the above, the Indian Contract Act, The Negotiable Instruments Act, The Law of Limitation Act, The Banking Regulations Act, The Stamp Act etc., deserve a special mention. When the financial system grows, the necessity of regulating it also grows side by side by means of bringing suitable legislations. These legislative measures have re-organised the Indian financing system to a greater extent and have restored confidence in the minds of the investing public as well.

1.5 WEAKNESSES OF INDIAN FINANCIAL SYSTEM

After the introduction of planning, rapid industrialization has taken place. It has in turn led to the growth of the corporate sector and the Government sector. In order to meet the growing requirements of the Government and the industries, many innovative financial instruments have been introduced. Besides, there has been a mushroom growth of financial intermediaries to meet the ever growing financial requirements of different types of customers. Hence, the Indian financial system is more developed and integrated today than what it was 50 years ago. Yet, it suffers from some weaknesses as listed below:

(i) Lack of Co-ordination between different Financial Institutions

There are a large number of financial intermediaries. Most of the vital financial institutions are owned by the Government. At the same time, the Government is also the controlling authority of these institutions. In these circumstances, the problem of co-ordination arises. As there is multiplicity of institutions in the Indian financial system, there is lack of co-ordination in the working of these institutions.

(ii) Monopolistic Market Structures

In India some financial institutions are so large that they have created a monopolistic market structures in the financial system. For instance the entire life insurance business is in the hands of LIC. The UTI has more or less monopolized the mutual fund industry. The weakness of this large structure is that it could lead to inefficiency in their working or mismanagement or lack of effort in mobilizing savings of the public and so on. Ultimately it would retard the development of the financial system of the country itself.

(iii) Dominance of Development Banks in Industrial Financing

The development banks constitute the backbone of the Indian financial system occupying an important place in the capital market. The industrial financing today in India is largely through the financial institutions created by the Government both at the national and regional levels. These development banks act as distributive agencies only, since, they derive most of their funds, from their sponsors. As such, they fail to mobilize the savings of the public. This would be a serious bottleneck which stands in the way of the growth of an efficient financial system in the country. For industries abroad, institutional finance has been a result of institutionalization of personal savings through media like banks, LIC, pension and provident funds, unit trusts and so on. But they play a less significant role in Indian financial system, as far as industrial financing is concerned. However, in recent times attempts are being made to raise funds from the public through the issue of bonds, units, debentures and so on. It will go a long way in forging a link between the normal channels of savings and the distributing mechanism.

(iv) Inactive and Erratic Capital Market

The important function of any capital market is to promote economic development through mobilization of savings and their distribution to productive ventures. As far as industrial finance in India is concerned, corporate customers are able to raise their financial resources through development banks. So, they need not go to the capital market. Moreover, they don't resort to capital market since it is very erratic and inactive. Investors too prefer investments in physical assets to investments in financial assets. The weakness of the capital market is a serious problem in our financial system.

(v) Imprudent Financial Practice

The dominance of development banks has developed imprudent financial practice among corporate customers. The development banks provide most of the funds in the form of term loans. So there is a preponderance of debt in the financial structure of corporate enterprises. This predominance of debt capital has made the capital structure of the borrowing concerns uneven and lopsided. To make maters worse, when corporate enterprises face any financial crises, these financial institutions permit a greater use of debt than a warranted. It is against the traditional concept of a sound capital structure.

However, in recent times all efforts have been taken to activate the capital market. Integration is also taking place between different financial institutions. For instance, the Unit Linked Insurance Schemes of the UTI are being offered to the public in collaboration with the LIC. Similarly the refinance and rediscounting facilities provided by the IDBI aim at integration. Thus, the Indian financial system has become a developed one.

CHART-1

WORKING OF FINANCIAL SYSTEM

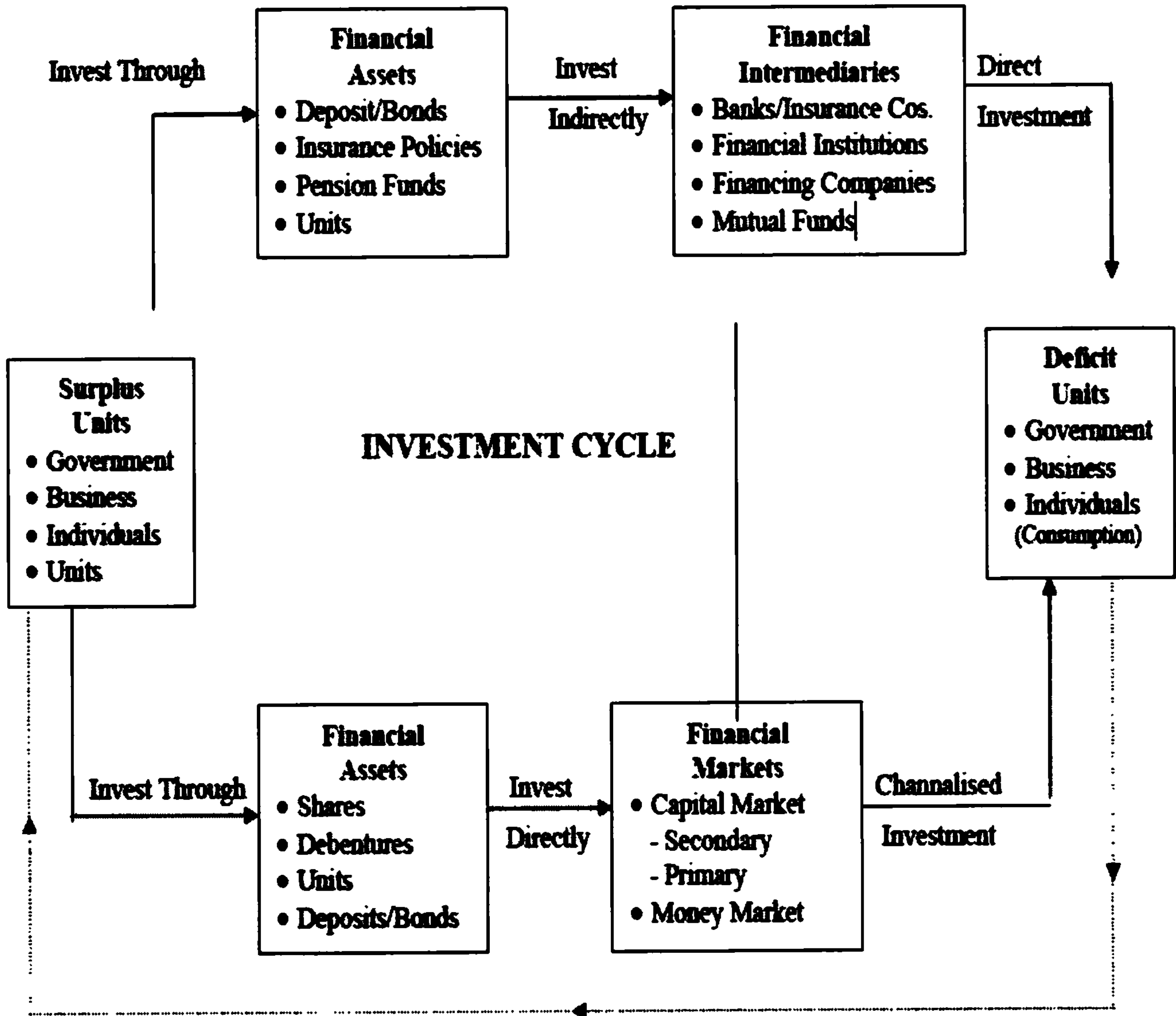


CHART-II

FINANCIAL INTERMEDIARIES IN INDIA

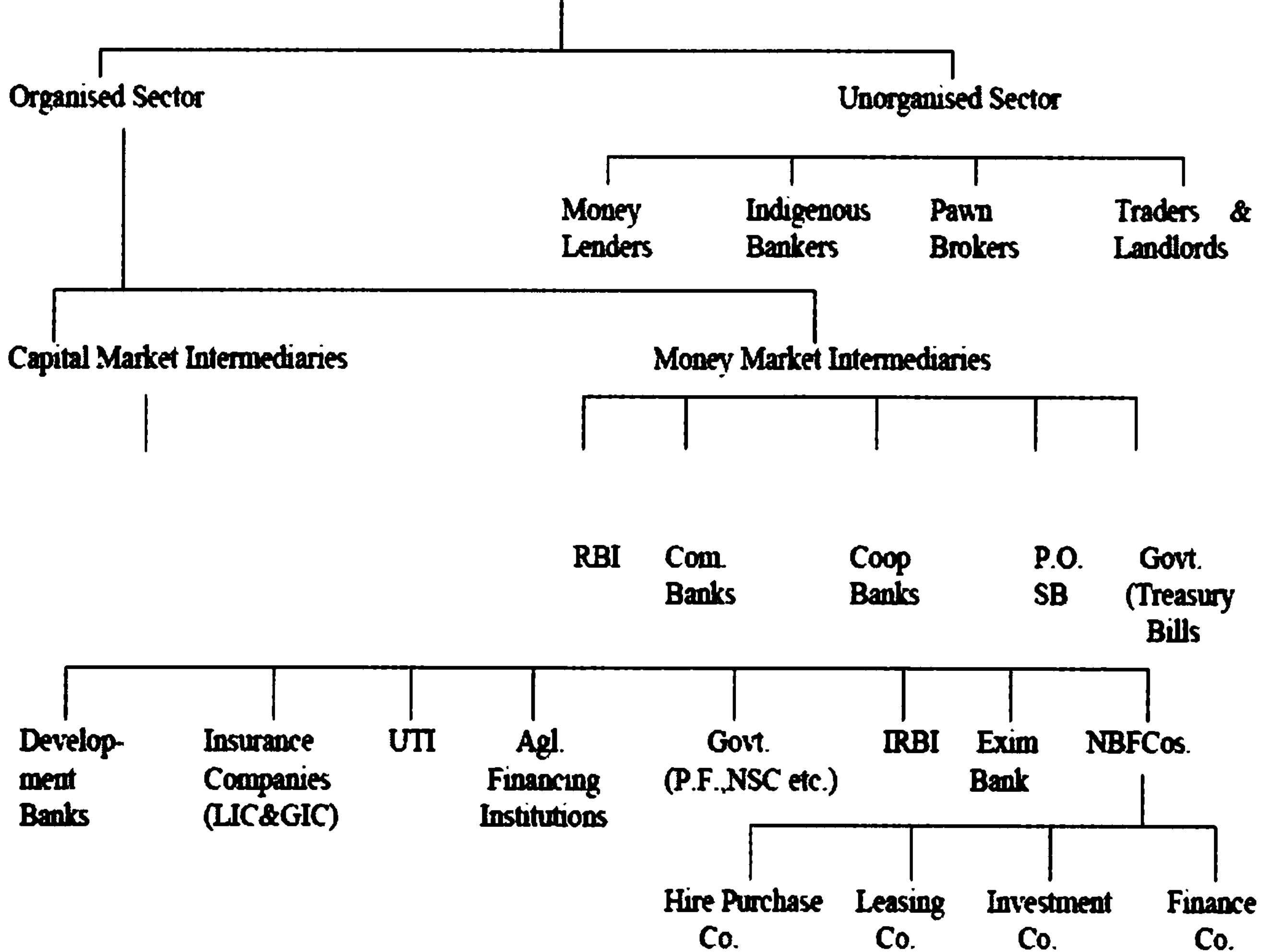
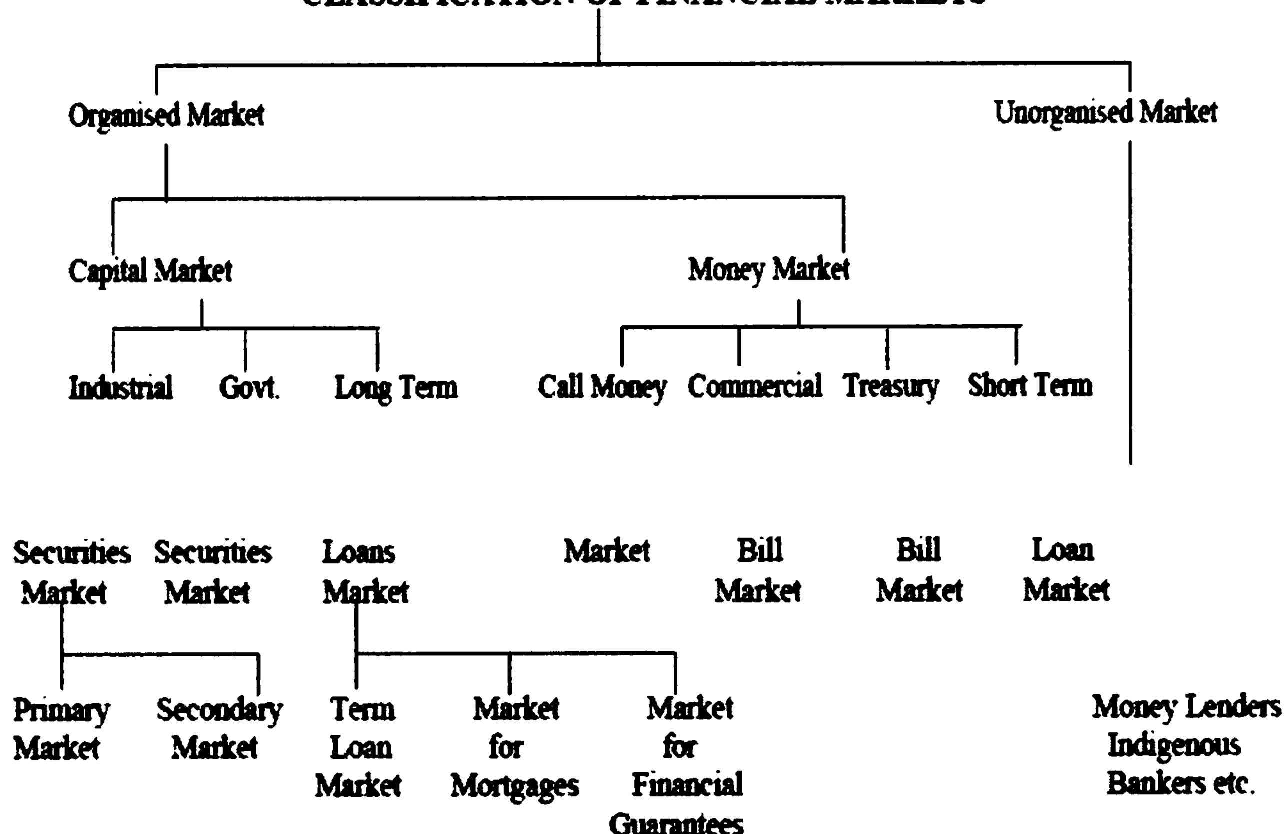


CHART-III

CLASSIFICATION OF FINANCIAL MARKETS



1.6.MEANING OF FINANCIAL SERVICES

The Indian Financial services industry has undergone a metamorphosis since 1990. During the late seventies and eighties, the Indian financial service industry was dominated by commercial banks and other financial institutions which cater to the requirements of the Indian industry. Infact the capital market played a secondary role only. The economic liberalization has brought in a complete transformation in the Indian financial services industry.

Prior to the economic liberalization, the Indian financial service sector was characterized by so many factors which retarded the growth of this sector. Some of the significant factors were:

(i) Excessive controls in the form of regulations of interest rates, money rates etc.

(ii) Too many control over the prices of securities under the erstwhile Controller of Capital Issues.

(iii) Non-availability of financial instruments on a large scale as well as on different varieties.

(iv) Absence of independent credit rating and credit research agencies.

(v) Strict regulation of the foreign exchange market with too many restrictions on foreign investment and foreign equity holding in Indian companies.

(vi) Lack of information about international developments in the financial sector.

(vii) Absence of a developed Government securities market and the existence of stagnant capital market without any reformation.

(viii) Non-availability of debt instruments on a large scale.

However, after the economic liberalisation, the entire financial sector has undergone a sea-saw change and now we are witnessing the emergence of new financial products and services almost everyday. Thus, the present scenario is characterized by financial innovation and financial creativity and before going deep into it, it is imperative that one should understand the meaning and scope of financial services.

In general, all types of activities which are of a financial nature could be brought under the term 'financial services'. The term "Financial Services" in a broad sense means "mobilizing and allocating savings". Thus, it includes all activities involved in the transformation of saving into investment.

The 'financial service' can also be called 'financial intermediation' Financial intermediation is a process by which funds are moblised from a large number of savers and make them available to all those who are in need of it and particularly to corporate customers. Thus, financial services sector is a key are and it is very vital for industrial developments. A well developed financial services industry is absolutely necessary to mobilize the savings and to allocate them to various investable channels and thereby to promote industrial development in a country.

1.7. CLASSIFICATION OF FINANCIAL SERVICES INDUSTRY

The financial intermediaries in India can be traditionally classified into two:

(i) Capital market intermediaries and (ii) Money market intermediaries.

The capital market intermediaries consist of term lending institutions and investing institutions which mainly provide long term funds. On the other hand, money market consists of commercial banks, co-operative banks and other agencies which supply only short term funds. Hence, the term 'financial services industry' includes all kinds of organizations which intermediate and facilitate financial transactions of both individuals and corporate customers.

1.8. SCOPE OF FINANCIAL SERVICES

Financial services cover a wide range of activities. They can be broadly classified into two namely:

(i) Traditional activities

(ii) Modern activities

Traditional activities

Traditionally, the financial intermediaries have been rendering a wide range of services encompassing both capital and money market activities. They can be grouped under two heads viz;

(i) Fund based activities and

(ii) Non-fund based activities

Fund based activities : The traditional services which come under fund based activities are the following:

(i) Underwriting of or investment in shares, debentures, bonds etc. of new issues (primary market activities)

(ii) Dealing in secondary market activities.

(iii) Participating in money market instruments like commercial papers, certificate of deposits, treasury bills, discounting of bills etc.

(iv) Involving in equipment leasing, hire purchase, venture capital, seed capital etc.

(v) Dealing in foreign exchange market activities.

Non-fund based activities : Financial intermediaries provide services on the basis of non-fund activities also. This can also be called "fee based" activity. Today, customers whether individual or corporate are not satisfied with mere provision of finance. They expect more from financial service companies. Hence, a wide variety of services, are being provided under this head. They include the following :

(i) Managing the capital issues i.e., management of pre-issue and post-issue activities relating to the capital issue in accordance with the SEBI guidelines and thus enabling the promoters to market their issues.

(ii) Making arrangements for the placement of capital and debt instruments with investment institutions.

(iii) Arrangement of funds from financial institutions for the clients' project cost or his working capital requirements.

(iv) Assisting in the process of getting all Government and other clearances.

Modern activities

Besides the above traditional services, the financial intermediaries render innumerable services in recent times. Most of them are in the nature of non-fund based activity. In view of the importance, these activities have been discussed in brief under the head 'New financial products and services'. However, some of the modern services provided by them are given in brief hereunder:

(i) Rendering project advisory services right from the preparation of the project report till the raising of funds for starting the project with necessary Government approval.

(ii) Planning for mergers and acquisitions and assisting for their smooth carry out.

(iii) Guiding corporate customers in capital restructuring.

(iv) Acting as Trustees to the debenture-holders.

(v) Recommending suitable changes in the management structure and management style with a view to achieving better results.

(vi) Structuring the financial collaboration/joint ventures by identifying suitable joint venture partner and preparing joint venture agreement.

(vii) Rehabilitating and reconstructing sick companies through appropriate scheme of reconstruction and facilitating the implementation of the scheme.

(viii) Hedging of risk due to exchange rate risk, interest rate risk, economic risk and political risk by using swaps and other derivative products.

(ix) Managing the portfolio of large Public Sector Corporations.

(x) Undertaking risk management services like insurance services, buy-back options etc.

(xi) Advising the clients on the question of selecting the best source of funds taking into consideration the quantum of funds required, their cost, lending period etc.

(xii) Guiding the clients in the minimization of the cost of debt and in the determination of the optimum debt-equity mix.

(xiii) Undertaking services relating to the capital market such as:

- (a) Clearing services,
- (b) Registration and transfers,
- (c) Safe-custody of securities,
- (d) Collection of income on securities.

(xiv) Promoting credit rating agencies for the purpose of rating companies which want to go public by the issue of debt instruments.

1.9. CAUSES FOR FINANCIAL INNOVATION

Financial intermediaries have to perform the task of financial innovation to meet the dynamically changing needs of the economy and to help the investors cope with an increasingly volatile and uncertain market [illegible]. There is a dire necessity for the financial intermediaries to go for innovation due to the following reasons:

(i) Low profitability : The profitability of the major financial intermediary, namely the banks has been very much affected in recent times. There is a decline in the profitability of traditional banking products. So they have been compelled to seek out new products which may fetch high returns.

(ii) Keen competition : The entry of many financial intermediaries in the financial sector market has led to severe competition amount themselves. This keen competition has paved the way for the entry of varied nature of innovative financial products so as to meet the varied requirements of the investors.

(iii) Economic Liberalisation : Reform of the financial sector constitutes the most important component of India's programme towards economic liberalization. The recent economic liberalization measures have opened the door to foreign competitors to enter into our domestic market. Deregulation in the form of elimination of exchange controls and interest rate ceilings have made the market more competitive. Innovation has become a must for survival.

(iv) Improved communication technology : The communication technology has become so advanced that even the world's issuers can be linked with the investors in the global financial market without any difficulty by means of offering so many options and opportunities. Hence, innovative products are brought into the domestic market in no time.

(v) Customer Service : Now-a-days, the customer's expectations are very great. They want newer products at lower cost or at lower credit risk to replace the existing ones. To meet this increased customer sophistication, the financial intermediaries are constantly undertaking research in order to invent a new product which may suit to the requirement of the investing public. Innovations thus help them in soliciting new business.

(vi) Global impact : Many of the providers and users of capital have changed their roles all over the [illegible] financial intermediaries have come out of their traditional approach and they are ready to assume [illegible] credit risks. As a consequence, many innovations have taken place in the global financial sector which have its own impact on the domestic sector also.

(vii) Investor awareness : With a growing awareness amongst the investing public, there has been a distinct shift from investing the savings in physical assets like gold, silver, land etc. to financial assets like shares, debentures, mutual funds etc. Again, within the financial assets, they go from 'risk free' bank deposits to risky investments in shares. To meet the growing awareness of the public, innovation has become the need of the hour.

Financial Engineering

Thus, the growing need for innovation has assumed immense importance in recent times. This process is being referred to as financial engineering. Financial engineering is the lifeblood of any financial ability. "Financial engineering is the design, the development and the implementation of innovative financial instruments and processes and the formulation of creative solutions to problems in finance".

1.10. NEW FINANCIAL PRODUCTS AND SERVICES

Today, the importance of financial services is gaining momentum all over the world. In these days of complex finance, people expect a Financial Service Company to play a very dynamic role not only as a provider of finance but also as a departmental store of finance. With the injection of the economic liberation policy into our economy and the opening of the economy to multinationals, the free market concept has assumed much significance. As a result, the clients both corporates and individuals are exposed to the phenomena of volatility and uncertainty and hence they expect the financial service company to innovate new products and service so as to meet their varied requirements.

As a result of innovations, new instruments and new products are emerging in the capital market. The capital market and the money market are getting widened and deepened. Moreover, there has been a structural change in the international capital market with the emergence of new products and innovative techniques of operation in the capital market. Many financial intermediaries including banks have already started expanding their activities in the financial services sector by offering a variety of new products. As a result, sophistication and innovations have appeared in the arena of financial intermediations. Some of them are discussed below :

(i) Merchant Banking : A merchant banker is a financial intermediary who helps to transfer capital from those who posses it to those who need it. Merchant banking includes a wide range of activities such as management of customers securities, portfolio management, project counseling and appraisal, underwriting of shares and debentures, loan syndication, acting as banker for the refund orders, handling interest and dividend warrants etc. Thus, a merchant banker renders a host of services to corporates and thus promotes industrial development in the country.

(ii) Loan Syndication : This is more or less similar to 'consortium financing'. But, this work is taken up by the merchant banker as a lead-manager. It refers to a loan arranged by a bank called lead manager for a borrower who is usually a large corporate customer or a Government Department. The other banks who are willing to lend can participate in the loan by contributing an amount suitable to their own lending policies. Since a single bank cannot provide such a huge sum as loan, a number of banks join together and form a syndicate. It also enables the members of the syndicate to share the credit risk associated with a particular loan among themselves.

(iii) Leasing : A lease is an agreement under which a company or a firm, acquires a right to make use of a capital asset like machinery, on payment of a prescribed fee called "rental charges". The lessee cannot acquire any ownership to the asset, but he can use it and have full control over it. he is expected to pay for all maintenance charges and repairing and operating costs. In countries like the U.S.A., the U.K. and Japan equipment leasing is very popular and nearly 25% of plant and equipment is being financed by leasing

companies. In India also, many financial companies have started equipment leasing business. Commercial banks have also been permitted to carry on this business by forming subsidiary companies.

(iv) Mutual Funds : A mutual fund refers to a find raised by a financial service company by pooling the savings of the public. It is invested in a diversified portfolio with a view to spreading and minimizing risk. The fund provides investment avenue for small investors who cannot participate in the equities of big companies. It ensures low risk, steady returns, high liquidity and better capital appreciation in the long run.

(v) Factoring : Factoring refers to the process of managing the sales ledger of a client by a financial service company. In other words, it is an arrangement under which a financial intermediary assumes the credit risk in the collection of book debts for its clients. The entire responsibility of collecting the book debts passes on to the factor. His services can be compared to a *del credre agent* who undertakes to collect debts. But, a factor provides credit information, collects debts, monitors the sales ledger and provides finance against debts. Thus, he provides a number of services apart from financing.

(vi) Forfeiting : Forfeiting is a technique by which a forfeitor (financing agency) discounts an export bill and pay ready cash to the exporter who can concentrate on the export front without bothering about collection of export bills. The forfeitor does so without any recourse to the exporter and the exporter is protected against the risk of non-payment of debts by the importers.

(vii) Venture Capital : A venture capital is another method of financing in the form of equity participation. A venture capitalist finances a project based on the potentialities of a new innovative project. It is in contrast to the conventional "security based financing". Much thrust is given to new ideas or technological innovations. Finance is being provided not only for 'start-up capital' but also for 'development capital' by the financial intermediary.

(viii) Custodial Services : It is another line of activity which has gained importance, of late. Under this, a financial intermediary mainly provides services to clients, particularly to foreign investors, for a prescribed fee. Custodial services provide agency services like safe keeping of shares and debentures, collection of interest and dividend and reporting of matters on corporate developments and corporate securities to foreign investors.

(ix) Corporate Advisory Service : Financial intermediaries particularly banks have set up corporate advisory service branches to render services exclusively to their corporate customers. For instance, some banks have extended computer terminals to their corporate customers to that they can transact some of their important banking transactions by sitting in their own office. As new avenues of finance like Euro loans, GDRs etc. are available to corporate customers, this service is of immense help to the customers.

(x) Securitisation : Securitisation is a technique whereby a financial company converts its ill-liquid, non-negotiable and high value financial assets into securities of small value which are made tradable and transferable. A financial institution might have a lot of its assets blocked up in assets like real estate, machinery etc. which are long term in nature and which are non-negotiable. In such cases, securitisation would help the financial institution to raise cash against such assets by means of issuing securities of small values to the public. Like any other security, they can be traded in the market. it is best suited to housing finance companies whose loans are always long term in nature and their money is locked up for a considerable long period in real estates. Securitisation is the only answer to convert these ill-liquid assets into liquid assets.

(xi) Derivative Security : A derivative security is a security whose value depends upon the values of other basic variables backing the security. In most cases, these variables are nothing but the prices of

traded securities. A derivative security is basically used as a risk management tool and it is resorted to cover the risk due to price fluctuations by the investments manager. Just like a forward contract which is a derivative of a spot contract, a derivative security is derived from other trading securities backing it. Naturally the value of a derivative security depends upon the values of the backing securities. Derivative helps to break the risks into various components such as credit risk, interest rates risk, exchange rates risk and so on. It enables the various risk components to be identified precisely and priced them and even traded them if necessary. Financial intermediaries can go for derivatives since they will have greater importance in the near future. In India some forms of derivatives are in operation.

(xii) New Products in Forex Market : New products have also emerged in the forex markets of developed countries. Some of these products are yet to make full entry in Indian markets. Among them, the following are the important ones :

(a) Forward Contracts : A forward transaction is one where the delivery of a foreign currency takes place at a specified future date for a specified price. It may have a fixed maturity for e.g. 31st May or a flexible maturity for e.g. 1st to 31st May. There is an obligation to honour this contract at any cost, failing which, there will be some penalty. Forward contracts are permitted only for genuine business transactions. It can be extended to other transactions like interest payments.

(b) Options : As the very name implies, it is a contract wherein the buyer of the option has a right to buy or sell a fixed amount of currency against another currency at a fixed rate on a future date according to his option. There is no obligation to buy or sell, but it is completely left to his option. Options may be of two types namely call options and put options. Under call options, the customer has an option to buy and it is the option to sell under put options. Options trading would lead to speculation and hence there are much restrictions in India.

(c) Futures : It is a contract wherein there is an agreement to buy or sell a stated quantity of foreign currency at a future date at a price agreed to between the parties on the stated exchange. Unlike options, there is an obligation to buy or sell foreign exchange on a future date at a specified rate. it can be dealt only in a stock exchange.

(d) Swaps : A swap refers to a transaction wherein a financial intermediary buys and sells a specified foreign currency simultaneously for different maturity dates-say, for instance, purchase of spot and sale of forward or vice versa with different maturities. Thus swaps would result in simultaneous buying and selling of the same foreign currency of the same value for different maturities to eliminate exposure risk. It can also be used as a tool to enter arbitrage operations, if any, between two countries. It can also be used in the interest rate market also.

(xiii) Lines of Credit (LOC) : It is an innovative funding mechanism for the import of goods and services on deferred payment terms. LOC is an arrangement of financing institution/bank of one country with another institution/bank/agent to support the export of goods and services to as to enable the importers to import no deferred payment terms. This may be backed by a guarantee furnished by the institution/bank in the importing country. The LOC helps the exporters to get payment immediately as soon as the goods are shipped, since, the funds would be paid out of the pool account with the financing agency and it would be debited to the account of the borrower agency/importer whose contract for availing the facility is already approved by the financing agency on the recommendation of the overseas institution. It acts as conduct of financing which is for a certain period and on certain terms for the required goods to be imported. The greatest advantage is that it saves a lot of time and money on mutual verification of bonafides, source of finance etc. It serves as a source of forex.

1.11. INNOVATIVE FINANCIAL INSTRUMENTS

In recent years, innovation has been the key word behind the phenomenal success of many of the financial service companies and it forms an integral part of all planning and policy decisions. This has helped them to keep in tune with the changing times and changing customer needs. Accordingly, many innovative financial instruments have come into the financial market in recent times. Some of them have been discussed hereunder:

(i) Commercial Paper : A paper is a short-term negotiable money market instrument. It has the character of an unsecured promissory note with a fixed maturity of 3 to 6 months. Banking and non-banking companies can issue this for raising their short term debt. It also carries an attractive rate of interest. Commercial papers are sold at a discount from their face value and redeemed at their face value. Since its denomination is very high, it is suitable only to institutional investors and companies.

(ii) Treasury Bill : A treasury bill is also a money market instrument issued by the Central Government. It is also issued at a discount and redeemed at par. Recently, the Government has come out with short term treasury bills of 182-days bills and 364-days bills.

(iii) Certificate of Deposit : The scheduled commercial banks have been permitted to issue certificate of deposit without any regulation on interest rates. This is also a money market instrument and unlike a fixed deposit receipt, it is a negotiable instrument and hence it offers maximum liquidity. As such, it has a secondary market too. Since the denomination is very high, it is suitable to mainly institutional investors and companies.

(iv) Inter-bank Participations (IBPs) : The scheme of inter-bank participation is confined to scheduled banks only for a period ranging between 91 days and 180 days. This may be 'with risk' participation or 'without risk' participation. However, only a few banks have so far issued IBPs carrying an interest rate ranging between 14 and 17 per cent per annum. This is also a money market instrument.

(v) Zero Interest Convertible Debenture/Bonds : As the very name suggests, these instruments carry no interest till the time of conversion. These instruments are converted into equity shares after a period of time.

(vi) Deep Discount Bonds : There will be no interest payments in the case of deep discount bonds also. Hence, they are sold at a large discount to their nominal value. For example, the Industrial Development Bank of India issued in February 1996 deep discount bonds. Each bond having a face value of Rs.2,00,000 was issued at a deep discounted price of Rs.5300 with a maturity period of 25 years. Of course, provisions are there for early withdrawal or redemption in which case the deemed face value of the bond would be reduced proportionately. This bond could be gifted to any person.

(vii) Index-Linked Guilt Bonds : These are instruments having a fixed maturity. Their maturity value is linked to the index prevailing as on the date of maturity. Hence, they are inflation-free instruments.

(viii) Option Bonds : These bonds may be cumulative or non-cumulative as per the option of the holder of the bonds. In the case of cumulative bonds, interest is accumulated and is payable only on maturity. But, in the case of non-cumulative bond, the interest is paid periodically. This option has to be exercised by the prospective investor at the time of investment.

(ix) Secured Premium Notes : These are instruments which carry no interest of three years. In other words, their interest will be paid only after 3 years, and hence, companies with high capital intensive investments can resort to this type of financing.

(x) Medium Term Debentures : Generally, debentures are repayable only after a long period. But, these debentures have a medium term maturity. Since they are secured and negotiable, they are highly liquid. These types of debt instruments are very popular in Germany.

(xi) Variable Rate Debentures : Variable rate debentures are debt instruments. They carry a compound rate of interest, but this rate of interest is not a fixed one. It varies from time to time in accordance with some pre-determined formula as we adopt in the case of Dearness Allowance calculations.

(xii) Non-Convertible Debentures with Equity Warrants : Generally debentures are redeemed on the date of maturity. but, these debentures are redeemed in full at a premium in instalments as in the case of anticipated insurance policies. The instalments may be paid at the end of 5th, 6th, 7th and 8th year from the date of allotment.

(xiii) Equity with 100% Safety Net : Some companies make "100% safety net" offer to the public. It means that they give a guarantee to the issue price. Suppose, the issue price is Rs.40/- per share (nominal value of Rs.10/- per share), the company is ready to get it back at Rs.40/- at any time, irrespective of the market price. That is, even if the market price comes down to Rs.30/- there is 100% safety net and hence the company will get it back at Rs.40/-.

(xiv) Cumulative convertible Preference Shares : These instruments along with capital and accumulated dividend must be compulsorily converted into equity shares in a period of 3 to 5 years from the date of their issue, according to the discretion of the issuing company. The main object of introducing it is to offer the investor an assured minimum return together with the prospect of equity appreciation. This instrument is not popular in India.

(xv) Convertible Bonds : A convertible bond is one which can be converted into equity shares at a per-determined timing neither fully or partially. There are compulsory convertible bonds which provide for conversion within 18 months of their issue. There are optionally convertible bonds which provide for conversion within 36 months. There are also bonds which provide for conversion after 36 months and they carry 'call' and 'put' features.

(xvi) Debentures with 'Call' and 'Put' Feature : Sometimes debentures may be issued with 'Call' and 'Put' feature. In the case of debentures with 'Call feature', the issuing company has the option to redeem the debentures at a certain price before the maturity date. In the case of debentures with 'Put features', the company gives the holder the right to seek redemption at specified times at predetermined prices.

(xvii) Easy Exit Bond : As the name indicates, this bond enables the small investors to encash the bond at any time after 18 months of its issue and thereby paving a way for an easy exit. It has a maturity period of 10 years with a call option any time after 5 years. Recently the IDBI has issued this type of bond with a face value of Rs.5000 per bond.

(xviii) Retirement Bond : This type of bond enables an investor to get an assured monthly income for a fixed period after the expiry of the 'wait period' chosen by him. No payment will be made during the 'wait period'. The longer the wait period, the higher will be the monthly income. Besides these, the investor will also get a lump sum amount on maturity. For example, the IDBI has issued Retirement Bond '96 assuring a fixed monthly income for 10 years after the expiry of the wait period. This bond can be gifted to any person.

(xix) Regular Income Bond : This bond offers an attractive rate of interest payable half yearly with the facility of early redemption. The investor is assured of regular and fixed income. For example, the IDBI has issued Regular Income Bond '96 carrying 16% interest p.a. It is redeemable at the end of every year from the expiry of 3 years from the date of allotment.

(xx) Infrastructure Bond : It is a kind of debt instrument issued with a view to giving tax shelter to investors. The resources raised through this bond will be used for promoting investment in the field of certain infrastructure industries. Tax concessions are available under Sec.88, Sec.54 EA and Sec.54EB of the Income Tax Act. HUDCO has issued for the first time such bonds. Its face value is Rs.1000 each carrying an interest rate of 15% per annum payable semi annually. This bond will also be listed in important stock exchanges.

(xxi) Carrot and Stick bonds : Carrot bonds have a low conversion premium to encourage early conversion, and sticks allow the issuer to call the bond at a specified premium if the common stock is trading at a specified percentage above the strike price.

(xxii) Convertible Bonds with a Premium put : These are bonds issued at face value with a put, which means that the bond holder can redeem the bonds for more than their face value.

(xxiii) Debt with Equity Warrant : Sometimes bonds are issued with warrants for the purchase of shares. These warrants are separately tradable.

(xxiv) Dual Currency Bonds : Bonds that are denominated and pay interest in one currency and are redeemable in another currency come under this category. They facilitate interest rate arbitrage between two markets.

(xxv) ECU Bonds (European Currency Unit Bonds) : These bonds are denominated in a basket of currencies of the 10 countries that constitute the European community. They pay principal and interest in ECUs or in any of the 10 currencies at the option of the holder.

(xxvi) Yankee Bonds : If bonds are raised in U.S.A., they are called Yankee bonds and if they are raised in Japan, they are called Samurai Bonds.

(xxvii) Flip-Flop Notes : It is a kind of debt instrument which permits investors to switch between two types of securities e.g. to switch over from a long term bond to a short term fixed-rate note.

(xxviii) Floating Rate Notes (FRNs) : These are debt instruments which facilitate periodic interest rate adjustments.

(xxix) Loyalty Coupons : These are entitlements to the holder of debt for two to three years to exchange into equity shares at discount prices. To get this facility, the original subscriber must hold the debt instruments for the said period.

(xxx) Global Depository Receipt (GDR) : A global depository receipt is a dollar denominated instrument traded on a stock exchange in Europe or the U.S.A./ or both. It represents a certain number of underlying equity shares. Though the GDR is quoted and traded in dollar terms, the underlying equity shares are denominated in rupees. The shares are issued by the company to an intermediary called depository in whose name the shares are registered. It is the depository which subsequently issues the GDRs.

1.12. CHALLENGES FACING THE FINANCIAL SERVICES SECTOR

However, the financial service sector has to face many challenges in its attempt to fulfill the ever growing financial demands of the economy. Some of the important challenges are reported hereunder :

(i) Lack of qualified personnel : The financial services sector is fully geared to the task of 'financial creativity'. However, this sector has to face many challenges. In fact, the dearth of qualified and trained personnel is an important impediment in its growth. Hence, it is very vital that a proper and comprehensive training must be given to the various financial intermediaries.

(ii) Lack of investor awareness : The introduction of new financial products and instruments will be of no use unless the investor is aware of the advantages and uses of the new and innovative products and instruments. Hence, the financial intermediaries should educate the prospective investors/users of the advantages of the innovative instruments through literature, seminars, workshops, advertisements and even through audio-visual aids.

(iii) Lack of transparency : The whole financial system is undergoing a phenomenal change in accordance with the requirements of the national and global environments. It is high time that this sector gave up their orthodox attitude of keeping accounts in a highly secret manner. Hence, this sector should opt for better levels of transparency. In other words, the disclosure requirements and the accounting practices have to be in line with the international standards.

(iv) Lack of specialization : In the Indian scene, each financial intermediary seems to deal in different financial service lines without specializing in one or two areas. In other words, each intermediary is acting as a financial super market delivering so many financial products and dealing in different varieties of instruments. In other countries, financial intermediaries like Newtons, Solomon Brothers etc. specialize in one or two areas only. This helps them to achieve high levels of efficiency and excellence. Hence, in India also, financial intermediaries can go for specialization.

(v) Lack of recent data : Most of the intermediaries do not spend more on research. It is very vital that one should build up a proper data base on the basis of which one could embark upon 'financial creativity'. Moreover, a proper data base would keep oneself abreast of the recent developments in other parts of the whole world and above all, it would enable the fund managers to take sound financial decisions.

(vi) Lack of efficient risk management system : With the opening of the economy to multinationals and the exposure of Indian companies to international competition, much importance is given to foreign portfolio flows. It involves the utilization of multi currency transactions which exposes the client to exchange rate risk, interest rate risk and economic and political risk. Unless a proper risk management system is developed by the financial intermediaries as in the West, they would not be in a position to fulfil the growing requirements of their customers. Hence, it is absolutely essential that they should introduce Futures, Options, Swaps and other derivative products which are necessary for an efficient risk management system.

The above challenges are likely to increase in number with the growing requirements of the customers. The financial services sector should rise up to the occasion to meet these challenges by adopting new instruments and innovative means of financing so that it could play a very dynamic role in the economy.

1.13.PRESENT SCENARIO

The present scenario of financial service sector is :

(i) Conservatism to dynamism

At present, the financial system in India is in a process of rapid transformation, particularly after the introduction of reforms in the financial sector. The main objective of the financial sector reforms is to promote an efficient, competitive and diversified financial system in the country. This is very essential to raise the allocative efficiency of available savings, increase the return on investment and thus to promote the accelerated growth of the economy as a whole. As a result, we have recently witnessed phenomenal changes in the money market, securities market, capital market, debt market and the foreign exchange market. In this changed context, the role of financial services has assumed greater significance in our county. At present, numerous new financial intermediaries have started functioning with a view to extending multifarious services to the investing public in the area of financial services. The emergence of various financial institutions and regulatory bodies have transformed the financial services sector from being a conservative industry to a very dynamic one.

(ii) Emergence of Primary Equity Market

Now, we are also witnessing the emergence of many private sector financial services. The capital markets which were very sluggish, have become a popular source of raising finance. The number of stock exchanges in the country has gone up from 9 in 1980 to 24 in 2004. The aggregate funds raised by the industries in the primary markets have gone from up. The number of companies listed on the stock exchange have also gone up from 2265 in 1980 to over 10000 in 2004. Thus, the primary equity market has emerged as an important vehicle to channelise the savings of the individuals and corporates for productive purposes and thus to promote the industrial and economic growth of our nation.

(iii) Concept of Credit Rating

There is every possibility of introducing equity grading. Hitherto, the investment decisions of the investors have been based on factors like name recognition of the company, operations of the group, market sentiments, reputation of the promoters etc. Now, grading from an independent agency would help the investor in his portfolio management and thus, equity grading is going to play a significant role in investment decision-making. From the company point of view, equity grading would help to broaden the market for their public offer, to replace the name recognition by objective opinion and to have a wider investor base. Thus, grading would give further fillip to the primary market. Moreover, the concept of credit rating would play a significant role in identifying the risk level of the corporate entity in which the investor wants to take part.

Now it is mandatory for the non-banking financial companies to get credit rating for their debt instruments. The three major credit rating agencies functioning in India are:

(i) Credit Rating Information Services of India Ltd. (CRISIL)

(ii) Credit Analysis and Research ltd. (CARE) and

(iii) Investment Information and Credit Rating Agency (ICRA)

(iv) Duff Phelps Credit Rating Pvt. Ltd. (DCR India)

Their activities have been mainly confined to debt instruments only.

(iv) Process of Globalisation

Again, the process of globalisation has paved the way for the entry of innovative and sophisticated financial products into our country. Since the Government is very keen in removing all obstacles that stand in the way of inflow of foreign capital, the potentiabilities for the introduction of innovative international financial products in India are very great. Moreover, India is likely to enter the full convertibility era soon. Hence, there is every possibility of introduction of more and more innovative and sophisticated financial services in our country.

(v) Process of Liberalisation

Realizing all these factors, the Government of India has initiated many steps to reform the financial services industry. The Government has already switched over to free pricing of issues from pricing issues. The interest rates have been deregulated. The private sector has been permitted to participate in banking and mutual funds and the public sector undertakings are being privatized. The Securities Exchange Board of India has liberalized many stringent conditions so as to boost the capital and money markets. In this changed context, the financial service industry in India has to play a very position and dynamic role in the years to come by offering many innovative products to suit to the varied requirements of the millions of prospective investors spread throughout the country.

UNIT - II

VENTURE CAPITAL AND MERCHANT BANKING

2.1. INTRODUCTION - CONCEPT OF VENTURE CAPITAL

Venture capital is a growing business of recent origin in the area of industrial financing in India. The various financial institutions set up in India to promote industries have done commendable work. However, these institutions do not come upto the benefit of risky ventures when they are undertaken by new or relatively unknown entrepreneurs. They contend to give debt finance, mostly in the form of term loans to the promoters and their functioning has been more akin to that of commercial banks. The financial institutions have devised schemes such as seed capital scheme, risk capital fund etc., to help new entrepreneurs. However, to evaluate the projects and extend financial assistance they follow the criteria such as safety, security, liquidity and profitability and not potentiality. The capital market with its conventional financial instruments/schemes does not come much to the benefit or risky venture. New institutions such as mutual funds, leasing and hire purchase company's have been established as another source of finance to industries. These institutions also do not mitigate the problems of new entrepreneurs who undertake risky and innovative ventures.

India is poised for a technological revolution with the emergence of new breed of entrepreneurs with required professional temperament and technical know how. To make the innovative technology of the entrepreneurs a successful business venture, support in all respects and more particularly in the form of financial assistance is all the more essential. This has necessitated the setting up of venture capital financing Division/companies during the latter part of eighties.

The term 'Venture Capital' is understood in many ways. In a narrow sense, if refers to, investment in new and tried enterprises that are lacking a stable record of growth.

In a broader sense, venture capital refers to the commitment of capital as shareholding, for the formulation and setting up of small firms specializing in new ideas or new technologies. It is not merely an injection of funds into a new firm, it is a simultaneous input of skill needed to set up the firm, design its marketing strategy and organise and manage it. It is an association with successive stages of firm's development with distinctive types of financing appropriate to each stage of development.

Venture capital is long term risk capital to finance high technology projects which involve risk but at the same time has strong potential for growth. Venture capitalist pool their resources including managerial abilities to assist new entrepreneurs in the early years of the project. Once the project reaches the stage of profitability, they sell their equity holdings at high premium.

A venture capital company is defined as "a financing institution which joins an entrepreneur as a co-promote in a project and shares the risks and rewards of the enterprise."

Features of venture capital

Some of the features of venture capital financing are as under:

1. Venture capital is usually in the form of an equity participation. It may also take the form of convertible debt or long term loan.
2. Investment is made only in high risk but high growth potential projects.

3. Venture capital is available only for commercialisation of new ideas or new technologies and not for enterprises which are engaged in trading, booking, financial services, agency, liaison work or research and development.

4. Venture capitalist joins the entrepreneur as a co-promoter in projects and share the risks and rewards of the enterprise.

5. There is continuous involvement in business after making an investment by the investor.

6. Once the venture has reached the full potential the venture capitalist disinvests his holdings either to the promoters or in the market. The basic objective of investment is not profit but capital appreciation at the time of disinvestments.

7. Venture capital is not just injection of money but also an input needed to setup the firm, design its marketing strategy and organise and manage it.

8. Investment is usually made in small and medium scale enterprises.

2.2. SCOPE OF VENTURE CAPITAL

Venture capital may take various forms at different stages of the project. There are four successive stages of development of a project viz. development of a project idea, implementation of the idea, commercial production and marketing and finally large scale investment to exploit the economics of scale and achieve stability. Financial institutions and banks usually start financing the project only at the second or third stage but rarely from the first stage. But venture capitalists provide finance even from the first stage of idea formulation. The various stages in the financing of venture capital are described below:

(1) Development of an Idea - Seed Finance: In the initial stage venture capitalists provide see capital for translating an idea into business proposition. At this stage investigation is made in-depth which normally takes a year or more.

(2) Implementation Stage - Start up Finance: When the firm is set up to manufacture a product or provide a service, start up finance is provided by the venture capitalists. The first and second stage capital is used for full scale manufacturing and further business growth.

(3) Fledging Stage :- Additional Finance: In the third stage, the firm has made some headway and entered the stage of manufacturing a product but faces teething problem. It may not be able to generate adequate funds and so additional round of financing is provided to develop the marketing infrastructure.

(4) Establishment Stage - Establishment Finance: At this stage the firm is established in the market and expected to expand at a rapid pace. It needs further financing for expansion and diversification so that is can reap economics of scale and attain stability. At the end of the establishment stage, the firm is listed on the stock exchange and at this point the venture capitalist disinvests their shareholdings through available exist routes.

Before investing in small, new or young hi-tech enterprises, the venture capitalists look for percentage of key success factors of a venture capital project. They prefer projects that address these problems.

After assessing the viability of projects, the investors decide for what stage they should provide venture capital so that it leads to greater capital appreciation. All the above stages of finance involve varying degrees of risks and venture capital industry, only after analysing such risks, invest in one or more. Hence they specialize in one or more but rarely all.

2.3. IMPORTANCE OF VENTURE CAPITAL

Venture Capital is of great practical value to every corporate enterprise in modern times.

I. Advantage to Investing Public

1. The investing public will be able to reduce risk significantly against unscrupulous management, if the public invest in venture fund who in turn will invest in equity of new business. With their expertise in the field and continuous involvement in the business they would be able to stop malpractices by management.

2. Investor have no means to vouch for the reasonableness of the claims made by the promoters about profitability of the business. The venture funds equipped with necessary skills will be able to analyses the prospects of the business.

3. The investors do not have any means to ensure that the affairs of the business are conducted prudently. The venture fund having representatives on the Board of Directors of the company would overcome it.

II. Advantages to Promoters

1. The entrepreneur for the success of public issue is required to convince tens of underwriters, brokers and thousands of investors but to obtain venture capital assistance, he will be required to sell his idea to justify the officials of the venture fund.

2. Public issue of equity shares has to be proceeded by a lot of efforts viz. necessary statutory sanctions, underwriting and brokers arrangement, publicity of issue etc. The new entrepreneurs find it very difficult to make underwriting arrangements which involves a great deal of effort. Venture fund assistance would eliminate those efforts by leaving entrepreneur to concentrate upon bread and butter activities of business.

3. Costs of public issues of equity share often range between 10 per cent to 15 per cent of nominal value of issue of moderate size, which are often even higher for small issues. The company is required, in addition to above, to incur recurring costs for maintenance of share registry cell, stock exchange listing fee, expenditure on printing and posting of annual reports etc. These items of expenditure can be ill afforded by the business when it is new. Assistance from venture fund does not require such expenditure.

III. General

1. A developed venture capital institutional set up reduces the time lag between a technological innovation and its commercial exploitation.

2. It helps in developing new processes/products in conducive atmosphere, free from the dead weight of corporate bureaucracy, which helps in exploiting full potential.

3. Venture capital acts as a cushion to support business borrowings, as bankers and investors will not lend money with, inadequate margin of equity capital.

4. Once venture capital funds start earning profits, it will be very easy for them to raise resources from primary capital market in the form of equity and debts. Therefore, the investors would be able to invest in new business through venture funds and, at the same time, they can directly invest in existing business when venture fund disposes its own holding. This mechanism will help to channelise investment in new high-tech business or the existing sick business. These business

will take-off with the help of finance from venture funds and this would help in increasing productivity, better capacity utilisation etc.

5. The economy with well developed venture capital network induces the entry of large number of technocrats in industry, helps in stabilizing industries and in creating a new set of trained technocrats to build and manage medium and large industries, resulting in faster industrial development.

6. A venture capital firm serves as an intermediary between investors looking for high returns for their money and entrepreneurs in search of needed capital for their start ups.

7. It also paves the way for private sector to share the responsibility with public sector.

2.4. GROWTH OF VENTURE CAPITAL IN INDIA:

Indian tradition of venture capital for industry goes back more than 150 years when many of the managing agency houses acted as venture capitalists providing both finance and management skill to risky projects. It was the managing agency system through which Tata Iron and Steels and Empress Mills were able to raise equity capital from the investing public. The Tatas also initiated a managing agency hours, named Investment Corporation of India in 1937 which by acting as venture capitalist, successfully promoted hi-tech enterprises such as CEAT tyres, Associated Bearings, National Rayon etc. The early form of venture capital enabled the entrepreneurs to raise large amount of funds and yet retain management control. After the abolition of managing agency system, the public sector term lending institutions met a part of venture capital requirements through seed capital and risk capital for hi tech industries which were not able to meet promoters contribution. However, all these institutions supported only proven and sound technology while technology development remained largely confined to government labs and academic institutions. Many hi-tech industries, thus, found it impossible to obtain financial assistance from banks and other financial institutions due to unproven technology, conservative attitude, risk awareness and rigid security parameters.

Venture capital's growth in India passed through various stages. In 1973, R.S. Bhatt Committee recommended formation of Rs.100 crore venture capital fund. The Seventh Five Year Plan emphasised the need for developing a system of funding venture capital. The Research and Development Cess Act was enacted in May 1986 which introduced a cess of 5% on all payments made for purchase of technology from abroad. The levy provides the source for the venture capital fund.

United Nations Development Programme in 1987 on behalf of government examined the possibility of developing venture capital in private sector. Technology Policy Implementation Committee in the same year also recommended the same provision. Formalised venture capital took roots when venture capital guidelines were issued by Comptroller of Capital Issues in November 1988.

2.5. METHODS OF VENTURE FINANCING

Venture capital is available in three forms in India

1. Equity
2. Conditional Loan
3. Income Note.

1. Equity: All VCF's in India provide but generally their contribution does not exceed 49% of the total equity capital. VCF's buy equity shares of an enterprise with an intention to ultimately sell of to make capital gain.

2. Conditional Loan : A conditional loan is repayable in the form of royalty after the project generates sales. No interest is paid on such loans. VCF's charge royalty ranging between 2 and 15 per cent. Some VCF's give a choice to the entrepreneur to pay a high interest rate instead of royalty on sales once the project becomes commercially sound.

3. Income note : An income note combines the features of both conventional loan and conditional loan. The entrepreneur has to pay both interest and royalty on sales. Funds are made available in the form unsecured loans at 9 per cent per year during development phase. In addition to interest, royalty on sales could also be charged.

2.6. LEASING – CONCEPT AND ESSENTIALS OF LEASING

Leasing, as a financing concept, is an arrangement between two parties, the leasing company or lessor and the user or lessee, whereby the former arranges to buy capital equipment for the use of the latter for an agreed period of time in return for the payment of rent. The rentals are predetermined and payable at fixed intervals of time, according to the mutual convenience of both the parties. However, the lessor remains the owner of the equipment over the primary period.

By resorting to leasing, the lessee company is able to exploit the economic value of the equipment by using it as if he owned it without having to pay for its capital cost. Lease rentals can be conveniently paid over the lease period out of profits earned from the use of the equipment and the rent is cent percent tax deductible.

Conceptually, a lease may be defined as a contractual arrangement /transaction in which a party owning an asset/equipment (lessor) provides the asset for use to another/transfers the right to use the equipment to the user (lessee). Over a certain/for an agreed period of time for consideration in the form of/in return for periodic payment (rentals) with or without a further payment (premium). At the end of the period of contract (lease period), the asset/ equipment reverts back to the lessor unless there is a provision for the renewal of the contract. Leasing essentially involves the divorce of ownership from the economic use of an asset/equipment. It is a device of financing the cost of an asset. It is a contract in which a specific equipment required by the lessee is purchased by the lessor (Financier) from a manufacturer/vendor selected by the lessee. The lessee has possession and use of the asset on payment of the specified rentals over a predetermined period of time. Lease financing is thus a device of financing/money lending. The real function or a lessor is not renting of asset but lending of funds/finance/credit and lease financing is in effect a contract of lending money. The lessor (financier) is the nominal owner of the asset as the possession and economic use to the equipment vests in the lessee. The lessee is free to choose the asset according to his requirements and the lessor dose not take recourse to the equipment as long as the rentals are regularly paid to him.

The essential elements of leasing are the following :

1. Parties to the Contract : There are essentially two parties to a contract of lease financing, viz, the owner and the user, respectively called the lessor and the lessee Lessors as well as lessees may be individuals, partnerships, joint stock companies, corporations or financial Institution. Sometimes. there may be joint lessors or joint lessess, particularly where the properties or the amount of finance involved is enormous. Besides, there may be a lease-broker who acts as an intermediary in arranging lease deals. Merchant banking divisions of certain foreign banks in India, subsidiaries of some Indian banks and even some private merchant bankers are acting as lease brokers. They charge certain percentage of fees for their services, ranging between 0.50 to I per cent. Besides, a lease contract may involve a 'lease financier', who refinances the lessor, either by providing term loans or by subscribing to equity or under a specific refinance scheme.

2. Asset : The asset, property or equipment to be leased is the subject matter of a contract of lease financing. The asset may be an automobile, plant and machinery, equipment, land and building, factory, a running business, aircraft, etc. The asset must, however, be of the lessee's choice suitable for his business needs.

3. Ownership Separated from user : The essence of a lease financing contract is that during the lease tenure, ownership of the asset vests with the lessor and its use is allowed to the lessee. On the expiry of the lease tenure, the asset reverts to the lessor.

4. Term of Lease : The term of lease is the period for which the agreement of lease remains in operation. Every lease should have a definite period, otherwise it will be legally inoperative. The lease period may sometimes stretch over the entire economic life of the asset (i.e., financial lease) or a period shorter than the useful life of the asset (i.e, operating lease). The lease may be perpetual, i.e., with an option at the end of the lease period to renew the lease for a further specific period.

5. Lease Rentals : The consideration which the lessee pays to the lessor for the lease transaction is the lease rental. The lease rentals are so structured as to compensate the lessor for the investment made in the asset (in the form of depreciation), the interest on the investment, repairs, etc. if any borne by the 1essor and servicing charges over the lease period.

6. Modes of Terminating Lease : At the end ot the lease period, the lease is terminated and various courses are possible, viz.,

(a) The lease is renewed on a perpetual basis or for a definite period,

(b) The asset reverts to the lessor,

(c) The asset reverts to the lessor and the lessor sells it to a third party,

(d) The lessor sells the asset to the lessee.

The parties may mutually agree to and choose any of the aforesaid alternatives at the beginning of the lease nature.

2.7. CLASSIFICATION OF LEASING

An equipment lease transaction can differ on the basis of (1) the extent to which the risks and rewards of ownership are transferred, (ii) number of parties to the transaction, (iii) domiciles of the equipment manufacturer, the lessor and the lessee, etc. Risk with reference to leasing refers to the possibility of loss arising on account of under-utilization or technological obsolescence of the equipment while reward means the incremental net cash flows that are generated from the usage of the equipment over its economic life and the realization of the anticipated residual value on expiry of the economic life. On the basis of these variations, leasing can be classified into the following types:

(a) Finance lease and operating lease

(b) Sales and lease back, and direct lease

(c) Single investor lease and leveraged lease

(d) Domestic lease and International lease

(a) Finance Lease and Operating Lease

Finance Lease : According to the International Accounting Standards (IAS-17), in a finance lease the lessor transfers to the lessee, substantially all the risks and rewards incidental to the ownership of the asset whether or not the title is eventually transferred. It involves payment of rentals over an obligatory non-cancelable lease period, sufficient in total to amortize the capital outlay of the lessor and leave some profit. In such leases, the lessor is only a financier and is usually not interested in the assets. It is for this reason that such leases are also usually not interested in the assests, It is for this reason that such leases are also called full payout leases as they enable a lessor to recover his investment in the lease and device a profit types of assets. Included under such lease are ships, aircraft, railway wagons, lands, building heavy machinery, diesel generating sets and so on.

The IAS-17 stipulates that a substantial part of the ownership related risks and rewards in leasing are transferred when :

(i) The ownership of the equipment is transferred to the lease by the end of the lease term or

(ii) The lease has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair market value at the date the option becomes exercisable and at the stipulation of the lease it is reasonable certain that the option will be exercise

(iii) The lease term is for a major part of the useful life of the asset. The title may not eventually be transferred. The useful life of an asset refers to the minimum of its :

1) Physical life in terms of the period for which it can perform its function,

2) Technological life in the sense of the period in which it does not become obsolete.

3) Product market life deemed as the period during which its product enjoys satisfactory market.

The criterion/cut-off point is that if the lease term exceeds 75 per cent of the useful life of the equipment, it is a finance lease.

(iv) The present value of the minimum lease payment is greater than, or substantially equal to, the fair market value of the asset at the inception of the lease (cost or equipment). The title may or may not be eventually transferred. The cut-off point is that the present value exceeds 90 per cent of the fair market value of the equipment. The present value should be computed using a discount rate equal to the rate implicit in the lease in the case of lessor and, in the case of the lessee, upon the incremental borrowing rate

In India, however, a lease is a finance lease, if one of the last two conditions, is satisfied. A lease agreement with any of the first two conditions is treated as hire-purchase agreement.

A finance lease is structured to include the following features :

(i) The lessee (the intending buyer) selects the equipment according to his requirement from its manufacturer or distributor.

(ii) The lessee negotiates and settles with the manufacturer or distributor, the price, the delivery schedule, installation, terms of warranties, maintenance and payment, etc.

(iii) The lessor purchases the equipment either directly from the manufacturer or distributor (under straight-forward leasing) or from the lessee after the equipment is delivered (under sale and lease back).

(iv) The lessor then leases out the equipment to the lessee. The lessor retains the ownership while lessee is allowed to use the equipment.

(v) A finance lease may provide a right or option, to the lessee, to purchase the equipment at a future date. However, this practice is rarely found in India

(vi) The lease period spreads over the expected economic life of the asset. The lease is originally for a non-cancelable period called the primary lease period during which the lessor seeks to recover his investment along with some profit. During this period cancellation of lease is possible only at a very heavy cost. Thereafter, the lease is subject to renewal for the secondary lease period, during which the rentals are substantially low.

(vii) The lessee is entitled to exclusive and peaceful use of the equipment during the entire lease period provided he pays the rentals and complies with the terms of the lease.

(viii) As the equipment is chosen by the lessee, the responsibility of its suitability, the risk of obsolescence and the liability for repair, maintenance and insurance or the equipment rest with the lessee.

Operating Lease: According to the IAS-17, an operating lease is one which is not a finance lease. In an operating lease, the lessor does not transfer all the risks and rewards incidental to the ownership of the asset and the cost of the asset is not fully amortized during the primary lease period. The lessor provides services (other than the financing of the purchase price) attached to the leased asset, such as maintenance, repair and technical advice. For this reason, operating lease include a cost for the services provided, and the lessor does not depend on a single lessee for recovery of his cost. Operating lease is generally used for computers, office equipments, automobiles, trucks, telephones, etc.

An operating lease is structured with the following features :

(i) An operating lease is generally for a period significantly shorter than the economic life of the leased asset. In some cases it may be even on hourly, daily, weekly or monthly basis. The lease is cancelable by either party during the lease period.

(ii) Since the lease periods are shorter than the expected life of the asset, the lease rentals are not sufficient to totally amortize the cost of the assets.

(iii) The lessor does not rely on the single lessee for recovery of his investment. He has the ultimate interest in the residual value of the asset. The lessor bears the risk of obsolescence, since the lessee is free to cancel the lease at any time.

(iv) Operating lease normally include maintenance clause requiring the lessor to maintain the leased asset and provide services such as insurance, support stair, fuel, etc.

Examples of Operating leases are:-

(a) Providing mobile cranes with operators,

(b) Chartering of aircraft and ships, including the provision of crew, fuel and support services.

(c) Hiring of computers with operators,

(d) Hiring of taxi for a particular travel, which includes service of driver, provision for maintenance, fuel immediate repairs, etc.

(b) Sale and Lease Back and Direct Lease

Sale and Lease back : In a way, it is an indirect from of leasing. The owner of an equipment/asset sells it to a leasing company (Lessor) which leases it back to the owner (lessee). A classic example of this type of leasing is the sale and lease back of safe deposits values by banks under which banks sell them in their custody to a leasing company at a market price substantially higher than the book value. The leasing company in turn offers these lockers on a long-term basis to the bank. The bank subleases the lockers to its customers. The lease back arrangement in sale and lease back type of leasing can be in the form of finance lease or operating lease.

Direct Lease : In direct lease, the lessee, and the owner of the equipment are two different entities a direct lease can be of two types : Bipartite and Tripartite Lease.

Bipartite Lease : There are two parties in the lease transaction, namely,

(i) equipment supplier-cum-lessor

(ii) lessee. Such a type of lease is typically structured as an operating lease with inbuilt facilities, like up gradation of the equipment (Upgrade Lease), addition to the original equipment configuration and so on. The lessor maintains the asset and, if necessary, replaces it with a similar equipment in working conditions (Swap Lease).

Tripartite Lease : Such type of lease involves three different parties in the lease agreement : equipment supplier, lessor and lessee. An innovative variant of tripartite lease is the sales-aid lease under which the equipment supplier arranges for lease finance in various company;

- Providing reference about the customer to the leasing company,
- Negotiating the terms of the lease with the customer and completing all the formalities on behalf of the leasing company,
- Writing the lease on his own account and discounting the lease receivables with the designated leasing company. The effect is that the leasing company owns the equipment and obtains an assignment of lease rental.

The sales-aid lease is usually with recourse to the supplier in the event of default by the lessee either in the form of offer from the supplier to buy back the equipment from the lessor or a guarantee on behalf of the lessee.

(c) Single Investor Lease and Leveraged Lease

Single Investor Lease : There are only two parties to the lease transaction – the lessor and the lessee. The leasing company (lessor) funds the entire investment by an appropriate mix of debt and equity funds. The debts raised by the leasing company to finance the asset are without recourse to the lessee, i.e. in the case of default in servicing the debt by the leasing company, the lender is not entitled to payment from the lessee.

Leveraged Lease : There are three parties to the transaction : (i) lessor (equity investor), (ii) lender and (iii) lessee. In such type of lease, the leasing company (equity investor) buys the asset through substantial borrowing. The lender (loan participant) obtains an assignment of the lease and a first mortgaged asset on the leased asset. The transaction is routed through a trustee who looks after the interest of the lender and lessor. On receipt of the rentals from the lessee, the trustee remits the debt service component of the rental to the loan participant and the balance to the lessor.

Like other lease transactions, leveraged lease entitles the lessor to claim tax shields on depreciation and other capital allowances on the entire investment cost including the non-recourse debt. The return on equity (profit after tax divided by net worth) is, therefore, high. From the lessee's point of view, the effective rate of interest implicit in the lease arrangement is less than on a straight loan as the lessor passes on the portion of the tax benefits to the lessee in the form of lower rental payments. Leveraged lease packages are generally structured for leasing investment-intensive assets like aircrafts, ships, etc,

(d) Domestic Lease and International Lease

Domestic Lease: A lease transaction is classified as domestic if all parties to the agreement, namely, equipment supplier, lessor and the lessee, are domiciled in the same country.

International Lease : If the parties to the lease transaction arc domiciled in different countries, it is known as international lease, This type of lease is further sub-classified into (I) Import Lease and (2) cross-border lease.

Import Lease : In an import lease, the lessor and the lessee are domiciled in the same country, but the equipment supplier is located in a different country The lessor imports the asset and leases it to the lessee.

Cross-border Lease : When the lessor and the lessee are domiciled in different countries, the lease is classified as cross-border lease, The domicile of the supplier is immaterial.

Operationally, domestic and international leases are differentiated on the basis of risk. The latter type of lease transaction is effected by two additional risk factors, i,e, country risk and currency risk. The country risk arises from the need to structure the lease transaction in the light of an understanding of the political and economic climate and a knowledge or the tax and regulatory environment governing them in the foreign countries concerned. As the payment to the supplier and the lease rentals are denominated in different currencies, any variation in the exchange rate will involve currency risk.

2.8. ADVANTAGES OF LEASING

To the Lessee : Lease financing has the following advantages to the lessee:

- Financing of Capital goods :- Lease financing enables the lessee to have finance for huge investments in land, building, plant, machinery, heavy equipments, etc., up to 100 per cent, without requiring any immediate down payment. Thus, the lessee is able to commence his business virtually without making any initial investment (of course, he may have to invest the minimal sum of working capital needs).

- Additional Source of Finance :- Leasing facilitates the acquisition of equipment, plant and machinery, without the necessary capital outlay, and, thus, has a competitive advantage of mobilizing the scarce financial resources of the business enterprise. It enhances the working capital position and makes available the internal accruals for business operations.

- Less Costly :- Leasing as a method of financing is less costly than other alternatives available.

- Off-Balance Sheet Financing :- Neither the leased asset is depicted on the balance sheet, nor the lease liability is shown, except that the fact of lease arrangement is mentioned by way of a footnote. Lease financing, therefore, does not affect the debt raising capacity of the enterprise, the lessor's security being also confirmed to the leased asset However, the advantage is by, and large, more apparent than real. Development banks and other lending agencies do not base their decision to lend solely on the apparent strength of the balance sheet of the borrower. They certainly call for information regarding the off-balance sheet liabilities to assess the real borrowing capacity.

But the off-balance sheet financing can be misleading to lenders who rely on the financial statements. In brief, the non-disclosure of outstanding lease obligations and the value of the leased assets in the balance sheet would result in (i) understatement of debt -equity ratio and (ii) Over statement of asset turnover ratio as well as return on investment. They under-estimate the real risk and over-estimate the value of the firm as they are affected by these variables. In recognition of the distortions implicit in the non-disclosures of finance lease in the financial statements of the lessee, the IAS-17 has recommended capitalization of finance leases in the books of the lessee.

- Ownership Preserved: - Leasing provides finance without diluting the ownership or control of the promoters. Against it, other modes of long-term finance, viz,

equity or debentures, normally dilute the ownership of the promoters.

- Avoid Conditionalities:- Lease finance is considered preferable to institutional finance, as in the former case, there are no conditionalities. Lease financing is beneficial since it is free from restrictive covenants and conditionalities, such as, representations on the board, conversion of debt into equity, payment of dividend, etc, which usually accompany institutional finance and term loans from banks.

- Flexibility in Structuring of Rentals:- The lease rentals can be structured to accommodate the cash flow situation of the lessee, making the payment of rentals convenient to him. The lease rentals are so tailor-made that the lessee is able to pay the rentals from the funds generated from operations. The lease period is also chosen so as to suit the lessee's capacity to pay rentals and considering the operating life-span of the asset.

- Simplicity:- A lease finance arrangement is simple to negotiate and free from cumbersome procedures with faster and simple documentation. As against it, institutional finance and term loans require compliance of covenants and formalities and bulk of documentation, causing procedural delays.

- Tax Benefits:- By suitable structuring of lease rentals, a lot of tax advantages can be derived. If the lessee is in a tax paying position, the rental may be increased to lower his taxable income. The cost of asset is thus amortized more rapidly than in a case where the asset is owned by the lessee, since depreciation is allowable at the prescribed rates. If the lessor is in tax paying position, the rentals may be lowered to pass on a part of the tax benefit to the lessee. Thus, the rentals can be adjusted suitably for postponement of taxes.

- Obsolescence Risk is Averted :- In a lease arrangement the lessor being the owner bears the risk of obsolescence and the lessee is always free to replace the asset with the latest technology.

- Full Security :- The lessor's interest is fully secured since he is always the owner of the leased asset and can take repossession of the asset if the lessee defaults. As against it, realising an asset secured against a loan is more difficult and cumbersome.

- Tax Benefit :- The greatest advantage for the lessor is the tax relief by way of depreciation. If the lessor is in high tax bracket, he can lease out assets with high depreciation rates, and thus, reduce his tax liability substantially. Besides, the rentals can be suitably structured to pass on some tax benefit to the lessees.

- High Profitability :- The leasing business is highly profitable since the rate of return is more than what the lessor pays on his borrowings. Also, the rate of return is more than in case of lending finance directly.

• **Trading on Equity** :- Lessors usually carry out their operations with greater financial leverage, That is, they have a very low equity capital and use a substantial amount of borrowed funds and deposits. Thus, the ultimate return on equity is very high.

• **High Growth Potential** :- The leasing industry has a high growth potential. Leasing financing enables the lessees to acquire equipment and machinery even during a period of depression, since they do not have to invest any capital. Leasing, thus, maintains the economic growth even during recessionary period.

2.9. LIMITATIONS OF LEASING

Lease financing suffers from certain limitations too :

Restrictions on Use of Equipment:- A lease arrangement may impose certain restrictions on use or the equipment, or require compulsory insurance, etc. Besides, the lessee is not free to make additions or alterations to the leased asset to suit his requirements.

Limitations of Financial Lease:- A financial lease may entail higher payout obligations, if the equipment is found not useful and the lessee opts for premature termination of the lease agreement. Besides, the lessee is not entitled to the protection of express or implied warranties since he is not the owner of the asset.

Loss of Residual Value:- The lessee never becomes the owner of the leased asset. Thus, he is deprived of the residual value of the asset and is not even entitled to any improvements done by the lessor or caused by inflation or otherwise, such as appreciation in value of leasehold land.

Consequences of Default:- If the lessee defaults in complying with any terms and conditions of the lease contract, the lessor may terminate the lease and take over the possession of the leased asset. In case of finance lease, the lessee may be required to pay for damages and accelerated rental payments.

Understatement of Lessee's Asset :- Since the leased assets do not form part of lessee's assets, there is an effective understatement of his assets, which may sometimes lead to gross under-estimation of the lessee. However, there is now an accounting practice to disclose the leased assets by way or footnote to the balance sheet.

Double Sales Tax:- With the amendment of sale-tax law in various states, a lease financing transaction may be charged to sales tax twice-once when the lessor purchases the equipment and again when it is leased to the lessee.

2.10.CONTENTS OF A LEASE AGREEMENT

The lease agreement specifies the legal rights and obligations of the lessor and the lessee. It typically contains terms relating to the following :

1. Description of the lessor, the lessee, and the equipment.
2. Amount, time, and place of rental payments.
3. Time and place of equipment delivery.
4. Lessee's responsibility for taking delivery and possession of the leased equipment.
5. Lessee's responsibility for maintenance, repairs, registration, etc and the lessor's right in case of default by the lessee.

6. Lessee's right to enjoy the benefits of the warranties provided by the equipment manufacturer/ supplier.

7. Insurance to be taken by the lessee on behalf of the lessor.

8. Variation in lease rentals if there is a change in certain external factors like bank interest rates, depreciation rates, and fiscal incentives.

9. Option of lease renewal for the lessee.

10. Return of equipment on expiry of the lease period.

11. Arbitration procedure in the event of dispute.

2.11. LEASING AND BORROWING

- Lease vs. buying/ borrowing is a blend of investing and financing decision.
- Tax shield on depreciation is allowed only for lessor
- Lease rental is an expense for the lessee but and income for the lessor

First Approach

i. Investing decision is evaluated separately based on NPV.

ii. Identify all relevant operating Cash Flows including taxes and capital allowances.

iii.Discount rates always based on WACC or COC.

iv. If NPV is positive, proceed to the financing decision other wise Reject the proposal.

Second Approach

i. Evaluate financing Decision: Only Cash Flows, which are relevant to the sourceof finance, are considered. (*Operating Cash Flows are ignored*, because they aresame throughout the period).

1.LEASE

Following Cash Flows are considered only1.Lease Rental2.Tax Shield on lease rental

2.BUYING/ BORROWING

1. Cost of purchase
2. Tax Shield on Capital Allowance
3. Interest expense and its tax shield are considered only if annual interest paymentsare made
4. Do not considered interest expense and its shield if lump sum amount of loan is paid at the end of the period.

2.12. CREDIT RATING – CONCEPT

The changing financial scenario in our country after liberalization movement has led to emergence of many new institutions which were concomitant for changed financial set up. In this scene there have been innovations in the financial instruments, a result of financial engineering. Irrespective of type of financial instrument the basic parameter to evaluate an investment proposal have been the return and safety. Debt

instruments have been playing an important role for raising funds and in times to come still it is most potential avenue. The basic feature of debt i.e. assured return is very attractive for investors to plan their portfolio but it is associated with a risk especially if it is unsecured. How the investors is to gauge such risks? Credit Rating is the answer.

Credit Rating is a symbolic indicator of the current objective assessment by a rating agency of the relative capability and willingness of an issuer of a debt programmes to service the debt obligations as per the terms of the contract. It may be referred as current opinion of a borrower's credit quality in terms of business and financial risk. On the basis of such evaluation the investors get some idea about the degree of certainty of timely repayment of the principal amount of the debt instrument besides regular payment of returns on it i.e. interest. So credit rating is neither a general purpose evaluation of a corporate entity nor an overall assessment of the credit risk associated with the instruments issued or to be issued by the concerned business house. It only indicates a representatives characters of the particular security which does not amount to any recommendation to purchase, sell or hold that security.

To understand the concept of credit rating it is worth to have an idea of different credit rating agencies what they consider credit rating as:

Investment Information and Credit Rating Agency of India Ltd. (ICRA)

Rating is a symbolic indicator of the current opinion of the relative capability of timely servicing of debt and obligations by the corporate entity with reference to the instrument rated.

Credit Rating Information Services of India Ltd. (CRISIL)

Rating is current opinion as to the relative safety of timely payment of interest and principal on a debenture, structured obligation, preference shares, fixed deposits programme or shot term instruments.

Credit Analysis and Research Ltd. (CARE)

Credit rating is an opinion on the relative ability and willingness of an issuer to make timely payment on specific debt or related obligations over the life of the instrument.

Australian Ratings

Rating provides lender with a simple system of gradation by which the relative capacities of companies to make timely repayment of interest and principal on a particular type of debt can be noted.

Standard & Poors

Rating is current assessment of the credit worthiness of an obligor with respect to specific obligation.

From the above definitions it is understood that:

(i) Credit rating is an assessment of the capacity of an issuer of debt security, by an independent agency, to pay interest and repay the principal as per the terms of issue of debt. A rating agency collects the qualitative as well as quantitative data from a company which has to be rated and assesses the relative strength and capacity of company to honour its obligations contained in the debt instrument through out the duration of the instrument. The rating given is based on an objective judgement of a team of experts from the rating agency.

(ii) The ratings are expressed in code number which can be easily comprehended even by the lay investors. The ratings are the quickest way of understanding a company' financial standing without going into the complicated financial reports. Credit rating is only a guidance to the investors and not a recommendation

to a particular debt instrument. The important element for investment decision making in debt security are (i) yield to maturity (ii) risk tolerance to investor and (iii) credit risk of the security. Clearly the focus of credit rating is on any one of these three elements viz., credit risk of the security and hence it can not by itself be a basis for investment decision making. It is only a current opinion on the relative capacity of firms to repay debt in time.

(iii) Credit rating, as it exists in India, is done for a specific debt security and not for a company as a whole. No rating agency tells that it is an indicator of the financial status of the company. All that a rating agency claims is that the rating symbols indicate the capacity of the company to honour the terms of contract of a debt instrument.

(iv) A debt rating is not a one time evaluation of credit risk, which can be regarded as valid for the entire life of the security. It is an on going appraisal. Changes in dynamic world of business may imply a change in the risk characteristics of the security. Hence debt rating agencies monitor the business and financial conditions of the issuer to determine whether modification in rating is warranted.

(v) A credit rating does not create a fiduciary relationship between the rating agency and the users of rating since there is no legal basis for such relationships.

2.13. FUNCTIONS OF CREDIT RATINGS

The credit rating firms are supposed to do the following functions:

1. Superior Information

Rating by an independent and professional firm offers a superior and more reliable source of information on credit risk for three inter related risks:

(a) It provides unbiased opinion.

(b) Due to professional resources, a rating firm has greater ability to assess risks.

(c) It has access to lot of information which may not be publicly available.

2. Low Cost Information

A rating firm which gathers, analyses, interprets and summarizes complex information in a simple and readily understood format for wide public consumption represents a cost effective arrangement.

3. Basis for a Proper Risk-Return Trade Off

If debt securities are rated professionally and if such ratings enjoy widespread investor acceptance and confidence, a more rational risk return trade off would be established in the capital market.

4. Healthy Discipline on Corporate Borrowers

Public exposure has healthy influence over the management of issuer because of its desire to have a clear image.

5. Formulation of Public Policy Guidelines on Institutional Investment

The public policy on the kinds of securities that are eligible for inclusion in different kinds of institutional portfolios can be developed with great confidence if securities are rated professionally by independent agencies.

2.14. BENEFITS OF CREDIT RATING

The following are the benefits of credit rating :

1. Low Cost Information

Credit rating is a source of low cost information to investors. The collection, processing and analysis of relevant information is done by a specialised agency which a group of investors can trust.

2. Quick Investment Decision

In the present day complex world ratings enable investors to take quickest possible decisions based on associated ratings.

3. Sources of Additional Certification

Credit rating agency provides additional certification to the issue of debt/financial instrument. A highly rated firm can enter the market with great confidence. Indian experience shows that individual companies that use credit rating, benefit a great deal by getting larger amount of money from a wider audience at a lower cost.

4. Increase the Investors Population

A sound credit rating system gives an alternative method to name recognition as a determining factor in making investment and helps increase the population of those investing in debt obligations of the company.

5. Forewarns Risks

Credit rating acts as a guide to companies which get a lower rating. It forewarns the management of the perception of risk in the market and prompts to take steps on their operating and marketing risks and thereby changes the perception in the market.

6. Encourages Financial Discipline

Rating also encourage discipline among corporate borrowers to improve their financial structure and performance to obtain better rating for their debt obligations.

7. Merchant Bankers Job Made Easy

Merchant bankers and brokers will be relieved of the responsibility of guiding investors as to the risk of a particular investment. Merchant bankers and brokers, in the absence of objective information, go on the basis of name recognition in guiding their clients. With the advent of credit rating, what they would be required to do is to bring to the attention of their clients the ratings of debt obligations.

8. Investors Protection

Hiring of credit agency implies that the management of the company is ready to show its operations for independent scrutiny. So, the investors who are not provided with confidential information can have overall assessment based on ratings. A credible and objective rating agency can provide increased disclosure, better accounting standard and improved investor protection.

9. Foreign Collaborations made Easy

The foreign collaborators always ask for credit rating while negotiating with an Indian company. Credit rating enables to identify instantly the relative credit standing of the company. The importance of credit rating is being increasingly recognized in the Euro-markets.

10. Benefits the Industry as a Whole

Relatively small and unknown companies use ratings to instill confidence in investors. Higher rate companies get larger amount of money at a lower cost. Thus the industry as a whole can benefit from ratings by direct mobilization of savings from individuals rather than from intermediary lending institutions.

2.15. TYPES OF RATING

The rating methodology and process discussed earlier is primarily for debt instruments like debentures, fixed deposits, bonds etc. This type of rating constitutes the major business of a rating company. But with the passage of time these agencies have started providing other types of rating such as :

a) Equity rating

Rating of equity shares issued in capital market is termed as equity rating. In such exercises the opinion on the earnings prospects and risk associated with such earnings can be arrived at through comprehensive information on acquisition, interaction with the management of the corporate, critical analysis and collective judgmental process. This exercise is also known as 'equity grading' which is initiated on the initiative of the issuer of equity before making a public issue. Grading examines very closely the level, quality, growth and substantiality of earnings in the medium term on the expanded equity base resulting from the present offer and other known future equity expansion. Like credit rating, equity grading can also be communicated both as a symbolic grade and a detailed rational. Surveillance such grading will make it relevant for secondary market of the issued share. The key parameter in the whole exercise is the prospective return on net worth. Rating agencies may also make equity assessment at the request of institutional investors with the consent of the corporate house whose equity is sought to be assessed.

b) Mutual fund rating

Mutual Funds which are popular world over are evaluated by rating agencies and it is known as mutual fund rating. It facilitate selection of right fund from the available funds. Given the nature of mutual funds, the analysis of performance has to rely to a large extent, on past performance. Therefore, evaluation is primarily based on the two indicators 'risk and return'. Expense ratio, turnover ratio, composition of portfolio, accounting practices, fund management qualities, NAV in past are some of the main parameters to evaluate mutual funds.

c) Individual credit rating

Consumer finance is gaining popularity in developing countries. The success of consumer finance depends on the credit worthiness of the consumer. Rating agencies may take up rating of such individuals. Individual credit rating is own objective assessment of the risk attached to a financial transaction with respect to an individual at a given point of time based on qualification of parameters influencing credit risk. Every aspect of credit seeker's history; age, qualification, occupation, stability at work, residence, martial status, assets, repaying capacity, savings and earnings potentials are used to assess creditworthiness of an individual. Agencies broadly rate individuals on social status, economic status and financial status.

d) Rating of banks and financial companies

Banks and financing companies are also issuers of debts like banks issue certificates of deposits (CD). The issuer's internal affair is scanned by evaluation of their background and history. Their relation with government and central bank are studied. The issuer's innovations and competitive ability to attract cheaper funds is analysed. Maturity pattern between the source and deployment of fund is studied. Its competitive position and market share is also studied. The rating exercise could include a case by case review of major

non-performing assets to determine the prospect of reliability. The quality of assets is judged. Profitability is also gazed. The quality of management is judged by the profile of operating executives, human resources policies and organizational structure. In case of financial companies, support of group companies could be important in determining their success. Accounting figures are considered after adjusting for non standard accounting policies.

e) Sovereign rating

It is primarily rating of a country as to its credit worthiness and probability to risk etc. In this process economic parameters and economic policies of the country are under constant observation. Such rating influences the availability of foreign aids from agencies like World Bank. All rating agencies may not take up such assignment because of lack of infrastructure and specialists.

f) Rating structured obligation

Structured obligation is a negotiable instrument or security which is backed by some asset. The main role of a credit rating agency in analyzing an asset backed security or a structured obligation is to assess the risk of default in meeting the contractual obligations to the investors. As in the rating of conventional debt instruments, the rating assesses the default risk rating to other debt instruments available to the investor. The main thrust in the evaluation of an asset backed transaction is to ensure that the cash flows from the assets and the envisaged structure are capable of meeting the committed payments to the investors even in a "worstcase" scenario. A key point to kept in mind is that in the rating of a structured obligation it is not rating the issuer but is assessing the risk associated with the transaction. More specially, a AAA rating on a particular structured obligation of a particular originator does not necessarily mean that all other issues by the entity would also get a AAA.

2.16. CREDIT RATING AGENCIES IN INDIA

Currently there are four credit rating agencies in India.

1. Credit Rating Information Service Ltd. (CRISIL)
2. Information and Credit Rating Agency of India (ICRA)
3. Credit Analysis and Research (CARE)
4. Duff Phelps Credit Rating Pvt. Ltd. (DCR India)

1. Credit Rating Information Service Ltd. (CRISIL)

On January 1, 1988 the Industrial Credit and Investment Corporation of India (ICICI) and Unit Trust of India (UTI) joined hands to float CRISIL, first rating agency in India with an equity base of Rs.4.00 crores. Each of them holds 18 per cent of the stock. The other promoters are : The Asian Development Bank (15 percent) ; the LIC, the GIC and its subsidiaries and the State Bank of India (each 5 per cent); the Housing Development Finance Corporation (6.2 per cent); 9 nationalized Banks owning 19.5 per cent, the remaining equity is distributed among 10 foreign banks i.e. Standard Chartered Bank, Banque Indo Suez, Mitsui Bank, Bank of Tokyo, Hongkong and Shanghai Banking Corporation, Citi Bank, Grindlays Bank, Deutsche Bank, Societe General, Banque Nationals de Peris. CRISIL became a public limited company in November 1993 and is presently a quoted company on the Bombay Stock Exchange.

Objective : The main objective of CRISIL has been to rate debt obligation of Indian companies. Its rating provides a guide to the investors as to the risk of timely payment of interest and principal on a particular debt instrument. Its ratings create awareness of the concept of credit rating amongst corporations, merchant bankers brokers, regulatory authorities and helps in creating environment that facilitates the debt rating.

At the time when CRISIL commenced its operations it was contemplated that it would undertake credit rating for a company at its specific request and subsequently it might cover all companies on its own initiative with the basic idea to provide information about creditworthiness of all companies whether they approach CRISIL or not so that investors know about the company offering securities to the public. It had also envisaged to cover under credit rating all securities viz. equity shares as well as preference shares, debentures, secured, unsecured convertible and non-convertible and fixed deposits. To achieve the objectives and contribute towards stable and healthy growth of the Indian Capital market, the thrust of the CRISIL operations was planned towards :

i) Shifting the primary responsibility of established corporate credit quality from the merchant bankers/ brokers/underwriters/financial advisor to CRISIL and making available widely acceptable standard and uniform rating for the investors;

ii) Providing for increased disclosure, better accounting standards improved financial information to the users i.e. individual investors, financial institutions, stock exchange and corporate research bodies;

iii) Reducing the cost of issue by helping direct mobilization of finance without depending on intermediary agencies; and

iv) Protecting the interest of investors by constant monitoring of the results of rated companies and altering the grading to reflect the true and fair state of affairs of the financial position of companies.

Credit Rating Symbols : CRISIL uses the conventional rating symbols used in the USA and widely accepted in many other countries. The following table shows the investment wise rating symbols assigned by CRISIL and the meaning of each rating from the angle of safety to the investors.

CRISIL Debenture Rating Symbols

Grade	Symbol		Meaning
High Investment Grades			
	AAA (Triple A)	:	Highest Safety
	AA (Double A)	:	High Safety
Investment Grades			
	A	:	Adequate Safety
	BBB (Triple B)	:	Moderate Safety
Speculative Grades			
	BB (Double B)	:	Inadequate Safety
	B	:	High Risk
	C	:	Substantial Risk
	D	:	Default

CRISIL Fixed Deposit Rating Symbols

Investment Grades		
FAAA (F-Triple A)	:	Highest Safety
FAA (F-Double A)	:	High Safety
FA	:	Adequate Safety
Speculative Grades		
FB	:	Inadequate Safety
FB	:	High Risk
FC	:	Substantial Risk
FD	:	Default

Credit Rating for Short Term Instruments

Rating Symbol	Indication (Each rating indicates that the degree of safety regarding timely payment on the instrument is shown against the symbol)
P-1	Very Strong
P-2	Strong
P-3	Adequate
P-4	Minimal
P-5	Expected to be in default on maturity or in default

CRISIL monitors the ratings it assigns constantly. The ratings may be upgraded, downgraded or withdrawn depending upon new information or developments concerning the company whose debt obligation is rated. It has the right to widely disseminate the ratings through the media, through its own publications or through any other methods.

2. ICRA Ltd

The ICRA Ltd. has been promoted by the IFCI Ltd. as the main promoter to meet the requirements of the companies based in the northern parts of the country. Apart from the main promoter, which holds 26 per cent of the share capital, the other shareholders are the Unit Trust of India, banks, LIC, GIC, Exim Bank, HDFC Ltd. and ILFS Ltd. It started operations in 1991. In order to bring international experience and practices to the Indian capital markets, the ICRA has entered into a MOU with Moody's Investors Service to provide, through its company Financial Programmes Inc (FPI), credit education, risk management software, credit research and consulting services to banks, financial/investment institutions, financial services companies and mutual funds in India. As in the case of the CRISIL, the main objectives of the ICRA are :

- To assist investors, both individual and institutional, in making well informed decisions;
- To assist issuers in raising funds, from a wider investor base, in large amounts and at a lower cost for highly rated entities;
- To enable banks, investment bankers, brokers in placing debt with investors by providing them with a marketing tool and
- To provide regulators with market driven systems to encourage the healthy growth of the capital markets in a disciplined manner, without additional burden on the Government.

Over the years, the ICRA has diversified the range of its services. It currently provides three types of services ; (1) rating services; (2) information services and (3) advisory services.

ICRA Rating Scale

Long Term including Debentures Bonds and Preference Shares

LAAA	:	Highest Safety
LAA	:	High Safety
LA	:	Adequate Safety
LBBB	:	Moderate Safety
LBB	:	Inadequate Safety
LB	:	Risk Prone
LC	:	Substantial Risk
LD	:	Default, Extremely Speculative

Medium Term including Deposits Fixed

MAAA	:	Highest Safety
MAA	:	High Safety
MA	:	Adequate Safety
MB	:	Inadequate Safety
MC	:	Risk Prone
MD	:	Default

Short Term Including Commercial Paper

A-1	Highest Safety
A-2	High Safety
A-3	Adequate Safety
A-4	Risk Prone
A-5	Default

3. CARE Ltd.

The CARE Ltd. is a credit rating and information services company promoted by the Industrial Development Bank of India (IDBI) jointly with financial institutions, public/private sector banks and private finance companies. It commenced its credit rating operations in October 1993 and offers a wide range of products and services in the field of credit information and equity research. Unlike the CRISIL and the ICRA, the CARE is very cautions in entering new areas of business. Currently, it offers the following services:

(a) Credit Rating : The CARE undertake credit rating of all types of debt instruments, both short-term and long-term.

(b) Advisory Services : The CARE provides advisory services in the areas of :

- Securitisation transactions;
- Structuring financial instruments;
- Financing of infrastructure projects and
- Municipal finances

2.17.FACTORING – CONCEPT

As stated earlier, a lot of working capital is tied up in the form of trade debts. Collection of debts, especially for the small-scale and medium scale companies is the biggest problem. The average collection period has been on the increase. Delays in collection process inturn lead to liquidity problems and consequently to delay in production and supplies. The peculiar situation in India is that a number of small scale units are catering to the requirements of a single large buyer. This large buyer is always known for his procrastination in paying his small suppliers. The crux of the problem is not so much the failure to pay altogether as the failure to pay on time. As a result, the interest cost of financing book debts is quite heavy. This increase in cost of capital reduces profit and competitiveness of a company particularly the small ones in the market. Ultimately, the small unit may become even sick. To overcome this situation, the factoring service has been conceived.

The word 'Factor' has been derived from the Latin word 'Facere' which means to 'to make or to do'. In other words, it means 'to get things done'. According to the Webster Dictionary 'Factor' is an agent, as a banking or insurance company, engaged in financing the operations of certain companies or in financing wholesale or retail trade sales, through the purchase of account receivables. As the dictionary rightly points out, factoring is nothing but financing through purchase of account receivables.

Thus, factoring is a method of financing whereby a company sells its trade debts at a discount to a financial institution. In other words, factoring is a continuous arrangement between a financial institution, (namely the factor) and a company (namely the client) which sells goods and services to trade customers on credit. As per this arrangement, the factor purchases the client's trade debts including accounts receivables either with or without recourse to the client, and thus, exercises control over the credit extended to the customers and administers the sales ledger of his client. The client is immediately paid 80 per cent of the trade debts taken over and when the trade customers repay their dues, the factor will make the remaining 20 per cent payment. To put it in a layman's language, a factor is an agent who collects the dues of his client for a certain fee.

Robert W. Johnson states "factoring is a service involving the purchase by a financial organization, called a factor, of receivables owned to manufacturers and distributors by their customers, with the factor assuming full credit and collection responsibilities".

In the words of Kohok "factorings is an asset based means of financing by which the factor buys up the book debts of a company on a regular basis, paying cash down against receivables, and then collects the amounts from the customers to whom the company has supplied goods".

2.18. TERMS AND CONDITION IN A FACTORING AGREEMENT

The existence of an agreement between the factor and the client is central to the function of factoring. The main terms and conditions generally included in a factoring agreement are the following :

(i) Assignment of debt in favour of the factor,

(ii) Selling limits for the client,

(iii) Conditions within which the factor will have recourse to the client in case of non-payment by the trade customer,

(iv) Circumstances under which the factor will have recourse in case of non-payment,

(v) Details regarding the payment to the factor for his services, say for instance, as a certain percentage on turnover,

(vi) Interest to be allowed to the factor on the account where credit has been sanctioned to the supplier, and

(vii) Limit of any overdraft facility and the rate of interest to be charged by the factor.

2.19. FUNCTIONS OF FACTORING

As stated earlier the term 'factoring' simply refers to the process of selling trade debts of a company to a financial institution. But, in practice, it is more than that. Factoring involves the following functions :

(i) Purchase and collection debts

Factoring envisages the sale of trade debts to the factor by the company, i.e., the client. It is where factoring differs from discounting. Under discounting, the financier simply discounts the debts backed by account receivables of the client. He does so as an agent of the client. But, under factoring, the factor purchases the entire trade debts and thus, he becomes a holder for value and not an agent. Once the debts are purchased by the factor, collection of those debts becomes his duty automatically.

(ii) Credit investigation and undertaking of credit risk

Sales ledger management function is a very important one in factoring. Once the factoring relationship is established, it becomes the factor's responsibility to take care of all the functions relating to the maintenance of sales ledger. The factor has to credit the customer's account whenever payment is received, send monthly statements to the customers and to maintain liaison with the client and the customer to resolve all possible disputes. He has to inform the client about the balances in the account, the overdue period, the financial standing of the customers, etc. Thus the factor takes up the work of monthly sales analysis, overdue invoice analysis and credit analysis.

(iii) Credit investigation and undertaking of credit risk

The factor has to monitor the financial position of the customer carefully, since, he assumes the risk of default in payment by customers due to their financial inability to pay. This assumption of credit risk is one of the most important functions which the factor accepts. Hence, before accepting the risk, he must be fully aware of the financial viability of the customer, his past financial performance record, his future

ability, his honesty and integrity in the business world etc. For this purpose, the factor also undertakes credit investigation work.

(iv) Provision of Finance

After the finalization of the agreement and sale of goods by the client, the factor provides 80% of the credit sales as prepayment to the client. Hence, the client can go ahead with his business plans or production schedule without any interruption. This payment is generally made without any recourse to the client. That is, in the event of non-payment, the factor has to bear the loss of payment.

(v) Rendering Consultancy Service

Apart from the above, the factor also provides management services to the client. He informs the client about the additional business opportunities available, the changing business and financial profiles of the customers, the likelihood of coming recession etc.

2.20. TYPES OF FACTORING

The type of factoring services varies on the basis of the nature of transactions between the client and the factor, the nature and volume of client's business, the nature of factor's security etc. In general, the factoring services can be classified as follows :

(i) Full service factoring or without recourse factoring

(ii) With Recourse Factoring

(iii) Maturity Factoring

(iv) Bulk Factoring

(v) Invoice Factoring

(vi) Agency Factoring

(vii) International Factoring

(i) Full Service Factoring

Under this type, factor provides all kinds of services discussed above. Thus, a factor provides finance, administers the sales ledger, collects the debts at his risk and renders consultancy service. This type of factoring is a standard one. If the debtors fail to repay the debts, the entire responsibility falls on the shoulders of the factor since the assumes the credit risk also. He can not pass on this responsibility to his client and hence, this type of factoring is also called 'Without Recourse' Factoring.

(ii) With Recourse Factoring

As the very name suggest, under this type, the factor does not assume the credit risk. In other words, if the debtors do not repay their dues in time and if their debts are outstanding beyond a fixed period, say 60 to 90 days from the due date, such debts are automatically assigned back to the client. The client has to take up the work of collection of overdue account by himself. If the client wants the factor to go on with the collection work of overdue accounts, the client has to pay extra charges called 'Refactoring Charges".

(iii) Maturity Factoring

Under this, the factor does not provide immediate cash payment to the client at the time of assignment of debts. He undertakes to pay cash as and when collections are made from the debtors. The entire amount

collected less factoring fees is paid to the client immediately. Hence it is also called 'collection Factoring'. In fact, under this type, no financing is involved. But all other services are available.

(iv) Bulk Factoring

Under this type, the factor provides finance after disclosing the fact of assignment of debts to the debtors concerned. This type of factoring is resorted to when the factor is not fully satisfied with the financial condition of the client. The work relating to sales ledger administration, credit control, collection work etc. has to be done by the client himself. Since the notification has been made, the factor simply collects the debts on behalf of the client. This is otherwise called as "Disclosed Factoring" or Notified Factoring".

(v) Invoice Factoring

Under this type, the factor simply provides finance against invoices without undertaking any other functions. All works connected with sales administration, collection of dues etc. have to be done by the client himself. The debtors are not at all notified and hence they are not aware of the financing arrangement. This type of factoring is very confidential in nature and hence it is called 'Confidential Invoice discounting' or 'Undisclosed Factoring'.

(vi) Agency Factoring

The word agency has no meaning as far as factoring is concerned. Under this type, the factor and the client share the work between themselves as follows :

(i) The client has to look after the sales ledger administration and collection work and

(ii) The factor has to provide finance and assume the credit risk

(vii) International Factoring

Under this type, the services of a factor in a domestic business are simply extended to international business. Factoring is done purely on the basis of the invoice prepared by the exporter. Thus, the exporter is able to get immediate cash to the extent of 80% of the export invoice under international factoring. International factoring is facilitated with the help of export factors and import factors.

2.21. BENEFITS OF FACTORING

Factoring offers a number of benefits to the clients. Some of the important benefits are :

(i) Financial Service

Many of the manufacturers and traders find their working capital being locked up in the form of trade debts. This has been a great handicap to the small and medium scale manufacturers because they have to wait for 3 months to 9 months to realize their debts. In the meantime, the business may suffer due to want of funds. Infact, many business concerns fail more as a result of inadequate cash flow than anything else. The key to successful working capital management lies in the ability of an enterprise to convert sales into cash flow and the speed at which it is done. The major benefit of the factoring service is that the clients will be able to convert their trade debts into cash upto 80% immediately as soon as the credit sales are over. They need not wait for months together to get cash for recycling.

Another major advantage is that there are no constrains by way of fixed limits as in the case of cash credit or O.D. As sales grow, the financial assistance also grow and both are directly proportional to each other.

The greatest advantage is that factoring assures immediate cash flow. When the cash position improves, the client is able to make his purchases on cash basis and thus, he can avail of cash discount facilities also.

(ii) Collection Service

Collection of debts is another problematic area for many concerns. It is found that over 60% of the total sales of the SSI sector and over 50% of total sales of the medium and large scale sector are made on "On Account Terms of Payment" i.e. credit sales. It means that collection of debts becomes an important internal credit management and it requires more and more time. So, industrialists cannot concentrate on production. Delay in collection process often leads to delay in production and supplies. Moreover, the interest cost of financing book debts is also on the increase. Ultimately, it affects the profitability of the company. Now, this collection work is completely taken up by the factoring organization, leaving the client to concentrate on production alone. This is an important service rendered by a factor to his client. The cost of collection is also cut down as a result of the professional expertise of a factor.

(iii) 'Credit risk' Service

In the absence of a factor, the entire credit risk has to be borne by the client himself. Bad debts eat away the profits of a concern and in some cases, it may lead to the closure of a business. But, once the factoring relationship is established, the client need not bother about the loss due to bad debts. The factor assumes the risk of default in payment by customers and thus, the client is assured of complete realization of his book debts. Even if the customer fails to pay the debt, it becomes the responsibility of the factor to pay that amount to the client. It is the greatest advantage of factoring.

(iv) Provision of Expertise 'Sales Ledger Management' Service

Administration of sales ledger is purely an accounting function which can be performed efficiently only by a few. Infact, the success of any organization depends upon the efficiency with which the sales ledger is managed. It requires a specialised knowledge which the client may not possess. But, the client can receive services like maintenance of accounting records, monthly sales analysis, overdue invoice analysis and customer payment statement from the factor. Besides, he maintains contact with customers to ensure that they repay their dues promptly. Thus, it becomes the factor's responsibility to take care of all the functions relating to the maintenance of sales ledger. Thus, factoring offers an excellent credit control for the client.

(v) Consultancy Service

Factors are professionals in offering management services like consultancy. They collect information regarding the credit worthiness of the customers of their clients, ascertain their track record, quality of portfolio turnover, average size of inventory etc., and pass on the same to their clients. It helps the clients avoid poor quality and risky customers. They also advise their clients on important financial matters. Generally no time is available to the client for investigating his customer's credit standing. Now, the factor takes up this work on behalf of his client.

(vi) Economy in Servicing

Factors are able to render very economic service to their clients because their overhead cost is spread over a number of clients. Moreover, their service charges are also reasonable. Factoring is a cheap source of finance to the client because the interest rate is charged only on the amount actually provided to the client, say, for instance, 80% of his total invoices and not on the total amount of the invoices. Thus, clients are able to get factoring services at economic rates.

(vii) Off-balance Sheet Financing

Factoring is an off-balance sheet means of financing. when the factor purchases the book debts of the client, these debts no longer exist on the current asset side of the balance sheet. It leads to reduction in debts

and less collection problems. The client can utilise the money so received to reduce his current liabilities. It means an improved current ratio.

(viii) Trade benefits

Availability of ready cash against bills enables the supplier to negotiate better prices for the inputs and also offer finer terms to customers. It ensures a steady flow of inputs on the one hand and better market prospects on the other. Again, factoring enables the supplier to concentrate on production and materials management without bothering about the financial management. Factoring enables clients to offer longer credit facilities to their customers and thus to attract more business. Thus many trade benefits are available under factoring.

(ix) Miscellaneous Service

Generally, factors are able to computerize their operations fully. So they are able to render prompt service at reasonable rates. They spend more on M.I.S. analysis. They also build bigger credit library of debtors by means of collecting information about new debtors.

Thus, improved cash flow through realization of trade debts by factoring, efficient follow up of collections, computerized sales ledger maintenance and the competitive rates are the main benefits of factoring.

2.22. CONSUMER FINANCE:

Consumer finance in the most basic sense of the word refers to any kind of lending to consumers. One of the best ways to get the unsecured loans is through the consumer finance.

Durables which are financed

- Television
- Washing Machine
- Air Conditioner
- DVD/VCD players
- Refrigerator
- Computers/laptops
- And other consumer durables

Growth of Consumer Durables

- Cyclical & Seasonal Demand
- Demand in Rural India
- Consumer Awareness & Preference for new models
- Attractive consumers loan schemes
- Growth of Media
- Use of Internet by Market Functionaries

Future prospects of Consumer Finance

- Growth of GDP
- Opportunities in Rural Market
- Schemes of Banks & Financial Institutions
- Increasing Consumer Awareness

FICCI Research

- Report-
  1. Attractive Schemes
  2. Phenomenal growth of Media
  3. Use of Internet
  4. The ability of Imports
  5. Reduction in Import duties and Input costs
- Table of Projected growth in Production

Projected growth in production of Consumer Durables(Table)

- Refrigerator -5-10%
- Air conditioner -20-25%
- Washing Machines -5-10%
- Microwave Ovens - 25%
- Consumer Electronics(overall)%
- Colour televisions -15-20%
- Black & White televisions -20%
- VCDs/MP3 -30%
- DVD -25%
- Clock -10%
- Watch -10%

RURAL MARKET ANDCONSUMER FINANCE

- Sales were high during festive season.
- Rural people feel ease in giving installments instead of single down payment.
- Rural persons found consumer loans useful because consumer durables are used for productive purposes.

PROBLEMS FACED IN RURALSECTORS

- Process of sanctioning loans, documentation and formalities takes too much time.
- Higher interest rates for quicker sanctioning of loans.
- People want advance information about the documents needed for taking loan.

RECOVERY OF LOANS

- Recovery of loans is the toughest job in rural area.
- Recovery rates are higher in co-operative banks.
- Schemes for hardcore defaulters discourages the consumers who pay on time.

2.23. CONCEPT AND NATURE OF MERCHANT BANKING

Despite the fact that merchant banking is emerging as one of the prominent segment of financial service sector, it is difficult to define what merchant banking is. The reason is very obvious as its limits have never been adequately and strictly defined and it caters to wide variety of financial activities. Dictionary of Banking and Finance explains merchant bank as an organisation that underwrites securities for corporations, advises such clients on mergers and is involved in the ownership of commercial ventures. Securities and Exchange Board of India (Merchant Bankers) Rules 1992 defines merchant bankers as "any person who is engaged in the business of issue management either by making arrangement regarding selling, buying or subscribing to securities or acting as manager, consultant, adviser or rendering corporate advisory services in relation to such issue management. The Guidelines for Merchant Bankers (issued by Ministry of Finance, Deptt. of Economic Affairs, Stock Exchange Division on 9-4-1990) instead of defining merchant banking stated that these guidelines shall apply to those presently engaged in merchant banking activity including as managers to issue and undertakes authorised activities. These activities interalia include underwriting, portfolio management etc. Thus. to defines merchant bankers a definite better approach is to include those agencies as merchant bankers which do what a merchant banker does.

To understand nature of merchant banking well, a contrast may be involved, between commercial banking and merchant banking. Although the terms 'Merchant' and 'Commercial' have similar connotations yet commercial banking and merchant banking are different. Commercial bankers are basically a financing agency where as merchant banks provide basically financial (not financing) services. Commercial bankers are comparatively retail banking activity where as merchant banking is a whole sale banking (even if it provides financing services also). A merchant banking firm does not undertake commercial banking where as its, reverse is possible. Commercial banking involves collections of savings and putting it, to optimum use as per plans and guidelines where as merchant banking refers to just an agency facilitating transfer capital from those who own to those who can use it without handling the amount of its own. Merchant bankers is more of an intermediary. In the same context a merchant bank can be distinguished from a development bank since the latter is more involved in fund raising and lending. Like commercial banks, development banks may also have separate merchant banking division.

2.24. FUNCTIONS OF MERCHANT BANKER

Setting up of new industrial units, expansion, diversification and modernisation of existing units have been the central plank of the rapid industrialisation in any economy. This process besides adequate financial resources requires sound technical and managerial inputs. Though, a number of financial agencies are instituted to cater to the needs of rapid industrialisation, the task of financing has become more complicated, thus requiring a fresh look. In view of increasing specialisation in every sphere the process of industrialisation

from the primary planning stages of setting up a new unit to that of research and development including expansion, diversification or modernisation requires the services of specialists or professionals. Thus, the need for having expert advice, guidance of specialists or professionals in the field has become an absolute necessity with rapid economic growth and spectacular industrial development in India. It has also been necessitated by the plethora of regulations for industry, capital, issues, foreign investment and collaboration, amalgamations, Companies Act, SEBI, Government policy regarding backward area development, export promotion and import substitution etc. A few agencies are able to provide expert advice in the diversified areas mentioned above. But it is inconvenient to entrepreneurs industrialists to knock at the doors of several agencies in getting the guidance of specialists and professionals. Hence, it is highly essential to provide expert advice in diversified areas under a single roof to provide a comfortable cushion to entrepreneurs to accelerate industrial development. This is where merchant bankers come to picture. Although is it is very difficult to spellout all the areas where merchant bankers can interact, yet, some important areas where merchant bankers have decisive role are discussed here. These role can broadly be divided into two parts. One is service based another is fund based.

A. Service based Functions

i) Project counselling

The first step to launch a business unit is selection of a viable project. Merchant bankers undertake this assignment on a very large scale since they have experts with them in diverse fields. Project counselling covers a variety of sub assignments. Illustrative list of services which can be rendered under this category is :

- Guidance in relation to project viability i.e. project identification and counselling. It may be for setting up new units, expansion or improvement of existing facilities.
- Selection of consultants for preparation of project reports/market surveys etc. Sometimes merchant bankers also engage in preparation of project reports or market surveys.
- Advice on various procedural steps including obtaining of governmental approvals clearance etc. e.g. for foreign collaboration.
- Proposing a suitable capital structure laying broad as well as specific features.
- Teachno- economic soundness of the project and marketing aspects. Financial engineering i.e. selection of right mix of financing pattern specifically for short term requirements.
- Organisation and management set up for a strong base and efficient working of the project.

ii) Credit syndication

Normally every project has to raise debt funds for different sources as per need. Substantial debt raising may be required for a new and capital intensive project. For such project merchant bankers may undertake credit syndication. Credit syndication is credit procurement service. As per the requirements, such syndication can be from national as well as international sources. Some of the important credit syndication services offered are.

- Preparing applications for financial assistance to be submitted to financial institutions and banks.
- Monitoring the sanction of funds while acting as a specialised liaison agency.
- Negotiating the term of assistance on behalf of client.
- Post sanction formalities with these institutions and banks.
- Assistance in drawl of term loans and or bridging loans.
- Assessing working capital requirements and arranging it.

Need of syndication arises due to the fact that specially in big projects one institution may hesitate to meet the whole debt requirement of the project. They want to spread the risk. Further shortage of funds availability with one lender also requires credit syndication. The merchant banker by rendering credit syndication services saves the time of the borrower.

The modus operandi of a syndication is really quite simple. The borrower approaches several banks which might be willing to syndicate a loan, specifying the amount and the tenor for which loan is to be syndicated. On receiving a query, the syndicator scouts for banks who may be willing to participate in the syndicate. Based on an informal survey, it communicates its desire to syndicate the loan at an indicative price to the corporate borrower, all in a matter of days. After reviewing the bids from various banks, the borrower awards the mandate to the bank that offers him the best terms.

The syndicator, on his part, can underscore his willingness to syndicate the loan on a firm commitment basis or on a best-efforts basis. The former is akin to underwriting and will attract capital adequacy requirements. That may reduce the bank's flexibility. "In India, given the fact that banks may not be willing to maintain capital in the interim period, most syndicates the likely to be done on a best-efforts basis."

Best-efforts, as the name suggests, limits the obligation of the syndicator, as he is not compelled to provide the loan on his own, in case he fails to arrange the loan.

However, more often than not, the syndicator would try to fulfill his commitments for the inability to do so would tarnish his reputation. Once the syndicator has been awarded a mandate, the borrower has to sign a 'clear market clause' which stops him from seeking a syndicated loan from any other bank, till such time as the documentation for the syndication is drawn up by the syndicate manager. This may take about three-four weeks.

In the interim period, the syndicate manager gets the banks to agree to syndicating the loan. It can do this on a 'broadcast' basis, by sending taxes to the concerned banks inviting participation. If the company is well known, the loan uncomplicated and the market liquid, such a method would work well. However, if the corporate tends to keep a low profile and the loan structure is complicated, the syndicate manager would have to woo the participant banks with offer documents or an information memorandum on the company. The document is similar to a prospects but less detailed. Nevertheless drawing up such a document does call for a lot of homework. The syndicate manager has to be very careful because he can be held responsible for any inaccuracy or omission of material facts.

The participants, after reviewing the prospects, decide whether or not to join the syndicate. However, given the fact that most of the participants may be smaller Indian banks, they may take weeks to give the final nod. Once the bank decides to become a member of the syndicate, it indicates the amount and the price that it is likely to charge on the loan. Based on information received from all participants, the syndicate manager prepares a common document to be signed by all the members of the syndicate and the borrowing company. The document usually lists out details of the agreement with regard to tenor, interest prepayment clause, security, covenants, warranties and agency clause.

iii) Issue management

Traditionally this is one of the main functions of merchant banker. When ever an issue is made whether it is public issue or private placement and further whether it is for equity shares, preference shares or debentures, the merchant banker has a crucial role to play. Raising of funds from public has many dimensions and formalities which are not possible for the concerned. companies to comply with, where merchant banker comes to their rescue. Marketing effort to convince the prospective investor needs special attention. Here again merchant bankers are specialists. The specific important activities related to issue management performed by merchant banks are mentioned here:

- Advise the company about the quantum and terms of raising funds.
- Advise as to what type of security may be acceptable in the market as well as to the concerned lending institutions at the time of issue.
- Advise as to whether a fresh issue to be made or right issue to be made or if both, then in what proportion, obtaining the desired consents, if any, from government or other authorities.
- Advice on the appointment of bankers, brokers to the issue.
- Advice on the selection of issue house or Registrar to the issue, printer advertising agency etc.
- Fixing the terms of the agencies engaged to facilitate making a public issue.
- Preparation of a complete action plan and budget for total expenses of the issue.
- Drafting of documents like prospectus, letter of offer and getting approval from concerned agencies.
- Assisting in advertisement campaigns, holding the press, brokers' and investors' conferences etc. for grooming the issue.
- Advise the company for the issue period and days of opening and closing the issue.
- Monitoring the collection of funds in public issue.
- Coordination with underwriters, brokers and bankers to the issue and stock exchange etc.
- Strict compliance of post issue activities.

iv) Corporate counselling

Although the functions discussed up till now are also covered under corporate counselling but here other dimensions will be deliberated. Corporate counselling is to rejuvenate the corporate units which are otherwise having signals to low productivity, low efficiency and low profitability. The merchant bankers can play a substantial role in reviving the sick units. They make mergers and acquisition exercise smooth, They can advise on improvement in the systems operating in managing the show of a corporate unit. Some of the specific assignments for the merchant banker are:-

- Rejuvenating old line and ailing/sick unit or appraising their technology and process, assessing their requirements and. restructuring their capital base.
- Evolving rehabilitation programmes/packages which can be acceptable to the financial institutions and banks.
- Assisting in obtaining approvals from Board for Industrial and Financial Reconstruction (BIFR) and other authorities under the Sick Industrial Companies (special provisions) Act1985 (SICA).
- Monitoring implementation of schemes of rehabilitation.
- Advice on financial restructuring involving redeployment of corporate assets to refocus companies line of business.
- Advice on rearranging the portfolio of business assets through acquisition etc.
- Assisting in valuing the assets and liabilities.

- Identifying potential buyers for disposal of assets if required. Identify the candidates for take over.
- Advice on tactics in approaching potential acquisition.
- Assisting in deciding the mode of acquisition whether friendly or unfriendly or hostile.
- Designing the transaction to reap the maximum tax advantages. Acting as an agent for leveraged buyout (LBO) involving heavy use of borrowed funds to purchase a company or division of a company.
- Facilitating Management Buy outs (MBO) i.e selling a part of business to their own managers by a company.
- Clearly spelling out organisation goals.
- Evolving corporate strategies to achieve the laid down goals.
- Designing or restructuring the organisational pattern and size.
- Evolving Management Information System.

Corporate advisory services should offer real value addition to the client. Highly specialised in nature, these services should be clearly distinguished from the gamut of other financial services offered by NBFCs such as underwriting or fund-based activities of leasing and hire purchase. In India corporate advisory has a good potential. The Indian industry is going through an unprecedented churning, bracing itself for global com-petition. The Indian corporate sector has been on a restructuring spree. Groups have been shedding companies. Companies in turn, have been dropping divisions as they struggle to become fit to survive in the new milieu. Free pricing of issues and the opportunity to tap the international market through the Euro-issue route has greatly enhanced the need for expert advisory services. In areas of restructuring, strategic alliances and corporate planning is now advising foreign companies in their plans for development of infrastructure in India. Merchant bankers have a great role to play.

Strategic product consolidation is another recent phenomenon. Units in which the company does not plan to become a market leader are spun off to others. A good corporate advisor is always on the alert to seize such opportunities. The process of acquisition cannot be done overnight. It requires a patient search for the right company which can be acquired, the proper evaluation of the financial impact of the acquisition, a sound strategy in blending the business acquired within the fold of the group, followed by negotiation and execution of the agreement. Occasionally, advisory services are required in cases of splits within the family group. In such cases, there is a need to split the company into different units amongst the disputing family members. At the same time, the shareholders interest is to be kept in mind by the corporate advisor.

v) Portfolio management

Merchant bankers as a body of professionally qualified persons also undertake assignments of managing an individual investor's portfolio. Portfolio management is being practised as an investment management counselling in which the investor is advised to seek financial assets like government securities, commercial papers, debentures, shares, warrants etc. that would grow in value and/or provide income. The investors whether local or foreigner with substantial amount for investment in securities seek portfolio management services of authorised merchant bankers. The functioning of portfolio manager can be regulated or unregulated. Portfolio manager may use totally his discretion or may act only after getting signal from investor for each transaction of sale or purchase. A diverse range of services which may be rendered by merchant banker include: -

- Advising what and when to sell and buy.
- Arranging sale or purchase of securities.
- Communicating changes in investment market to the client investor
- Compliance of regulations of different regulating bodies for sale of purchase of portfolio.
- Collection of returns and reinvest as per directions of clients.
- Evaluating the portfolio at regular intervals or at direction of investors.
- Advising on tax matters pertaining to income from and investment in portfolio
- Safe custody of securities.

vi) Stock broking and dealership

The merchant bankers who have requisite professional knowledge and experience may also act as share broker on a stock exchange and even as dealer for Over The Counter trading. To venture into this area it is normally desired that the merchant banker has reasonable network. Their actions and activities are regulated by rules and regulations of the concerned stock exchange. They are at liberty to appoint sub brokers and sub dealers to ensure wider net work of their operations. They can be broker for inland as well as foreign stock exchanges. In India the merchant bankers who desire to act as brokers are regulated by SEBI (Stock Broker and Sub-brokers) Rules 1992.

vii) Joint venture abroad

Depending on economic and political considerations many countries may permit joint ventures by local businessmen abroad. Here again merchant bankers can play a decisive role. They facilitate meeting of foreign partner, get sanctions under various provisions, make techno economic surveys, legal documentations under local as well as foreign legal provisions etc.

viii) Debenture trusteeship

The merchant bankers can get themselves registered to act as trustee. These trustees are to protect the interests of debenture holders as per the terms laid down in trust deed. They are, as trustees, to undertake redressal of grievances of debenture holders. They are to ensure that refund monies are paid and debenture certificates are dispatched in accordance with the Companies Act. Debenture trustees are expected to observe high standards of integrity and fairness in discharging their functions. They can call for periodical reports from the body corporate. They charge fee for such services.

B. Fund based Functions

(i) Bill discunting

Bill discounting is a service against which merchant banker has to arrange funds against the bills which have been discounted. This service is undertaken by merchant bankers generally if bill market is big as well as mature. Otherwise bill discounting is undertaken by banks only. Depending on their credibility they may also undertake the assignment of bill acceptance. These bills accepted and or discounted can be foreign and merchant bankers can specify what types of bills they entertain. They charge commission for these services.

(ii) Venture capital

Venture capital is the organized financing of relatively new enterprises to achieve substantial capital gains. Such new companies are chosen because of their potential for considerable growth due to advance technology, new products or services or other valuable innovations. A high risk is implied in the term and is implicit in this type of investment. Since certain ingredients necessary for success of such projects are missing in the begging but are added later on. Merchant bankers undertake to arrange and if necessary, to provide such venture capital since traditional sources of finance like banks, financial institutions or public issue etc. may not be available. Since expected returns on projects involving venture capital is high, these are normally provided on soft terms. Such scheme is also popular as seed capital or risk capital scheme. Merchant bankers deeply study such proposals before releasing the money. At opportune time such investment can be disinvested to keep the cycle of venture capital more on.

(iii) Bought out deals

When a promoter envisages that if public issue made to raise capital will not clinch, he may approach merchant bankers (bought out dealer or sponsor) and places the shares of company initially with him which are offered to public at a later stage, this route is known as bought out deal. Many a time a syndicate of merchant bankers jointly sponsor a bought out deal to spread the risk involved. In contract to venture capital, there is no role to be played by non traditional technology. Such bought shares by sponsor can be disposed off at an opportune time on 'over the counter' or other stock exchanges.

(iv) Lease financing and hire purchase

Depending on the funds available, merchant bankers can also enter the field of lease or hire purchase financing. Lease is an agreement where by the lessor (merchant banker in our case) conveys to the lessee (the user), in return for rent, the right to use an asset for an agreed period of time. On the other hand in hire purchase the user at the end of the agreed period has an option to purchase the asset which he has used till date. The merchant bankers can advise the client to go in for leasing or hire purchase system of financing an asset. A comparative study may be communicated to the prospective client showing benefits of these alternatives. The client can also depend on merchant banker for acquiring the needed asset and complying with all formalities.

(v) Factoring

Factoring is a novel financing innovation. It is a mixed service having financial as well as non financial aspects. On one hand it involves management and collection of books debts which arise in process of credit sale. The merchant bankers can take up this assignment and are required to perform activities like sales ledger administration, credit collection, credit protection, evolving credit policy, arranging letter of credit etc. On the other hand there is involvement of finance. Against factored debts the merchant banker may provide advance with a certain margin. The released funds can be used by client to manage its liquidity and working capital. Merchant bankers are entitled to service charges for factoring services. The merchant banker's role is thus to :

- Maintain the books of accounts pertaining to credit sales
- Make a systematic analysis of relevant information for credit monitoring and control.
- Provide full or partial protection against bad debts and accepting the risk of non realization.
- Provide financial assistance to the client.
- Provide information about prospective buyers.
- Provide financial counseling and assisting managing the liquidity.

vi) Underwriting

It refers to a contract by means of which merchant banker gives an assurance to the issuing company that the former would subscribe to the securities offered in the event of non-subscription by the persons to whom it was offered. The liability of merchant banker arises if the issue is not fully subscribed and this liability is restricted to the commitment extended by him. The merchant bankers undertaking underwriting make efforts on their own to induce the prospective investors to subscribe to the concerned issue. Such assignment is accepted after evaluating viz :

- Company's standing and its past record.
- Competence of the management.
- Purpose of the issue.
- Potentials of the project being financed.
- Offer price and terms of the issue.
- Business environment.

The financial involvement of merchant banker in underwriting arises in case of development. To get their blocked funds released, the merchant bankers have stock exchange as exit route. They get underwriting commission.

These are some of the prominent activities being undertaken by merchant bankers world over. The practices may differ from country to country depending on maturity of financial sector of their economy. The multifarious activities of the corporate sector and spectacular growth of industry gives new dimensions to merchant banking activities. In the phase of globalisation of economies merchant bankers are facing new challenges. The changing international financing environment has rather pushed merchant bankers to operate at international level creating more opportunities to serve the world business community in diverse ways.

Lead Manager

It is required under regulations that every issue should be managed by at least one merchant banker acting as 'lead manager'. Such lead manager is not required if :

- the issue is right issue.
- the size of issue is not exceeding rupees 50 lakh.

The merchant banker acting as lead manager must enter into an agreement with the concerned company. This agreement must state their mutual rights, liabilities and obligations relating to such issue. Agreement terms pertaining to particulars to disclosures, allotment and refund should be clearly defined, allocated and determined.

In bigger issues more than one lead managers can be appointed but their number is subject to norms laid down by SEBI.

Size of issue Maximum number of

led manager

a) Less than rupees fifty crore Two

b) Rupees 50 crore but less than Rs.100 crore. Three c) Rs.100 crore but less than Rs.200 crore Four

d) Rs.200 crore but less than Rs.400 crore Five

e) Rs.400 crore and above Five or more as agreed by SEBI

Duties of Merchant Banker/Lead Manager

a) In case more than one merchant bankers are engaged as lead manager, they have to clearly demark their duties and responsibilities. A statement of such division of job and responsibilities is to be furnished to SEBI at least one month before opening of the issue. Where the circumstances warrant joint and several responsibility of lead manager for a particular activity, a coordinator designated from among the lead managers shall furnish to SEBI with report, comments etc. on the matters relating to the joint responsibility. The activities where division is normally sought is on 'pre-issue activities' and 'post issue activities', SEBI requires that 'post issue activities' should be the responsibility of one lead manager. It involves essential follow up steps like finalisation of basis of allotment/weeding out multiple applications, listing of instrument, dispatch of certificates and refunds etc.

b) A merchant banker can not be a lead manager to an issue made by any body corporate which is an associate of the lead merchant banker.

c) A lead manager is not to associate with an issue if any merchant banker associated with the issue is not holder of certificate of registration.

d) A lead manager who is category I merchant banker has to accept a minimum underwriting obligation of 5 per cent of the total underwriting commitment or Rs.25 lakh which ever is less. This is to ensure his financial involvement in the issue.

e) It is his duty to submit SEBI a due diligence certificate in 'Form C'. This is to ensure that the contents of the prospectus or letter of an offer are verified and are reasonable. This certificate is to reach at least two weeks prior to opening of an issue.

f) SEBI requires lead manager to submit specified documents like particulars to the issue, draft letter of offer or prospectus.

g) Lead manager to incorporate changes in prospectus etc. if desired by SEBI.

h) Lead manager has to continue as lead manager with the issue till the subscribers have received the certificates or refunds of excess money.

i) Merchant bankers are prohibited from entering into any transaction, directly or indirectly in securities on the basis of unpublished price sensitive information obtained by them during the course of any professional assignment. It is referring to insider trading.

j) SEBI is to be informed, by merchant banker about the acquisition of securities of the boy corporate whose issue is being managed by the merchant banker, within 15 days from the date of entering into such transaction.

k) A merchant banker has to disclose to SEBI the following information :

i) his responsibilities with regard to the management of the issue.

ii) any change in the information or particulars previously furnished which have a bearing on the certificate granted to it.

iii) the name of body corporate whose issues he has managed or has been associated with.

iv) any default in capital adequacy requirements.

v) his activities as a manager, underwriter, consultant or adviser to an issue as the case may be.

l) Every merchant banker shall keep and maintain the required books of accounts, records and documents like balance sheet, income statement, auditor's report, a statement of financial statement. Such records are to be maintained for 5 years. They are to submit half yearly unaudited financial results when required by SEBI with a view to monitor the capital adequacy of the merchant banker.

m) When SEBI initiates inspection of the said records, the merchant banker has to cooperate. SEBI shall give notice before inspection.

2.25.STOCK EXCHANGE

A stock exchange or bourse is an exchange where stock brokers and traders can buy and/or sell stocks (also called shares), bonds, and other securities. Stock exchanges may also provide facilities for issue and redemption of securities and other financial instruments, and capital events including the payment of income and dividends. Securities traded on a stock exchange include stock issued by listed companies, unit trusts, derivatives, pooled investment products and bonds. Stock exchanges often function as "continuous auction" markets, with buyers and sellers consummating transactions at a central location, such as the floor of the exchange.[2]

To be able to trade a security on a certain stock exchange, it must be listed there. Usually, there is a central location at least for record keeping, but trade is increasingly less linked to such a physical place, as modern markets use electronic networks, which gives them advantages of increased speed and reduced cost of transactions. Trade on an exchange is restricted to brokers who are members of the exchange. In recent years, various other trading venues, such as electronic communication networks, alternative trading systems and "dark pools" have taken much of the trading activity away from traditional stock exchanges.[3]

The initial public offering of stocks and bonds to investors is by definition done in the primary market and subsequent trading is done in the secondary market. A stock exchange is often the most important component of a stock market. Supply and demand in stock markets are driven by various factors that, as in all free markets, affect the price of stocks (see stock valuation).

There is usually no obligation for stock to be issued via the stock exchange itself, nor must stock be subsequently traded on the exchange. Such trading may be *off exchange* or over-the-counter. This is the usual way that derivatives and bonds are traded. Increasingly, stock exchanges are part of a global securities market.

Role of stock exchanges

Stock exchanges have multiple roles in the economy. This may include the following:

Raising capital for businesses

A stock exchange provides companies with the facility to raise capital for expansion through selling shares to the investing public

Common forms of capital raising

Besides the borrowing capacity provided to an individual or firm by the banking system, in the form of credit or a loan, there are four common forms of capital raising used by companies and entrepreneurs. Most of these available options might be achieved, directly or indirectly, through a stock exchange.

Going public

Capital intensive companies, particularly high tech companies, always need to raise high volumes of capital in their early stages. For this reason, the public market provided by the stock exchanges has been one of the most important funding sources for many capital intensive startups. After the 1990s and early-2000s hi-tech listed companies' boom and bust in the world's major stock exchanges, it has been much more demanding for the high-tech entrepreneur to take his/her company public, unless either the company already has products in the market and is generating sales and earnings, or the company has completed advanced promising clinical trials, earned potentially profitable patents or conducted market research which demonstrated very positive outcomes. This is quite different from the situation of the 1990s to early-2000s period, when a number of companies (particularly Internet boom and biotechnology companies) went public in the most prominent stock exchanges around the world, in the total absence of sales, earnings and any well-documented promising outcome. Anyway, every year a number of companies, including unknown highly speculative and financially unpredictable hi-tech startups, are listed for the first time in all the major stock exchanges – there are even specialized entry markets for these kind of companies or stock indexes tracking their performance (examples include the Alternext, CAC Small, SDAX, TecDAX, or most of the third market good companies).

Limited partnerships

A number of companies have also raised significant amounts of capital through R&D limited partnerships. Tax law changes that were enacted in 1987 in the United States changed the tax deductibility of investments in R&D limited partnerships. In order for a partnership to be of interest to investors today, the cash on cash return must be high enough to entice investors.

Venture capital

A third usual source of capital for startup companies has been venture capital. This source remains largely available today, but the maximum statistical amount that the venture company firms in aggregate will invest in any one company is not limitless (it was approximately $15 million in 2001 for a biotechnology company).

Corporate partners

A fourth alternative source of cash for a private company is a corporate partner, usually an established multinational company, which provides capital for the smaller company in return for marketing rights, patent rights, or equity. Corporate partnerships have been used successfully in a large number of cases.

Mobilizing savings for investment

When people draw their savings and invest in shares (through an IPO or the issuance of new company shares of an already listed company), it usually leads to rational allocation of resources because funds, which could have been consumed, or kept in idle deposits with banks, are mobilized and redirected to help companies' management boards finance their organizations. This may promote business activity with benefits for several economic sectors such as agriculture, commerce and industry, resulting in stronger economic growth and higher productivity levels of firms.

Facilitating company growth

Companies view acquisitions as an opportunity to expand product lines, increase distribution channels, hedge against volatility, increase their market share, or acquire other necessary business assets. A takeover bid or a merger agreement through the stock market is one of the simplest and most common ways for a company to grow by acquisition or fusion.

Profit sharing

Both casual and professional stock investors, as large as institutional investors or as small as an ordinary middle-class family, through dividends and stock price increases that may result in capital gains, share in the wealth of profitable businesses. Unprofitable and troubled businesses may result in capital losses for shareholders.

Corporate governance

By having a wide and varied scope of owners, companies generally tend to improve management standards and efficiency to satisfy the demands of these shareholders, and the more stringent rules for public corporations imposed by public stock exchanges and the government. Consequently, it is alleged that public companies (companies that are owned by shareholders who are members of the general public and trade shares on public exchanges) tend to have better management records than privately held companies (those companies where shares are not publicly traded, often owned by the company founders and/or their families and heirs, or otherwise by a small group of investors).

Despite this claim, some well-documented cases are known where it is alleged that there has been considerable slippage in corporate governance on the part of some public companies. The dot-com bubble in the late 1990s, and the subprime mortgage crisis in 2007–08, are classical examples of corporate mismanagement. Companies like Pets.com (2000), Enron (2001), One.Tel (2001), Sunbeam (2001), Webvan (2001), Adelphia (2002), MCI WorldCom (2002), Parmalat (2003), American International Group (2008), Bear Stearns (2008), Lehman Brothers (2008), General Motors (2009) and Satyam Computer Services (2009) were among the most widely scrutinized by the media.

To assist in corporate governance many banks and companies worldwide utilize securities identification numbers (ISIN) to identify, uniquely, their stocks, bonds and other securities. Adding an ISIN code helps to distinctly identify securities and the ISIN system is used worldwide by funds, companies, and governments.

However, when poor financial, ethical or managerial records are known by the stock investors, the stock and the company tend to lose value. In the stock exchanges, shareholders of underperforming firms are often penalized by significant share price decline, and they tend as well to dismiss incompetent management teams.

Creating investment opportunities for small investors

As opposed to other businesses that require huge capital outlay, investing in shares is open to both the large and small stock investors because a person buys the number of shares they can afford. Therefore, the Stock Exchange provides the opportunity for small investors to own shares of the same companies as large investors.

Government capital-raising for development projects

Governments at various levels may decide to borrow money to finance infrastructure projects such as sewage and water treatment works or housing estates by selling another category of securities known as bonds. These bonds can be raised through the stock exchange whereby members of the public buy them, thus loaning money to the government. The issuance of such bonds can obviate, in the short term, direct taxation of

citizens to finance development—though by securing such bonds with the full faith and credit of the government instead of with collateral, the government must eventually tax citizens or otherwise raise additional funds to make any regular coupon payments and refund the principal when the bonds mature.

Barometer of the economy

At the stock exchange, share prices rise and fall depending, largely, on economic forces. Share prices tend to rise or remain stable when companies and the economy in general show signs of stability and growth. An economic recession, depression, or financial crisis could eventually lead to a stock market crash. Therefore, the movement of share prices and in general of the stock indexes can be an indicator of the general trend in the economy

Listing requirements

Listing requirements are the set of conditions imposed by a given stock exchange upon companies that want to be listed on that exchange. Such conditions sometimes include minimum number of shares outstanding, minimum market capitalization, and minimum annual income.

Requirements by stock exchange

Companies must meet an exchange's requirements to have their stocks and shares listed and traded there, but requirements vary by stock exchange:

- New York Stock Exchange: To be listed on the New York Stock Exchange (NYSE), a company must have issued at least a million shares of stock worth $100 million and must have earned more than $10 million over the last three years.[7]
- NASDAQ Stock Exchange: To be listed on the NASDAQ a company must have issued at least 1.25 million shares of stock worth at least $70 million and must have earned more than $11 million over the last three years.[8]
- London Stock Exchange: The main market of the London Stock Exchange has requirements for a minimum market capitalization (£700,000), three years of audited financial statements, minimum public float (25 per cent) and sufficient working capital for at least 12 months from the date of listing.
- Bombay Stock Exchange: Bombay Stock Exchange (BSE) has requirements for a minimum market capitalization of 250 million (US$3.7 million) and minimum public float equivalent to 100 million (US$1.5 million).[9]

Ownership

Stock exchanges originated as mutual organizations, owned by its member stock brokers. There has been a recent trend for stock exchanges to *demutualize*, where the members sell their shares in an initial public offering. In this way the mutual organization becomes a corporation, with shares that are listed on a stock exchange. Examples are Australian Securities Exchange (1998), Euronext (merged with New York Stock Exchange), NASDAQ (2002), Bursa Malaysia (2004), the New York Stock Exchange (2005), Bolsas y Mercados Españoles, and the São Paulo Stock Exchange (2007). The Shenzhen and Shanghai stock exchanges can been characterized as quasi-state institutions insofar as they were created by government bodies in China and their leading personnel are directly appointed by the China Securities Regulatory Commission. Another example is Tashkent republican stock exchange (Uzbekistan) established in 1994, three years after collapse of Soviet Union, mainly state-owned but has a form of a public corporation (joint stock company). According to an Uzbek government decision (March 2012) 25 percent minus one share of Tashkent stock exchange was expected to be sold to Korea Exchange(KRX) in 2014.[10]

2.26. ROLE OF SEBI

Securities Exchange Board of India (SEBI) was set up in 1988 to regulate the functions of securities market. SEBI promotes orderly and healthy development in the stock market but initially SEBI was not able to exercise complete control over the stock market transactions.

It was left as a watch dog to observe the activities but was found ineffective in regulating and controlling them. As a result in May 1992, SEBI was granted legal status. SEBI is a body corporate having a separate legal existence and perpetual succession.

Reasons for Establishment of SEBI:

With the growth in the dealings of stock markets, lot of malpractices also started in stock markets such as price rigging, 'unofficial premium on new issue, and delay in delivery of shares, violation of rules and regulations of stock exchange and listing requirements. Due to these malpractices the customers started losing confidence and faith in the stock exchange. So government of India decided to set up an agency or regulatory body known as Securities Exchange Board of India (SEBI).

Purpose and Role of SEBI:

SEBI was set up with the main purpose of keeping a check on malpractices and protect the interest of investors. It was set up to meet the needs of three groups.

1. Issuers:

For issuers it provides a market place in which they can raise finance fairly and easily.

2. Investors:

For investors it provides protection and supply of accurate and correct information.

3. Intermediaries:

For intermediaries it provides a competitive professional market.

Objectives of SEBI:

The overall objectives of SEBI are to protect the interest of investors and to promote the development of stock exchange and to regulate the activities of stock market. The objectives of SEBI are:

1. To regulate the activities of stock exchange.

2. To protect the rights of investors and ensuring safety to their investment.

3. To prevent fraudulent and malpractices by having balance between self regulation of business and its statutory regulations.

4. To regulate and develop a code of conduct for intermediaries such as brokers, underwriters, etc.

Functions of SEBI:

The SEBI performs functions to meet its objectives. To meet three objectives SEBI has three important functions. These are:

i. Protective functions

ii. Developmental functions

iii. Regulatory functions.

1. Protective Functions:

These functions are performed by SEBI to protect the interest of investor and provide safety of investment.

As protective functions SEBI performs following functions:

(i) It Checks Price Rigging:

Price rigging refers to manipulating the prices of securities with the main objective of inflating or depressing the market price of securities. SEBI prohibits such practice because this can defraud and cheat the investors.

(ii) It Prohibits Insider trading:

Insider is any person connected with the company such as directors, promoters etc. These insiders have sensitive information which affects the prices of the securities. This information is not available to people at large but the insiders get this privileged information by working inside the company and if they use this information to make profit, then it is known as insider trading, e.g., the directors of a company may know that company will issue Bonus shares to its shareholders at the end of year and they purchase shares from market to make profit with bonus issue. This is known as insider trading. SEBI keeps a strict check when insiders are buying securities of the company and takes strict action on insider trading.

(iii) SEBI prohibits fraudulent and Unfair Trade Practices:

SEBI does not allow the companies to make misleading statements which are likely to induce the sale or purchase of securities by any other person.

(iv) SEBI undertakes steps to educate investors so that they are able to evaluate the securities of various companies and select the most profitable securities.

(v) SEBI promotes fair practices and code of conduct in security market by taking following steps:

(a) SEBI has issued guidelines to protect the interest of debenture-holders wherein companies cannot change terms in midterm.

(b) SEBI is empowered to investigate cases of insider trading and has provisions for stiff fine and imprisonment.

(c) SEBI has stopped the practice of making preferential allotment of shares unrelated to market prices.

2. Developmental Functions:

These functions are performed by the SEBI to promote and develop activities in stock exchange and increase the business in stock exchange. Under developmental categories following functions are performed by SEBI:

(i) SEBI promotes training of intermediaries of the securities market.

(ii) SEBI tries to promote activities of stock exchange by adopting flexible and adoptable approach in following way:

(a) SEBI has permitted internet trading through registered stock brokers.

(b) SEBI has made underwriting optional to reduce the cost of issue.

(c) Even initial public offer of primary market is permitted through stock exchange.

3. Regulatory Functions:

These functions are performed by SEBI to regulate the business in stock exchange. To regulate the activities of stock exchange following functions are performed:

(i) SEBI has framed rules and regulations and a code of conduct to regulate the intermediaries such as merchant bankers, brokers, underwriters, etc.

(ii) These intermediaries have been brought under the regulatory purview and private placement has been made more restrictive.

(iii) SEBI registers and regulates the working of stock brokers, sub-brokers, share transfer agents, trustees, merchant bankers and all those who are associated with stock exchange in any manner.

(iv) SEBI registers and regulates the working of mutual funds etc.

(v) SEBI regulates takeover of the companies.

(vi) SEBI conducts inquiries and audit of stock exchanges.

The Organisational Structure of SEBI:

1. SEBI is working as a corporate sector.

2. Its activities are divided into five departments. Each department is headed by an executive director.

3. The head office of SEBI is in Mumbai and it has branch office in Kolkata, Chennai and Delhi.

4. SEBI has formed two advisory committees to deal with primary and secondary markets.

5. These committees consist of market players, investors associations and eminent persons.

Objectives of the two Committees are:

1. To advise SEBI to regulate intermediaries.

2. To advise SEBI on issue of securities in primary market.

3. To advise SEBI on disclosure requirements of companies.

4. To advise for changes in legal framework and to make stock exchange more transparent.

5. To advise on matters related to regulation and development of secondary stock exchange.

These committees can only advise SEBI but they cannot force SEBI to take action on their advice.

UNIT – III

MUTUAL FUNDS AND FOREIGN EXCHANGE MARKET

3.1. CONCEPT AND ORIGIN OF MUTUAL FUNDS

To state in simple words, a mutual fund collects the savings from small investors, invest them in Government and other corporate securities and earn income through interest and dividends, besides capital gains. It works on the principle of 'small drops of water make a big ocean'. For instance, if one has Rs.1000 to invest, it may not fetch very much on its own. But, when it is pooled with Rs. 1000 each from a lot of other people, then, one could create a 'big fund' large enough to invest in a wide varieties of shares and debentures on a commanding scale and thus, to enjoy the economies of large scale operations. Hence, a mutual fund is nothing but a form of collective investment. It is formed by the coming together of a number of investors who transfer their surplus funds to a professionally qualified organization to manage it. To get the surplus funds from investors, the fund adopts a simple technique. Each fund is divided into a small fraction called "units" of equal value. Each investor is allocated units in proportion to the size of his investment. Thus, every investor, whether big or small, will have a stake in the fund and can enjoy the wide portfolio of the investment held by the fund. Hence, mutual funds enable millions of small and large investors to participate in and derive the benefit of the capital market growth. It has emerged as a popular vehicle of creation of wealth due to high return, lower cost and diversified risk.

The Securities and Exchange Board of India (Mutual Funds) Regulations, 1993 defines a mutual fund as "a fund established in the form of a trust by a sponsor, to raise monies by the trustees through the sale of units to the public, under one or more schemes, for investing in securities in accordance with these regulations".

These mutual funds are referred to as Unit Trusts in the U.K. and as open end investment companies in the U.S.A. Therefore, Kamm, J.O. defines an open end investment company as "an organization formed for the investment of funds obtained from individuals and institutional investors who in exchange for the funds receive shares which can be redeemed at any time at their underlying asset value".

According to Weston J. Fred and Brigham, Eugene, F., Unit Trusts are "Corporations which accept dollars from savers and then use these dollars to buy stocks, long term bonds, short term debt instruments issued by business or government units; these corporations pool funds and thus reduce risk by diversification".

Thus, mutual funds are corporations which pool funds by selling their own shares and reduce risk by diversification.

Fund Unit Vs. Share : Just like shares, the price of units of a fund is also quoted in the market. This price is governed basically by the value of the underlying investments held by that fund. At this juncture, one should not confuse a mutual fund investment on units with that of an investment on equity shares. Investment on equity share represents investment in a particular company alone. On the other hand, investment on an unit of a Fund represents investment in the parts of shares of a large number of companies. This itself gives an idea how safe the units are. If a particular company fails the share-holders of that company are affected very much whereas the unit holders of that company are able to withstand that risk by means of their profitable holdings in other companies shares.

Again, investment on equity shares can be used as a tool by speculators and inveterate stock market enthusiasts with a view to gaining abnormal profits. These people play an investment game in the stock market on the basis of daily movement of prices. But, mutual funds cannot be invested for such purposes and the mutual fund is not at all concerned with the daily ebbs and flows of the market. In short, mutual fund is not the right investment vehicle for speculators. Mutual funds are, therefore, suitable only to genuine investors whereas shares are suitable to both the genuine investors and the speculators.

Origin of the Fund

The origin of the concept of mutual fund dates back to the very dawn of commercial history. It is said that Egyptians and Phoenicians sold their shares in vessels and caravans with a view to spreading the risk attached with these risky ventures. However, the real credit of introducing the modern concept of mutual fund goes to the Foreign and Colonial Government Trust of London established in 1868. Thereafter, a large number of close-ended mutual funds were formed in the U.S.A. in 1930's followed by many countries in Europe, the Far East and Latin America. In most of the countries, both open and close-ended types were popular. In India, it gained momentum only in 1980, though it began in the year 1964 with the Unit Trust of India launching its first fund, the Unit Scheme 1964.

3.2.TYPES OF FUNDS/CLASSIFICATION OF FUNDS

In the investment market, one can find a variety of investors with different needs, objectives and risk taking capacities. For instance, a young businessman would like to get more capital appreciation for his funds and he would be prepared to take greater risk than a person who is just on the verge of his retiring age. So, it is very difficult to offer one fund to satisfy all the requirements of investors. Just as one shoe is not suitable for all legs, one fund is not suitable to meet the vast requirements of all investors. Therefore, many types of funds are available to the investor. It is completely left to the discretion of the investor to choose any one of them depending upon his requirement and his risk taking capacity.

Mutual fund schemes can broadly be classified into many types as given below:

1. On the basis of execution and operation

(A) Close-ended Funds

Under this scheme, the corpus of the fund and its duration are prefixed. In other words, the corpus of the fund and the number of units are determined in advance. Once the subscription reaches the pre-determined level, the entry of investors is closed. After the expiry of the fixed period, the entire corpus is disinvested and the proceeds are distributed to the various unit holders in proportion to their holding. Thus, the fund ceases to be a fund, after the final distribution.

Features : The main features of the close-ended funds are:

(i) The period and/or the target amount of the fund is definite and fixed beforehand.

(ii) Once the period is over and/or the target is reached, the door is closed for the investors. They cannot purchase any more units.

(iii) These units are publicly traded through stock exchange and generally, there is no repurchase facility by the fund.

(iv) The main objective of this fund is capital appreciation.

(v) The whole fund is available for the entire duration of the scheme and there will not be any redemption demands before its maturity. Hence, the fund manager can manage the investments efficiently and profitably without the necessity of maintaining and liquidity.

(vi) At the time of redemption, the entire investment pertaining to a closed-end scheme is liquidated and the proceeds are distributed among the unit holders.

(vii) From the investor's point of view, it may attract more tax since the entire capital appreciation is realized in toto at one stage itself.

(viii) If the market condition is not favourable, it may also affect the investor since he may not get the full benefit of capital appreciation in the value of the investment.

(ix) Generally, the prices of closed-end scheme units are quoted at a discount of upto 40 percent below their Net Asset Value (NAV).

(B) Open-ended Funds

It is just the opposite of close-ended funds. Under this scheme, the size of the fund and/or the period of the fund is not pre-determined. The investors are free to buy and sell any number of units at any point of time. For instance, the Unit Scheme (1964) of the Unit Trust of India is an open ended one, both in terms of period and target amount. Anybody can buy this unit at any time and sell it also at any time at his discretion.

The main features of the Open-Ended Funds are :

(i) The investor is assured of regular income at periodic intervals, say half-yearly or yearly and so on.

(ii) The main objective of this type of Fund is to declare regular dividends and not capital appreciation.

(iii) The pattern of investment is oriented towards high and fixed income yielding securities like debentures, bonds etc.

(iv) This is best suited to the old are retired people who may not have any regular income.

(v) It concerns itself with short run gains only.

(B) Pure Growth Funds (Growth Oriented Funds)

Unlike the Income Funds, Growth Funds concentrate mainly on long run gains i.e., capital appreciation. They do not offer regular income and they aim at capital appreciation in the long run. Hence, they have been described as "Nest Eggs" investments.

The main features of the Growth Funds are :

(i) The growth oriented fund aims at meeting the investors' need for capital appreciation.

(ii) The investment strategy therefore, conforms to the fund objective by investing the funds predominantly on equities with high growth potential.

(iii) The fund tries to get capital appreciation by taking much risks and investing on risk bearing equities and high growth equity shares.

(iv) The fund may declare dividend, but its principal objective is only capital appreciation.

(v) This is best suited to salaried and business people who have high risk bearing capacity and ability to defer liquidity. They can accumulate wealth for future needs.

(C) Balanced Funds

This is otherwise called income-cum-growth fund. It is nothing but a combination of both income and growth funds. It aims at distributing regular income as well as capital appreciation. This is achieved by balancing the investments between the high growth equity shares and also the fixed income earning securities.

(D) Specialised Funds

Besides the above, large number of specialised funds are in existence abroad. They offer special schemes so as to meet the specific needs of specific categories of people like pensioners, widows etc. There are also funds for investments in securities of specified areas. For instance, Japan Fund, South Korea Fund etc. In fact, these funds open the door for foreign investors to invest on the domestic securities of these countries.

Again certain funds may be confined to one particular sector or industry like fertilizer, automobiles, petroleum etc. These funds carry heavy risk since the entire investment is in one industry. But, there are high risk taking investors who prefer this type of fund. Of course, in such cases, the rewards may be commensurate with the risk taken. At times, it may be erratic. The best example of this type is the Petroleum Industry Funds in the U.S.A.

(E) Money-Market Mutual Funds (MMMFs)

These funds are basically open ended mutual funds and as such they have all the features of the open ended fund. But, they invest in highly liquid and safe securities like commercial paper, banker's acceptances, certificates of deposits, treasury bills etc. These instruments are called money market instruments. They take the place of shares, debentures and bonds in a capital market. They pay money market rates of interest. These funds are called 'money funds' in the U.S.A. and they have been functioning since 1972. Investors generally use it as a "parking place" or "stop gap arrangement" for their cash resources till they finally decide about the proper avenue for their investment i.e., long term financial assets like bonds and stocks.

Since MMMFs are a new concept in India, the RBI has laid down certain stringent regulations. For instance, the entry to MMMFs is restricted only to scheduled commercial banks and their subsidiaries. MMMFs can invest only in specified short term money market instruments like certificate of deposits, commercial papers and 182 days treasury bills. They can also lend to call market. These funds go for safe and liquid investment. Frequent realization of interest and redemption of fund at short notice are the special features of the fund. These funds will not be subject to reserve requirements. The re-purchase could be subject to a minimum lock in period of 3 months.

(F) Taxation Funds

A taxation fund is basically a growth oriented fund. But, it offers tax rebates to the investors either in the domestic or foreign capital market. It is suitable to salaried people who want to enjoy tax rebates particularly during the month of February and March. In India, at present the law relating to tax rebates is covered under section 88 of the Income Tax Act, 1961. An investor is entitled to get 20% rebate in Income Tax for investments made under this fund subject to a maximum investment of Rs.10,000/- per annum. The Tax Saving Magnum of SBI Capital Market Limited is the best example for the domestic type. UTI's US $60 million India Fund, based in the USA, is an example for the foreign type.

OTHER CLASSIFICATION

(G) Leveraged Funds

These funds are also called borrowed funds since they are used primarily to increase the size of the value of portfolio of a mutual fund. When the value increases, the earning capacity of the fund also increases. The gains are distributed to the unit holders. This is resorted to only when the gains from the borrowed funds are more than the cost of borrowed funds.

(H) Dual Funds

This is a special kind of closed end fund. It provides a single investment opportunity for two different types of investors. For this purpose, it sells two types of investment stocks viz., income shares and capital shares. Those investors who seek current investment income can purchase income shares. They receive all the interest and dividends earned from the entire investment portfolio. However, they are guaranteed a minimum annual dividend payment. The holders of capital shares receive all the capital gains earned on those shares and they are not entitled to receive any dividend of any type. In this respect, the dual fund is different from a balanced fund.

(I) Index Funds

Index funds refer to those funds where the portfolios are designed in such a way that they reflect the composition of some broad based market index. This is done by holding securities in the same proportion as the index itself. The value of these index linked funds will automatically go up whenever the market index goes up and vice-versa. Since the construction of portfolio is entirely based upon maintaining proper proportions of the index being followed, it involves less administrative expenses, lower transaction costs, less number of portfolio managers etc. It is so because only fewer purchases and sales of securities would take place.

(J) Bond Funds

These funds have portfolios consisting mainly of fixed income securities like bonds. the main thrust of these funds is mostly on income rather than capital gains. They differ from income funds in the sense income funds offer an average returns higher than that from bank deposits and also capital gains lesser than that in equity shares.

(K) Aggressive Growth Funds

These funds are just the opposite of bond funds. These funds are capital gains oriented and thus the thrust area of these funds is capital gains. Hence, these funds are generally invested in speculative stocks. They may also use specialised investment techniques like short term trading, option writing etc. Naturally, these funds tend to be volatile in nature.

(L) Off-Shore Mutual Funds

Off-shore mutual funds are those funds which are meant for non-residential investors. In other words, the sources of investments for these funds are from abroad. So, they are regulated by the provisions of the foreign countries where those funds are registered. These funds facilitate flow of funds across different countries, with free and efficient movement of capital for investment and repatriation. Off-shore funds are preferred to direct foreign investment, since, it does not allow foreign domination over host country's corporate sector. However, these funds involve much currency and country risk and hence they generally yield higher return.

In India, these funds are subject to the approval of the Department of Economic Affairs, Ministry of Finance and the RBI monitors such funds by issuing directions then and there. In India, a number of off-shore funds exist. 'India Fund' and 'India Growth Fund' were floated by the UTI in U.K. and U.S.A. respectively. The State Bank of India floated the India Magnum Fund in Netherlands. 'The Indo-Suez Himalayan Fund N.V.' was launched by Canbank Mutual Fund in collaboration with Indo-Suez Asia Investment Services Ltd. It also floated 'Commonwealth Equity Fund'.

3.3. IMPORTANCE OF MUTUAL FUNDS

The mutual fund industry has grown at a phenomenal rate in the recent past. One can witness a revolution in the mutual fund industry in view of its importance to the investors in general and the country's economy at large. The following are some of the important advantages of mutual funds :

(i) Channelising Savings for Investment

Mutual funds act as a vehicle in galvanizing the savings of the people by offering various schemes suitable to the various classes of customers for the development of the economy as a whole. A number of schemes are being offered by MFs so as to meet the varied requirements of the masses, and thus, savings are directed towards capital investments directly. In the absence of MFs, these savings would have remained idle. Thus, the whole economy benefits due to the cost efficient and optimum use and allocation of scarce financial and real resources in the economy for its speedy development.

(ii) Offering Wide Portfolio Investment

Small and medium investors used to burn their fingers in stock exchange operations with a relatively modest outlay. If they invest in a select few shares, some may even sink without a trace never to rise again. Now, these investors can enjoy the wide portfolio of th investment held by the mutual fund. The fund diversifies its risks by investing on a large varieties of shares and bonds which cannot be done by small and medium investors. This is in accordance with the maxim 'Not to lay all eggs in one basket'. These funds have large amounts at their disposal, and so, they carry a clout in respect of stock exchange transactions. They are in a position to have a balanced portfolio which is free from risks. Thus MF's provide instantaneous portfolio diversification. The risk diversification which a pool of savings through mutual funds can achieve cannot be attained by a single investor's savings.

(iii) Providing Better Yields

The pooling of funds from a large number of customers enables the fund to have large funds at its disposal. Due to these large funds, mutual funds are able to buy cheaper and sell dearer than the small and medium investors. Thus, they are able to command better market rates and lower rates of brokerage. So, they provide better yields to their customers. They also enjoy the economies of large scale and can reduce the cost of capital market participation. The transaction costs of large investments are definitely lower than that of small investments. In fact, all the profits of a mutual fund are passed on to the investors by way of dividends and capital appreciation. The expenses pertaining to a particular scheme alone are charged to the respective scheme. Most of the mutual funds so far floated have given a dividend at the rate ranging between 12% p.a. and 17% p.a. It is fairly a good yield. It is an ideal vehicle for those who look for long term capital appreciation.

(iv) Rendering Expertise Investment Service at Low Cost

The management of the fund is generally assigned to professionals who are well trained and have adequate experience in the field of investment. The investment decisions of these professionals are always backed by informed judgement and experience. Thus, investors are assured of quality services in their best interest. Due to the complex nature of the securities market, a single investor cannot do all these works by himself or he cannot go to a professional manager who manages individual portfolios. In such a case, he may charge hefty management fee. The intermediation fee is the lowest being one per cent in the case of a mutual fund.

(v) Providing Research Service

A mutual fund is able to command vast resources and hence it is possible for it to have an in depth study and carry out research on corporate securities. Each fund maintains a large research team which constantly analyses the companies and the industries and recommends the fund to buy or sell a particular share. Thus, investments are made purely on the basis of a thorough research. Since research involves a lot of time, efforts and expenditure, an individual investor cannot take up this work. By investing in a mutual fund, the investor gets the benefit of the research done by the fund.

(vi) Offering Tax Benefits

Certain funds offer tax benefits to its customers. Thus, apart from dividends, interest and capital appreciation, investors also stand to get the benefit of tax concession. For instance, under section 80L of the Income Tax Act, a sum of Rs.10,000 received as dividend (Rs.13000 to UTI) from a MF is deductible from the gross total income. Under the wealth Tax Act, investments in MF are exempted upto Rs. 5 lakhs. The mutual funds themselves are totally exempt from tax on all income on their investments. But, all other companies have to pay taxes and they can declare dividends only from the profits after tax. But, mutual funds to do not deduct tax at source from dividends. This is really a boon to investors.

(vii) Introducing Flexible Investment Schedule

Some mutual funds have permitted the investors to exchange their units from one scheme to another and this flexibility is a great boon to investors. Income Units can be exchanged for growth units depending upon the performance of the funds. One can not derive such a flexibility in any other investments.

(viii) Providing Greater Affordability and Liquidity

Even a very small investor can afford to invest in mutual funds. They provide an attractive and cost effective alternative to direct purchase of shares. In the absence of MFs, small investors cannot think of participating in a number of investments with such a meager sum. Again, there is grater liquidity. Units can be sold to the fund at anytime at the Net Asset Value and thus quick access to liquid cash is assured. Besides, branches of the sponsoring bank is always ready to provide loan facility against the unit certificates.

(ix) Simplified Record Keeping

An investor with just an investment in 500 shares or so in 3 or 4 companies has to keep proper records of dividend payments, bonus issues, price movements, purchase or sale instruction, brokerage and other related items. It is very tedious and consumes a lot of time. One may even forget to record the rights issue and may have to forfeit the same. Thus, record keeping is the biggest problem for small and medium investors. Now, a mutual fund offers a single investment source facility, i.e., a single buy order of 100 units from a mutual fund is equivalent to investment in more than 100 companies. The investor has to keep a record of only one deal with the Mutual Fund. Even if he does not keep a record, the MF sends statements very often to the investor. Thus, by investing in MFs, the record keeping work is also passed on to the fund.

(x) Supporting Capital Market

Mutual funds play a vital role in supporting the development of capital markets. The mutual funds make the capital market active by means of providing a sustainable domestic source of demand for capital market instruments. In other words, the savings of the people are directed towards investments in capital markets through these mutual funds. Thus, funds serve as a conduit for dis-intermediating bank deposits into stocks, shares and bonds. Mutual Funds also provide a valuable liquidity to the capital market, and thus, the market is made very active and stable. When foreign investors and speculators exit and re-enter the markets

en masse, mutual funds keep the market stable and liquid. In the absence of mutual funds, the prices of shares would be subject to wide price fluctuation due to the exit and re-entry of speculators into the capital market en masse. Thus, it is rending an excellent support to the capital market and helping in the process of institutionalization of the market.

(xi) Promoting Industrial Development

The economic development of any nation depends upon its industrial advancement and agricultural development. All industrial units have to raise their funds by resorting to the capital market by the issue of shares and debentures. The mutual funds not only create a demand for these capital market instruments but also supply a large source of funds to the market, and thus, the industries are assured of their capital requirements. In fact the entry of mutual funds has enhanced the demand for India's stock and bonds. Thus, mutual funds provide financial resources to the industries at market rates.

(xii) Acting as Substitute for Initial Public Offerings (IPOs)

In most cases investors are not able to get allotment in IPOs of companies because they are often oversubscribed many time. Moroever, they have to apply for a minimum of 500 shares which is very difficult particularly for small investors. But, in mutual funds, allotment is more or less guaranteed. Mutual Funds are also guaranteed a certain percentage of IPOs by companies. Thus, by participating in MFs, investors are able to get the satisfaction of participating in hundreds of varieties of companies.

(xiii) Reducing the Marketing Cost of New Issues

Moreover the mutual funds help to reduce the marketing cost of the new issues. The promoters used to allot a major share of the Initial Public offering to the mutual funds and thus they are saved from the marketing cost of such issues.

(xiv) Keeping the Money Market Active

An individual investor can not have any access to money market instruments since the minimum amount of investment is out of his reach. On the other hand, mutual funds keep the money market active by investing money on the money market instruments. In fact, the availability of more money market instruments itself is a good sign for a developed money market which is very essential for the successful functioning of the central bank in a country.

Thus mutual funds provide stability to share prices, safety to investors and resources to prospective entrepreneurs.

3.4. ORGANIZATION OF THE FUND

The structure of mutual fund operations in India envisages a three tier establishment namely :

(i) A sponsor institution to promote the fund

(ii) A team of trustees to oversee the operations and to provide checks for the efficient, profitable and transparent operations of the fund and

(iii) An Asset Management Company AMC) to actually deal with the funds.

Sponsoring Institution : The company which sets up the Mutual Fund is called the sponsor. The SEBI has laid down certain criteria to be met by the sponsor. These criteria mainly deal with adequate experience, good past track record, net worth etc.

Trustees : Trustees are people with long experience and good integrity in their respective fields. They carry the crucial responsibility of safeguarding the interest of investors. For this purpose, they monitor the operations of the different schemes. They have wide ranging powers and they can even dismiss Asset Management Companies with the approval of the SEBI.

Asset Management Company (AMC) : The AMC actually manages the funds of the various schemes. The AMC employs a large number of professionals to make investments, carry out research and to do agent and investor servicing. In fact, the success of any Mutual Fund depends upon the efficiency of this AMC. The AMC submits a quarterly report on the functioning f the mutual fund to the trustees who will guide and control the AMC.

3.5. OPERATION OF THE FUND

A mutual fund invites the prospective investors to join the fund by offering various schemes so as to suit to the requirements of different categories of investors. The resources of individual investors are pooled together and the investors are issued units/shares for the money invested. The amount so collected is invested in capital market instruments like shares and debentures and money market instruments like treasury bills, commercial papers, etc.

For managing this fund, a mutual fund gets an annual fee of 1.25% of funds managed at the maximum as fixed by the SEBI (MF) Regulations, 1993 and if the funds exceed Rs.100 crores, it is only 1%. It can not take more than that. Of course regular expenses like custodial fee, cost of dividend warrants, fee for registration, the asset management fee etc. are debited to the respective scheme. These expenses cannot exceed 3% of the assets in the respective schemes each year. The remaining amount is given back to the investors in full.

3.6.FACILITIES AVAILABLE TO INVESTORS

Mutual funds provide following facilities to the investors :

(i) Repurchase Facilities

The units of closed ended schemes must be compulsorily listed in recognized stock exchanges. Such units can be sold or bought at market prices. But, units of open ended schemes are not at all listed and hence they have to be bought only from the fund. So, the fund reserves the right to buy back the units from its members. This process of buying back the units from the investors by the fund is called repurchase facility. This is available in both schemes so as to provide liquidity to investors. The price fixed for this purpose is called repurchase price.

(ii) Reissue Facilities

In the case of open ended schemes, units can be bought only from the fund and not in the open market. The units bought from the investors are again reissued to those who are interested in purchasing them. The price fixed for this purpose is called re-issue price.

(iii) Roll Over Facilities

At the time of redemption, the investor is given an option to reinvest his entire investment once again for another term. An investor can overcome an adverse market condition prevailing at the time of redemption by resorting to this roll over facility. This is applicable in the case of close-ended funds.

(iv) Lateral Shifting Facilities

Some mutual funds permit the investors to shift from one scheme to another on the basis of the Net Asset Value with a view to providing total flexibility in their operation. This is done without any discount on the fund and without any additional charges. This is a great privilege given to the investors. This shifting is called 'lateral shifting'.

3.7.CONCEPT OF DEBT SECURITISATION

Securitisation of debt or asset refers to the process of liquidating the illiquid and long term assets like loans and receivables of financial institutions by issuing marketable securities against them. In other words, it is a technique by which a long term, non-negotiable and high valued financial asset like hire purchase is converted into securities of small values which can be tradable in the market just like shares.

Thus, it is nothing but a process of removing long term assets from the balance sheet of a lending financial institution and replacing them with liquid cash through the issue of securities against them. Under securitisation, a financial institution pools its illiquid, non-negotiable and long term assets, creates securities against them, gets them rated and sells them to investors. It is an ongoing process in the sense that assets are converted into securities, securities into cash, cash into assets and assets into securities and so on.

Generally, extension of credit by banks and other financial institutions in the form of bills purchase or discounting or hire purchase financing appears as an asset on their balance sheets. Some of these assets are long term in nature and it implies that funds are locked up unnecessarily for an undue long period. So, it carry on their lending operations without much interruptions, they have to rely upon various other sources of finance which are not only costly but also not available easily. Again, they have to bear the risk of the credit outstandings. Now, securitisation is a readymade solution for them. Securitisation helps them to recycle funds at a reasonable cost and with less credit risk. In other words, securitisation helps to remove these assets from the balance sheets of financial institutions by providing liquidity through tradable financial instruments.

Again from another angle also, securitisation is a boon to financial institutions. From the risk management point of view, the lending financial institutions have to absorb the entire credit risk by holding the credit outstandings in their own portfolio. Securitisation offers a good scope for risk diversification. It is worthwhile to note that the entire transaction relating to securitisation is carried out on the asset side of the Balance Sheet. That is one asset (illiquid) is converted into another asset (cash).

As stated earlier, securitisation helps to liquidity assets mainly of medium and long term loans and receivables of financial institutions. The concept of securitisation can be defined as follows:

"A carefully structured process whereby loans and other receivables are packaged, underwritten and sold in the form of asset backed securities".

Yet another simple definition is as follows:

"Securitization is nothing but liquifying assets comprising loans and receivables of an institution through systematic issuance of financial instruments".

According to Hendersen, J. and Scott, J.P. "Securitisation is the process which takes when a lending institution's assets are removed in one way or another from the balance sheet of that lending institution and are funded instead, by the investors who purchase a negotiable financial instrument evidencing this indebtedness without recourse, or in some cases with limited recourse, to the original lender". Thus, financial assets can be made liquid through securitisation i.e., through packaging loans and selling them in the

market. It is very clear from the above definitions that securitisation is nothing but the packaging of a pool of financial assets into marketable securities. In brief, illiquid assets are converted into tradable securities.

3.8. MODUS OPERANDI OF SECURITISATION

For the operational mechanics of securitisation, the following parties are required:

(i) The originator

(ii) A Special Purpose Vehicle (SPV) or a trust

(iii) A merchant or investment banker

(iv) A credit rating agency

(v) A servicing agent-Receiving and Paying agent (RPA)

(vi) The original borrowers or obligors

(vii) The prospective investors i.e. the buyers of securities

The various stages involved in the working of securitisation are as follows :

(1) Identification stage/process

(2) Transfer stage/process

(3) Issue stage/process

(4) Redemption stage/process

(5) Credit Rating stage/process

1. Identification Process

The lending financial institution either a bank or any other institution for that matter which decides to go in for securitisation of its assets is called the 'originator'. The originator might have got assets comprising of a variety of receivables like commercial mortgages, lease receivables, hire purchase receivables etc. The originator has to pick up a pool of assets of homogeneous nature, considering the maturities, interest rates involved, frequency of repayments and marketability. This process of selecting a pool of loans and receivables from the asset portfolios for securitisation is called "identification process'.

2. Transfer Process

After the identification process is over, the selected pool of assets are then "passed through" to another institution which is ready to help the originator to convert those pools of assets into securities. This institution is called the special purpose vehicle (SPV) or the trust. The pass through transaction between the originator and the SPV is either by way of outright sale i.e. full transfer of assets in question for valuable consideration or by passing them for a collateralized loan. Generally, it is done on an outright sale basis. This process of passing through the selected poof of assets by the originator to a SPV is called transfer process and once this transfer process is over, the assets are removed from the balance sheet of the originator.

3. Issue Process

After this transfer process is over, the SPV takes up the onerous task of converting these assets of various types of different maturities. It is on this basis, the SPV issues securities to investors. The SPV actually splits the package into individual securities of smaller values and they are sold to the investing public. The SPV gets itself reimbursed out of the sale proceeds. The securities issued by the SPV is called by different names like Pay through Certificates, Pass through Certificates, Interest only Certificate, Principal only Certificates etc. The securities are structured in such a way that the maturity of these securities may synchronies with the maturities of the securitised loans or receivables.

4. Redemption Process

The redemption and payments of interest on these securities are facilitated by the collections received by the SPV from the securitised assets. The task of collection of dues is generally entrusted to the originator of a special servicing agent can be appointed for this purpose. This agency is paid a certain percentage of commission for the collection services rendered. The servicing agent is responsible for collecting the principal and interest payments on assets pooled when due and he must pay a special attention to delinquent accounts. Usually, the originator is appointed as the servicer. Thus, under securitisation, the role of the originator gets reduced to that of a collection agent on behalf of the SPV, in case he is appointed as a collection agent. A pass through certificate may be either 'with recourse' to the originator or 'without recourse'. The usual practice is to make it 'without recourse'. Hence, the holder of a pass through certificate has to look to the SPV for payment of the principal and interest on the certificates held by him. Thus, the main task of the SPV is to structure the deal, raise proceeds by issuing pass through certificates and arrange for payment f interest and principal to the investors.

5. Credit Rating Process

Since the pass through certificates have to be publicly issued, they require credit rating by a good credit rating agency so that they become more attractive and easily acceptable. Hence, these certificates are rated at least by one credit rating agency on the eve of the securitisation. The issues could also be guaranteed by external guarantor institutions like merchant bankers which would enhance the credit worthiness of the certificates and would be readily acceptable to investors. Of course, this rating guarantee provides a sense of confidence to the investor with regard to the timely payment of principal and interest by the SPV.

Pass through certificates, like debentures, directly reflect the ownership rights in the assets securitised, their repayment schedule, interest rate etc. These certificates, before maturity, are tradable in a secondary market to ensure liquidity for the investors. They are negotiable securities and hence they can be easily tradable in the market.

3.9. BENEFITS OF SECURITISATION

Debt securitisation provides many benefits to all the parties, such as, the originator, investors and the regulatory authorities. Some of the important benefits are the following:

(i) Additional Source of Fund

The originator (i.e. the lending institution) is much benefited because securitisation provides an additional source of funds by converting an otherwise illiquid asset into ready liquidity. As a result, there is an immediate improvement in the cash flow of the originator. Thus, it acts as a source of liquidity.

(ii) Greater Profitability

Securitisation helps financial institutions to get liquid cash from medium term and long term assets immediately rather than over a longer period. It leads to greater recycling of funds which, turn, leads to higher business turnover and profitability. Again, the cash flow could be recycled for investment in higher yielding assets. This means greater profitability. Moreover, economies of scale can be achieved since securitisation offers scope for the fuller utilization of the existing capabilities by providing liquid cash immediately. It results in additional business turnover. Again, the originator can also act as the receiving and paying agent. If so, it gets additional income in the form of servicing fee.

(iii) Enhancement of Capital Adequacy Ratio

Securitisation enables financial institutions to enhance their capital adequacy ratio by reducing their assets volume. The process of securitisation necessitates the selection of a pool of assets by the financial institutions to be sold or transferred to another institution called SPV. Once the assets are transferred, they are removed from the balance sheet of the originator. It results in the reduction of assets volume, thereby increasing the capital adequacy ratio. Capital adequacy ratio can also be improved by replacing the loan assets with the lesser risk weighted assets. Thus, the removal of assets from the Balance Sheet under a true sale improves the capital adequacy norms.

(iv) Spreading of Credit Risk

Securitisation facilities the spreading of credit risk to different parties involved in the process of securitisation. In the absence of securitisation, the entire credit risk associated with a particular financial transaction has to be borne by the originator himself. Now, the originator is able to diversify the risk factors among the various parties involved in securitisation. Thus, securitisation helps to achieve diversification of credit risks which are greater in the case of medium term and long term loans. Thus, it is used as tool for risk management.

(v) Lower Cost of Funding

In view of enhancement of cash flows and diversification of risk factors, securitisation enables the originator to have an easy access to the securities market. It means that companies with low credit rating can issue asset backed securities at lower interest cost due to high credit rating on such securities. This helps it to secure funds at lower cost. Moreover, the criteria for choosing the pool of assets ensures an efficient cost of funds. In the present context of scarcity of funds and higher interest rates, securitisation provides a good scope for cheap funding.

(vi) Provision of Multiple Instrument

From the investor's point of view, securitisation provides multiple new investment instruments so as to meet the varying requirements of the investing public. It also offers varieties of instruments for other financial intermediaries like mutual funds, insurance companies, pension funds etc. giving them many choices.

(vii) Higher Rate of Return

When compared to traditional debt securities like bonds and debentures, securitised securities offer better rate of return along with better liquidity. These instruments are rated by good credit rating agencies and hence more attractive. Being structured assets based securities, they offer more protection and yield a good return. The bankruptcy/winding up of the originator does not affect the investors since the payment is guaranteed by the SPV.

(viii) Prevention of Idle Capital

In the absence of securitisation, capital would remain idle in the form of illiquid assets like mortgages, term loans etc., in many of the lending institutions. Now, securitisation helps recycling of funds by converting these assets into liquidity, liquidity into assets, assets into liquidity and so on by means of issuing tradable and transferable securities against these assets. Thus, it provides impetus for capital formation.

(ix) Better than Traditional Instruments

Certificates are issued to investors against the backing of assets securitised. The underlying assets are used not only as a collateral to the certificates but also to generate the income to pay the principal and interest to the investors. It does not entail any servicing needs and hence does not require much costs. It is better than even mutual fund units because it is issued against the backing of collateral securities whereas there is no such backing for mutual fund certificates. Thus, these instruments, being structured asset backed securities, afford a greater protection to investors.

Again, there is much transparency from the investor's point of view. They can very well see the collateral pool that a particular issue represents and this transparency reduces uncertainty as to the risk element.

(x) Other Benefits

Securitisation, if carried out in true spirit, leads to greater economy in the use of capital with efficiency and cost effectiveness in both funding and lending. This is a great boon to the regulating authorities as well since their primary objective is to prevent the accumulation of capital where it is not needed.

In the long run, it is beneficial to the borrowers also. They will be able to get funds at cheaper rates since the originators are likely to pass on the benefit to the ultimate borrows. There is no doubt that securitisation is a low cost and innovative funding source ensuring economy in the use of capital.

3.10. DE-MAT SERVICES

In India, shares and securities are held electronically in a dematerialized (or "Demat") (/dimæt/;) account, instead of the investor taking physical possession of certificates. A Dematerialized account is opened by the investor while registering with an investment broker (or sub-broker). The Dematerialized account number is quoted for all transactions to enable electronic settlements of trades to take place. Every shareholder will have a Dematerialized account for the purpose of transacting shares.

Access to the Dematerialized account requires an internet password and a transaction password. Transfers or purchases of securities can then be initiated. Purchases and sales of securities on the Dematerialized account are automatically made once transactions are confirmed and completed.

Advantages of demat

The bonus/right shares allotted to the investor will be immediately credited into his account.There is no risk due to loss on account of fire, theft or mutilation. Transaction costs are usually lower than that in the physical segment. A demat account also helps avoid problems typically associated with physical share certificates. For example: delivery failures caused by signature mismatch, postal delays and loss of certificate during transit. Further, it eliminates the risks associated with forgery and due to damaged stock certificates. Demat account holders also avoid stamp duty (as against 0.5 per cent payable on physical shares) and filling up of transfer deeds. The biggest advantage of having demat account is that you don't have to pay for stamp since these are electronically stored which reduces the transaction cost.

Goal of Demat Syste

India adopted the Demat System for electronic storing, wherein shares and securities are represented and maintained electronically, thus eliminating the troubles associated with paper shares. After the introduction of the depository system by the Depository Act of 1996, the process for sales, purchases and transfers of shares became significantly easier and most of the risks associated with paper certificates were mitigated.

In 1996, trading began on NSE for shares held in demat account form. It was the beginning of a new paperless trading stock market trading environment. If an investor buys a share today, it gets credited to the investor's account in two days. Today, shares get transferred to the investor's demat account.[1]

Demat benefits

Demat account for shares and securities with Business purpose

The benefits of demat are enumerated[by whom?] as follows:

- Easy and convenient way to hold securities
- Immediate transfer of securities
- No stamp duty on transfer of securities
- Safer than paper-shares (earlier risks associated with physical certificates such as bad delivery, fake securities, delays, thefts etc. are mostly eliminated)
- Reduced paperwork for transfer of securities
- Reduced transaction cost
- No "odd lot" problem: even one share can be sold
- Change in address recorded with a DP gets registered with all companies in which investor holds securities eliminating the need to correspond with each of them separately.
- Transmission of securities is done by DP, eliminating the need for notifying companies.
- Automatic credit into demat account for shares arising out of bonus/split, consolidation/merger, etc.
- A single demat account can hold investments in both equity and debt instruments.
- Traders can work from anywhere (e.g. even from home).

Benefit to the company

The depository system helps in reducing the cost of new issues due to lower printing and distribution costs. It increases the efficiency of the registrars and transfer agents and the secretarial department of a company. It provides better facilities for communication and timely service to shareholders and investors.

Benefit to the investor

The depository system reduces risks involved in holding physical certificates, e.g., loss, theft, mutilation, forgery, etc. It ensures transfer settlements and reduces delay in registration of shares. It ensures faster communication to investors. It helps avoid bad delivery problems due to signature differences, etc. It ensures faster payment on sale of shares. No stamp duty is paid on transfer of shares. It provides more acceptability and liquidity of securities.

Benefits to brokers

It reduces risks of delayed settlement. It ensures greater profit due to increase in volume of trading. It eliminates chances of forgery or bad delivery. It increases overall trading and profitability. It increases confidence in their investors.

Depository Participant (DP)

A depository (in simple terms) is an institution holding a pool of pre-verified shares held in electronic mode that offers efficient settlement of transactions. A Depository Participant (DP) is an intermediary between the investor and the depository. A DP is typically a financial organization like a bank, broker, financial institution, or custodian acting as an agent of the depository to make its services available to the investors. Each DP is assigned a unique identification number known as DP-ID. As of March 2006, there were a total of 538 DPs registered with SEBI.

Demat conversion

Converting physical records of investments into electronic records is called "dematerialising" of securities. In order to dematerialise physical securities, investors must fill in a Demat Request Form (DRF), which is available with the DP and submit the same along with physical certificates. Every security has an ISIN (International Securities Identification Number). A separate DRF must be filled for each ISIN.

The complete process of dematerialisation is outlined below:

- The investor surrenders the certificates for dematerialisation to the DP.
- DP updates the account of the investor.

Demat options

There are many hundreds of Depository Participants (DPs) offering the Demat account facility in India as of September 2011. A comparison of the fees charged by different DPs is detailed below.

There are a few distinct advantages of having a bank as a DP. Having a Demat account with a bank DP, usually provides quick processing, accessibility, convenience, and online transaction capability to the investor. Generally, banks credit the Demat account with shares in case of purchase, or credit a savings account with the proceeds of a sale, on the third day. Banks are also advantageous because of the number of branches they have. Some banks give the option of opening a demat account in any branch, while others restrict themselves to a select set of branches. Some private banks also provide online access to the demat account. Hence, the investors can conveniently check online details of their holdings, transactions and status of requests through their bank's net-banking facility. A broker who acts as a DP may not be able to provide these services.

Documents Required For Demat Account

To open a Demat account you have to provide documents which fulfill the requirements of KYC (Know Your Customer) norms. You have to sign a contract with Stock broker. Generally the documents are:

- PAN (Compulsory)
- Bank statement (last 3 months)
- Address Proof
- Income Tax Return

- Two colour photos
- Bank crossed Cheque (If required)
- KYC details

Disadvantages of Demat

- Trading in securities may become uncontrolled in case of dematerialized securities.
- It is incumbent upon the capital market regulator to keep a close watch on the trading in dematerialized securities and see to it that trading does not act as a detriment to investors.
- For dematerialized securities, the role of key market players such as stock-brokers needs to be supervised as they have the capability of manipulating the market.
- Multiple regulatory frameworks have to be conformed to, including the Depositories Act, Regulations and the various Bye-Laws of various depositories.
- Agreements are entered at various levels in the process of dematerialization. These may cause worries to the investor desirous of simplicity.
- There is no provision to close a demat account, which is having illiquid shares. The investor cannot close the account and he and his successors have to go on paying the charges to the participant, like annual folio charges etc..
- After liquidating the holdings, many Indian investors don't close their dp account.They are unaware that DPs charge even on dormant accounts sat

Transfer of Shares between (depository participant) DPs

To transfer shares, an investor has to fill one of two kinds of Depository Instruction Slip (DIS). The first check made is whether both Demat accounts are at the same depository. There are two depositories: (CDSL (Central Depository Service (India) Limited) and NSDL (National Securities Depository Limited)). If both demat accounts are not at the same depository, then an Inter Depository Slip (Inter DIS) has to be filled and submitted. For example:

- If there is one Demat account with CDSL and the other Demat account with NSDL, then an Inter-DIS is needed. (In case the investor needs an Inter-DIS, the investor should check with the broker, since brokers usually issue an Inter-DIS).
- Now that the correct DIS has been determined, information pertaining to the transfer transaction has to be entered: scrip name, INE number, quantity in words and figures.
- Finally, the investor should submit that DIS to the broker with signatures.
- The transfer broker shall accept that DIS in duplicate and acknowledge receipt of DIS on duplicate copy.

The investor should submit the DIS when the market is open. Accordingly, date of submission of DIS and date of execution of DIS can be same or a difference of one day is also acceptable. The investor also has to pay the broker some charges for the transfer.

3.11. ROLE OF NSDL AND CSDL

NSDL and CDSL are both depositories which hold various securities like money, property, etc. in an electronic form. NSDL works for National Stock Exchange, whereas CDSL works for Bombay Stock Exchange.

NSDL stands for 'National Securities Depository', whereas CDSL stands for 'Central Depository Securities' Limited. They both are depositories that hold various securities like shares in electronic form. There is no major difference between the two; however there is small difference in their charges and their source of work.

A depository is an organization that holds securities of investors in an electronic format at the request of an investor through a registered Depository Participant. It assists in the allotment and transfer of securities and securities lending. In a depository, securities such as money, shares and properties, etc. are kept for safekeeping under their or depositary terms. The securities are held in the form of electronic accounts. They carry out their various operations through functionaries called as business partners or a Depository Participant. This system is governed under the Depositories Act by the government. The enactment of this act paved the way for the establishment of NSDL and CDSL.

The National Securities Depository Limited (NSDL) was the first depository in India. It was registered by SEBI on 7th June 1996, as the very first Depository to facilitate trading and settlement of securities in Demat form. It is promoted by institutions of national stature, which are responsible for the economic development of India and have established an infrastructure of international standards. They handle most of the securities, which are held and settled in a dematerialized form in the Indian capital market. Its main promoters are IDBI, UTI and NSE

Central Depository Services Limited (CDSL) is the second Indian central securities depository. It is based in Mumbai. Its main function is the holding securities either in certificated or un-certificated i.e. dematerialized form; it helps to enable the book entry transfer of securities. It began operating in February in the year 1999. Its main promoters are BSE, HDFC, SBI, BOI and BOB.

The main role and the different functions of a depository are as follows:

- Maintenance of individual investors' beneficial holdings in an electronic form
- Dematerialization and re-materialization of securities
- Account transfer for settlement of trades in electronic shares
- Allotments in the electronic form in case of initial public offerings
- Distribution of non-cash corporate actions
- Facility for freezing/locking of investor accounts
- Facility for pledge and hypothecation of securities

Comparison between NDSL and CDSL:

	NDSL	CDSL
Abbreviation	It stands for 'National Securities Depository Limited'.	It stands for 'Central Depository Securities Limited'.
Founded	November 1996	February 1999
Headquarters	Mumbai, India.	Mumbai, India.
Promoters	IDBI, UTI, etc.	HDFC, SBI, BOI and BOB.
Market	National Stock Exchange (NSE)	Bombay Stock Exchange (BSE)

3.12. MEANING OF EXCHANGE RATE

The price of a nation's currency in terms of another currency. An exchange rate thus has two components, the domestic currency and a foreign currency, and can be quoted either directly or indirectly. In a direct quotation, the price of a unit of foreign currency is expressed in terms of the domestic currency. In an indirect quotation, the price of a unit of domestic currency is expressed in terms of the foreign currency. An exchange rate that does not have the domestic currency as one of the two currency components is known as a cross currency, or cross rate.

Also known as a currency quotation, the foreign exchange rate or forex rate.

3.13.CURRENCYSWAP

A currency swap (or a cross currency swap) is a foreign exchange derivative between two institutions to exchange the principal and/or interest payments of a loan in one currency for equivalent amounts, in net present value terms, in another currency. Currency swaps are motivated by comparative advantage.[1] A currency swap should be distinguished from interest rate swap, for in currency swap, both principal and interest of loan is exchanged from one party to another party for mutual benefits.[1][2]

Currency swaps are over-the-counter (OTC) derivatives.

Uses

Currency swaps have three main uses:

- To secure cheaper debt (by borrowing at the best available rate regardless of currency and then swapping for debt in desired currency using a back-to-back-loan).
- To hedge against (reduce exposure to) exchange rate fluctuations.
- To defend against financial turmoil by allowing a country beset by a liquidity crisis to borrow money from others with its own currency.

3.14.DIFFERENCE BETWEEN FORWARD CONTRACT AND FUTURE CONTRACTS

Fundamentally, forward and futures contracts have the same function: both types of contracts allow people to buy or sell a specific type of asset at a specific time at a given price.

However, it is in the specific details that these contracts differ. First of all, futures contracts are exchange-traded and, therefore, are standardized contracts. Forward contracts, on the other hand, are private agreements between two parties and are not as rigid in their stated terms and conditions. Because forward contracts are private agreements, there is always a chance that a party may default on its side of the agreement. Futures contracts have clearing houses that guarantee the transactions, which drastically lowers the probability of default to almost never.

Secondly, the specific details concerning settlement and delivery are quite distinct. For forward contracts, settlement of the contract occurs at the end of the contract. Futures contracts are marked-to-market daily, which means that daily changes are settled day by day until the end of the contract. Furthermore, settlement for futures contracts can occur over a range of dates. Forward contracts, on the other hand, only possess one settlement date.

Lastly, because futures contracts are quite frequently employed by speculators, who bet on the direction in which an asset's price will move, they are usually closed out prior to maturity and delivery usually never happens. On the other hand, forward contracts are mostly used by hedgers that want to eliminate the volatility of an asset's price, and delivery of the asset or cash settlement will usually take place.

3.15.MONEY LAUNDERING

Money laundering is the process of transforming the proceeds of crime, corruption or kleptomania into ostensibly legitimate money or other assets.[1] However, in a number of legal and regulatory systems, the term money laundering has become conflated with other forms of financial crime, and sometimes used more generally to include misuse of the financial system (involving things such as securities, digital currencies, credit cards, and traditional currency), including terrorism financing and evasion of international sanctions. Most anti-money laundering laws openly conflate money laundering (which is concerned with *source* of funds) with terrorism financing (which is concerned with *destination* of funds) when regulating the financial system.[2]

Some countries define money laundering as obfuscating sources of money, either intentionally or by merely using financial systems or services that do not identify or track sources or destinations. Other countries define money laundering to include money from activity that *would have been* a crime in that country, even if it was legal where the actual conduct occurred.

UNIT - IV

NATIONAL INCOME

4.1. CHARACTERISTICS OF INDIAN ECONOMY

Indian economy is an under developed economy in which Agriculture is the back bone of Indian economic. 60% of India's population are on the below poverty line. Mineral resources are not fully utilized. We are selling iron ore by trucks and getting blades by packets. Majority of the people of India are leading a poverty line. Indian economic is affected by it. Countries which are on the part of progress and which have their potential for development are called developing economic. So India is termed as developing economic by modern views.

The important features of Indian economic:

1. Low per capita income:

Under developed economy is characterized by low per capital income. India per capital income is very low as compared to the advanced countries. For example the capital income of India was 460 dollar, in 2000. Where as their capita income of U.S.A in 2000 was 83 times than India. This trend of difference of per capita income between under developed and advanced countries is gradually increasing in present times. India not only the per capita income is low but also the income is unequally distributed. This mal-distribution of income and wealth makes the problem of poverty in ore critical and acute and stands an obstacle in the process of economic progress

2. Heavy Population Pressure:

The Indian economy is facing the problem population explosion. It is clearly evident from the total population of India which was 102.67 cores in 2001 census. It is the second highest populated country China being the first. India's population has reached 110 cores. All the under developed countries are characterized by high birth rate which stimulates the growth of population; the fast rate of growth of population necessitates a higher rate of economic growth to maintain the same standard of living. The failure to sustain the living standard makes the poor and under developed countries poor and under developed.

3. Pre-dominance of Agriculture:

Occupational distribution of population in India clearly reflects the backwardness of the economy. One of the basis characteristics of an under developed economy is that agriculture contributes a very large portion in the national income and a very high proportion of working population is engaged in agriculture

4. Unemployment:

There is larger unemployed and under employment is another important feature of Indian economy. In under developed countries labor is an abundant factor. It is not possible to provide gainful employment the entire population. Lack of job opportunities disguised unemployed is created' in the agriculture fields. There deficiency of capital formation.

5. Low Rate of Capital Formation:

In backward economics like India, the rate of capital formation is also low. capital formation mainly depends on the ability and willingness of the people save since the per capita income is low and there is mal-distribution of income and wealth the ability of the people to save is very low in under developed countries for which capital formation is very low.

6. Poor Technology:

The lever of technology is a common factor in under developed economy. India economy also suffers from this typical feature of technological backwardness. The techniques applied in agriculture industries milling and other economic fields are primitive in nature.

7. Back ward Institutional and social frame work:

The social and institutional frame work in under developed countries like India is hopelessly backward, which is a strong obstacle to any change in the form of production. Moreover religious institutions such as caste system, joint family universal marriage affects the economic life of the people.

8. Under utilization of Resources:

India is a poor land. So our people remain economically backwards for the lack of utilization of resources of the country.

9. Price instability:

Price instability is also a basis feature of Indian economy. In almost all the underdeveloped countries like India there is continuous price instability. Shortage of essential commodities and gap between consumption aid productions increase the price persistently. Rising trend of price creates a problem to maintain standard of living of the common people.

4.2. NATIONAL INCOME

National income is an uncertain term which is used interchangeably with national dividend, national output and national expenditure. On this basis, national income has been defined in a number of ways. In common parlance, national income means the total value of goods and services produced annually in a country.

In other words, the total amount of income accruing to a country from economic activities in a year's time is known as national income. It includes payments made to all resources in the form of wages, interest, rent and profits.

Definitions of National Income:

The definitions of national income can be grouped into two classes: One, the traditional definitions advanced by Marshall, Pigou and Fisher; and two, modern definitions.

The Marshallian Definition:

According to Marshall: "The labour and capital of a country acting on its natural resources produce annually a certain net aggregate of commodities, material and immaterial including services of all kinds. This is the true net annual income or revenue of the country or national dividend." In this definition, the word 'net' refers to deductions from the gross national income in respect of depreciation and wearing out of machines. And to this, must be added income from abroad.

It's Defects:

Though the definition advanced by Marshall is simple and comprehensive, yet it suffers from a number of limitations. First, in the present day world, so varied and numerous are the goods and services produced that it is very difficult to have a correct estimation of them.

Consequently, the national income cannot be calculated correctly. Second, there always exists the fear of the mistake of double counting, and hence the national income cannot be correctly estimated. Double counting means that a particular commodity or service like raw material or labour, etc. might get included in the national income twice or more than twice.

For example, a peasant sells wheat worth Rs.2000 to a flour mill which sells wheat flour to the wholesaler and the wholesaler sells it to the retailer who, in turn, sells it to the customers. If each time, this wheat or its flour is taken into consideration, it will work out to Rs.8000, whereas, in actuality, there is only an increase of Rs.2000 in the national income.

Third, it is again not possible to have a correct estimation of national income because many of the commodities produced are not marketed and the producer either keeps the produce for self-consumption or exchanges it for other commodities. It generally happens in an agriculture- oriented country like India. Thus the volume of national income is underestimated.

The Pigouvian Definition:

A.C. Pigou has in his definition of national income included that income which can be measured in terms of money. In the words of Pigou, "National income is that part of objective income of the community, including of course income derived from abroad which can be measured in money."

This definition is better than the Marshallian definition. It has proved to be more practical also. While calculating the national income now-a- days, estimates are prepared in accordance with the two criteria laid down in this definition.

First, avoiding double counting, the goods and services which can be measured in money are included in national income. Second, income received on account of investment in foreign countries is included in national income.

It's Defects:

The Pigouvian definition is precise, simple and practical but it is not free from criticism. First, in the light of the definition put forth by Pigou, we have to unnecessarily differentiate between commodities which can and which cannot be exchanged for money.

But, in actuality, there is no difference in the fundamental forms of such commodities, no matter they can be exchanged for money. Second, according to this definition when only such commodities as can be exchanged for money are included in estimation of national income, the national income cannot be correctly measured.

According to Pigou, a woman's services as a nurse would be included in national income but excluded when she worked in the home to look after her children because she did not receive any salary for it. Similarly, Pigou is of the view that if a man marries his lady secretary, the national income diminishes as he has no longer to pay for her services.

Thus the Pigovian definition gives rise to a number of paradoxes. Third, the Pigovian definition is applicable only to the developed countries where goods and services are exchanged for money in the market.

According to this definition, in the backward and underdeveloped countries of the world, where a major portion of the produce is simply bartered, correct estimate of national income will not be possible, because it will always work out less than the real level of income. Thus the definition advanced by Pigou has a limited scope.

Fisher's Definition:

Fisher adopted 'consumption' as the criterion of national income whereas Marshall and Pigou regarded it to be production. According to Fisher, "The National dividend or income consists solely of services as received by ultimate consumers, whether from their material or from the human environments. Thus, a piano, or an overcoat made for me this year is not a part of this year's income, but an addition to the capital. Only the services rendered to me during this year by these things are income."

Fisher's definition is considered to be better than that of Marshall or Pigou, because Fisher's definition provides an adequate concept of economic welfare which is dependent on consumption and consumption represents our standard of living.

It's Defects:

But from the practical point of view, this definition is less useful, because there are certain difficulties in measuring the goods and services in terms of money. First, it is more difficult to estimate the money value of net consumption than that of net production.

In one country there are several individuals who consume a particular good and that too at different places and, therefore, it is very difficult to estimate their total consumption in terms of money. Second, certain consumption goods are durable and last for many years.

Modern Definitions:

From the modern point of view, Simon Kuznets has defined national income as "the net output of commodities and services flowing during the year from the country's productive system in the hands of the ultimate consumers."

On the other hand, in one of the reports of United Nations, national income has been defined on the basis of the systems of estimating national income, as net national product, as addition to the shares of different factors, and as net national expenditure in a country in a year's time. In practice, while estimating national income, any of these three definitions may be adopted, because the same national income would be derived, if different items were correctly included in the estimate.

2. Concepts of National Income:

There are a number of concepts pertaining to national income and methods of measurement relating to them.

(A) Gross Domestic Product (GDP):

GDP is the total value of goods and services produced within the country during a year. This is calculated at market prices and is known as GDP at market prices. Dernberg defines GDP at market price as "the market value of the output of final goods and services produced in the domestic territory of a country during an accounting year."

There are three different ways to measure GDP:

Product Method, Income Method and Expenditure Method.

These three methods of calculating GDP yield the same result because National Product = National Income = National Expenditure.

1. The Product Method:

In this method, the value of all goods and services produced in different industries during the year is added up. This is also known as the value added method to GDP or GDP at factor cost by industry of origin. The following items are included in India in this: agriculture and allied services; mining; manufacturing, construction, electricity, gas and water supply; transport, communication and trade; banking and insurance, real estates and ownership of dwellings and business services; and public administration and defense and other services (or government services). In other words, it is the sum of gross value added.

2. The Income Method:

The people of a country who produce GDP during a year receive incomes from their work. Thus GDP by income method is the sum of all factor incomes: Wages and Salaries (compensation of employees) + Rent + Interest + Profit.

3. Expenditure Method:

This method focuses on goods and services produced within the country during one year.

GDP by expenditure method includes:

(1) Consumer expenditure on services and durable and non-durable goods (C),

(2) Investment in fixed capital such as residential and non-residential building, machinery, and inventories (I),

(3) Government expenditure on final goods and services (G),

(4) Export of goods and services produced by the people of country (X),

(5) Less imports (M). That part of consumption, investment and government expenditure which is spent on imports is subtracted from GDP. Similarly, any imported component, such as raw materials, which is used in the manufacture of export goods, is also excluded.

Thus GDP by expenditure method at market prices = C+ I + G + (X – M), where (X-M) is net export which can be positive or negative.

(B) GDP at Factor Cost:

GDP at factor cost is the sum of net value added by all producers within the country. Since the net value added gets distributed as income to the owners of factors of production, GDP is the sum of domestic factor incomes and fixed capital consumption (or depreciation).

Thus GDP at Factor Cost = Net value added + Depreciation.

GDP at factor cost includes:

(i) Compensation of employees i.e., wages, salaries, etc.

(ii) Operating surplus which is the business profit of both incorporated and unincorporated firms. [Operating Surplus = Gross Value Added at Factor Cost—Compensation of Employees—Depreciation]

(iii) Mixed Income of Self- employed.

Conceptually, GDP at factor cost and GDP at market price must be identical/This is because the factor cost (payments to factors) of producing goods must equal the final value of goods and services at market prices. However, the market value of goods and services is different from the earnings of the factors of production.

In GDP at market price are included indirect taxes and are excluded subsidies by the government. Therefore, in order to arrive at GDP at factor cost, indirect taxes are subtracted and subsidies are added to GDP at market price.

Thus, GDP at Factor Cost = GDP at Market Price – Indirect Taxes + Subsidies.

(C) Net Domestic Product (NDP):

NDP is the value of net output of the economy during the year. Some of the country's capital equipment wears out or becomes obsolete each year during the production process. The value of this capital consumption is some percentage of gross investment which is deducted from GDP. Thus Net Domestic Product = GDP at Factor Cost – Depreciation.

(D) Nominal and Real GDP:

When GDP is measured on the basis of current price, it is called GDP at current prices or nominal GDP. On the other hand, when GDP is calculated on the basis of fixed prices in some year, it is called GDP at constant prices or real GDP.

Nominal GDP is the value of goods and services produced in a year and measured in terms of rupees (money) at current (market) prices. In comparing one year with another, we are faced with the problem that the rupee is not a stable measure of purchasing power. GDP may rise a great deal in a year, not because the economy has been growing rapidly but because of rise in prices (or inflation).

On the contrary, GDP may increase as a result of fall in prices in a year but actually it may be less as compared to the last year. In both 5 cases, GDP does not show the real state of the economy. To rectify the underestimation and overestimation of GDP, we need a measure that adjusts for rising and falling prices.

This can be done by measuring GDP at constant prices which is called real GDP. To find out the real GDP, a base year is chosen when the general price level is normal, i.e., it is neither too high nor too low. The prices are set to 100 (or 1) in the base year.

Now the general price level of the year for which real GDP is to be calculated is related to the base year on the basis of the following formula which is called the deflator index:

Suppose 1990-91 is the base year and GDP for 1999-2000 is Rs. 6, 00,000 crores and the price index for this year is 300.

Thus, Real GDP for 1999-2000 = Rs. 6, 00,000 x 100/300 = Rs. 2, 00,000 crores

(E) GDP Deflator:

GDP deflator is an index of price changes of goods and services included in GDP. It is a price index which is calculated by dividing the nominal GDP in a given year by the real GDP for the same year and multiplying it by 100. Thus, It shows that at constant prices (1993-94), GDP in 1997-98 increased by 135.9% due to inflation (or rise in prices) from Rs. 1049.2 thousand crores in 1993-94 to Rs. 1426.7 thousand crores in 1997-98.

(F) Gross National Product (GNP):

GNP is the total measure of the flow of goods and services at market value resulting from current production during a year in a country, including net income from abroad.

GNP includes four types of final goods and services:

(1) Consumers' goods and services to satisfy the immediate wants of the people;

(2) Gross private domestic investment in capital goods consisting of fixed capital formation, residential construction and inventories of finished and unfinished goods;

(3) Goods and services produced by the government; and

(4) Net exports of goods and services, i.e., the difference between value of exports and imports of goods and services, known as net income from abroad.

In this concept of GNP, there are certain factors that have to be taken into consideration: First, GNP is the measure of money, in which all kinds of goods and services produced in a country during one year are measured in terms of money at current prices and then added together.

But in this manner, due to an increase or decrease in the prices, the GNP shows a rise or decline, which may not be real. To guard against erring on this account, a particular year (say for instance 1990-91) when prices be normal, is taken as the base year and the GNP is adjusted in accordance with the index number for that year. This will be known as GNP at 1990-91 prices or at constant prices.

Second, in estimating GNP of the economy, the market price of only the final products should be taken into account. Many of the products pass through a number of stages before they are ultimately purchased by consumers.

If those products were counted at every stage, they would be included many a time in the national product. Consequently, the GNP would increase too much. To avoid double counting, therefore, only the final products and not the intermediary goods should be taken into account.

Third, goods and services rendered free of charge are not included in the GNP, because it is not possible to have a correct estimate of their market price. For example, the bringing up of a child by the mother, imparting instructions to his son by a teacher, recitals to his friends by a musician, etc.

Fourth, the transactions which do not arise from the produce of current year or which do not contribute in any way to production are not included in the GNP. The sale and purchase of old goods, and of shares, bonds and assets of existing companies are not included in GNP because these do not make any addition to the national product, and the goods are simply transferred.

Fifth, the payments received under social security, e.g., unemployment insurance allowance, old age pension, and interest on public loans are also not included in GNP, because the recipients do not provide any service in lieu of them. But the depreciation of machines, plants and other capital goods is not deducted from GNP.

Sixth, the profits earned or losses incurred on account of changes in capital assets as a result of fluctuations in market prices are not included in the GNP if they are not responsible for current production or economic activity.

For example, if the price of a house or a piece of land increases due to inflation, the profit earned by selling it will not be a part of GNP. But if, during the current year, a portion of a house is constructed anew, the increase in the value of the house (after subtracting the cost of the newly constructed portion) will be included in the GNP. Similarly, variations in the value of assets, that can be ascertained beforehand and are insured against flood or fire, are not included in the GNP.

Last, the income earned through illegal activities is not included in the GNP. Although the goods sold in the black market are priced and fulfill the needs of the people, but as they are not useful from the social point of view, the income received from their sale and purchase is always excluded from the GNP.

There are two main reasons for this. One, it is not known whether these things were produced during the current year or the preceding years. Two, many of these goods are foreign made and smuggled and hence not included in the GNP.

Three Approaches to GNP:

After having studied the fundamental constituents of GNP, it is essential to know how it is estimated. Three approaches are employed for this purpose. One, the income method to GNP; two, the expenditure method to GNP and three, the value added method to GNP. Since gross income equals gross expenditure, GNP estimated by all these methods would be the same with appropriate adjustments.

1. Income Method to GNP:

The income method to GNP consists of the remuneration paid in terms of money to the factors of production annually in a country.

Thus GNP is the sum total of the following items:

(i) Wages and salaries:

Under this head are included all forms of wages and salaries earned through productive activities by workers and entrepreneurs. It includes all sums received or deposited during a year by way of all types of contributions like overtime, commission, provident fund, insurance, etc.

(ii) Rents:

Total rent includes the rents of land, shop, house, factory, etc. and the estimated rents of all such assets as are used by the owners themselves.

(iii) Interest:

Under interest comes the income by way of interest received by the individual of a country from different sources. To this is added, the estimated interest on that private capital which is invested and not borrowed by the businessman in his personal business. But the interest received on governmental loans has to be excluded, because it is a mere transfer of national income.

(iv) Dividends:

Dividends earned by the shareholders from companies are included in the GNP.

(v) Undistributed corporate profits:

Profits which are not distributed by companies and are retained by them are included in the GNP.

(vi) Mixed incomes:

These include profits of unincorporated business, self-employed persons and partnerships. They form part of GNP.

(vii) Direct taxes:

Taxes levied on individuals, corporations and other businesses are included in the GNP.

(viii) Indirect taxes:

The government levies a number of indirect taxes, like excise duties and sales tax.

These taxes are included in the price of commodities. But revenue from these goes to the government treasury and not to the factors of production. Therefore, the income due to such taxes is added to the GNP.

(ix) Depreciation:

Every corporation makes allowance for expenditure on wearing out and depreciation of machines, plants and other capital equipment. Since this sum also is not a part of the income received by the factors of production, it is, therefore, also included in the GNP.

(x) Net income earned from abroad:

This is the difference between the value of exports of goods and services and the value of imports of goods and services. If this difference is positive, it is added to the GNP and if it is negative, it is deducted from the GNP.

Thus GNP according to the Income Method = Wages and Salaries + Rents + Interest + Dividends + Undistributed Corporate Profits + Mixed Income + Direct Taxes + Indirect Taxes + Depreciation + Net Income from abroad.

2. Expenditure Method to GNP:

From the expenditure view point, GNP is the sum total of expenditure incurred on goods and services during one year in a country.

It includes the following items:

(i) Private consumption expenditure:

It includes all types of expenditure on personal consumption by the individuals of a country. It comprises expenses on durable goods like watch, bicycle, radio, etc., expenditure on single-used consumers' goods like milk, bread, ghee, clothes, etc., as also the expenditure incurred on services of all kinds like fees for school, doctor, lawyer and transport. All these are taken as final goods.

(ii) Gross domestic private investment:

Under this comes the expenditure incurred by private enterprise on new investment and on replacement of old capital. It includes expenditure on house construction, factory- buildings, and all types of machinery, plants and capital equipment.

In particular, the increase or decrease in inventory is added to or subtracted from it. The inventory includes produced but unsold manufactured and semi-manufactured goods during the year and the stocks of raw materials, which have to be accounted for in GNP. It does not take into account the financial exchange of shares and stocks because their sale and purchase is not real investment. But depreciation is added.

(iii) Net foreign investment:

It means the difference between exports and imports or export surplus. Every country exports to or imports from certain foreign countries. The imported goods are not produced within the country and hence cannot be included in national income, but the exported goods are manufactured within the country. Therefore, the difference of value between exports (X) and imports (M), whether positive or negative, is included in the GNP.

(iv) Government expenditure on goods and services:

The expenditure incurred by the government on goods and services is a part of the GNP. Central, state or local governments spend a lot on their employees, police and army. To run the offices, the governments have also to spend on contingencies which include paper, pen, pencil and various types of stationery, cloth, furniture, cars, etc.

It also includes the expenditure on government enterprises. But expenditure on transfer payments is not added, because these payments are not made in exchange for goods and services produced during the current year.

Thus GNP according to the Expenditure Method=Private Consumption Expenditure (C) + Gross Domestic Private Investment (I) + Net Foreign Investment (X-M) + Government Expenditure on Goods and Services (G) = C+ I + (X-M) + G.

As already pointed out above, GNP estimated by either the income or the expenditure method would work out to be the same, if all the items are correctly calculated.

3. Value Added Method to GNP:

Another method of measuring GNP is by value added. In calculating GNP, the money value of final goods and services produced at current prices during a year is taken into account. This is one of the ways to avoid double counting. But it is difficult to distinguish properly between a final product and an intermediate product.

For instance, raw materials, semi-finished products, fuels and services, etc. are sold as inputs by one industry to the other. They may be final goods for one industry and intermediate for others. So, to avoid duplication, the value of intermediate products used in manufacturing final products must be subtracted from the value of total output of each industry in the economy.

Thus, the difference between the value of material outputs and inputs at each stage of production is called the value added. If all such differences are added up for all industries in the economy, we arrive at the GNP by value added. GNP by value added = Gross value added + net income from abroad. Its calculation is shown in Tables 1, 2 and 3.

Table 1 is constructed on the supposition that the entire economy for purposes of total production consists of three sectors. They are agriculture, manufacturing, and others, consisting of the tertiary sector.

Out of the value of total output of each sector is deducted the value of its intermediate purchases (or primary inputs) to arrive at the value added for the entire economy. Thus the value of total output of the entire economy as per Table 1, is Rs. 155 crores and the value of its primary inputs comes to Rs. 80 crores. Thus the GDP by value added is Rs. 75 crores (Rs. 155 minus Rs. 80 crores).

The total value added equals the value of gross domestic product of the economy. Out of this value added, the major portion goes in the form wages and salaries, rent, interest and profits, a small portion goes to the government as indirect taxes and the remaining amount is meant for depreciation. This is shown in Table 3.

Thus we find that the total gross value added of an economy equals the value of its gross domestic product. If depreciation is deducted from the gross value added, we have net value added which comes to Rs. 67 crores (Rs. 75 minus Rs. 8 crores).

This is nothing but net domestic product at market prices. Again, if indirect taxes (Rs. 7 crores) are deducted from the net domestic product of Rs. 67 crores, we get Rs. 60 crores as the net value added at factor cost which is equivalent to net domestic product at factor cost. This is illustrated in Table 2.

Net value added at factor cost is equal to the net domestic product at factor cost, as given by the total of items 1 to 4 of Table 2 (Rs. 45+3+4+8 crores=Rs. 60 crores). By adding indirect taxes (Rs 7 crores) and depreciation (Rs 8 crores), we get gross value added or GDP which comes to Rs 75 crores.

If we add net income received from abroad to the gross value added, this gives -us, gross national income. Suppose net income from abroad is Rs. 5 crores. Then the gross national income is Rs. 80 crores (Rs. 75 crores + Rs. 5 crores) as shown in Table 3.

It's Importance:

The value added method for measuring national income is more realistic than the product and income methods because it avoids the problem of double counting by excluding the value of intermediate products. Thus this method establishes the importance of intermediate products in the national economy. Second, by studying the national income accounts relating to value added, the contribution of each production sector to the value of the GNP can be found out.

For instance, it can tell us whether agriculture is contributing more or the share of manufacturing is falling, or of the tertiary sector is increasing in the current year as compared to some previous years. Third, this method is highly useful because "it provides a means of checking the GNP estimates obtained by summing the various types of commodity purchases."

It's Difficulties:

However, difficulties arise in the calculation of value added in the case of certain public services like police, military, health, education, etc. which cannot be estimated accurately in money terms. Similarly, it is difficult to estimate the contribution made to value added by profits earned on irrigation and power projects.

(G) GNP at Market Prices:

When we multiply the total output produced in one year by their market prices prevalent during that year in a country, we get the Gross National Product at market prices. Thus GNP at market prices means the gross value of final goods and services produced annually in a country plus net income from abroad. It includes the gross value of output of all items from (1) to (4) mentioned under GNP. GNP at Market Prices = GDP at Market Prices + Net Income from Abroad.

(H) GNP at Factor Cost:

GNP at factor cost is the sum of the money value of the income produced by and accruing to the various factors of production in one year in a country. It includes all items mentioned above under income method to GNP less indirect taxes.

GNP at market prices always includes indirect taxes levied by the government on goods which raise their prices. But GNP at factor cost is the income which the factors of production receive in return for their services alone. It is the cost of production.

Thus GNP at market prices is always higher than GNP at factor cost. Therefore, in order to arrive at GNP at factor cost, we deduct indirect taxes from GNP at market prices. Again, it often happens that the cost of production of a commodity to the producer is higher than a price of a similar commodity in the market.

In order to protect such producers, the government helps them by granting monetary help in the form of a subsidy equal to the difference between the market price and the cost of production of the commodity. As a result, the price of the commodity to the producer is reduced and equals the market price of similar commodity.

For example if the market price of rice is Rs. 3 per kg but it costs the producers in certain areas Rs. 3.50. The government gives a subsidy of 50 paisa per kg to them in order to meet their cost of production. Thus in order to arrive at GNP at factor cost, subsidies are added to GNP at market prices.

GNP at Factor Cost = GNP at Market Prices – Indirect Taxes + Subsidies.

(I) Net National Product (NNP):

NNP includes the value of total output of consumption goods and investment goods. But the process of production uses up a certain amount of fixed capital. Some fixed equipment wears out, its other components are damaged or destroyed, and still others are rendered obsolete through technological changes.

All this process is termed depreciation or capital consumption allowance. In order to arrive at NNP, we deduct depreciation from GNP. The word 'net' refers to the exclusion of that part of total output which represents depreciation. So NNP = GNP—Depreciation.

(J) NNP at Market Prices:

Net National Product at market prices is the net value of final goods and services evaluated at market prices in the course of one year in a country. If we deduct depreciation from GNP at market prices, we get NNP at market prices. So NNP at Market Prices = GNP at Market Prices—Depreciation.

(K) NNP at Factor Cost:

Net National Product at factor cost is the net output evaluated at factor prices. It includes income earned by factors of production through participation in the production process such as wages and salaries, rents, profits, etc. It is also called National Income. This measure differs from NNP at market prices in that indirect taxes are deducted and subsidies are added to NNP at market prices in order to arrive at NNP at factor cost. Thus

NNP at Factor Cost = NNP at Market Prices – Indirect taxes+ Subsidies

= GNP at Market Prices – Depreciation – Indirect taxes + Subsidies.

= National Income.

Normally, NNP at market prices is higher than NNP at factor cost because indirect taxes exceed government subsidies. However, NNP at market prices can be less than NNP at factor cost when government subsidies exceed indirect taxes.

(L) Domestic Income:

Income generated (or earned) by factors of production within the country from its own resources is called domestic income or domestic product.

Domestic income includes:

(i) Wages and salaries, (ii) rents, including imputed house rents, (iii) interest, (iv) dividends, (v) undistributed corporate profits, including surpluses of public undertakings, (vi) mixed incomes consisting of profits of unincorporated firms, self- employed persons, partnerships, etc., and (vii) direct taxes.

Since domestic income does not include income earned from abroad, it can also be shown as: Domestic Income = National Income-Net income earned from abroad. Thus the difference between domestic income f and national income is the net income earned from abroad. If we add net income from abroad to domestic income, we get national income, i.e., National Income = Domestic Income + Net income earned from abroad.

But the net national income earned from abroad may be positive or negative. If exports exceed import, net income earned from abroad is positive. In this case, national income is greater than domestic income. On the other hand, when imports exceed exports, net income earned from abroad is negative and domestic income is greater than national income.

(M) Private Income:

Private income is income obtained by private individuals from any source, productive or otherwise, and the retained income of corporations. It can be arrived at from NNP at Factor Cost by making certain additions and deductions.

The additions include transfer payments such as pensions, unemployment allowances, sickness and other social security benefits, gifts and remittances from abroad, windfall gains from lotteries or from horse racing, and interest on public debt. The deductions include income from government departments as well as surpluses from public undertakings, and employees' contribution to social security schemes like provident funds, life insurance, etc.

Thus Private Income = National Income (or NNP at Factor Cost) + Transfer Payments + Interest on Public Debt — Social Security — Profits and Surpluses of Public Undertakings.

(N) Personal Income:

Personal income is the total income received by the individuals of a country from all sources before payment of direct taxes in one year. Personal income is never equal to the national income, because the former includes the transfer payments whereas they are not included in national income.

Personal income is derived from national income by deducting undistributed corporate profits, profit taxes, and employees' contributions to social security schemes. These three components are excluded from national income because they do reach individuals.

But business and government transfer payments, and transfer payments from abroad in the form of gifts and remittances, windfall gains, and interest on public debt which are a source of income for individuals are added to national income. Thus Personal Income = National Income – Undistributed Corporate Profits – Profit Taxes – Social Security Contribution + Transfer Payments + Interest on Public Debt.

Personal income differs from private income in that it is less than the latter because it excludes undistributed corporate profits.

Thus Personal Income = Private Income – Undistributed Corporate Profits – Profit Taxes.

(O) Disposable Income:

Disposable income or personal disposable income means the actual income which can be spent on consumption by individuals and families. The whole of the personal income cannot be spent on consumption, because it is the income that accrues before direct taxes have actually been paid. Therefore, in order to obtain disposable income, direct taxes are deducted from personal income. Thus Disposable Income=Personal Income – Direct Taxes.

But the whole of disposable income is not spent on consumption and a part of it is saved. Therefore, disposable income is divided into consumption expenditure and savings. Thus Disposable Income = Consumption Expenditure + Savings.

If disposable income is to be deduced from national income, we deduct indirect taxes plus subsidies, direct taxes on personal and on business, social security payments, undistributed corporate profits or business savings from it and add transfer payments and net income from abroad to it.

Thus Disposable Income = National Income – Business Savings – Indirect Taxes + Subsidies – Direct Taxes on Persons – Direct Taxes on Business – Social Security Payments + Transfer Payments + Net Income from abroad.

(P) Real Income:

Real income is national income expressed in terms of a general level of prices of a particular year taken as base. National income is the value of goods and services produced as expressed in terms of money at current prices. But it does not indicate the real state of the economy.

It is possible that the net national product of goods and services this year might have been less than that of the last year, but owing to an increase in prices, NNP might be higher this year. On the contrary, it is also possible that NNP might have increased but the price level might have fallen, as a result national income would appear to be less than that of the last year. In both the situations, the national income does not depict the real state of the country. To rectify such a mistake, the concept of real income has been evolved.

In order to find out the real income of a country, a particular year is taken as the base year when the general price level is neither too high nor too low and the price level for that year is assumed to be 100. Now the general level of prices of the given year for which the national income (real) is to be determined is assessed in accordance with the prices of the base year. For this purpose the following formula is employed.

Real NNP = NNP for the Current Year x Base Year Index (=100) / Current Year Index

Suppose 1990-91 is the base year and the national income for 1999-2000 is Rs. 20,000 crores and the index number for this year is 250. Hence, Real National Income for 1999-2000 will be = 20000 x 100/250 = Rs. 8000 crores. This is also known as national income at constant prices.

(Q) Per Capita Income:

The average income of the people of a country in a particular year is called Per Capita Income for that year. This concept also refers to the measurement of income at current prices and at constant prices. For instance, in order to find out the per capita income for 2001, at current prices, the national income of a country is divided by the population of the country in that year.

Similarly, for the purpose of arriving at the Real Per Capita Income, this very formula is used.

This concept enables us to know the average income and the standard of living of the people. But it is not very reliable, because in every country due to unequal distribution of national income, a major portion of it goes to the richer sections of the society and thus income received by the common man is lower than the per capita income.

3. Methods of Measuring National Income:

There are four methods of measuring national income. Which method is to be used depends on the availability of data in a country and the purpose in hand.

(1) Product Method:

According to this method, the total value of final goods and services produced in a country during a year is calculated at market prices. To find out the GNP, the data of all productive activities, such as agricultural products, wood received from forests, minerals received from mines, commodities produced by industries, the contributions to production made by transport, communications, insurance companies, lawyers, doctors, teachers, etc. are collected and assessed at market prices. Only the final goods and services are included and the intermediary goods and services are left out.

(2) Income Method:

According to this method, the net income payments received by all citizens of a country in a particular year are added up, i.e., net incomes that accrue to all factors of production by way of net rents, net wages, net interest and net profits are all added together but incomes received in the form of transfer payments are not included in it. The data pertaining to income are obtained from different sources, for instance, from income tax department in respect of high income groups and in case of workers from their wage bills.

(3) Expenditure Method:

According to this method, the total expenditure incurred by the society in a particular year is added together and includes personal consumption expenditure, net domestic investment, government expenditure on goods and services, and net foreign investment. This concept is based on the assumption that national income equals national expenditure.

(4) Value Added Method:

Another method of measuring national income is the value added by industries. The difference between the value of material outputs and inputs at each stage of production is the value added. If all such differences are added up for all industries in the economy, we arrive at the gross domestic product.

4. Difficulties or Limitations in Measuring National Income:

There are many conceptual and statistical problems involved in measuring national income by the income method, product method, and expenditure method.

We discuss them separately in the light of the three methods:

(A) Problems in Income Method:

The following problems arise in the computation of National Income by income method:

1. Owner-occupied Houses:

A person who rents a house to another earns rental income, but if he occupies the house himself, will the services of the house-owner be included in national income. The services of the owner-occupied house are included in national income as if the owner sells to himself as a tenant its services.

For the purpose of national income accounts, the amount of imputed rent is estimated as the sum for which the owner-occupied house could have been rented. The imputed net rent is calculated as that portion of the amount that would have accrued to the house-owner after deducting all expenses.

2. Self-employed Persons:

Another problem arises with regard to the income of self-employed persons. In their case, it is very difficult to find out the different inputs provided by the owner himself. He might be contributing his capital, land, labour and his abilities in the business. But it is not possible to estimate the value of each factor input to production. So he gets a mixed income consisting of interest, rent, wage and profits for his factor services. This is included in national income.

3. Goods meant for Self-consumption:

In under-developed countries like India, farmers keep a large portion of food and other goods produced on the farm for self-consumption. The problem is whether that part of the produce which is not sold in the market can be included in national income or not. If the farmer were to sell his entire produce in the market, he will

have to buy what he needs for self-consumption out of his money income. If, instead he keeps some produce for his self-consumption, it has money value which must be included in national income.

4. Wages and Salaries paid in Kind:

Another problem arises with regard to wages and salaries paid in kind to the employees in the form of free food, lodging, dress and other amenities. Payments in kind by employers are included in national income. This is because the employees would have received money income equal to the value of free food, lodging, etc. from the employer and spent the same in paying for food, lodging, etc.

(B) Problems in Product Method:

The following problems arise in the computation of national income by product method:

1. Services of Housewives:

The estimation of the unpaid services of the housewife in the national income presents a serious difficulty. A housewife renders a number of useful services like preparation of meals, serving, tailoring, mending, washing, cleaning, bringing up children, etc.

She is not paid for them and her services are not including in national income. Such services performed by paid servants are included in national income. The national income is, therefore, underestimated by excluding the services of a housewife.

The reason for the exclusion of her services from national income is that the love and affection of a housewife in performing her domestic work cannot be measured in monetary terms. That is why when the owner of a firm marries his lady secretary, her services are not included in national income when she stops working as a secretary and becomes a housewife.

When a teacher teaches his own children, his work is also not included in national income. Similarly, there are a number of goods and services which are difficult to be assessed in money terms for the reason stated above, such as painting, singing, dancing, etc. as hobbies.

2. Intermediate and Final Goods:

The greatest difficulty in estimating national income by product method is the failure to distinguish properly between intermediate and final goods. There is always the possibility of including a good or service more than once, whereas only final goods are included in national income estimates. This leads to the problem of double counting which leads to the overestimation of national income.

3. Second-hand Goods and Assets:

Another problem arises with regard to the sale and purchase of second-hand goods and assets. We find that old scooters, cars, houses, machinery, etc. are transacted daily in the country. But they are not included in national income because they were counted in the national product in the year they were manufactured.

If they are included every time they are bought and sold, national income would increase many times. Similarly, the sale and purchase of old stocks, shares, and bonds of companies are not included in national income because they were included in national income when the companies were started for the first time. Now they are simply financial transactions and represent claims.

But the commission or fees charged by the brokers in the repurchase and resale of old shares, bonds, houses, cars or scooters, etc. are included in national income. For these are the payments they receive for their productive services during the year.

4. Illegal Activities:

Income earned through illegal activities like gambling, smuggling, illicit extraction of wine, etc. is not included in national income. Such activities have value and satisfy the wants of the people but they are not considered productive from the point of view of society. But in countries like Nepal and Monaco where gambling is legalised, it is included in national income. Similarly, horse-racing is a legal activity in England and is included in national income.

5. Consumers' Service:

There are a number of persons in society who render services to consumers but they do not produce anything tangible. They are the actors, dancers, doctors, singers, teachers, musicians, lawyers, barbers, etc. The problem arises about the inclusion of their services in national income since they do not produce tangible commodities. But as they satisfy human wants and receive payments for their services, their services are included as final goods in estimating national income.

6. Capital Gains:

The problem also arises with regard to capital gains. Capital gains arise when a capital asset such as a house, some other property, stocks or shares, etc. is sold at higher price than was paid for it at the time of purchase. Capital gains are excluded from national income because these do not arise from current economic activities. Similarly, capital losses are not taken into account while estimating national income.

7. Inventory Changes:

All inventory changes (or changes in stocks) whether positive or negative are included in national income. The procedure is to take changes in physical units of inventories for the year valued at average current prices paid for them.

The value of changes in inventories may be positive or negative which is added or subtracted from the current production of the firm. Remember, it is the change in inventories and not total inventories for the year that are taken into account in national income estimates.

8. Depreciation:

Depreciation is deducted from GNP in order to arrive at NNP. Thus depreciation lowers the national income. But the problem is of estimating the current depreciated value of, say, a machine, whose expected life is supposed to be thirty years. Firms calculate the depreciation value on the original cost of machines for their expected life. This does not solve the problem because the prices of machines change almost every year.

9. Price Changes:

National income by product method is measured by the value of final goods and services at current market prices. But prices do not remain stable. They rise or fall. When the price level rises, the national income also rises, though the national production might have fallen.

On the contrary, with the fall in the price level, the national income also falls, though the national production might have increased. So price changes do not adequately measure national income. To solve this problem, economists calculate the real national income at a constant price level by the consumer price index.

(C) Problems in Expenditure Method:

The following problems arise in the calculation of national income by expenditure method:

(1) Government Services:

In calculating national income by, expenditure method, the problem of estimating government services arises. Government provides a number of services, such as police and military services, administrative and legal services. Should expenditure on government services be included in national income?

If they are final goods, then only they would be included in national income. On the other hand, if they are used as intermediate goods, meant for further production, they would not be included in national income. There are many divergent views on this issue.

One view is that if police, military, legal and administrative services protect the lives, property and liberty of the people, they are treated as final goods and hence form part of national income. If they help in the smooth functioning of the production process by maintaining peace and seeurity, then they are like intermediate goods that do not enter into national income.

In reality, it is not possible to make a clear demarcation as to which service protects the people and which protects the productive process. Therefore, all such services are regarded as final goods and are included in national income.

(2) Transfer Payments:

There arises the problem of including transfer payments in national income. Government makes payments in the form of pensions, unemployment allowance, subsidies, interest on national debt, etc. These are government expenditures but they are not included in national income because they are paid without adding anything to the production process during the current year.

For instance, pensions and unemployment allowances are paid to individuals by the government without doing any productive work during the year. Subsidies tend to lower the market price of the commodities. Interest on national or public debt is also considered a transfer payment because it is paid by the government to individuals and firms on their past savings without any productive work.

(3) Durable-use Consumers' Goods:

Durable-use consumers' goods also pose a problem. Such durable-use consumers' goods as scooters, cars, fans, TVs, furniture's, etc. are bought in one year but they are used for a number of years. Should they be included under investment expenditure or consumption expenditure in national income estimates? The expenditure on them is regarded as final consumption expenditure because it is not possible to measure their used up value for the subsequent years.

But there is one exception. The expenditure on a new house is regarded as investment expenditure and not consumption expenditure. This is because the rental income or the imputed rent which the house-owner gets is for making investment on the new house. However, expenditure on a car by a household is consumption expenditure. But if he spends the amount for using it as a taxi, it is investment expenditure.

(4) Public Expenditure:

Government spends on police, military, administrative and legal services, parks, street lighting, irrigation, museums, education, public health, roads, canals, buildings, etc. The problem is to find out which expenditure is consumption expenditure and which investment expenditure is.

Expenses on education, museums, public health, police, parks, street lighting, civil and judicial administration are consumption expenditure. Expenses on roads, canals, buildings, etc. are investment expenditure. But expenses on defence equipment are treated as consumption expenditure because they are consumed during a war as they are destroyed or become obsolete. However, all such expenses including the salaries of armed personnel are included in national income.

5. Importance of National Income Analysis:

The national income data have the following importance:

1. For the Economy:

National income data are of great importance for the economy of a country. These days the national income data are regarded as accounts of the economy, which are known as social accounts. These refer to net national income and net national expenditure, which ultimately equal each other.

Social accounts tell us how the aggregates of a nation's income, output and product result from the income of different individuals, products of industries and transactions of international trade. Their main constituents are inter-related and each particular account can be used to verify the correctness of any other account.

2. National Policies:

National income data form the basis of national policies such as employment policy, because these figures enable us to know the direction in which the industrial output, investment and savings, etc. change, and proper measures can be adopted to bring the economy to the right path.

3. Economic Planning:

In the present age of planning, the national data are of great importance. For economic planning, it is essential that the data pertaining to a country's gross income, output, saving and consumption from different sources should be available. Without these, planning is not possible.

4. Economic Models:

The economists propound short-run as well as long-run economic models or long-run investment models in which the national income data are very widely used.

5. Research:

The national income data are also made use of by the research scholars of economics. They make use of the various data of the country's input, output, income, saving, consumption, investment, employment, etc., which are obtained from social accounts.

6. Per Capita Income:

National income data are significant for a country's per capita income which reflects the economic welfare of the country. The higher the per capita income, the higher the economic welfare of the country.

7. Distribution of Income:

National income statistics enable us to know about the distribution of income in the country. From the data pertaining to wages, rent, interest and profits, we learn of the disparities in the incomes of different sections of the society. Similarly, the regional distribution of income is revealed.

It is only on the basis of these that the government can adopt measures to remove the inequalities in income distribution and to restore regional equilibrium. With a view to removing these personal and regional disequibria, the decisions to levy more taxes and increase public expenditure also rest on national income statistics.

4.3. TRENDS IN NATIONAL INCOME

Methods of National Income Accounting in India

- United Nations for the sake of uniformity and comparison suggest methodology to nations.
- India follows the methodology suggested by UNO and divides the economy in 14 broad categories which are further organized in three groups A, B and C.

  Methods of National Income Accounting in India

- In Group A has 6 activities viz : 1.Agriculture2.forestry 3.mining 4. finishing 5.quarrying and registered manufacturing and 6.construction.
- Production method is used for these activities. The value addition is calculated by deducting value of raw material and inputs from the aggregate production commodity wise

Methods of National Income Accounting in India

- In group B has Electricity, railways ,Air Transport ,water ,organized transportation, Communication, banking , and insurance ,real estate, public administration and defense.
- Income method is adopted for theseactivities. All types of factor income reportedin the accounts of these organization areaggregated.

Methods of National IncomeAccounting in India

- In group C, gas and water supply , unorganized roadand water transport, storage , trade , hotel andrestaurants, ownership of dwelling and other servicesare included.
- For this group sample survey is done to find outaverage productivity of the workers.
- Estimates of the work force are interpolated andextrapolated and periodical computation of averageproductivity are carried forward and backward . Theyear to year productivity so derived are thenmultiplied to arrive at the estimates of value added.

In the Pre-independence Period the first estimation of National Income is done by the father of Indian economy DadaBhai Naorojiin 1868.In his book Poverty and Un-British Rule in India, estimated India's Percapita Income as Rs.20. While the first systematic effort to estimate National Income is undertaken by V.K.R.V. Rao in his Book, National Income in British India 1931-32. In 1949, the Govt. of India appointed a National Income Committee under the Chairmanship of P.C. Mahalanobis and V.K.R.V. Rao and D.R.Gadgil as the Members. Its first Report came in 1951 and second in 1954. According to the report the National Income of the country is Rs. 8650 crore and Percapita Income is Rs.246.90. Now, in India the National Income is estimated by CSO which is founded in 1951 and located in Delhi. The National Income is estimated both in current and constant year prices.

National Income is defined as the money value of all final goods and services produced in a country during a particular time period.

In India it is one year period known as financial year. The financial year starts in April 1st and ends in March 31st. The national income figures are deflated at constant prices to eliminate the effect of any change of price level during the period. The national income figures at constant prices, therefore, become comparable, but they conceal the population effect and show nothing about the standard of living. Therefore the per capita national product or per capita income is calculated. PCI at constant price is an indicator of change in the standard of living of the people. The current base year for the estimation of National Income in India is 2004-05. Since NNP at factor cost represents the national income, below table shows both NI and PCI in the base year 2004-05. Its growth rate is also shown in the table.

From the data given in the table revealed that for the 30 years periods, i.e.,1950-51 to 1980-81 the annual average growth rate is 3.5%. This was referred as Hindu rate of growth by Prof. Raj Krishna because the growth rate of the economy is very similar to the growth rate of Hindu families in India during the same period of time. During this period the growth rate of per capita income is very low and it is just 1.4 % annually.

There was very perceptible improvement in the growth rate during the eighties. During 1980-81 and 1990-91 the national income showed a growth rate of 5.2 % per annum and the Per capita NNP at 3 % per annum. This is very healthy development as far as the economy is concerned.

During 1990-91 to 2000-01 the annual average growth rate of NNP at factor cost (NI) was 5.5 % per annum and that of NNP Per capita was 3.4 % per annum. During 2000-01 and 2004-05, NNP growth rate accelerated to 6.4% and Per capita NNP grew at the rate of 4.7 % per annum. During 2004-05 to 2010-11 we find further acceleration in the NNP to 8.4 % and that of Per capita income to 6.9 %.

In State wise GSDP at constant price Maharashtra stood top with Rs. 8,05,031 Crores in 2011-12 and Mizoram in the lowest position with GSDP Rs. 5,017. In the case of Per capita Net State Domestic Product Goa stood top with Rs.1,12,602 and Bihar in the bottom with Rs.13,178 in 2011-12 estimates at constant price.

NNP at Factor Cost and Per Capita NNP at constant Price (2004-05)

Period	NNP at Factor Cost(In crore)	Per Capita NNP at factor Cost(In Rs.)
1950-51	255,405	7,114
1955-56	314,238	7,996
1960-61	385,761	8,889
1965-66	436,650	9,003
1970-71	541,867	10,016
1975-76	626,779	10,326
1980-81	727,359	10,712
1985-86	913,143	12,095
1990-91	1,202,305	14,330
1995-96	1,547,480	16,675
2000-01	2,074,858	20,362
2005-06	2,877,284	26,015
2010-11	4,268,715	35,993
2011-12	4,549,652	37,851
2012-13(AE)	4,764,819	39,143

Source: A Hand Book on Indian Economy Published by RBI

Rate of growth of NNP at Factor Cost and Per Capita NNP

Period	NNP at Factor Cost	Per Capita NNP at factor Cost
1950-51 to1960-61	4.2	2.3
1960-61 to 1970-71	3.5	1.2
1970-71 to 1980-81	2.9	0.6
1980-81 to 1990-91	5.2	3.0
1990-91 to 2000-01	5.5	3.4
2000-01 to 2004-05	6.4	4.6
2004-05 to 2010-11	8.4	6.9
2011-2012	6.2	4.7
2012-2013	4.9	2.9

Source: A Hand Book on Indian Economy Published by RBI

Share of GDP by Industry origin at 1999-00 series

	1950-51	1960-61	1970-71	1980-81	1990-91	2001-02	2010-11	2012-13
Primary	55.4	54.8	46.3	38.0	32.2	24.0	14.3	13.68
Secondary	15	16.6	21.6	24.0	27.2	26.7	27.9	27.03
Tertiary	29.6	28.6	32.1	38.0	40.6	49.3	57.8	59.29

Source: CSO and Various Economic Surveys

4.4.INEQUALITIES OF INCOME AND WEALTH

The Concept of Inequality

While the concept of poverty is rooted in the "lack of access" or "a low level of access" to food, nutrition, shelter, education and other services. Inequality is related to "unequal access" or "different degrees of access" of individuals or groups of individuals to opportunities, services and benefits. Inequality is, thus, a more general concept than poverty. It looks at the relative levels of access of different groups to development opportunities and benefits. The "different levels of access" in the concept of inequality also include the low level of access below which people are considered poor. In fact, the low level of access or the limit (like for example, the calorie limit for consumption) that may be set for defining poverty will itself include a lower levels of access.

Inequality in India

India is shining for only a select few. The impressive economic growth of our country has brought smiles on the faces of the rich and the powerful even as the rest suffer in distress and drudgery. This was revealed by the Human Development Report, 2011 (HDR) released by Planning Commission. The report highlights the skewed income and wealth distribution in India and the widening gap between the rich and the poor. According to HDR 2011, inequality in India for the period 2010-11 in terms of the income Gini coefficient was 36.8. India's Gini index was more favourable than those of comparable countries like South Africa (57.8), Brazil(53.9), Thailand (53.6), Turkey (39.7), China (41.5), Sri Lanka (40.3), Malaysia (46.2),Vietnam (37.6), and even the USA (40.8), Hong Kong (43.4), Argentina (45.8), Israel (39.2), and Bulgaria (45.3) which are otherwise ranked very high in human development.

There are three important types of inequality exist in India, namely inequality in income and consumption, inequality in assets and regional inequality. These three forms of inequality are interrelated and mutually reinforcing. The Government of India has been concerned about rising inequalities and uneven distribution of the benefits of growth. Accordingly, the thrust of the 11th Five-Year Plan (2007-) was on inclusive growth. The Forth coming 12th Five-Year Plan is expected to deepen and sharpen the focus on inequalities.

Inequality in Income and Consumption

Let us look at levels of inequality in income or consumption. Consumer expenditure of households is a good proxy for income, at least in the lower classes. A study of inequalities in levels of consumption will by itself be useful in an economy where agriculture, the un-organised sector, payment of wages in kind and the non-monetised sector still play an important role Such an analysis will be able to pinpoint attention on specific areas of concern in the consumption pyramid. Let us, therefore, turn to levels of inequality in consumption.

The household consumer expenditure surveys of the NSSO provide the levels of consumption of expenditure in the population by Monthly Per capita Consumer Expenditure (MPSE) classes. The Average MPCE of the rural people in India is only Rs.1054 and in Urban it is Rs.1984.

Share of Household Expenditure by Percentile Groups of Households (in %)

Percentile groups of Households	1989-90	1994	1997	2004-05
Lowest 20 percent	8.8	9.2	8.1	8.1
Second quintile	12.5	13.0	11.0	11.3
Third quintile	16.2	16.8	15.0	14.9
Fourth quintile	21.3	21.7	19.3	20.4
Highest 20 percent	41.3	39.3	46.1	45.3
Highest 10 percent	27.1	25.0	33.5	31.1

Source: Various NSSO Report

A comparison of the share of the bottom 10 per cent(or 20 per cent or 50 per cent) of the population in total consumption with that of top 10 per cent (or 20 per cent or 50 per cent) of the population brings out dramatically the extent of inequality in consumption. The inequality situation is worse in urban areas than in rural areas. This is so in all States and Union Territories. Inequality in consumption is declining, albeit slowly, in rural areas according to all measures of inequality. On the other hand, urban inequality shows no sign of any decline.

Inequality in Assets

Incomes are derived from two main sources. Namely, assets like land, cattle, shares and labour etc. In India a few own a large chunk of income-earning assets therefore the distribution of assets is extremely unequal. The top 5 per cent of the households possess 38 per cent of the total assets and the bottom 60 per cent of households owning a mere 13 per cent. The disparity is more glaring in the urban areas where 60 per cent of the households at the bottom own just 10 per cent of the assets. Predictably, asset accumulation is minimal among the agricultural labour households in rural areas and casual labour ho use holds in urban areas. But the asset distribution is even more unequal in the urban than in the rural areas. At the one extreme there are highly rich households of industrial, commercial, financial, and real estate magnates and some ex-princes and political leaders. They own enormous assets and running for huge profits. On the other extreme there are slums, and pavement dwellers, unemployed and casual labourers, independent workers providing petty services etc. who generally hold negligible assets.

Regional Inequality

Third important type of inequality that India faces is the regional inequality. Some states are economically and socially advanced while others are backward. Even within each state some regions are more developed while others are primitive. The co existence of relatively developed and economically depressed states and even regions within each state is known as regional inequality. The existence of regional inequality creates social, economic and political issues. The regional inequality is so prominent in India in the case of HDI Value, growth of the economy, poverty, unemployment, education, health, monthly per capita expenditure, rural- urban divide etc.

The India Human Development Report, 2013 shows that India has a HDI value of 0.547. The HDI is the highest for Kerala (0.790) followed by Goa (0.617) and then Punjab (0.605) and the lowest for Chhattisgarh (0.358), Odisha (0.362) and Bihar (0.367). While the HDI scores across states show little variation the variation in the sub-indices for education and health show a greater degree of variation. The income index shows the least degree of variation. The major states are distributed between the categories of countries with 'Medium' and 'Low Human Development' as per the HDR 2011 classification. Kerala is in the 'Medium HDI' category. Other major states in this group are Punjab, Himachal Pradesh, Haryana, Maharashtra, Tamil Nadu, Karnataka, Gujarat, West Bengal and Uttarakhand. Nine other states, namely Andhra Pradesh, Assam, Uttar Pradesh, Rajasthan, Jharkhand, Madhya Pradesh, Chhattisgarh, Bihar and Odisha fall in the 'Low HDI' category India is ranked 134 out of 187 countries in the Global HDI,2011.

The best performer in terms of growth in 2009-10 was Uttarakhand, followed by Odisha, Chhattisgarh, and Gujarat and the worst performers were Karnataka, Rajasthan, and Jharkhand. States with above 10 per cent growth rate for the period 2004-5 to 2009-10 are Uttarakhand, followed by Maharashtra, Gujarat, and Bihar.

The state-wise estimates of poverty as recomputed by the Tendulkar Committee show that the highest poverty headcount ratios (PHRs) for 2009-10exist in Odisha (57.2 per cent), followed by Bihar (54.4 per cent) and Chhattisgarh (49.4 per cent) against the national average of 37.2 per cent.

The unemployment rate (per 1000) according to usual status(adjusted) as per the NSS 66th round 2009-10 among the major states is lowest in Rajasthan(4) and highest in Kerala(75) in rural areas and the lowest in Gujarat(18) and highest again in Kerala(73) and Bihar(73) in urban areas.

In the area of education, Madhya Pradesh has the highest GER (6 -13 years) in 2008-9while Punjab has the lowest. Pupil-teacher ratios in primary and middle/basic schools are the lowest in Himachal Pradesh and high in states like Bihar and Uttar Pradesh.

Health-wise, Kerala is the best performer and Madhya Pradesh the worst in terms of life expectancy at birth (both male and female) during 2002-6. IMR in 2010 is also the lowest in Kerala and highest in Madhya Pradesh. Kerala has the lowest and Uttar Pradesh the highest birth rate in 2010, followed by Bihar and Madhya Pradesh. Odisha has the highest and interestingly West Bengal the lowest death rate.

The MPCE indicator shows that there is disparity both in the MPCE and food share across states. According to the 66th round NSS o round estimates India 's average monthly per capita expenditure is Rs .1053.64 rural and Rs. 1984.46 in urban areas. Bihar has the lowest MPCE of Rs 780 with 65 per cent food share in rural areas and Rs 1238 with 53 percent food share in urban areas whereas Kerala has the highest MPCE of Rs1835 with 46 per cent food share in rural areas and Rs 2413 with 40 per cent food share in urban areas. States with low average MPCE tend to have a higher share of food in total consumer expenditure as food is the primary need for survival and takes up a larger proportion of overall expenditure in the poorer sections of population. The top states spending more than the national average on food items both in rural and urban India are Bihar, Assam, Odisha, and Jharkhand.

Turning to the rural urban gap, we begin with the Monthly per capita expenditure (MPCE) defined first at household level to assign a value that indicates level of living to each individual or household. Based on the 68th round (2011-\12) of the National Sample Survey (NSS), average MPCE [Uniform Reference Period (URP) based] is Rs. 1281.45 and Rs.2401.68 respectively for rural and urban India at the all India level indicating rural-urban income disparities. Out of the MPCE, the share of food is 53.6 per cent and Rs. 40.7 per cent for rural

and urban India respectively which shows that food share is more in rural India as compared to urban area.

Causes of Inequality in India

1.Private ownership of means of production

2. Poverty of the people

3. Law of inheritance

4. Concentration of economic power in the hands of a few

5. Highly unequal asset distribution

6. Inadequate employment generation

7. Inadequate development of the economy

8. Differential regional growth

9. Inequalities in professional training

10. Low investment in social sectors

11. Use of capital intensive technique of production

12. Failure of implementation of land reforms

13. Tax evasion and of the richer sections of the community

14. Inflation

15. Privatisation and globalisation

Remedial measures

In order to find out the remedial measures for inequality it is better to solve first the real causes of it in the country. Any how the following are the some of the measures to solve inequality.

1.Reduction in the concentration of economic power

2. Development of backward areas

3. Better distribution of income and wealth

4. Land reforms

5. Creating more employment opportunities

6. Provide more social security measures

7. Control of black money

8. Progressive income tax

9. Control of monopolies and trade restriction practices

10. High taxes on luxuries

11. Change in inheritance law

12. Use of labour intensive technique of production

13. More investment in social sectors

14. Control of inflation

15. Population control

4.5. LIMITATIONS OF NATIONAL INCOME ESTIMATION

Measurement of national income poses several difficulties, which include both conceptual and statistical ones. They are briefly described below.

1. National income consists of not one but innumerable goods, service, and they have to be somehow added up to arrive at a measure of national income. The real difficulty arises from the fact that dissimilar things cannot be added up. They have to be converted into some common denominator before doing so and the only practical way of doing so is to take their market prices. Now it is widely recognized that market prices do not represent the true social valuation of the goods and services. In the case of officially determined prices, they reflect only what the authorities decide them to be and in the case of market determined prices, all kinds of market imperfections distort them. The market prices are deeply influenced by

(i) The market structure.

(ii) The sales and marketing campaigns of the suppliers.

(iii) Taxation, subsidies and other rules, regulations and restrictions of the authorities.

(iv) The prices of productive resources and distribution of income and wealth.

(v) The role of speculative forces.

(vi) Shifts in prices of imports and exports.

(vii) Several other factors.

In other words, we do not have a reliable method of adding flows of diverse goods and services.

2. The problems of addition increase manifold when we consider the question of estimating national income in real terms. All the problems faced in the compilation of price index numbers are encountered in this case.

3. There are also serious problems regarding the reliability of information to be used in estimating national income. They include the following.

(a) Several pieces of information are available with undue delay and it is not possible to use them in time for formulation of effective policy measures. At the most, this information may be used to revise the past estimates.

(b) A modern economy is so complex that it is next to impossible to gather complete information needed for estimates of national income. A number of intelligent guesses have to be made and used for this purpose. These omissions can be quite serious, particularly in the case of developing countries where adequate records are not maintained. Moreover, in the absence of records, most individuals and households are not able to provide correct information of their consumption and investment values.

(c) In some cases, relevant information may not be available to the authorities because the households and business units required to provide the information may have reasons to hide the information. In still other cases, they may not have the exact information.

4. National income estimates are faulty in terms of their conceptual approach as well. They tend to concentrate on the market pricing of production flows. This in itself is a major limitation of these estimates. The problem is that there is a lack of consistency even in this.

(a) Thus, the household services performed by the members of the household are left out of estimates of income generation. But if the same services are performed by others and are paid for in money terms, they are included in national income estimates. The logical inconsistency of this stand comes to the fore when we compare two Situations. In situation, one, two households perform various household services for themselves and no payment is involved. In situation two, the two households perform same domestic services for each other and pay each other in money terms. Clearly, there is no difference in real national income when we move from one situation to the other. But in national income estimates, this is not so.

(b) Take the case of houses, factory buildings and other structures. When they are constructed, there is a corresponding addition to national production. However, they are also taken to add to the national income in later years when they are used for residential purposes or as production centres. Moreover, this methodology is given up when we consider certain other structures like roads. While the construction of roads is taken to contribute to national income in the year of construction and the repairs are taken to add to national income later, the use of roads is not taken to add to national income. However, if there is a road, which is owned privately and can be used only on payment, the income received by the road owner is again counted as a part of national income. There are similar contradictions in the case of several other durable goods also. Thus, the manufacture of cars is counted as part of national product during the year of manufacture but they are also taken to add to national income in later years if they are hired out on payment instead of being used by the owners themselves. In reality, however, the consumption service provided in both cases is the same.

(c) While consumption of fixed capital is considered for arriving at net output of the economy, loss of other productive assets is ignored. Production activities not only lead to a permanent loss of several mineral deposits, but also lead to degradation of many reproducible resources. Examples include degradation of

land fertility, forest resources, pollution of water, discharge of harmful chemicals in the air and soil and so on. Some of these activities also lead to a loss of human health. However, all such forms of losses to the economy are ignored while estimating net value produced by the economy.

(d) Even if the national income estimates ignore the loss of other productive resources and confine themselves only to the consumption of fixed capital, certain questions are not answered satisfactorily. It can be debated as to whether depreciation should be estimated on the basis of the cost of acquisition and technical life of the capital assets, or it should be estimated on the basis of replacement cost.

5. The national income estimates do not cover illegal activities even though they may be adding to national product. They include smuggling, inland trade activities, production and income generation concealed from the authorities for avoiding tax obligations and prosecution etc.

6. Several economic activities only add to the disutility of the members of society and entail use of resources (resource cost) which could be used for more productive purposes. But an increase in such activities is taken to add to national income rather than reduce it. For example, let us take the case of a worker who has shifted his residence to a greater distance from his work place. Therefore, compared with the earlier situation, he has to commute a longer distance to his work and has to spend additional time, effort and money for doing so. Though, in reality, both the individual worker and the country are losers on account of the shifting of residence of this worker, national income estimates record the additional resource cost as an addition to national income.

7. Similarly, economic activities of the country may add to the output of goods and services (like drugs) which adversely affect the health and productivity of their users. But national income estimates do not take this fact into account. So long as a good or service has a market value, its production is added to the national income estimates.

8. National income estimates include profit of the corporate sector. However, the profit of a business does not reflect the productive contribution of the entrepreneurship. Instead, it varies in relation to several factors like the overall expected or prevailing rate of profit in the economy. This rate itself tends to vary from economy to economy, region-to-region, industry to industry and with the passage of time. In this context, mention may also be made of the fact that a large number of public sector undertakings are not run with the motive of earning a profit, while during a period of deficient demand, even private enterprises often fail to earn a profit. As a result, national income estimates can vary simply because of shifts in rate of profit without any, corresponding change in real output.

Limitations of National Income Accounting

Statistics collection and representation must be looked at carefully or an incorrect thesis may be misconstrued from the data given. The three main limitations to national income accounting are:

Errors in Measurement: Black Market and underground activities are not included when calculating GDP. This is because there is no way to accurately measure black market activity. In the United States, this is a relatively small percentage of the total GDP; however, in many other less developed countries, it can go as high as 70% of the country's total GDP. Another big measurement error is inflation. It is adjusted according to base prices and various other things and the range of possible inflation can be as much as 1% to 15% in some places.

Subcategories that are Mis-represented: The various interpretations of what should be included in consumption or government spending plays a big part in the overall determination of GDP. Decisions are made about what is to be included where, but minor discrepancies will always arise.

Welfare is NOT Measured: GDP only measures the market activity and does not take welfare into account. The economic activity of a country could rise, while welfare could possibly have fallen. Different situations may occur that have a negative impact on the people which cause them to increase spending, therefore increasing the GDP.

4.6. POPULATION

The rapid growth of the world's population over the past one hundred years results from a difference between the rate of birth and the rate of death. The growth in human population around the world affects all people through its impact on the economy and environment. The current rate of population growth is now a significant burden to human well-being. Understanding the factors which affect population growth patterns can help us plan for the future.

Causes of Overpopulation:

i. Decline in the Death Rate:

The fall in death rates that is decline in mortality rate is one fundamental causes of overpopulation. Owing to the advancements in medicine, man has found cures to the previously fatal diseases. The new inventions in medicine have brought in treatments for most of the dreadful diseases. This has resulted in an increase in the life expectancy of individuals. Mortality rate has declined leading to an increase in population.

Owing to modern medications and improved treatments to various illnesses, the overall death rate has gone down. The brighter side of it is that we have been able to fight many diseases and prevent deaths. On the other hand, the medical boon has brought with it, the curse of overpopulation.

ii. Rise in the Birth Rate:

Thanks to the new discoveries in nutritional science, we have been able to bring in increase in the fertility rates of human beings. Medicines of today can boost the reproductive rate in human beings. There are medicines and treatments, which can help in conception. Thus, science has led to an increase in birth rate. This is certainly a reason to be proud and happy but advances in medicine have also become a cause of overpopulation.

iii. Migration:

Immigration is a problem in some parts of the world. If the inhabitants of various countries migrate to a particular part of the world and settle over there, the area is bound to suffer from the ill effects of overpopulation. If the rates of emigration from a certain nation do not match the rates of immigration to that country, overpopulation makes its way. The country becomes overly populated. Crowding of immigrants in certain parts of the world, results in an imbalance in the density of population.

iv. Lack of Education:

Illiteracy is another important cause of overpopulation. Those lacking education fail to understand the need to prevent excessive growth of population. They are unable to understand the harmful effects that overpopulation has.

They are unaware of the ways to control population. Lack of family planning is commonly seen in the illiterate lot of the world. This is one of the major factors leading to overpopulation. Due to ignorance, they do not take to family planning measures, thus contributing to a rise in population.

Viewing the issue of increasing population optimistically, one may say that overpopulation means the increase in human resources. The increase in the number of people is the increase in the number of productive hands and creative minds. But we cannot ignore the fact that the increase in the number producers implies an increase in the number of consumers. Greater number of people requires a greater number of resources.

Not every nation is capable of providing its people with the adequate amount of resources. The ever-increasing population will eventually leave no nation capable of providing its people with the resources they need to thrive. When the environment fails to accommodate the living beings that inhabit it, overpopulation becomes a disaster.

Population Characteristics:

i. Exponential growth:

When a quantity increases by a constant amount per unit time e.g. 1, 3, 5, 7 etc. it is called linear growth. But, when it increases by a fixed percentage it is known as exponential growth e.g. 10, 102, 103, 104, or 2, 4, 8, 16, 32 etc. Population growth takes place exponentially and that explains the dramatic increase in global population in the past 150 years

ii. Doubling time:

The time needed for a population to double its size at a constant annual rate is known as doubling time. It is calculated as follows:

Td = 70/r

where Td = Doubling time in years

r = annual growth rate

If a nation has 2% annual growth rate, its population will double in 35 years.

iii. Total Fertility Rates (TFR):

It is one of the key measures of a nation's population growth. TFR is defined as the average number of children that would be born to a woman in her lifetime if the age specific birth rates remain constant. The value of TFR varies from 1.9 in developed nations to 4.7 in developing nations. In 1950's the TFR has been 6.1. However, due to changes in cultural and technological set up of societies and government policies the TFR has come down which is a welcome change.

iv. Infant mortality rate:

It is an important parameter affecting future growth of a population. It is the percentage of infants died out of those born in a year. Although this rate has declined in the last 50 years, but the pattern differs widely in developed and developing countries.

v. Zero population growth (ZPG):

When birth plus immigration in a population are just equal to deaths plus emigration, it is said to be zero population growth.

vi. Male-female ratio:

The ratio of boys and girls should be fairly balanced in a society to flourish. However, due to female infanticides and gender-based abortions, the ratio has been upset in many countries including India. In China, the ratio of boys to girls became 140: 100 in many regions which led to scarcity of brides.

vii. Life expectancy:

It is the average age that a new-born infant is expected to attain in a given country. The average life expectancy, over the globe, has risen from 40 to 65.5 years over the past century.

In India, life expectancy of males and females was only 22.6 years and 23.3 years, respectively in 1900. In the last 100 years improved medical facilities and technological advancement has increased the life expectancy to 60.3 years and 60.5 years, respectively for the Indian males and females. In Japan and Sweden, life expectancy is quite higher, being 82.1-84.2 for females and 77-77.4 for males, respectively.

viii. Demographic transition:

Population growth is usually related to economic development. There occurs a typical fall in death rates and birth rates due to improved living conditions leading to low population growth, a phenomenon called demographic transition. It is associated with urbanisation and growth and occurs in four phases:

(a) Pre-industrial phase characterized by high growth and death rates and net population growth is low.

(b) Transitional phase that occurs with the advent of industrialization providing better hygiene and medical facilities and adequate food, thereby reducing deaths. Birth rates, however, remain high and the population shows 2.5-3% growth rate.

(c) Industrial phase while there is a fall in birth rates thereby lowering growth rate.

(d) Post industrial phase during which zero population growth is achieved.

Demographic transition is already observed in most developing nations. As a result of demographic transition the developed nations are now growing at a rate of about 0.5% with a doubling time of 118 years. However, the matter of concern is that more than 90% of the global population is concentrated in developing nations which have a growth rate a little more than 2%, and a doubling time of less than 35 years.

Population –The trends in India

- Growing India: India is the world's second most populous country and is expected to be the most populous by 2040.The country is undergoing the same forces of demographic transition that have been experienced elsewhere, only delayed by few decades.
- Young India: Over 700 million Indians are below 35 years of age and over 550 million are below 25.However despite its youthful population, India's size means that it is home to the second largest number of older people in the world, in absolute terms.
- Unequal India: The rising income gap is creating an urban-rural divide and a north-south imbalance. A quarter of India's population lives below the poverty line with most living off the land on small farms with little access to new technology.
- Urbanizing India: Almost 70% of Indians still reside in rural areas although in recent decades migration to larger cities has led to a dramatic increase in the country's urban population.
- Mega city India: India is home to around 18% of the world's population but accounts for only 2.42% of the total world area; the emergence of mega cities is inevitable.
- Aspirational India: The emerging middle class will surge tenfold; exceeding 500 million by 2025.It will command 60% of the country's spending power.

CONSEQUENCES:

Population explosion is a global phenomenon and its consequences can be seen on the surface and in the atmosphere of the Earth. The high growth rate of population, particularly in the developing and underdeveloped countries led a way for declining environmental quality in all spheres of the Earth.

Growing population means growing needs. To meet the need of the growing population, there was tremendous increase in developmental activities. As a result of this, over exploitation of natural resources took place. The over utilization of natural resources, tremendous growth in economic sector and setting up of the large scale industries worldwide manifested a way for declining biological and natural resources and enhancing pollution.

The Earth planet is passing through the major environmental problems such as global warming, climatic changes, ozone depletion, different types of pollution, depletion of natural resources, depletion in fertility of soil, desertification, shrinking forest covered areas and agricultural land, urbanization and acute shortage of water, origin of slums and many more. These problems are worldwide, but more intensive in the developing and underdeveloped countries. The origin of all mentioned problems is population explosion. The major consequen-ces of population explosion are as follows:

(1) Over Exploitation of Natural Resources:

The Earth has limited natural resources in the form of water, fauna and flora, minerals, power resources and soils. Out of them, some are renewable and some are non-renewable resources. The non-renewable resources are being extinct because of over utilization.

Due to high growth in population, the requirements of the people increased at a tremendous rate and consequently, the natural resources were unexpectedly over exploited. It is estimated that within 40 years, the reserves of petroleum will be vanished completely in the world. Similarly, water scarcity can be observed everywhere.

The water crisis and conflict of its sharing within and outside the countries is not a new phenomenon while it took and unprecedented turn and it is common assumption that the third world war would be fought for water. Along with this, all non-renewable resources are at the edge of vanish. The scientists world-wide are working hard to find the substitute for these resources so that the level of requirement can be maintained.

(2) Industrialization and Urbanization:

With the advent of industrial revolution in Europe and its further expansion in the other continents, the process of urbanization began. The high growth rate in population in the villages and urban centres further accentuated its magnitude and the cities mostly in the developing and underdeveloped countries are being converted into slums. The urban areas are facing acute shortage of land and water and severe environmental problems.

Urbanization is a result of growth of population in urban areas. As a country develops from primarily an agricultural to an industrial economy, large-scale emigrational rural residents to towns and cities takes place. During the process, the growth rate of urban areas is typically double the pace of overall population increase. Some 29 per cent of the world population was living in urban areas in 1950; this figure was 43 per cent in 1990, and was projected to be 50 per cent by the year 2005.

Urbanization eventually leads to a severe decline in the number of people living in the countryside, with negative population growth rates in rural areas. Rapid growth of overall population has deferred this event in most less- developed countries, but it is projected to occur in the early decades of the 21st century.

(3) Shrinking Agricultural Land:

There is unbreakable cycle of transformation of forest land into agricultural land and in the same way the agricultural lands are being converted into construction of settlements and establishment of industries in or around the cities. The rate of transformation is tremendous. The tropical rain forests of Amazon Basin, within the territory of Brazil were cut down at a large scale during eighties for construction of agricultural farm lands, which led a way for severe ecological disturbances.

(4) Global Warming:

All the environmental problems are interpreting into one platform, which are devastating for human survival and which are caused by the human induced activities. The global warming, which is caused by emission of toxic gases and enhancement of greenhouse gases in the atmosphere, is now being a global phenomenon.

In the route of this phenomenon, the developmental activities, launched by man for his welfare, are responsible. Due to global warming, the global average surface temperature has increased over the 20th century by about 0.6 °C. The global average surface temperature (the average of near surface air temperature over land, and sea surface air temperature) has increased since 1861.

(5) Environmental Pollution and Enhancement in Greenhouse Gases:

Life survives within the better environmental conditions. Air, water gases and land, which are called life-supporting layers, are very essential for the existence of life. All these given life-supporting layers are utterly polluted. Water is not much useful for drinking and other purposes in the cities because of high pollution. Similarly, air pollution has given birth to many diseases.

The upper layer of soil is burnt due to excessive use of chemicals fertilizers. It was done for high yield of crops. Population explosion has led a way for worldwide pollution, which is the major cause of contamination of Earth's environment with materials that interfere with human health, the quality of life, or the natural functioning of ecosystems (living organisms and their physical surroundings).

Although some environmental pollution is a result of natural causes such as volcanic eruptions, most is caused by induced activities. Along with this, an enhancement in the greenhouse gases has given rise to severe problems such as ozone depletion, global warming and climatic change. It is noticed that if the existing trend continues in the future, the issue of survival of life on the earth would be in crisis.

(6) Poverty, Malnutrition and Famine:

Poverty and malnutrition is a growing and common phenomenon in the underdeveloped countries. High growth rate of population and comparatively how production of crops has enhanced the situation of poverty, malnutrition and famine in these countries.

POPULATION POLICY 2000

The main targets fixed in the National population policy 2000, India are as follows:

The National Population Policy 2000 provides a policy framework for advancing goals and prorating strategies during the next decades to meet the reproductive and child health needs of the people of India.

This policy states that the objective of economic and social development is to improve the quality of lives people lead to enhance their well being and to provide them with opportunities and choices to become productive assets in society.

The immediate objective of this new policy is to address the unmet needs of contraception, health infrastructure, health personnel and to provide integrated service delivery for basic reproductive and child health care.

The long term targets is to achieve a stable population by 2045. In pursuance of these objectives, 14 National Socio Demographic Goals are formulated to be achieved by 2010. The important measures to this policy are:

a. Making school education compulsory and to reduce drop-outs.

b. Reduce Infant Mortality Rate (IMR) to 30 per 1000 live birth.

c. Reduce maternal mortality rate to below 100 per 100000 live birth.

d. Promote delayed marriage of girls.

e. Achieve 80% institutional deliveries.

f. Prevent and control communicable diseases

g. Promote vigorously the small family norm to achieve replacement levels to TFR.

Policy also suggests some promotional and motivational measures to promote adoption of the small family norm. The important measures are:

a. Reward Panchayat and Zila Parishads for promoting small family norm.

b. Incentives to adopt two child norms.

c. Couples below poverty line, having sterilisation with not more than two living children will be eligible for health insurance plan.

d. Strengthening abortion facility scheme.

4.7. POVERTY

The Concept of Poverty

Poverty is a plague as it is prevalent in almost all countries in the world and it has many

faces and dimensions. Therefore it is difficult to define the concept poverty in precise.

Poverty is always defined according to the conventions of society in which it occurs. But in the recent years, the concept of poverty has been refined and made more comprehensive. The New World requires better and more scientific ways to assess the concept of poverty in the society. Now its multidimensional aspect is recognized and uses a multidisciplinary approach to assess poverty. Poverty is not simply a social phenomenon but also include economic, political, historical, geographical and cultural aspects.

Various attempts have been made by societies to define poverty. In human terms poverty means little to eat and wear, and in economic terms the poverty means the inability to attain a minimum standard of living. It is natural to view poverty as the failure to meet the basic requirements to maintain a minimum standard of living. This minimum standard of living may vary from society to society. While biological requirement and nutritional norms provide the most elementary concept of a minimum standard of living, modern understanding of poverty requires other factors such as school enrolment, infant mortality, immunization, malnutrition, women empowerment, overall standard of living, asset holding etc.

Poverty can be defined as a social phenomenon in which a section of the society is unable to fulfill even its basic necessities of life. In India the generally accepted definition of poverty emphasizes minimum level of living rather than a reasonable level of living. In economics there are two important classification of poverty; Absolute Poverty' and 'Relative Poverty'.

Absolute Poverty and Relative Poverty

Absolute Poverty is the sheer deprivation or non-fulfillment of bare minimum needs of existence-of food, shelter, health or education. It is based on the absolute needs of the people and people are defined as poor when some absolute needs are not sufficiently satisfied. Hence according to this type poverty is treated as deprivation. Most of the developing countries are experiencing such type. An absolute poverty line is based on the cost of minimum consumption basket based on the food necessary for a recommended calorie intake.

Relative Poverty is related with high income countries, where people are poor because they cannot maintain or equivalent to others in the society. There should be differences in living standards among the people. It reflects economic distress, despair and dissension that stem from serious inequalities in income and wealth .The relative poverty line varies with the level of average income. Relative poverty is based on inequality and differences in standard of living. According to the relative concept of poverty, people are poor because, From this classification we know that poverty is not inequality. Poverty is only one of the evil consequences of inequality. Whereas poverty is concerned with the absolute standard of living of a part of the society i.e.; the poor, inequality refers to relative living standards across the whole society.

Measurement of Poverty

Once we understand poverty, it is essential to measure it with its various dimensions.

The measurement of poverty is needed to plan policies to check this global phenomenon. Many factors were listed, some of them are life expectancy, mortality, maternality, safe income. Therefore consumption data can be used to measure poverty.

Poverty Line

Poverty line is the most widely used measure for assessing poverty. Under this method, people are counted as poor when their measured standard of living is below a minimum acceptable level-known as Poverty Line. The poverty line in India is defined as 'the level of private consumption expenditure, which ensures a food basket that would supply the required amount of calories'. Actually in India the Planning Commission estimates the poverty on the basis of Calorie intake. By considering age, sex, activity etc., Indian Council of Medical Research (ICMR) proposes 2400 calorie intake for the rural person per day and 2100 calorie per person per day in urban. The calorie requirements in the rural areas is higher because people engaged in heavy work more in rural areas than in urban areas.

Poverty Estimation in the Independent India

In independent India, the first official definition of poverty was given in 1962. This pegged the rural poverty line at a Monthly Family Income of Rs.100 and urban one at Rs.125.

Dandekar and Rath (1971) estimated poverty in terms of consumer expenditure needed a diet adequate at least inform of calories, they adopted 2250 calories per person per day as the norm for their study. According to them, the consumer expenditure necessary to obtain the minimum nutritional standard was an amount of Rs. 14.16 per capita per month at 1960-61 prices for rural India. Based on this norm, 30.92 percent of the rural population lies below the poverty line in 1961-62, in India.

Bhrdhan (1974) adopted the poverty line of Rs 15 at 1960-61 all India rural prices as the minimum level of living, and also estimate poverty for 1967-68 period, taking Rs. 29.90 as minimum requirement and find that in 1960-61 about 38% of rural Indians and in 1967–68, 53 percent of rural Indians are below poverty line.

Vaidyanathan (1974) adopted Rs. 21.44 as rural poverty in India at 1960-61.prices. To his estimate the rural poverty in India is 15.65percent.

Bhatty (1974) measured the incidence of poverty for the year 1968-69. He selected poverty lines in terms of Per capita income instead of Per capita consumer expenditure. He made use of the income distribution data collected by National Council of Applied Economic Research (NCAER) for 1968-69. In order to overcome arbitrariness in using a single poverty line, Bhatty made use of five poverty lines namely Rs. 180, Rs 240 Rs.300, Rs. 360 and Rs.420. per capita per annum at 1968-69 prices or its per capita monthly equivalent Rs. 15, Rs.20, Rs. 25, Rs. 30 and Rs. 35. His results show that the poverty levels vary corresponding to different income levels. The corresponding rural poverty is 21.95 percent, 39.55 percent, 55.87percent, 69.70 percent, and 78.70 percent corresponding to monthly per capita income.

Ahluwalia's (1978) "estimates shows a fluctuating trend in the incidence of poverty over time. Rural poverty in India declined from 53.4 percent in 1957-58 to 42 percent in 1960-61. Then it started rising from 42.3 percent to 57.9 percent during 1961-62 to 1967-68 and then declined to 47.6 percent in 1973-74.

Mahendra Dev (1988) estimated the poverty lines for the reference years by making use of the estimates derived by Bardhan (1974) for the year (1960-61). He adjusted the poverty lines by the Consumer Price Index of Agricultural Labourers (CPIAL) for the reference years. He found that the percentage of rural Indian population living below the poverty line was continuously declining from 46.4 percent in 1964-65 to 44.78 percent in 1972-73 and from 40.45 percent in 1977-78 to 33.20 percent in 1983-84.

The Planning Commission (1981 and 1985) measured the extent of rural poverty for 4 years taking Rs.77 (at 1979-80 prices) per capita per month as the poverty line. In 1977- 78,about 51.2 percent of rural population was poor as against 54.1 percent in 1972- 73. It comes down to 40.4 percent in 1983-84. The Planning Commission calculates the poverty ratio on the basis of quinquennial Consumer Expenditure Surveys conducted by NSSO. The Planning Commission's estimates of the poverty ratio for 1987-88 indicated further decline in the incidence of poverty to 33.4 percent in 1987-88.

Criticising the Planning Commission's earlier estimates, Minhas, Jain and Tendulkar

(1991) measured the incidence of poverty by using correct procedure for three years 1970-71, 1983 and 1987-88. They converted the poverty norms to prices prevailing in the year for which NSS consumer expenditure data are available. They worked out State Specific Cost of Living Indices. Then, applying these indices, they calculated State Specific Poverty norms for 1970-71, 1983 and 1987-88. The poverty norms for rural India were Rs. 33.01, Rs 93.16 and Rs. 122.63 for the years considered respectively. Corresponding to these poverty lines, the percentage of population below poverty lines were 57.3, 49.02 and 44.88 for the corresponding years.

Rohini Nayyar (1991) measured the poverty line for 13 years period from 1960-61 to

1983-84 and estimated the incidence of rural poverty. Her calculations are based on actual consumption data by broad category. She made use of the calorie norm of 2200 to arrive at the poverty line. To her estimates rural poverty fluctuates over the years.

Kakwani and Subba Rao (1992) attempted a study on rural poverty for the period 1973-86. They used relative price levels in the rural areas to arrive at the poverty lines. Using the price relatives and consumer

price indices for agricultural labourers they worked out the State Specific Poverty Lines at the current prices for the years 1973-74, 1977-78, 1983 and1986–87. According to their estimates the rural poverty continuously declined.

Tendulkar and Jain (1995) estimated the incidence of poverty for 12 years from 1970-71 to 1992. They estimated the poverty lines for various years taking the Planning Commission's all India poverty line of monthly percapita total expenditure of Rs. 49.09 at1973-74 prices. Urban Poverty profile of the different authors are given in the Appendix,

Even though the earlier estimates of planning commission is based on this calorie norms which is criticized because of methodological defects and it cannot consider the other basic items like health, education etc. Therefore Planning Commission appointed an Expert Committee, under Suresh Tendulkar in 2008 and reported its recommendations in November 2009. The committee suggested a formula based on Consumption Expenditure for identifying BPL families. His recommendations are more scientific and there is some novelty in the measurement because Tendulkar committee uses a broad definition of poverty including expenditure for food, education, health etc., and uses consumer expenditure taking Mixed Recall Period as against Uniform Recall Period. According the committee the monthly consumption expenditure to measure poverty line is Rs. 446.68 per person per month in rural areas and Rs. 578.8 per person per month in urban areas. To their report India's poverty is 37.2 percent (2004-05) as against the Planning Commission's estimates of 27.5 percent in 2004-05 calculated on the basis of Dandekar-Rath formula based on calorie intake. Latest poverty estimates of Planning Commission are seen from the Table.

Poverty Rates in Various NSSO Rounds

Year	Round	Poverty Rate (%)
1973-74	27	54.88
1977-78	32	51.32
1983	38	44.48
1987-88	43	38.86
1993-94	50	35.97
1999-00	55	26.10
2004-05	61	27.50
2009-10	66	29.80

Source: Planning Commission, March, 2011 and NSSO Data

Planning Commission estimates India's poverty both on the basis of Uniform Recall Period (Uniform Recall Period took consumption in which the consumer expenditure data for allitems are collected from 30-day recall period.) and Mixed Recall Period (Mixed Recall Period took consumption in which the consumer expenditure data for five non-food items, namely, clothing, footwear, durable goods, education and institutional medical expenses are collected from 365-day recall period and the consumption data for the remaining items are collected from30-day recall period.). It consider Cost of Living as the basis of poverty.

Poverty in India, New Estimates

Uniform Recall Period				Mixed Recall Period		
Years	93-94	04-05	2009-10	99-00	04-05	2009-10
Rural	37.3	28.3	....	27.1	21.8	33.8
Urban	32.4	25.7	....	23.6	21.7	20.9
All India	36.0	27.5	....	26.1	21.8	29.8

Source: Economic Survey

In opposite to Tendulkar committee, Dr. N.C. Saxena committee was appointed by Rural Development Ministry in August 2008. This committee argued for a New BPL criterion, which suggests automatic inclusion of socially excluded groups and automatically exclusion of those who are relatively well-off. The committee recommended a new methodology of Score Based Ranking and put forwarded that Rs. 700 per month per rural person and Rs. 1000 per month per urban person to maintain 2400 and 2100 calorie intake for a day. The committee estimates that India's poverty is 49.1 percent in 2004-05.

According to Arjun Sengupta committee appointed by National Commission for Enterprises in the Unorganised Sector (NCEUS) India's poverty is 77 percent. The Committee uses the same data of NSSO and takes the norm of Rs. 20 per day per person to measure the poverty line.

Based on World Bank's estimates (2005), 41.6 percent of Indians fall below the

International Poverty Line this of $ 1.25 per day (PPP). In nominal terms Rs. 21.69 per day in urban area and Rs. 14.3/day in the rural area. They estimate 456 million Indians lived in poverty. World Bank's new International Poverty Line is based on $ 2 per day.

Abbijith Sen found out that if we took calorie norm even then the poverty is much higher i.e.; in urban 80 percent and in rural 64 percent of the Indians are lived below poverty line. This estimate is also very higher than official estimate.

Poverty line, 1973-74 to 2009-10

Year	Rs per capita per month, current prices	
	Rural	Urban
1973-74	49.63	56.76
1977-78	56.84	70.33
1983	89.50	115.65
1987-88	115.2	162.16
1993-94	205.84	281.35
1999-2000	327.56	454.11
2004-2005	356.30	538.60
2009-2010	672.80	859.60

Sources: Planning Commission

The planning commission has updated the poverty lines and poverty ratios for the

year 2009-10 as per the recommendations of the Tendulkar Committee using NSS 66th round(2009-10) data from the Household Consumer Expenditure Survey. It has estimated that the poverty lines at all India level as an MPCE of Rs. 672.80 for rural and Rs. 859.60 for urban in 2009-10. Based on these cut-offs, the percentage of people living below the poverty line in the country has declined from 37.2 % in 2004-05 to 29.8 % in 2009-10.

Causes of Poverty in India

Poverty is not caused by any single reason. It is the outcome of the interaction of several

factors; economic, non-economic, political, social, cultural, geographical etc.

1. Underdevelopment

The most important cause for poverty is the underdevelopment of the economy. Due to

Under development a large proportion of the people have go without even the basic necessities of life. With the low national income and per capita income the country cannot increase its aggregate consumption and investment. Hence the standard of living is also so low among the people. Even though there is much improvement in the development of the country after independence still we want to go a lot.

2. Inequality

The second important cause of poverty in India is inequality in income and wealth. Even the New Economic policies could not reduce the depth of inequality in India. Instead there is increase in inequality among the people.

3. Inadequate growth rate In the early years of planning the growth rate of Indian economy is not high enough to check the problem of poverty. Even though economy railed in a high growth path in the mid of 2000 onwards the benefits are not trickle down to the poor sections of the society. Still the gap between rich and poor is increasing.

4. Large population

Even though the growth rate of population is coming down still the size of it is very large. Therefore it is not capable to implement the poverty alleviation programmes successfully.

5. Unemployment

Another major cause for the growth of poverty is unemployment. The problem of unemployment is still so acute in the economy. Thus increasing unemployment and underemployment accentuate poverty.

6. Poor performance of agriculture sector

Still Indian agriculture is carried on largely with primitive techniques. High dependency on rain, small and scattered holdings, lack of inputs, exploitative land tenure system, competition from foreign markets, lack of storage and marketing facilities etc. are responsive to the poor performance of agriculture sector even after the Green Revolution.

7. Poor performance of industrial sector

In spite of much improvement in line with development of modern industries still performance is not up to the mark. Lack of dynamic entrepreneurs, lack of competitiveness, lack of skilled and trained workers, inadequate finance, irregular supply of power and raw materials, poor transport and methods of production etc. leads to slow industrialization of the country.

8. Inflation

Rise in price is an alarming problem to the economy. It is the poor who suffered a lot due to inflation. When prices are high the purchasing power of money falls and leads to

impoverishment of the poor sections of the country.

9. Social factors

It is agreed that the poverty in India is the outcome of social factors. It includes caste system, joint family system, law of inheritance, lack of initiative and entrepreneurship etc.

India is also poor in social overheads like education, health, medical facilities, illiteracy etc. The attitudes and aspirations of the people are not conducive to economic growth and development.

10. Political factors

Even after India escaped from the yoke of British exploitative administration still the political set up is not that much efficient to solve the problem of poverty. It is true that various programmes are initiated under five year plans. The Fifth Five Year Plan raised the slogan "Garibi Hatao" but still the poverty alleviation is a nightmare to Indian policy makers.

Thus the poverty in India is happened due to various reasons. Regional disparities, lack of investment, lack of proper implementation of public distributive system, lack of vocational training and education, migration of rural youth to cities etc. have also contributed to poverty in India.

- Remedial Measures

Poverty is a tragedy not only for the individuals but also for the economy at large. As a result of this the remedial measures to poverty is emphasized. From the experiences of the economy we can suggest the following to alleviate poverty.

1. Rapid Economic Growth

Fast economic growth is a necessary conditi on for poverty alleviation programme for the following reasons: It changes the low income agricultural set up, helps to strengthen the redistributive activities of the government, made a radical change in production and distribution process, create more employment opportunities etc. Even there is the possibility of trickledown effect to economic growth.

2. Accelerate agricultural growth

No doubt that when there is agricultural growth it reduces the burden of poverty because majority of poor are lived with agriculture sector. So steps should be taken to solve the problems of small and marginal farmers.

3. Accelerate industrial growth

The industrial development will create more income and employment opportunities to the people. Through this the depth of poverty can be reduced.

4. Development of small-scale and cottage industries

In Indian economy small-scale and cottage industries have played a crucial role. This sector which being labour intensive, create more employment opportunities and help in the removal of poverty.

5. Land reforms

Land reforms as poverty alleviation measures aimed to break the old feudal socio-economic structure of land ownership. It aims to eliminate exploitation by providing security of tenure and regulation of rent. It also aims to bring direct contact between the state and the tiller and give social economic status of the landless by distributive measures.

6.Better Public Distributive System

Poverty can be reduced if people are ensured with essential commodities at fair prices. Therefore the government should establish a wide network of fair price shops to provide the essential commodities.

7. Control Population

Unless the population is not reduced, the additions to wealth production will be eaten up by the fresh torrent of babies. Therefore the planners should aim at the family planning measures to bring down the birth in the country.

8. Provision of Common Services and social Security

The government should spend for the provision of free common services like primary education, medical aid, potable drinking water, housing and other facilities to the people. This will increase their real consumption and make them feel better off and hence reduce the poverty.

9. Improve the Status of the Women

Gender equality can help to reduce poverty and encourage growth in variety of ways. Women are provided with direct access to institutional credit, direct membership in cooperatives, setting up of women organization etc.

10. Good Administrative Setup

Above all the success of any programme primarily depends on the effective working of the administrative machinery.

A Brief Review of Poverty Alleviation Programmes

Beginning with the launch of Integrated Rural Development Programme (IRDP, 1978)

in the Sixth Five Year Plan, a number of PAPs have been formulated and implemented; many of them are have been restructured and formulated fresh from time to time . Among these PAPs the more important have been:

- (a) Training of Rural Youth for Self-Employment (TRYSEM, 1979)
- (b) National Rural Employment Programme (NREP, 1980)
- (c) Rural Landless Employment Guarantee Programme (RLEGP, 1983)
- (d) Million Wells Scheme (MWS, 1988)
- (e) Nehru Rozgar Yojana (NRY, 1989).It is for the urban poor people.
- (f) Jawahar Rozgar Yojana (JRY, 1989).NREGP and RLEGP are merged in this in 1989.
- (g) Development of Women and Children in Rural Areas (DWCRA, 1992)
- (h) Employment Assurance Scheme (EAS, 1993)
- (i) Prime Minister Rozgar Yojana (PMRY, 1994)
- (j) Prime Minister's Integrated Urban Poverty Eradication Programmes (PMIUPEP,1995)

Most of these programmes have been recently redesigned and restructured to improve their efficacy or impact on the poor.

The important PAPs, presently in operation are;

- ❖ Self Employment Programme:

  Swarnjayanthi Gram Swarozgar Yojana (SGSY, 1999). This replaces IRDP, TRYSEM, DWCRA, SITRA, GKY and MWS and work for rural poor.

- ❖ Wage Employment Programme:
  - National Food for Work Programme (NFWP, 2004). It intensifies the generation of supplementary wage employment.
  - Sampoorna Grameen Rozgar Yojana (SGRY, 2001). Rural Employment Generation Programme (REGP, 1995) was merged in SGRY in 2001.SGRY provide additional wage employment in the rural areas. Now this programme is entirely subsumed in NREGS with effect from April, 1, 2008.

- National Social Assistance Programme (NSAP, 1995). It provides social assistance to the rural poor.
- Urban Employment and Anti-poverty Programme:
- Prime Minister Rozgar Yojana (PMRY, 1993)
  - Swarna Jayanti Shahari Rozgar Yojana (Golden Jubilee Urban Employment Scheme, 1997). This scheme integrates three PAPs for urban areas, viz. NRY, PMIUPEP and Urban Basic Services for the poor.

4.8. Unemployment

Another major developmental issue in Indian economy is unemployment. Although this problem had existed in the past; it has become more acute after the independence. The backwardness and increasing population are mainly responsible for this problem. The socio-economic consequences of unemployment are very dangerous. It has economic consequences for the individual as well as the society.

Unemployment means idleness of man power. It is the state in which labour possesses necessary ability and health to perform a job, but does not get job opportunities. In other words unemployment is the situation in which individuals are available for work, but are not able to find a work.

In order to explain the concept unemployment it is better to distinguish between the concepts like labour force and work force. The labour force refers to the number of persons who are employed plus the number who are willing to be employed. In India the labour force excludes children below the age 15 and old people above the age 60 and mentally or physically handicapped. The work force includes those who are actually employed in economic activity. If we deduct work force from labour force we get the number of unemployment.

The unemployment rate means the number of persons unemployed per 1000 persons in the labour force.

The labour force participation rate and work force participation rate can be expressed in percentages and as given below.

Labour Force Participation Rate =Labour Force / Size of the population

Work Force Participation Rate = Work force /Size of the population

Types of unemployment

In every economy there is unemployment but the nature and magnitude differ according to the economic progress. Following are the important types of unemployment.

1. Voluntary unemployment

This is the main type of unemployment referred by the Classical economists. Voluntary unemployment is happened when people are not ready to work at the prevailing wage rate even if work is available. It is a type of unemployment by choice.

2. Involuntary Unemployment

Keynes analysed this type of unemployment. It is a situation when people are ready to work at the prevailing wage rate but could not find job.

3. Natural rate of Unemployment

This is postulated by the Post-Keynesians. According to them in every economy there exists a particular percentage of unemployment.

4. Structural unemployment

This type of unemployment is not a temporary phenomenon. It is chronic and is the

result of backwardness and low rate of economic development. The structural changes of an economy are the main reason for this type of unemployment.

5. Disguised Unemployment

When more people are engaged in a job than actually required, then it is called disguised unemployment. If a part of labour is withdrawn and the total production remains unchanged because their marginal product is zero. This is a part of structural unemployment.

6. Under Employment

This exists when people are not fully employment i.e., when people are partially employed. In other words it is a situation in which a person does not get the type of work he is capable of doing.

7. Open Unemployment

Mrs. Joan Robinson calls this type of unemployment as 'Marxian Unemployment'. Open

Unemployment is a situation where a large labour force does not get work opportunities that may yield regular income to them. It is just opposite to disguised unemployment. It exists when people are ready to work but are not working due to non-availability of work

8. Seasonal unemployment

Generally this type of unemployment is associated with agriculture because the unemployment rate is changed according to the season.

9. Cyclical Unemployment

It is generally witnessed in developed nations. This type of unemployment is due to business fluctuation and is known as cyclical unemployment.

10. Technological Unemployment

When the introduction of a new technology causes displacement of workers it is called technological unemployment.

11. Frictional Unemployment

It is a temporary unemployment which exists when people moved from one occupation to another. It will take time lag in transferring one work to another. The market imperfections are the main reasons for this.

Measurement of Unemployment in India

The National Sample Survey Organization (NSSO), which provides estimates of the rates of unemployment in India on the basis of its quinquennial surveys, uses three different concepts. They are Usual Status Unemployment, Current Weekly Status unemployment and Current Daily Status unemployment.

I. Usual Status Unemployment (US)

Here the reference period is 365 days. The usual status gives an idea about long-term

employment (or chronic and open employment) during the reference year. A person is considered unemployed on Usual Status basis, if he/she was not working, but was willing to work for the major part of the reference year (more than 183 days) but did not get work for even 183 days. Dividing the usual status unemployment by the size of the labour force, we get unemployment rate by usual status. This measure is more appropriate to those in search of regular employment (educated and skilled persons) who may not accept casual work.

II. Current Weekly Status Unemployment (CWS)

Here the reference period is one week .A person is considered unemployed by Current

Weekly Status, if he/she had not worked even for one hour during the week, but was seeking or was Available for work. The estimates are made in terms of the average number of persons unemployed per week. The Current Weekly Status approach gives an idea about temporary unemployment (or chronic plus temporary unemployment) during the reference week. Current Weekly Status is used by the agencies like Inter National Organisations (ILO) to estimate employment and unemployment rates based on weekly reference period for international comparison. Dividing the weekly status unemployment by the size of the labour force, we get unemployment rate by weekly status.

III. Current Daily Status Unemployment (CDS)

Here the reference period is each of the 7 days, preceding the date of survey in each of

these days. It records the activity status of a person for each day of the 7 days preceding the survey i.e. persons who did not find work on a day or some days during the survey week. The Current daily status approach gives a composite or comprehensive measure of unemployment, i.e., it is a measure of chronic and temporary unemployment as well as under employment. Dividing the current daily status unemployment by the size of the labour force, we get unemployment rate by usual status. The current daily status gives the most faithful picture of unemployment situation.

Magnitude of Unemployment in India

A comparison between different estimates of unemployment in 2009-10 indicates that the CDS estimate of unemployment is the highest (Table 1.15). The higher unemployment rates according to the CDS approach compared to the weekly status and usual status

approaches indicate a high degree of intermittent unemployment. Interestingly, urban

unemployment was higher under both the usual principal and subsidiary status (UPSS) and current weekly status (CWS) but rural unemployment was higher under the CDS approach. This possibly indicates higher intermittent or seasonal unemployment in rural than urban areas something that employment generation schemes like the MGNREGA need to pay attention to. However, overall unemployment rates we re lower in 2009 -10 under each approach vis-a-vis 2004-05.

All-India NSS 66th Round Rural and Urban Unemployment Rates

Si No	Estimates	Rural (2009-10)	Urban (2009-10)	Total (2009-10)	Total (2004-05)
1	UPSS	1.6	3.4	2.0	2.3
2	CWS	3.3	4.2	3.6	4.4
3	CDS	6.8	5.8	6.6	8.2

Source: NSSO

Labour force participation rates (LFPR) under all three approaches declined in2009-10 compared to 2004-05 (Table 1.16). However, the decline in female LFPRs was larger under each measure in comparison with male LFP Rs which either declined marginally

(UPSS), remained constant (CWS), or increased marginally (CDS).

All-India Employment and Unemployment Indicators (per 1000)

	NSS 66th Round (2009-10)			NSS 61th Round (2004-05)		
Indicators	Male	Female	Total Person	Male	Female	Total persons
UPSS						
LFPR	557	233	400	559	294	430
Work Participation Rate	546	228	392	547	287	420
Unemployment Rate	20	23	20	22	26	23
CWS						
LFPR	550	207	384	550	257	407
Work Participation Rate	532	198	370	527	244	389
Unemployment Rate	33	43	36	42	50	44
CDS						
LFPR	540	179	365	538	215	381
Work Participation Rate	507	164	341	496	195	350
Unemployment Rate	61	82	66	78	92	82

Source: Key Indicators of Employment and Unemployment in India, 2009-10, NSSO.

Causes of unemployment in India

Following are the important causes of unemployment in India

1. Rapid population growth
2. Slow growth of the economy
3. Decay of small scale and cottage industries
4. Low rate of capital formation
5. Defective planning
6. Slow growth of agriculture sector
7. Global financial crisis
8. Illiteracy
9. Lack of training facilities

Remedial Measures for unemployment

In order to solve the problem of unemployment there is both government measures and other measures. It includes the following measures.

1. Rapid growth and expansion of the economy
2. Establishment of more work and training centers
3. Development of small scale and cottage industries
4. Establishment of poverty eradication programmes
5. Liberal institutional finance and self employment programmes
6. Establishment of more employment exchanges
7. Introduction of population control measures
8. Introduction of more public works programmes
9. Reduce illiteracy
10. Stress on vocational and technical education

4.9.HDI of India

Human Development Index was introduced by UNDP in 1990.The committee for the introduction of this index is headed by the Pakistani Economist Mahbub-Ul-Haq and helped by Amartya Sen. The Human Development Report2013,The Rise of the South: Human Progress in a Diverse World, notes that over the last decades, all countries accelerated their achievements ineducation, health, and income dimensions as measured in the Human Development Index. In 2010 Human Development Report the UNDP began using a new method of calculating the HDI. The HDI combines following three dimensions:

- A long and healthy life: Life expectancy at birth
- Educational Index: Mean years of schooling and Expected years of schooling
- A decent standard of living: GNI per capita (PPP US$)

1. Life Expectancy Index (LEI) = $\frac{LE-20}{82.3-20}$

2. Educational Index (EI) = $\frac{\sqrt{MYSI.EYSI}}{0.951}$

2.1 Mean Years of Schooling Index (MYSI) = $\frac{MYS}{13.2}$

2.2 Expected Years of Schooling Index (EYSI) = $\frac{EYS}{20.6}$

3. Income Index (II) = $\frac{\ln(GNIpc)-\ln(100)}{\ln(107{,}721)-\ln(100)}$

Finally, the HDI is the Geometric Mean of the previous three normalized indices: HDI = $\sqrt[3]{LEI.EI.II}$

LE: Life Expectancy at Birth.

MYS: Mean Years of Schooling (Years that a 25-year-old person or older has spent in schools).

EYS: Expected Years of Schooling (Years that a 5-year-old child will spend with his education in his whole life).

GNI pc: Gross National Income at Purchasing Power Parity Percapita.

India's progress in each of the HDI indicators is given in Table 1.18 . Between 1980 and 2012, India's life expectancy at birth increased by 10.5 years, mean years of schooling

Increased by 2.5 years and expected years of schooling increased by 4.4 years. India's GNI per capita increased by 273% between 1980 and 2012.

India's HDI Trend Values Components and Indicators

Year	Life expectancy at Birth	Expected Years of Schooling	Mean Years of Schooling	GNI Percapita (2005 PPP $)	HDI Value
1980	55.3	6.3	1.9	0,880	0.345
1985	57	7.1	2.4	1,007	0.379
1990	58.3	7.4	3.0	1,191	0.410
1995	59.8	8.2	3.3	1,389	0.438
2000	61.6	8.3	3.6	1,702	0.463
2005	63.3	9.9	4.0	2,190	0.507
2010	65.1	10.7	4.4	3,009	0.547
2011	65.4	10.7	4.4	3,175	0.551
2012	65.8	10.7	4.4	3,285	0.554

Source: Various Reports of UNDP.

The human development index is estimated in terms of three basic capabilities: to live

a long and healthy life, to be educated and knowledgeable, and to enjoy a decent economic standard of living. Between 1980 and 2012, India's HDI value increased from 0.345 to 0.554, an increase of 61 percent or average annual increase of about 1.5 percent. In the 2011 HDR, India was ranked 134 out of 187 countries. The HDI value of India at different years is given in Table. However, it is misleading to compare values and rankings with those of previously published reports, because the underlying data and methods have changed. Among the Indian states Kerala ranks First with HDI value 0.790 in 2011 while Chattisgarh in the bottom with HDI value 0.304 in the same year.

The HDI for India was 0.554 in 2013 with an overall global ranking of 136 out of 186 countries placing the country in medium human development category. Novey stands First with HDI value 0.955.

India and HDI Value for Different Years

Years	HDI Value
1975	0.419
1980	0.345
1985	0.380
1990	0.410
1995	0.437
2000	0.463
2005	0.507
2006	0.515
2007	0.525
2008	0.533
2009	0.540
2010	0.547
2011	0.551
2012	0.554
2013	0.554

Source: Various Reports of UNDP

UNIT - V
PROBLEMS OF AGRICULTURE AND INDUSTRY

5.1. AGRICULTURE AND ITS FEATURES

Agriculture, with its allied sectors, is unquestionably the largest livelihood provider in India, more so in the vast rural areas. It also contributes a significant figure to the Gross Domestic Product (GDP). Sustainable agriculture, in terms of food security, rural employment, and environmentally sustainable technologies such as soil conservation, sustainable natural resource management and biodiversity protection, are essential for holistic rural development. Indian agriculture and allied activities have witnessed a green revolution, a white revolution, a yellow revolution and a blue revolution.

FEATURES:

(a) Subsistence Agriculture: As mentioned earlier, most parts of India have subsistence agriculture. This type of agriculture has been practised in India for several hundreds of years and still prevails in a larger part of India in spite of the large scale change in agricultural practices after independence.

(b) Pressure of population on Agriculture: Despite increase in urbanization and industrialization, about 70% of population is still directly or indirectly dependent on agriculture.

(c) Mechanization of farming: Green Revolution took place in India in the late sixties and early seventies. After more than forty years of Green Revolution and revolution in agricultural machinery and equipments, complete mechanization is still a distant dream.

(d) Dependence upon monsoon: Since independence, there has been a rapid expansion of irrigation infrastructure. Despite the large scale expansion, only about one third of total cropped area is irrigated today. As a consequence, two third of cropped areas is still dependent upon monsoon. As you know, monsoon in India is uncertain and unreliable. This has become even more unreliable due to change in climate.

(e) Variety of crops: Can you guess why India has a variety of crops? As mentioned in the beginning of the lesson, India has diversity of topography, climate and soil. Since India has both tropical and temperate climate, crops of both the climate are found in India. There are very few countries in the world that have variety comparable to that of India.

(f) Predominance of food crops: Since Indian agriculture has to feed a large population, production of food crops is the first priority of the farmers almost everywhere in the country. However, in recent years, there has been a decline in the share of land used for food crops due to various other commercially most advantageous uses of these land.

(g) Seasonal patterns: India has three distinct agricultural/cropping seasons. You might have heard about *kharif*, *rabi* and *zaid*. In India there are specific crops grown in these three seasons. For example rice is a *kharif* crop whereas wheat is a *rabi* crop.

5.2. LAND REFORMS

Land reform (also agrarian reform, though that can have a broader meaning) involves the changing of laws, regulations or customs regarding land ownership.[1] Land reform may consist of a government initiated or government-backed property redistribution, generally of agricultural land. Land reform can, therefore, refer to transfer of ownership from the more powerful to the less powerful, such as from a relatively small number of wealthy (or noble) owners with extensive land holdings (e.g., plantations, large ranches, or

agribusiness plots) to individual ownership by those who work the land.[2] Such transfers of ownership may be with or without compensation; compensation may vary from token amounts to the full value of the land.[3]

Land reform may also entail the transfer of land from individual ownership—even peasant ownership in smallholdings—to government-owned collective farms; it has also, in other times and places, referred to the exact opposite: division of government-owned collective farms into smallholdings.[4] The common characteristic of all land reforms, however, is modification or replacement of existing institutional arrangements governing possession and use of land. Thus, while land reform may be radical in nature, such as through large-scale transfers of land from one group to another, it can also be less dramatic, such as regulatory reforms aimed at improving land administration.[5]

5.3. GREEN REVOLUTION

Green Revolution in India was a period when agriculture in India increased its yields due to improved agronomic technology. It allowed developing countries, like India, to overcome chronic food defects. It started in India in the early 1960s and led to an increase in food production, especially in Punjab, Haryana and Uttar Pradesh during the early phase. The main development was higher-yielding varieties of wheat, which were developed by many scientists, including American agronomist Dr. Norman Borlaug, Indian geneticist M. S. Swaminathan, and others. The Indian Agricultural Research Institute also claims credit for enabling the Green Revolution,[1] in part by developing rust resistant strains of wheat.[2]

The introduction of high-yielding varieties of seeds (hybrid seeds) and the increased use of chemical fertilizers and irrigation led to the increase in production needed to make the country self-sufficient in food grains, thus improving agriculture in India.[3] The methods adopted included the use of high-yielding varieties (HYVs) of seeds with modern farming methods.

The production of wheat has produced the best results in fueling self-sufficiency of India. Along with high-yielding seeds and irrigation facilities, the enthusiasm of farmers mobilised the idea of agricultural revolution. Due to the rise in use of chemical pesticides and fertilizers there were negative effects on the soil and the land such as land degradation.

Measures adopted

- Use of high yielding varieties (HYVs) of seeds or hybrid seeds
- Expansion of irrigation infrastructure
- Use of insecticides
- Use of pesticides
- Consolidation of holdings
- Land reforms
- Improved rural infrastructure
- Supply of agricultural credit
- Use of chemical or synthetic fertilizers
- Use of sprinklers or drip irrigation
- Use of advanced machinery
- Use of vector quantity

Problems that were addressed

Low irrigation

The well irrigated and permanently irrigated area was only 17% in 1951. The majority of the area was dependent on rainfall and, consequently, agriculture suffered from low level of production.

The green revolution was possible due to adequate water supply through irrigation. The government undertook a number of minor, major and multipurpose irrigation projects to supply sufficient water to cultivable lands so that the dependence of farmers on rainfall reduced to great extents. The government also made provisions for digging canals, hand pumps, etc., for adequate and increased water supply.

Going forward, the government should create enabling mechanisms to fuel the growth in quality seed production. Public sector spending on irrigation, rural infrastructure (storage, post-harvest and connectivity) and credit availability are key inventions which will encourage farmers to invest in newer technologies as their returns would be better.[4]

Frequent famines

Famines in India were very frequent during the period 1940s to 1970s. Due to faulty distribution of food, and because farmers did not receive the true value for their labour, the majority of the population did not get enough food.[5] Malnutrition and starvation was a huge problem.

Lack of finance

Small and marginal farmers found it very difficult to get finance and credit at economical rate from the government and banks, hence, fell as easy prey to the money lenders. They took loans from zamindars.

Lack of self-sufficiency

Due to traditional agricultural practices, low productivity, and a growing population, often food grains were imported — draining scarce foreign reserves. It was thought that with the increased production due to the Green Revolution, the government could maintain buffer stock and India can achieve self-sufficiency and self-reliability.

Agriculture was basically for subsistence and, therefore, less agricultural product was offered for sale in the market. Hence, the need was felt to encourage the farmers to increase their production and offer a greater portion of their products for sale in the market. The new methods in agriculture increased the yield of rice and wheat, which reduced India's dependence on food imports.

49% of people in India are employed in agriculture.

5.4. AGRICULTURAL MARKETING

Agricultural marketing covers the services involved in moving an agricultural product from the farm to the consumer. Numerous interconnected activities are involved in doing this, such as planning production, growing and harvesting, grading, packing, transport, storage, agro- and food processing, distribution, advertising and sale. Some definitions would even include "the acts of buying supplies, renting equipment, (and) paying labor", arguing that marketing is everything a business does. Such activities cannot take place without the exchange of information and are often heavily dependent on the availability of suitable finance.

Marketing systems are dynamic; they are competitive and involve continuous change and improvement. Businesses that have lower costs, are more efficient, and can deliver quality products, are those that prosper. Those that have high costs, fail to adapt to changes in market demand and provide poorer quality are often

forced out of business. Marketing has to be customer-oriented and has to provide the farmer, transporter, trader, processor, etc. with a profit. This requires those involved in marketing chains to understand buyer requirements, both in terms of product and business conditions.

In Western countries considerable agricultural marketing support to farmers is often provided. In the USA, for example, the USDA operates the Agricultural Marketing Service. Support to developing countries with agricultural marketing development is carried out by various donor organizations and there is a trend for countries to develop their own Agricultural Marketing or Agribusiness units, often attached to ministries of agriculture. Activities include market information development, marketing extension, training in marketing and infrastructure development. Since the 1990s trends have seen the growing importance of supermarkets and a growing interest in contract farming, both of which impact significantly on the way in which marketing takes place.

Agricultural marketing development

Well-functioning marketing systems necessitate a strong private sector backed up by appropriate policy and legislative frameworks and effective government support services. Such services can include provision of market infrastructure, supply of market information (as done by USDA, for example), and agricultural extension services able to advise farmers on marketing. Training in marketing at all levels is also needed. One of many problems faced in agricultural marketing in developing countries is the latent hostility to the private sector and the lack of understanding of the role of the intermediary. For this reason "middleman" has become very much a pejorative word.

Agricultural advisory services and the market

Promoting market orientation in agricultural advisory services aims to provide for the sustainable enhancement of the capabilities of the rural poor to enable them to benefit from agricultural markets and help them to adapt to factors which impact upon these. As a study by the Overseas Development Institute demonstrates, a value chain approach to advisory services indicates that the range of clients serviced should go beyond farmers to include input providers, producers, producer organizations and processors and traders.[1]

Market infrastructure

Efficient marketing infrastructure such as wholesale, retail and assembly markets and storage facilities is essential for cost-effective marketing, to minimize post-harvest losses and to reduce health risks. Markets play an important role in rural development, income generation, food security, developing rural-market linkages and gender issues. Planners need to be aware of how to design markets that meet a community's social and economic needs and how to choose a suitable site for a new market. In many cases sites are chosen that are inappropriate and result in under-use or even no use of the infrastructure constructed. It is also not sufficient just to build a market: attention needs to be paid to how that market will be managed, operated and maintained.[2] In most cases, where market improvements were only aimed at infrastructure upgrading and did not guarantee maintenance and management, most failed within a few years.[3]

Rural assembly markets are located in production areas and primarily serve as places where farmers can meet with traders to sell their products. These may be occasional (perhaps weekly) markets, such as haat bazaars in India and Nepal, or permanent. Terminal wholesale markets are located in major metropolitan areas, where produce is finally channelled to consumers through trade between wholesalers and retailers, caterers, etc. The characteristics of wholesale markets have changed considerably as retailing changes in response to urban growth, the increasing role of supermarkets and increased consumer spending capacity. These changes require responses in the way in which traditional wholesale markets are organized and managed.

Retail marketing systems in western countries have broadly evolved from traditional street markets through to the modern hypermarket or out-of-town shopping center. In developing countries, there remains considerable scope to improve agricultural marketing by constructing new retail markets, despite the growth of supermarkets, although municipalities often view markets as sources of revenue rather than infrastructure requiring development. Effective regulation of markets is essential. Inside the market, both hygiene rules and revenue collection activities have to be enforced. Of equal importance, however, is the maintenance of order outside the market. Licensed traders in a market will not be willing to cooperate in raising standards if they face competition from unlicensed operators outside who do not pay any of the costs involved in providing a proper service.

Market information

Efficient market information can be shown to have positive benefits for farmers and traders. Up-to-date information on prices and other market factors enables farmers to negotiate with traders and also facilitates spatial distribution of products from rural areas to towns and between markets.[5] Most governments in developing countries have tried to provide market information services to farmers, but these have tended to experience problems of sustainability. Moreover, even when they function, the service provided is often insufficient to allow commercial decisions to be made because of time lags between data collection and dissemination.[6] Modern communications technologies open up the possibility for market information services to improve information delivery through SMS on cell phones and the rapid growth of FM radio stations in many developing countries offers the possibility of more localized information services. In the longer run, the internet may become an effective way of delivering information to farmers. However, problems associated with the cost and accuracy of data collection still remain to be addressed. Even when they have access to market information, farmers often require assistance in interpreting that information. For example, the market price quoted on the radio may refer to a wholesale selling price and farmers may have difficulty in translating this into a realistic price at their local assembly market.[7] Various attempts have been made in developing countries to introduce commercial market information services but these have largely been targeted at traders, commercial farmers or exporters. It is not easy to see how small, poor farmers can generate sufficient income for a commercial service to be profitable although in India a new service introduced by Thomson Reuters was reportedly used by over 100,000 farmers in its first year of operation. Esoko in West Africa attempts to subsidize the cost of such services to farmers by charging access to a more advanced feature set of mobile-based tools to businesses.

Marketing training

Farmers frequently consider marketing as being their major problem. However, while they are able to identify such problems as poor prices, lack of transport and high post-harvest losses, they are often poorly equipped to identify potential solutions. Successful marketing requires learning new skills, new techniques and new ways of obtaining information. Extension officers working with ministries of agriculture or NGOs are often well-trained in horticultural production techniques but usually lack knowledge of marketing or post-harvest handling.[8] Ways of helping them develop their knowledge of these areas, in order to be better able to advise farmers about market-oriented horticulture, need to be explored. While there is a range of generic guides and other training materials available from FAO and others, these should ideally be tailored to national circumstances to have maximum effect.

Enabling environments

Agricultural marketing needs to be conducted within a supportive policy, legal, institutional, macro-economic, infrastructural and bureaucratic environment. Traders and others cannot make investments in a climate of arbitrary government policy changes, such as those that restrict imports and exports or internal

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produce movement. Those in business cannot function if their trading activities are hampered by excessive bureaucracy. Inappropriate law can distort and reduce the efficiency of the market, increase the costs of doing business and retard the development of a competitive private sector. Poor support institutions, such as agricultural extension services, municipalities that operate markets inefficiently and export promotion bodies, can be particularly damaging. Poor roads increase the cost of doing business, reduce payments to farmers and increase prices to consumers. Finally, the ever-present problem of corruption can seriously impact on agricultural marketing efficiency in many countries by increasing the transaction costs faced by those in the marketing chain.

Recent developments

New marketing linkages between agribusiness, large retailers and farmers are gradually being developed, e.g. through contract farming, group marketing and other forms of collective action. Donors and NGOs are paying increasing attention to ways of promoting direct linkages between farmers and buyers within a value chain context. More attention is now being paid to the development of regional markets (e.g. East Africa) and to structured trading systems that should facilitate such developments. The growth of supermarkets, particularly in Latin America and East and South East Asia, is having a significant impact on marketing channels for horticultural, dairy and livestock products.[1] Nevertheless, "spot" markets will continue to be important for many years, necessitating attention to infrastructure improvement such as for retail and wholesale markets.

5.5. AGRICULTURAL CREDIT

The essence and significance of agricultural credit are determined by the character of the production relations. Under capitalism, agricultural credit is a form of investment of loan capital in agriculture. Only large capitalist farms can easily afford the high interest rates charged for credit or come up with the mortgage collateral required for loans, so that land tenure becomes increasingly concentrated, with ruination being the fate of the poorest peasants and farmers. In the United States, interest reaches 8–12 percent per annum on short-term loans and 5 percent on long-term loans. Agricultural credit is closely inter-twined with mortgage credit.

In the socialist nations, agricultural credit is an important economic tie between the city and the countryside. With the aid of agricultural credit, the state influences the development of production and the mobilization and effective use of the monetary resources of agricultural enterprises. The socialist state uses agricultural credit to develop agriculture and raise the standard of living of the rural population. In the USSR, agricultural credit is an expression of the relations of public ownership of land and the means of production and is used for expanding and strengthening the material and production base of kolkhozes, sovkhozes, other agricultural production enterprises, and agricultural research institutions. Agricultural crediting in the USSR began with the founding of the Gosbank (State Bank) of the RSFSR in 1921. From 1932 through 1959, long-term agricultural crediting was provided by the Sel'khozbank (Agriculture Bank) of the USSR and short-term crediting by the Gosbank of the USSR. Since 1959 both types of crediting have been concentrated in the Gosbank of the USSR. Until the end of the 1950's, the kolkhozes received most of the long-term agricultural credit, but in the 1960's and 1970's, the inter kolkhoz associations, sovkhozes, and other agricultural enterprises that had been converted to full economic accountability also became recipients of agricultural credit.

Long-term agricultural credit is aimed at increasing the fixed assets of the kolkhozes, inter kolkhoz organizations, and sovkhozes. The decree On Measures to Raise the Economy of the Lagging Kolkhozes (1964), a decree of the Central Committee of the CPSU and the Council of Ministers of the USSR, established maximum periods for agricultural credit of 20 years for construction and eight years for the purchase of

tractors and combines. As a rule, the loans are granted for the full amount of expenditures for individual facilities. Around 83 percent of the credit is used for construction of production facilities and for the acquisition of equipment. Long-term agricultural credit is of a planned character. It is to be granted for stipulated purposes and is determined by the plan quotas for agricultural development.

Short-term agricultural credit is bank credit for covering a seasonal shortage of money. This form of credit is used to pay for commodities and the labor of kolkhoz members within the limits set by the production and financial plan, as well as to cover taxes and other fees. The periods of the loans are set up to 12 months, depending on when the income is received. The Gosbank of the USSR charges 0.75 percent per annum for long-term loans and 1 percent for short-term loans.

In the other socialist countries the development of agricultural production cooperatives has been accompanied by increased state investments in agricultural crediting. In these countries, longer periods are characteristic for agricultural credit. In Poland, loans for forming fixed capital are granted for a period of up to 30 years and more. In Bulgaria, the periods are timed so that the loans are paid at about the time the fixed capital is completely worn out. Agricultural credit is characterized by low interest rates in the other socialist nations, as it is in the USSR. In Czechoslovakia, 1.5 percent per annum is the charge for using credit for construction and for the purchase of machinery; in Hungary the rate is 1 percent. The banks of the socialist nations also provide preferential agricultural credit to individual peasant farms (in Poland, for example, farms can receive agricultural credit for 20 to 40 years at a rate of 1–3 percent per annum). In most of the foreign socialist nations, agricultural crediting is carried out by the state banks of issue; in Poland and the German Democratic Republic it is done by special banks.

5.6. PROBLEMS OF AGRICULTURAL LABOUR

Some of the major problems and their possible solutions have been discussed as follows. Indian agriculture is plagued by several problems; some of them are natural and some others are manmade.

1. Small and fragmented land-holdings:

The seemingly abundance of net sown area of 141.2 million hectares and total cropped area of 189.7 million hectares (1999-2000) pales into insignificance when we see that it is divided into economically unviable small and scattered holdings.

The average size of holdings was 2.28 hectares in 1970-71 which was reduced to 1.82 hectares in 1980-81 and 1.50 hectares in 1995-96. The size of the holdings will further decrease with the infinite Sub-division of the land holdings.

The problem of small and fragmented holdings is more serious in densely populated and intensively cultivated states like Kerala, West Bengal, Bihar and eastern part of Uttar Pradesh where the average size of land holdings is less than one hectare and in certain parts it is less than even 0.5 hectare.

Rajasthan with vast sandy stretches and Nagaland with the prevailing 'Jhoom' (shifting agriculture) have larger average sized holdings of 4 and 7.15 hectares respectively. States having high percentage of net sown area like Punjab, Haryana, Maharashtra, Gujarat, Karnataka and Madhya Pradesh have holding size above the national average.

Further it is shocking to note that a large proportion of 59 per cent holdings in 1990- 91 were marginal (below 1 hectare) accounting for 14.9 per cent of the total operated area. Another 19 per cent were small holdings (1-2 hectare) taking up 17.3 per cent of the total operated area.

Large holdings (above 10 hectare) accounted for only 1.6 per cent of total holdings but covered 17.4 per cent of the operated area. Hence, there is a wide gap between small farmers, medium farmers (peasant group) and big farmers (landlords).

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The main reason for this sad state of affairs is our inheritance laws. The land belonging to the father is equally distributed among his sons. This distribution of land does not entail a collection or consolidated one, but its nature is fragmented.

Different tracts have different levels of fertility and are to be distributed accordingly. If there are four tracts which are to be distributed between two sons, both the sons will get smaller plots of each land tract. In this way the holdings become smaller and more fragmented with each passing generation.

Sub-division and fragmentation of the holdings is one of the main causes of our low agricultural productivity and backward state of our agriculture. A lot of time and labour is wasted in moving seeds, manure, implements and cattle from one piece of land to another.

Irrigation becomes difficult on such small and fragmented fields. Further, a lot of fertile agricultural land is wasted in providing boundaries. Under such circumstances, the farmer cannot concentrate on improvement.

The only answer to this ticklish problem is the consolidation of holdings which means the reallocation of holdings which are fragmented, the creation of farms which comprise only one or a few parcels in place of multitude of patches formerly in the possession of each peasant.

But unfortunately, this plan has not succeeded much. Although legislation for consolidation of holdings has been enacted by almost all the states, it has been implemented only in Punjab, Haryana and in some parts of Uttar Pradesh.

Consolidation of about 45 million holdings has been done till 1990-91 in Punjab, Haryana and western Uttar Pradesh. The other solution to this problem is cooperative farming in which the farmers pool their resources and share the profit.

2. Seeds:

Seed is a critical and basic input for attaining higher crop yields and sustained growth in agricultural production. Distribution of assured quality seed is as critical as the production of such seeds. Unfortunately, good quality seeds are out of reach of the majority of farmers, especially small and marginal farmers mainly because of exorbitant prices of better seeds.

In order to solve this problem, the Government of India established the National Seeds Corporation (NSC) in 1963 and the State Farmers Corporation of India (SFCI) in 1969. Thirteen State Seed Corporations (SSCs) were also established to augment the supply of improved seeds to the farmers.

High Yielding Variety Programme (HYVP) was launched in 1966-67 as a major thrust plan to increase the production of food grains in the country.

The Indian seed industry had exhibited impressive growth in the past and is expected to provide further potential for growth in agricultural production: The role of seed industry is not only to produce adequate quantity of quality seeds but also to achieve varietal diversity to suit various agro-climatic zones of the country.

The policy statements are designed towards making available to the Indian farmer, adequate quantities of seed of superior quality at the appropriate time and place and at an affordable price so as to meet the country's food and nutritional security goals.

Indian seeds programme largely adheres to limited generation system for seed multiplication. The system recognizes three kinds of generation, namely breeder, foundation and certified seeds. Breeder seed is the basic seed and first stage in seed production. Foundation seed is the second stage in seed production chain and is the progeny of breeder seed.

Certified seed is the ultimate stage in seed production chain and is the progeny of foundation seed. Production of breeder and foundation seeds and certified seeds distribution have gone up at an annual average rate of 3.4 per cent, 7.5 per cent and 9.5 per cent respectively, between 2001-02 and 2005-06).

3. Manures, Fertilizers and Biocides:

Indian soils have been used for growing crops over thousands of years without caring much for replenishing. This has led to depletion and exhaustion of soils resulting in their low productivity. The average yields of almost all the crops are among t e lowest in the world. This is a serious problem which can be solved by using more manures and fertilizers.

Manures and fertilizers play the same role in relation to soils as good food in relation to body. Just as a well-nourished body is capable of doing any good job, a well nourished soil is capable of giving good yields. It has been estimated that about 70 per cent of growth in agricultural production can be attributed to increased fertilizer application.

Thus increase in the consumption of fertilizers is a barometer of agricultural prosperity. However, there are practical difficulties in providing sufficient manures and fertilizers in all parts of a country of India's dimensions inhabited by poor peasants. Cow dung provides the best manure to the soils.

But its use as such is limited because much of cow dung is used as kitchen fuel in the shape of dung cakes. Reduction in the supply of fire wood and increasing demand for fuel in the rural areas due to increase in population has further complicated the problem. Chemical fertilizers are costly and are often beyond the reach of the poor farmers. The fertilizer problem is, therefore, both acute and complex.

It has been felt that organic manures are essential for keeping the soil in good health. The country has a potential of 650 million tonnes of rural and 160 lakh tonnes of urban compost which is not fully utilized at present. The utilization of this potential will solve the twin problem of disposal of waste and providing manure to the soil.

The government has given high incentive especially in the form of heavy subsidy for using chemical fertilizers. There was practically no use of chemical fertilizers at the time of Independence As a result of initiative by the government and due to change in the attitude of some progressive farmers, the consumption of fertilizers increased tremendously.

In order to maintain the quality of the fertilizers, 52 fertilizer quality control laboratories have been set up in different parts of the country. In addition, there is one Central Fertilizer Quality Control and Training Institute at Faridabad with its three regional centres at Mumbai, Kolkata and Chennai.

Pests, germs and weeds cause heavy loss to crops which amounted to about one third of the total field produce at the time of Independence. Biocides (pesticides, herbicides and weedicides) are used to save the crops and to avoid losses. The increased use of these inputs has saved a lot of crops, especially the food crops from unnecessary wastage. But indiscriminate use of biocides has resulted in wide spread environmental pollution which takes its own toll.

4. Irrigation:

Although India is the second largest irrigated country of the world after China, only one-third of the cropped area is under irrigation. Irrigation is the most important agricultural input in a tropical monsoon country like India where rainfall is uncertain, unreliable and erratic India cannot achieve sustained progress in agriculture unless and until more than half of the cropped area is brought under assured irrigation.

This is testified by the success story of agricultural progress in Punjab Haryana and western part of Uttar Pradesh where over half of the cropped area is under irrigation! Large tracts still await irrigation to boost the agricultural output.

However, care must be taken to safeguard against ill effects of over irrigation especially in areas irrigated by canals. Large tracts in Punjab and Haryana have been rendered useless (areas affected by salinity, alkalinity and water-logging), due to faulty irrigation. In the Indira Gandhi Canal command area also intensive irrigation has led to sharp rise in sub-soil water level, leading to water-logging, soil salinity and alkalinity.

5. Lack of mechanisation:

In spite of the large scale mechanisation of agriculture in some parts of the country, most of the agricultural operations in larger parts are carried on by human hand using simple and conventional tools and implements like wooden plough, sickle, etc.

Little or no use of machines is made in ploughing, sowing, irrigating, thinning and pruning, weeding, harvesting threshing and transporting the crops. This is specially the case with small and marginal farmers. It results in huge wastage of human labour and in low yields per capita labour force.

There is urgent need to mechanise the agricultural operations so that wastage of labour force is avoided and farming is made convenient and efficient. Agricultural implements and machinery are a crucial input for efficient and timely agricultural operations, facilitating multiple cropping and thereby increasing production.

Some progress has been made for mechanising agriculture in India after Independence. Need for mechanisation was specially felt with the advent of Green Revolution in 1960s. Strategies and programmes have been directed towards replacement of traditional and inefficient implements by improved ones, enabling the farmer to own tractors, power tillers, harvesters and other machines.

A large industrial base for manufacturing of the agricultural machines has also been developed. Power availability for carrying out various agricultural operations has been increased to reach a level of 14 kW per hectare in 2003-04 from only 0.3 kW per hectare in 1971-72.

This increase was the result of increasing use of tractor, power tiller and combine harvesters, irrigation pumps and other power operated machines. The share of mechanical and electrical power has increased from 40 per cent in 1971 to 84 per cent in 2003-04.

Uttar Pradesh recorded the highest average sales of tractors during the five year period ending 2003-04 and/West Bengal recorded the highest average sales of power tillers during the same period.

Strenuous efforts are being made to encourage the farmers to adopt technically advanced agricultural equipments in order to carry farm operations timely and precisely and to economise the agricultural production process.

6. Soil erosion:

Large tracts of fertile land suffer from soil erosion by wind and water. This area must be properly treated and restored to its original fertility.

7. Agricultural Marketing:

Agricultural marketing still continues to be in a bad shape in rural India. In the absence of sound marketing facilities, the farmers have to depend upon local traders and middlemen for the disposal of their farm produce which is sold at throw-away price.

In most cases, these farmers are forced, under socio-economic conditions, to carry on distress sale of their produce. In most of small villages, the farmers sell their produce to the money lender from whom they usually borrow money.

According to an estimate 85 per cent of wheat and 75 per cent of oil seeds in Uttar Pradesh, 90 per cent of Jute in West Bengal, 70 per cent of oilseeds and 35 per cent of cotton in Punjab is sold by farmers in the village itself. Such a situation arises due to the inability of the poor farmers to wait for long after harvesting their crops.

In order to meet his commitments and pay his debt, the poor farmer is forced to sell the produce at whatever price is offered to him. The Rural Credit Survey Report rightly remarked that the producers in general sell their produce at an un favourable place and at an un favourable time and usually they get un favourable terms.

In the absence of an organised marketing structure, private traders and middlemen dominate the marketing and trading of agricultural produce. The remuneration of the services provided by the middlemen increases the load on the consumer, although the producer does not derive similar benefit.

Many market surveys have revealed that middlemen take away about 48 per cent of the price of rice, 52 per cent of the price of groundnuts and 60 per cent of the price of potatoes offered by consumers.

In order to save the farmer from the clutches of the money lenders and the middle men, the government has come out with regulated markets. These markets generally introduce a system of competitive buying, help in eradicating malpractices, ensure the use of standardised weights and measures and evolve suitable machinery for settlement of disputes thereby ensuring that the pro-ducers are not subjected to exploitation and receive remunerative prices.

8. Inadequate storage facilities:

Storage facilities in the rural areas are either totally absent or grossly inadequate. Under such conditions the farmers are compelled to sell their produce immediately after the harvest at the prevailing market prices which are bound to be low. Such distress sale deprives the farmers of their legitimate income.

The Parse Committee estimated the post-harvest losses at 9.3 per cent of which nearly 6.6 per cent occurred due to poor storage conditions alone. Scientific storage is, therefore, very essential to avoid losses and to benefit the farmers and the consumers alike.

At present there are number of agencies engaged in warehousing and storage activities. The Food Corporation of India (F.C.I.), the Central Warehousing Corporation (C.W.C.) and State Warehousing Corporation are among the principal agencies engaged in this task. These agencies help in building up buffer stock, which can be used in the hour of need. The Central Government is also implementing the scheme for establishment of national Grid of Rural Godowns since 1979-80.

This scheme provides storage facilities to the farmers near their fields and in particular to the small and marginal farmers. The Working Group on additional storage facilities in rural areas has recommended a scheme of establishing a network of Rural Storage Centres to serve the economic interests of the farming community.

9. Inadequate transport:

One of the main handicaps with Indian agriculture is the lack of cheap and efficient means of transportation. Even at present there are lakhs of villages which are not well connected with main roads or with market centres.

Most roads in the rural areas are Kutcha (bullock- cart roads) and become useless in the rainy season. Under these circumstances the farmers cannot carry their produce to the main market and are forced to sell it in the local market at low price. Linking each village by metalled road is a gigantic task and it needs huge sums of money to complete this task.

10. Scarcity of capital:

Agriculture is an important industry and like all other industries it also requires capital. The role of capital input is becoming more and more important with the advancement of farm technology. Since the agriculturists' capital is locked up in his lands and stocks, he is obliged to borrow money for stimulating the tempo of agricultural production.

The main suppliers of money to the farmer are the money-lenders, traders and commission agents who charge high rate of interest and purchase the agricultural produce at very low price. All India Rural Credit Survey Committee showed that in 1950-51 the share of money lenders stood at as high as 68.6 per cent of the total rural credit and in 1975-76 their share declined to 43 per cent of the credit needs of the farmers.

This shows that the money lender is losing ground but is still the single largest contributor of agricultural credit. Rural credit scenario has undergone a significant change and institutional agencies such as Central Cooperative Banks, State Cooperative Banks, Commercial Banks, Cooperative Credit Agencies and some Government Agencies are extending loans to farmers on easy terms.

5.7. INDUSTRY

Industry is the production of goods or related services within an economy.[1] The major source of revenue of a group or company is the indicator of its relevant industry.[2] When a large group has multiple sources of revenue generation, it is considered to be working in different industries. Manufacturing industry became a key sector of production and labour in European and North American countries during the Industrial Revolution, upsetting previous mercantile and feudal economies. This occurred through many successive rapid advances in technology, such as the production of steel and coal.

Following the Industrial Revolution, possibly a third of the world's economic output is derived that is from manufacturing industries. Many developed countries and many developing/semi-developed countries (People's Republic of China, India etc.) depend significantly on manufacturing industry. Industries, the countries they reside in, and the economies of those countries are interlinked in a complex web of interdependence.

Industrial development

The industrial revolution led to the development of factories for large-scale production, with consequent changes in society.[4] Originally the factories were steam-powered, but later transitioned to electricity once an electrical grid was developed. The mechanized assembly line was introduced to assemble parts in a repeatable fashion, with individual workers performing specific steps during the process. This led to significant increases in efficiency, lowering the cost of the end process. Later automation was increasingly used to replace human operators. This process has accelerated with the development of the computer and the robot.

ROLE OF INDUSTRY

The Gross Domestic Product popularly known as GDP of an economy requires contribution from major industries to be healthy. India is largely an agrarian economy; so agriculture makes the major contribution to the GDP. Role of major industries in India GDP is important as based on this only the total GDP is calculated. In terms of US Dollar exchange rate India's economy is the twelfth largest. Despite witnessing a slowdown, due to the global recession, India's economy has huge potential of expansion.

Major industries that contribute to India's GDP

There are various sectors that contribute to India's GDP. Some of the major sectors are Automobile Industry, Steel Industry, Real Estate Industry, Tourism Industry, Energy Sector, Textile Industry, Airlines Industry, Medical Industry, Biotechnology Industry, Electronics and Hardware and the power industry. Besides these industries, there are several other sectors that are important contributors to the GDP of India.

GDP: $1.209 trillion (2008 Estimate)

GDP growth: 6.7% (2009)

GDP per capita: $1016

Inflation (CPI): 7.8%

(CPI) (2008)

Unemployment: 6.8% (2008 Estimate)

Main Industries: Textiles, Chemicals, Food Processing, Steel, Transportation Equipment, Cement, Mining, Petroleum, Machinery, Software.

The fertilizer industry of India makes more than a 20% contribution to the GDP. Another sector that seems very promising for the future is biotechnology. This sector is very young, but it is growing at a very fast pace and will undoubtedly become one of the leading sectors contributing to the GDP in the near future. Currently this sector generates $ 2 billion revenue for the Indian economy. The real estate sector has witnessed a huge boom of late and has made significant contributions to the GDP of India. The real estate sector is one industry that has made significant contribution to the country's GDP. Due to the enormous demand in the retail and other sectors of the economy, more demands are being created for real estate. The automobile industry is another sector that makes good contribution to the Indian economy. Due to the changed lifestyle of the consumer the demand for vehicles is increasing at a huge pace.

Trend of Growth Rate of India's GDP

1960-1980: 3.5%

1980-1990: 5.4%

1990-2000: 4.4%

2000-2009: 6.4%

The trend of growth rate of India's economy demonstrates an upward trend. During the period of 1960 – 1980 the economy saw a growth rate of 3.5% due to the roles of major industries in India GDP. In the years from 1980 to 1990 the growth rate showed a marked improvement of 5.4%, while it was slightly lower in the period from 1990 to 2000 which was at 4.4%. The phase 2000 to 2009 saw a huge improvement and the growth rate of GDP were marked at 6.4%.

PROBLEMS OF INDUSTRY

Foregoing analysis shows that India has made sufficient achievement in industrial development during the last five decades and has emerged as the tenth largest industrialized country of the world. But considering the size of the country this development is far from satisfactory.

There are many areas where despite requisite facilities industrial development is either insufficient or completely absent. The pace of industrial progress has been very slow and the growth has always lagged behind the target (except in 7th Five Year Plan). Despite industrial progress self- sufficiency is a distant dream and import substitu-tion a major problem. Under utilization of existing capacity is another major problem which is due to lack of power, raw material and demand.

Industry has developed elite oriented pattern. Concentration of economic power in the hands of few, regional imbalances, sickness of industries, loss in public sector industries, unsatisfactory labour relations, lack of capital and industrial raw materials, chang-ing policy of the government, and defective licens-ing policy are some of the problems which are hindering the overall industrial development in the country. In following paragraphs an attempt has been made to highlight some of these problems.

1. Unbalanced Industrial Structure

Despite all efforts India has not been able to attain self sufficiency in respect of industrial mate-rial. India is still dependent on foreign imports for transport equipments, machineries (electrical and non-electrical), iron and steel, paper, chemicals and fertilisers, plastic material etc. In the total industrial production consumer goods contribute 38 per cent. In newly industrialised countries like Singapore, South Korea and Malaysia this percentage is 52, 29 and 28 respectively. This shows that import substi-tution is still a distant goal for the country.

2. Low Demand

There is low demand for industrial products in the country due to low consumption level, weak purchasing power and poor standard of living. The domestic market is chronically underdeveloped through lack of enthusiasm generated by the middle and upper class segment who do not wish to raise their standard and improve their living conditions.

3. Regional Concentration

In India most of the industries are located in few selected areas leaving out vast expanse of the country devoid of industrial establishments. Most of the industries are located in and around metropolitan cities like Mumbai, Kolkata, Delhi etc. Tables 18.1 and 18.11 present uneven concentration of indus-tries. While the states like Maharashtra, Gujarat, Tamil Nadu etc are well ahead in industrial develop-ment others like Meghalaya, Manipur, Jammu and Kashmir, Himachal Pradesh, Tripura, Orissa, As-sam etc are far behind. This has not only created regional imbalance and regional disparity but has encouraged fissiparous tendency including unrest, violence and terrorism.

4. Loss in Public Sector Industries

Owing to focus on socialistic pattern of de-velopment investment under public sector industries increased phenomenally during early five year plans. But due to defective policy of the government char-acterised by redtops and inefficiency and strained labour-management relations most of these public sector enterprises are running in loss. Every year the government has to incur huge expenditure to cover up this loss and meet obligations of paying wages to the employees.

This hardly leaves surplus money to go for new industrial ventures and launch schemes for social development. To avoid this burden on exchequer the government is promoting privatisa-tion and disinvestment of shares of public sector undertakings. This goes against the Peruvian model of development initiated during the fifties of the last century.

5. Industrial Sickness

In the private industrial sector a growing number of industrial units are becoming sick. Wide-spread sickness has, indeed, become a major prob-lem of this sector. The causal factors for this sickness are: (i) deficient management, (ii) under-utilisation of capacity due to shortage of raw materials, coal and power and transport, (iii) obsolete machinery, equip-ment and production techniques, (iv) uneconomical scale of production, (v) faulty choice of products and processes, (vi) difficulties in selling the products, (vii) diversion of funds to new units under same ownership, and (viii) conflict between different in-terest groups among the owners. A total of Rs. 19,464 crores of bank credit was locked up in these sick units. Sometimes, the government takes over sick units which further worsen the prob-lem.

In order to provide a focal point for the revival of sick units, the Industrial Reconstruction Corpora-tion was reconstituted in 1985 as the Industrial Reconstruction Bank. It is now the principal agency for reconstruction and rehabilitation of sick units.

The Central Government set up in 1986 two Funds, the Textile Modernisation Fund (TMF) and the Jute Modernisation Fund (JMF) to provide assistance on concessional terms to healthy as well as sick units for modernisation. These two Funds are being administered by the IDBI and the IFCI respectively. There is also a need for constant monitoring and deterrent penalties to the parties responsible for sickness.

6. Lack of Infrastructure

An inadequate infrastructural facility is another major problem faced by the Indian industries. En-ergy crisis has a great bearing on the industrial development and production. Although the installed capacity of electricity increased from 66.08 million km in 1990-91 to 85.79 million km in 1996-97 but it is much short of the actual demand.

It leads to power cut and rostering which hampers the industrial pro-duction. Most of the State Electricity Boards are running in loss and are in deplorable condition. Rail transport is overburdened while road transport is plagued with many problems. Even national highways in many places are in bad shape. Telecom-munication facilities are mainly confined to big cities.

7. Improper Location Base

Industrial locations, in several instances, were established without reference to cost-effective points. Each state clamors for the establishment of major industries in the public sector within its boundaries, and the location decisions are often politically motivated.

8. Lack of Capital

Indian industrial development is facing acute shortage of capital. The short-term and long-term loans from international agencies like World Bank and Asian Development Bank etc have done more harm to the economy than taking it out from the crisis. A lot of foreign exchange is being utilised in the payment of these loans.

The situation becomes acute when fresh loans are taken to pay the installments of the old loans. Due to liberalisation, the foreign exchange reserve position has improved in recent years and flow of foreign capital has started in industrial sector. These foreign investors also do not like to invest in such industries which require large capital, need long gestation period and where recovery is slow or more risk is involved. Instead of depending on foreign capital we have to place more reliance on indigenous capital with greater emphasis on the development of priority industries.

9. Shortage of Industrial Raw Material

Indian Agricore, the major source of indus-trial raw material, is still dependent on the monsoon. Natural calamities like drought, famine, flood etc badly affect agricultural production as well the sup-ply of industrial raw material. Failure of monsoon even affects the purchasing power of the people and also the demand for industrial products. It some-times creates glut in the market and industrial plumpness. Cement industry is recently facing such crisis.

Drought like situation even affects hydel generation, leading to energy crisis, more pressure on railways to transport coal and on thermal power sector for higher output. This leads to a chain of crises which have interlinking effect.

10. Higher Cost of Production and Low Quality of Goods

Indian industries mostly survive on home demands. These have been given a number of con-cessions and even protection from foreign indus-tries. Here most of the work is done by hand on old and obsolete machines.

This increases the cost of production and brings down the quality of products produced. Since these industries have virtual mo-nopoly they hardly bother to improve their quality. Public sector units, under direct control of the gov-ernment, frequently increase the prices which provide golden opportunity to private industrialists also to increase the prices. Our industrial products are not able to make wide market abroad.

The low purchasing power of the people even reduces home demand. The situtation is likely to change during globalisation when there is apprehension of wide spread closure of these industries due to stiff compe-tition offered by multinational companies. This is also not good for the country and the Indian indus-tries.

11. License Policy

The license policy approving the site, capac-ity, type and expansion of industries is a typical example of excessive state interference and red tapes which hinder the industrial development. Recently some examples of political vendetta have come to surface whereby central government over delayed the approval of industries from such states where hostile political party is in power. Ministers and influential political leaders are pres-surising industrialists to install industries in their electoral area so as to approve their licenses. With the introduction of liberalisation policy many of the shortcomings of the license policy have been re-moved.

12. Lack of Institutional Organization

A major development thrust during the Five Year Plans was toward the establishment of a vigor-ous public sector developed hastily without the crea-tion of a base of administrative machinery capable of undertaking this enormous task. Preparatory work for such tremendous institutional regorganization was poor. High performance was rarely insisted on even after the construction of an administrative base. The result was non-achievement of targets. During the Fourth, Fifth and Sixth Plans, achievement lev-els fell short of targets by 15-18 per cent. This malady is still persisting even after liberalisa-tion. There is no clear-cut planning at state level to attract foreign capital and promote industrialisation.

Industrialization started in India roughly a century later than in the developed countries. That is why, when it was in mature stage in the Western countries it was in infantile stage in India. Hence, India had to perform dual task of promoting indus-trialisation as well as to equip herself with latest technology in the field of electronics, nuclear sci-ence, space research etc.

This slowed down the pace of industrial progress. Frequent change in the ap-proach-sometimes emphasis on rural industrialisa-tion, sometimes on urban-nucleated industrialisa-tion or rural led employment-oriented strategy or creation of employment-oriented agro-based indus-tries-confuse the situation. Indian industrialisation has passed through great odds. Besides being victim of 'economics of scarcity' it has been mauled by political indecision, prejudices and confusion.

5.8. INDUSTRIAL POLICIES

The industrial policy of a country, sometimes denoted IP, is its official strategic effort to encourage the development and growth of part or all of the manufacturing sector as well as other sectors of the economy.[1][2][3] The government takes measures "aimed at improving the competitiveness and capabilities of domestic firms and promoting structural transformation."[4] A country's infrastructure (transportation, telecommunications and energy industry) is a major part of the manufacturing sector that often has a key role in IP.[citation needed]

Industrial policies are sector-specific, unlike broader macroeconomic policies. Examples of the latter, which are horizontal, economy wide policies, are tightening credit and taxing capital gains, while examples

of industrial policy, which involves vertical, sector-specific policies, include protecting textiles from imports and subsidizing export industries. Industrial policies are interventionist measures typical of mixed economy countries.

Many types of industrial policies contain common elements with other types of interventionist practices such as trade policy and fiscal policy. An example of a typical industrial policy is import-substitution-industrialization (ISI), where trade barriers are temporarily imposed on some key sectors, such as manufacturing.[5] By selectively protecting certain industries, these industries are given time to learn (learning by doing) and upgrade. Once competitive enough, these restrictions are lifted to expose the selected industries to the international market.[6]

Objectives of the Industrial Policy of the Government are –

- to maintain a sustained growth in productivity;
- to enhance gainful employment;
- to achieve optimal utilisation of human resources;
- to attain international competitiveness and
- to transform India into a major partner and player in the global arena.

Policy focus is on –

- Deregulating Indian industry;
- Allowing the industry freedom and flexibility in responding to market forces and
- Providing a policy regime that facilitates and fosters growth of Indian industry.

Policy measures

Some of the important policy measures announced and procedural simplifications undertaken to pursue the above objectives are as under:

i) Liberalization of Industrial Licensing Policy

The list of items covered under compulsory licensing under the Industries (Development & Regulation) Act, 1951 is reviewed on an ongoing basis. At present, only five industries are under compulsory licensing mainly on account of environmental, safety and strategic considerations. They are:

1. Distillation and brewing of alcoholic drinks.(Licensing ceased by DIPP in compliance with Supreme Court Order of 29.1.1997 in Bihar Distillery case which ruled that industries engaged in manufacture of potable alcohol would be under the jurisdiction of the States).

2. Cigars and cigarettes of tobacco and manufactured tobacco substitutes.

3. Electronic Aerospace and defense equipment: all types.

4. Industrial explosives including detonating fuses, safety fuses, gun powder, nitrocellulose and matches.

5. Specified Hazardous chemicals i.e. (i) Hydrocyanic acid and its derivatives, (ii) Phosgene and its derivatives and (iii)Isocyanates & diisocyanates of hydrocarbon, not elsewhere specified(example Methyl isocyanate).

Similarly, from 8 industries reserved for the public sector in 1991, there are only

following 2 industries reserved for public sector at present:

1. Atomic energy – Production, separation or enrichment of special fissionable materials and substances and operation of the facilities, specified in DIPP Notification No. S.O.2630 (E) dated 19.10.2009

2. Railway transport.

ii) Industrial Entrepreneurs' Memorandum (IEM)

Industries not covered under compulsory licensing are to file an Industrial Entrepreneurs' Memorandum (IEM) with the Secretariat for Industrial Assistance (SIA). No industrial approval is required for such exempted industries. Amendments are also allowed to IEMs filed w.e.f. 1.7.98.

iii) Policy for Small Scale Industries

At present, the SSI is defined under the Micro, Small & Medium Enterprises (MSMED) Act, 2006. Though reservation of items exclusively for the Small Scale sector forms a significant aspect of the industrial policy, review for de reservation of such items is also undertaken by the Government at periodic intervals, in order to enhance competitiveness of such products in the domestic/ global markets. Review of reserved items is thus a continuous process. During the last 5 years itself more than 600 items have been de reserved. At present 20 items are reserved for manufacture in the small scale sector.

All undertakings other than the small scale industrial undertakings engaged in the

manufacture of items reserved for manufacture in the small scale sector are required to obtain an industrial licence and undertake an export obligation of 50% of the annual production. This condition of licensing is, however, not applicable to those undertakings operating under 100% Export Oriented Undertakings Scheme, the Export Processing Zone (EPZ) or the Special Economic Zone Schemes (SEZs).

In tune with the provisions of the MSMED Act, 2006 and policy of liberalization, the provision of restricting equity participation by non-SSI undertakings in SSI undertakings up to 24% has been removed by way of rescinding notification No.S.O. 857(E) dated 10.12.1997 vide Notification No.S.O.563(E) dated 27.2.2009.

iv) Non-Resident Indians Scheme

The general policy and facilities for Foreign Direct Investment are applicable to NRIs as well. In addition, Government has extended some additional facilities to NRIs, which include investment in the real estate and civil aviation sectors up to 100 per cent, besides a liberal investment regime on non-repatriation basis.

v) Electronic Hardware Technology Park (EHTP)/Software Technology Park (STP)scheme

For building up strong electronics industry and with a view to enhancing export, two schemes viz. Electronic Hardware Technology Park (EHTP) and Software Technology Park (STP) are in operation. Under EHTP/ STP scheme, the inputs are allowed to be procured free of duties.

The Directors of STPs have powers to approved fresh STP/EHTP proposals and also grand post-approval amendment in respect of EHTP/STP projects as have been given to the Development Commissioners of Export Processing Zones in the case of Export Oriented Units. All other application for setting up projects under these schemes, are considered by the Inter-Ministerial Standing Committee (IMSC) Chaired by Secretary (Information Technology). The IMSC is serviced by the SIA.

vi) Policy for Foreign Direct Investment (FDI)

Promotion of Foreign Direct Investment (FDI) forms an integral part of the Industrial Policy. FDI helps in accelerating economic growth by means of infusion of capital, technology and modern management practices. Government has put in place a liberal and transparent foreign investment regime, wherein FDI, up to 100%, is allowed, under the automatic route, in most sectors/activities. The FDI policy is announced through issue of Consolidated FDI Policy Circulars.

The Department has also strengthened investment facilitation measures through Foreign Investment Implementation Authority (FIIA).

5.9. INDUSTRIAL DISPUTE

The Industrial Disputes Act 1947 extends to the whole of India and regulates Indian labour law so far as that concerns trade unions. It came into force April 1, 1947.

Objectives

The objective of the Industrial Disputes Act is to secure industrial peace and harmony by providing machinery and procedure for the investigation and settlement of industrial disputes by negotiations.

The laws apply only to the organised sector. Chapter V-B, introduced by an amendment in 1976, requires firms employing 300 or more workers to obtain government permission for layoffs, retrenchments and closures. A further amendment in 1982 (which took effect in 1984) expanded its ambit by reducing the threshold to 100 workers.

The Act also lays down:

1. The provision for payment of compensation to the workman on account of closure or lay off or retrenchment.
2. The procedure for prior permission of appropriate Government for laying off or retrenching the workers or closing down industrial establishments
3. Unfair labour practices on part of an employer or a trade union or workers.

Applicability

The Industrial Disputes Act extends to whole of India and applies to every industrial establishment carrying on any business, trade, manufacture or distribution of goods and services irrespective of the number of workmen employed therein.

Every person employed in an establishment for hire or reward including contract labour, apprentices and part-time employees to do any manual, clerical, skilled, unskilled, technical, operational or supervisory work, is covered by the Act.

This Act though does not apply to persons mainly in managerial or administrative capacity, persons engaged in a supervisory capacity and drawing > 10,000 p.m. or executing managerial functions and persons subject to Army Act, Air Force and Navy Act or those in police service or officer or employee of a prison.

5.10. INDUSTRIAL RELATIONS

"Industrial relationship is about the relationship between an employee and management. This page carries information about Industrial relations and its concept through definition and description of industrial relation."

Industrial relations has become one of the most delicate and complex problems of modern industrial society. Industrial progress is impossible without cooperation of labors and harmonious relationships. Therefore, it is in the interest of all to create and maintain good relations between employees (labor) and employers (management).

Definition of Industrial Relations

Industrial relation is defined as relation of Individual or group of employee and employer for engaging themselves in a way to maximize the productive activities.

In the words of Lester, "Industrial relations involve attempts at arriving at solutions between the conflicting objectives and values; between the profit motive and social gain; between discipline and freedom, between authority and industrial democracy; between bargaining and co-operation; and between conflicting interests of the individual, the group and the community.

Concept of Industrial Relations

The term 'Industrial Relations' comprises of two terms: 'Industry' and 'Relations'. "Industry" refers to "any productive activity in which an individual (or a group of individuals) is (are) engaged". By "relations" we mean "the relationships that exist within the industry between the employer and his workmen." The term industrial relations explains the relationship between employees and management which stems directly or indirectly from union-employer relationship.

❖ Industrial relations are the relationships between employees and employers within the organizational settings. The field of industrial relations looks at the relationship between management and workers, particularly groups of workers represented by a union. Industrial relations are basically the interactions between employers, employees and the government, and the institutions and associations through which such interactions are mediated.

❖ The term industrial relations has a broad as well as narrow outlook. Originally, industrial relations was broadly defined to include the relationships and interactions between employers and employees. From this perspective, industrial relations covers all aspects of the employment relationship, including human resource management, employee relations, and union-management (or labor) relations. Now its meaning has become more specific and restricted. Accordingly, industrial relations pertains to the study and practice of collective bargaining, trade unionism, and labor-management relations, while human resource management is a separate, largely distinct field that deals with nonunion employment relationships and the personnel practices and policies of employers.

The relationships which arise at and out of the workplace generally include the relationships between individual workers, the relationships between workers and their employer and the relationships between employees. The relationships employers and workers have with the organizations are formed to promote their respective interests, and the relations between those organizations, at all levels. Industrial relations also includes the processes through which these relationships are expressed (such as, collective bargaining, workers' participation in decision-making, and grievance and dispute settlement), and the management of conflict between employers, workers and trade unions, when it arises.

Need for Industrial Relation

Need of Industrial Relation has arisen to defend the interest of workers for adjusting the reasonable salary or wages. It also helps the workers to seek perfect working condition for producing maximum output. Workers/employees are concerned with social security measures through this. Industrial Relations is also needed for achieving the democracy by allowing worker to take part in management, which helps to

protect human rights of individual.Salaries in India are much more attractive in indian subcontinent. As India is having flourishing economy, the job opportunities are emerging and there is huge scope of expansion. The salary pattern of India is also growing. Even, the seventh pay commission is also spreading the way to coming soon. The Salaries of private sector is also in the upswing mode with the increase of 11% annually. Although, Inflation is one of the major factor which nullify the increase in the salary. But still, the inflation is lower than the increase in the salary. So, this can be seen as increase in the salary.

The National Commission on Labor (NCL) also emphasize on the same concept. According to NCL, industrial relations affect not merely the interests of the two participants- labor and management, but also the economic and social goals to which the State addresses itself. To regulate these relations in socially desirable channels is a function, which the State is in the best position to perform In fact, industrial relation encompasses all such factors that influence behaviour of people at work. A few such important factors are below:

In fact, industrial relation encompasses all such factors that influence behaviour of people at work. A few such important factors are below:

Characters

It aims to study the role of workers unions and employers federations officials, shop stewards, industrial relations officers/ manager, mediator/conciliators / arbitrator, judges of labor court, tribunal etc.

Institution

It includes government, employers, trade unions, union federations or associations, government bodies, labor courts, tribunals and other organizations which have direct or indirect impact on the industrial relations systems.

Methods

Methods focus on collective bargaining, workers participation in the industrial relations schemes, discipline procedure, grievance redressal machinery, dispute settlements machinery working of closed shops, union reorganization, organizations of protests through methods like revisions of existing rules, regulations, policies, procedures, hearing of labor courts, tribunals etc.

Contents

It includes matter pertaining to employment conditions like pay, hours of works, leave with wages, health, and safety disciplinary actions, lay-off, dismissals retirements etc., laws relating to such activities, regulations governing labor welfare, social security, industrial relations, issues concerning with workers participation in management, collective bargaining, etc.

5.11. PROBLEMS OF SMALL SCALE INDUSTRIES

Small scale industries play a vital role in the economic development of our country.

This sector can stimulate economic activity and is entrusted with the responsibility of realising various objectives generation of more employment opportunities with less investment, reducing regional imbalances etc. Small scale industries are not in a position to play their role effectively due to various constraints. The various constraints, the various problems faced by small scale industries are as under:

(1) Finance:

Finance is one of the most important problem confronting small scale industries Finance is the life blood of an organisation and no organisation can function proper 6 in the absence of adequate funds. The scarcity of capital and inadequate availability of credit facilities are the major causes of this problem.

Firstly, adequate funds are not available and secondly, entrepreneurs due to weak economic base, have lower credit worthiness. Neither they are having their own resources are others prepared to lend them. Entrepreneurs are forced to borrow money from money lenders at exorbitant rate of interest and this upsets all their calculations.

After nationalisation, banks have started financing this sector. These enterprises are still struggling with the problem of inadequate availability of high cost funds. These enterprises are promoting various social objectives and in order to facilitate then working adequate credit on easier terms and conditions must be provided to them.

(2) Raw Material:

Small scale industries normally tap local sources for meeting raw material requirements. These units have to face numerous problems like availability of inadequate quantity, poor quality and even supply of raw material is not on regular basis. All these factors adversely affect t e functioning of these units.

Large scale units, because of more resources, normally corner whatever raw material that is available in the open market. Small scale units are thus forced to purchase the same raw material from the open market at very high prices. It will lead to increase in the cost of production thereby making their functioning unviable.

(3) Idle Capacity:

There is under utilisation of installed capacity to the extent of 40 to 50 percent in case of small scale industries. Various causes of this under-utilisation are shortage of raw material problem associated with funds and even availability of power. Small scale units are not fully equipped to overcome all these problems as is the case with the rivals in the large scale sector.

(4) Technology:

Small scale entrepreneurs are not fully exposed to the latest technology. Moreover, they lack requisite resources to update or modernise their plant and machinery Due to obsolete methods of production, they are confronted with the problems of less production in inferior quality and that too at higher cost. They are in no position to compete with their better equipped rivals operating modem large scale units.

(5) Marketing:

These small scale units are also exposed to marketing problems. They are not in a position to get first hand information about the market i.e. about the competition, taste, liking, disliking of the consumers and prevalent fashion.

With the result they are not in a position to upgrade their products keeping in mind market requirements. They are producing less of inferior quality and that too at higher costs. Therefore, in competition with better equipped large scale units they are placed in a relatively disadvantageous position.

In order to safeguard the interests of small scale enterprises the Government of India has reserved certain items for exclusive production in the small scale sector. Various government agencies like Trade Fair Authority of India, State Trading Corporation and the National Small Industries Corporation are extending helping hand to small scale sector in selling its products both in the domestic and export markets.

(6) Infrastructure:

Infrastructure aspects adversely affect the functioning of small scale units. There is inadequate availability of transportation, communication, power and other facilities in the backward areas. Entrepreneurs are faced with the problem of getting power connections and even when they are lucky enough to get these they are exposed to unscheduled long power cuts.

Inadequate and inappropriate transportation and communication network will make the working of various units all the more difficult. All these factors are going to adversely affect the quantity, quality and production schedule of the enterprises operating in these areas. Thus their operations will become uneconomical and unviable.

(7) Under Utilisation of Capacity:

Most of the small-scale units are working below full potentials or there is gross underutilization of capacities. Large scale units are working for 24 hours a day i.e. in three shifts of 8 hours each and are thus making best possible use of their machinery and equipments.

On the other hand small scale units are making only 40 to 50 percent use of their installed capacities. Various reasons attributed to this gross under- utilisation of capacities are problems of finance, raw material, power and underdeveloped markets for their products.

(8) Project Planning:

Another important problem faced by small scale entrepreneurs is poor project planning. These entrepreneurs do not attach much significance to viability studies i.e. both technical and economical and plunge into entrepreneurial activity out of mere enthusiasm and excitement.

They do not bother to study the demand aspect, marketing problems, and sources of raw materials and even availability of proper infrastructure before starting their enterprises. Project feasibility analysis covering all these aspects in addition to technical and financial viability of the projects, is not at all given due weight-age.

Inexperienced and incomplete documents which invariably results in delays in completing promotional formalities. Small entrepreneurs often submit unrealistic feasibility reports and incompetent entrepreneurs do not fully understand project details.

Moreover, due to limited financial resources they cannot afford to avail services of project consultants. This result is poor project planning and execution. There is both time interests of these small scale enterprises.

(9) Skilled Manpower:

A small scale unit located in a remote backward area may not have problem with respect to unskilled workers, but skilled workers are not available there. The reason is Firstly, skilled workers may be reluctant to work in these areas and secondly, the enterprise may not afford to pay the wages and other facilities demanded by these workers.

Besides non-availability entrepreneurs are confronted with various other problems like absenteeism, high labour turnover indiscipline, strike etc. These labour related problems result in lower productivity, deterioration of quality, increase in wastages, and rise in other overhead costs and finally adverse impact on the profitability of these small scale units.

(10) Managerial:

Managerial inadequacies pose another serious problem for small scale units. Modern business demands vision, knowledge, skill, aptitude and whole hearted devotion. Competence of the entrepreneur is vital for the success of any venture. An entrepreneur is a pivot around whom the entire enterprise revolves.

Many small scale units have turned sick due to lack of managerial competence on the part of entrepreneurs. An entrepreneur who is required to undergo training and counseling for developing his managerial skills will add to the problems of entrepreneurs.

The small scale entrepreneurs have to encounter numerous problems relating to overdependence on institutional agencies for funds and consultancy services, lack of credit-worthiness, education, training, lower profitability and host of marketing and other problems. The Government of India has initiated various schemes aimed at improving the overall functioning of these units.

MEASURES TO REMOVE DIFFICULTIES FACED BY SMALL-SCALE INDUSTRIES IN INDIA

It will be noted that small scale industrial units experience serious handicaps by an inequitable allocation system for scarce raw materials, inadequate institutional finance, poor technical skill and managerial ability, and lack of marketing channels.

It is, therefore, essential to develop an overall approach to remove these difficulties and put the small-scale industrial sector on a sound path of development.

(1) Equitable Allocation of Raw Materials, Imported Components and Equipment:

The small scale industrial units should be given adequate degree of priority in the allocation pattern of essential, but scarce, raw materials, imported components and equipment.

(2) Improvement in the Methods and Techniques of Production:

The small scale industrial units should be encouraged to replace their outmoded equipment with that incorporating an up-to-date technology, and facilities and incentives should be provided wherever required.

Up-dating the methods and techniques of production of quality goods conforming to standards. The role of the Government in this respect is quite significant. Standardisation of certain products should be ensured, the quality of products should be guaranteed, and malpractices like adulteration, misrepresentation, etc., need to be curbed drastically.

(3) Provision of Adequate Finance:

Promoter's own capital in the small-scale industrial units is generally small and generation of internal resources small and slow. They depend, therefore, on the external sources of finance in a substantial measure.

This factor requires, therefore, a system of integrated credit whereby the long-term as well as short-term finance is made available in an adequate measure and at a rate of interest which these undertakings can bear.

(4) Marketing Assistance:

Marketing of their products at remunerative prices is the major problem of small-scale industrial units. There is, therefore, a clear case for government intervention with a view to reducing the disadvantages arising out of market imperfections. Market research, intelligence and information systems should be strengthened and the results made available to those units.

3

(5) Industrial Education and Training:

With full advantages of changing technique of production, dispensation of technical knowledge, both to the small-scale entrepreneurs as well as their workers, should form an essential element of the overall strategy. Provision of adequate facilities for industrial education and training, therefore cannot be over-emphasised.

(6) Demarcation of Spheres of Large-Scale and Small-Scale Industrial Units:

Once the role of small-scale industries in the national economy is recognised, it becomes imperative that a secured berth is provided to it. In this connection the guiding principle should be to clearly demarcate, as possible, the spheres of production for these units. It may be pointed out that all the measures suggested above should be viewed as a package and applied simultaneously.

5.12. INDUSTRIAL POLICY - 1956

Industrial Policy Resolution of 1956 (IPR 1956) is a resolution adopted by the Indian Parliament in April 1956. It was the first comprehensive statement on industrial development of India.[1] The 1956 policy continued to constitute the basic economic policy for a long time. This fact has been confirmed in all the Five-Year Plans of India. According to this resolution the objective of the social and economic policy in India was the establishment of a socialistic pattern of society. It provided more powers to the governmental machinery. It laid down three categories of industries which were more sharply defined. These categories were:

(a) Schedule A: those industries which were to be an exclusive responsibility of the state.

(b) Schedule B: those which were to be progressively state-owned and in which the state would generally set up new enterprises, but in which private enterprise would be expected only to supplement the effort of the state; and

(c) Schedule C: all the remaining industries and their future development would, in general be left to the initiative and enterprise of the private sector.

Although there was a category of industries left to the private sector (Schedule C above), the sector was kept under state control through a system of licenses. In order to open new industry or to expand production, obtaining a license from the government was a prerequisite. Opening new industries in economically backward areas was incentivised through easy licensing and subsidisation of critical inputs like electricity and water. This was done to counter regional disparities that existed in the country. Licenses to increase the production were issued only if the government was convinced that the economy required more of the goods.

Fair and non-discriminatory treatment for the private sector, encouragement to village and small-scale enterprises, removing regional disparities, and the need for the provision of amenities for labour, and attitude to foreign capital were other salient features of the IPR 1956.

The Industrial Policy of 1956 is known as the economic constitution of the country.

MODEL QUESTION PAPER

PART – A (2*12=24 marks)

ANSWER ANY TWO QUESTIONS:

1. Explain the various financial products and services.
2. Describe the importance of venture capital.
3. Enumerate the types of mutual funds. Explain.

PART – B (2*7=14 marks)

ANSWER ANY TWO QUESTIONS.

4. Explain the causes for over population.
5. Describe the features of agriculture in India.
6. How leasing can be classified? Explain.

PART – C (5*4=20 marks)

ANSWER ANY FIVE QUESTIONS.

7. a. Importance of capital market.
   b. Modern activities of financial services
   c. Contents of a lease agreement
   d. Benefits of credit rating
   e. Importance of Mutual funds
   f. Debt securitization
   g. Causes of poverty.

PART – D (6*2=12 marks)

ANSWER ANY SIX QUESTIONS.

8. a. Financial asset
   b. Call money market
   c. Consumer finance
   d. Types of factoring
   e. Currency swap
   g. HDI
   h. Agricultural credit.

SCHEME FOR THE QUESTION PAPER

PART – A

1. Today, the importance of financial services is gaining momentum all over the world. In these days of complex finance, people expect a Financial Service Company to play a very dynamic role not only as a provider of finance but also as a departmental store of finance. With the injection of the economic liberation policy into our economy and the opening of the economy to multinationals, the free market concept has assumed much significance. As a result, the clients both corporates and individuals are exposed to the phenomena of volatility and uncertainty and hence they expect the financial service company to innovate new products and service so as to meet their varied requirements.

As a result of innovations, new instruments and new products are emerging in the capital market. The capital market and the money market are getting widened and deepened. Moreover, there has been a structural change in the international capital market with the emergence of new products and innovative techniques of operation in the capital market. Many financial intermediaries including banks have already started expanding their activities in the financial services sector by offering a variety of new products. As a result, sophistication and innovations have appeared in the arena of financial intermediations. Some of them are discussed below :

(i) Merchant Banking : A merchant banker is a financial intermediary who helps to transfer capital from those who posses it to those who need it. Merchant banking includes a wide range of activities such as management of customers securities, portfolio management, project counseling and appraisal, underwriting of shares and debentures, loan syndication, acting as banker for the refund orders, handling interest and dividend warrants etc. Thus, a merchant banker renders a host of services to corporates and thus promotes industrial development in the country.

(ii) Loan Syndication : This is more or less similar to 'consortium financing'. But, this work is taken up by the merchant banker as a lead-manager. It refers to a loan arranged by a bank called lead manager for a borrower who is usually a large corporate customer or a Government Department. The other banks who are willing to lend can participate in the loan by contributing an amount suitable to their own lending policies. Since a single bank cannot provide such a huge sum as loan, a number of banks join together and form a syndicate. It also enables the members of the syndicate to share the credit risk associated with a particular loan among themselves.

(iii) Leasing : A lease is an agreement under which a company or a firm, acquires a right to make use of a capital asset like machinery, on payment of a prescribed fee called "rental charges". The lessee cannot acquire any ownership to the asset, but he can use it and have full control over it. he is expected to pay for all maintenance charges and repairing and operating costs. In countries like the U.S.A., the U.K. and Japan equipment leasing is very popular and nearly 25% of plant and equipment is being financed by leasing companies. In India also, many financial companies have started equipment leasing business. Commercial banks have also been permitted to carry on this business by forming subsidiary companies.

(iv) Mutual Funds : A mutual fund refers to a find raised by a financial service company by pooling the savings of the public. It is invested in a diversified portfolio with a view to spreading and minimizing risk. The fund provides investment avenue for small investors who cannot participate in the equities of big companies. It ensures low risk, steady returns, high liquidity and better capital appreciation in the long run.

(v) Factoring : Factoring refers to the process of managing the sales ledger of a client by a financial service company. In other words, it is an arrangement under which a financial intermediary assumes the credit risk in the collection of book debts for its clients. The entire responsibility of collecting the book

debts passes on to the factor. His services can be compared to a *del credre agent* who undertakes to collect debts. But, a factor provides credit information, collects debts, monitors the sales ledger and provides finance against debts. Thus, he provides a number of services apart from financing.

(vi) Forfeiting : Forfeiting is a technique by which a forfeitor (financing agency) discounts an export bill and pay ready cash to the exporter who can concentrate on the export front without bothering about collection of export bills. The forfeitor does so without any recourse to the exporter and the exporter is protected against the risk of non-payment of debts by the importers.

(vii) Venture Capital : A venture capital is another method of financing in the form of equity participation. A venture capitalist finances a project based on the potentialities of a new innovative project. It is in contrast to the conventional "security based financing". Much thrust is given to new ideas or technological innovations. Finance is being provided not only for 'start-up capital' but also for 'development capital' by the financial intermediary.

(viii) Custodial Services : It is another line of activity which has gained importance, of late. Under this, a financial intermediary mainly provides services to clients, particularly to foreign investors, for a prescribed fee. Custodial services provide agency services like safe keeping of shares and debentures, collection of interest and dividend and reporting of matters on corporate developments and corporate securities to foreign investors.

(ix) Corporate Advisory Service : Financial intermediaries particularly banks have set up corporate advisory service branches to render services exclusively to their corporate customers. For instance, some banks have extended computer terminals to their corporate customers to that they can transact some of their important banking transactions by sitting in their own office. As new avenues of finance like Euro loans, GDRs etc. are available to corporate customers, this service is of immense help to the customers.

(x) Securitisation : Securitisation is a technique whereby a financial company converts its ill-liquid, non-negotiable and high value financial assets into securities of small value which are made tradable and transferable. A financial institution might have a lot of its assets blocked up in assets like real estate, machinery etc. which are long term in nature and which are non-negotiable. In such cases, securitisation would help the financial institution to raise cash against such assets by means of issuing securities of small values to the public. Like any other security, they can be traded in the market. it is best suited to housing finance companies whose loans are always long term in nature and their money is locked up for a considerable long period in real estates. Securitisation is the only answer to convert these ill-liquid assets into liquid assets.

(xi) Derivative Security : A derivative security is a security whose value depends upon the values of other basic variables backing the security. In most cases, these variables are nothing but the prices of traded securities. A derivative security is basically used as a risk management tool and it is resorted to cover the risk due to price fluctuations by the investments manager. Just like a forward contract which is a derivative of a spot contract, a derivative security is derived from other trading securities backing it. Naturally the value of a derivative security depends upon the values of the backing securities. Derivative helps to break the risks into various components such as credit risk, interest rates risk, exchange rates risk and so on. It enables the various risk components to be identified precisely and priced them and even traded them if necessary. Financial intermediaries can go for derivatives since they will have greater importance in the near future. In India some forms of derivatives are in operation.

(xii) New Products in Forex Market : New products have also emerged in the forex markets of developed countries. Some of these products are yet to make full entry in Indian markets. Among them, the following are the important ones :

(a) Forward Contracts : A forward transaction is one where the delivery of a foreign currency takes place at a specified future date for a specified price. It may have a fixed maturity for e.g. 31st May or a flexible maturity for e.g. 1st to 31st May. There is an obligation to honour this contract at any cost, failing which, there will be some penalty. Forward contracts are permitted only for genuine business transactions. It can be extended to other transactions like interest payments.

(b) Options : As the very name implies, it is a contract wherein the buyer of the option has a right to buy or sell a fixed amount of currency against another currency at a fixed rate on a future date according to his option. There is no obligation to buy or sell, but it is completely left to his option. Options may be of two types namely call options and put options. Under call options, the customer has an option to buy and it is the option to sell under put options. Options trading would lead to speculation and hence there are much restrictions in India.

(c) Futures : It is a contract wherein there is an agreement to buy or sell a stated quantity of foreign currency at a future date at a price agreed to between the parties on the stated exchange. Unlike options, there is an obligation to buy or sell foreign exchange on a future date at a specified rate. it can be dealt only in a stock exchange.

(d) Swaps : A swap refers to a transaction wherein a financial intermediary buys and sells a specified foreign currency simultaneously for different maturity dates-say, for instance, purchase of spot and sale of forward or vice versa with different maturities. Thus swaps would result in simultaneous buying and selling of the same foreign currency of the same value for different maturities to eliminate exposure risk. It can also be used as a tool to enter arbitrage operations, if any, between two countries. It can also be used in the interest rate market also.

(xiii) Lines of Credit (LOC) : It is an innovative funding mechanism for the import of goods and services on deferred payment terms. LOC is an arrangement of financing institution/bank of one country with another institution/bank/agent to support the export of goods and services to as to enable the importers to import no deferred payment terms. This may be backed by a guarantee furnished by the institution/bank in the importing country. The LOC helps the exporters to get payment immediately as soon as the goods are shipped, since, the funds would be paid out of the pool account with the financing agency and it would be debited to the account of the borrower agency/importer whose contract for availing the facility is already approved by the financing agency on the recommendation of the overseas institution. It acts as conduct of financing which is for a certain period and on certain terms for the required goods to be imported. The greatest advantage is that it saves a lot of time and money on mutual verification of bonafides, source of finance etc. It serves as a source of forex.

2. IMPORTANCE OF VENTURE CAPITAL

Venture Capital is of great practical value to every corporate enterprise in modern times.

I. Advantage to Investing Public

1. The investing public will be able to reduce risk significantly against unscrupulous management, if the public invest in venture fund who in turn will invest in equity of new business. With their expertise in the field and continuous involvement in the business they would be able to stop malpractices by management.

2. Investor have no means to vouch for the reasonableness of the claims made by the promoters about profitability of the business. The venture funds equipped with necessary skills will be able to analyses the prospects of the business.

3. The investors do not have any means to ensure that the affairs of the business are conducted prudently. The venture fund having representatives on the Board of Directors of the company would overcome it.

II. Advantages to Promoters

1. The entrepreneur for the success of public issue is required to convince tens of underwriters, brokers and thousands of investors but to obtain venture capital assistance, he will be required to sell his idea to justify the officials of the venture fund.

2. Public issue of equity shares has to be proceeded by a lot of efforts viz. necessary statutory sanctions, underwriting and brokers arrangement, publicity of issue etc. The new entrepreneurs find it very difficult to make underwriting arrangements which involves a great deal of effort. Venture fund assistance would eliminate those efforts by leaving entrepreneur to concentrate upon bread and butter activities of business.

3. Costs of public issues of equity share often range between 10 per cent to 15 per cent of nominal value of issue of moderate size, which are often even higher for small issues. The company is required, in addition to above, to incur recurring costs for maintenance of share registry cell, stock exchange listing fee, expenditure on printing and posting of annual reports etc. These items of expenditure can be ill afforded by the business when it is new. Assistance from venture fund does not require such expenditure.

III. General

1. A developed venture capital institutional set up reduces the time lag between a technological innovation and its commercial exploitation.

2. It helps in developing new processes/products in conducive atmosphere, free from the dead weight of corporate bureaucracy, which helps in exploiting full potential.

3. Venture capital acts as a cushion to support business borrowings, as bankers and investors will not lend money with, inadequate margin of equity capital.

4. Once venture capital funds start earning profits, it will be very easy for them to raise resources from primary capital market in the form of equity and debts. Therefore, the investors would be able to invest in new business through venture funds and, at the same time, they can directly invest in existing business when venture fund disposes its own holding. This mechanism will help to channelise investment in new high-tech business or the existing sick business. These business will take-off with the help of finance from venture funds and this would help in increasing productivity, better capacity utilisation etc.

5. The economy with well developed venture capital network induces the entry of large number of technocrats in industry, helps in stabilizing industries and in creating a new set of trained technocrats to build and manage medium and large industries, resulting in faster industrial development. 6. A venture capital firm serves as an intermediary between investors looking for high returns for their money and entrepreneurs in search of needed capital for their start ups.

7. It also paves the way for private sector to share the responsibility with public sector.

3. TYPES OF FUNDS/CLASSIFICATION OF FUNDS

In the investment market, one can find a variety of investors with different needs, objectives and risk taking capacities. For instance, a young businessman would like to get more capital appreciation for his funds and he would be prepared to take greater risk than a person who is just on the verge of his retiring age. So, it is very difficult to offer one fund to satisfy all the requirements of investors. Just as one shoe is not suitable for all legs, one fund is not suitable to meet the vast requirements of all investors. Therefore,

many types of funds are available to the investor. It is completely left to the discretion of the investor to choose any one of them depending upon his requirement and his risk taking capacity.

Mutual fund schemes can broadly be classified into many types as given below:

1. On the basis of execution and operation

(A) Close-ended Funds

Under this scheme, the corpus of the fund and its duration are prefixed. In other words, the corpus of the fund and the number of units are determined in advance. Once the subscription reaches the pre-determined level, the entry of investors is closed. After the expiry of the fixed period, the entire corpus is disinvested and the proceeds are distributed to the various unit holders in proportion to their holding. Thus, the fund ceases to be a fund, after the final distribution.

Features : The main features of the close-ended funds are:

(i) The period and/or the target amount of the fund is definite and fixed beforehand.

(ii) Once the period is over and/or the target is reached, the door is closed for the investors. They cannot purchase any more units.

(iii) These units are publicly traded through stock exchange and generally, there is no repurchase facility by the fund.

(iv) The main objective of this fund is capital appreciation.

(v) The whole fund is available for the entire duration of the scheme and there will not be any redemption demands before its maturity. Hence, the fund manager can manage the investments efficiently and profitably without the necessity of maintaining and liquidity.

(vi) At the time of redemption, the entire investment pertaining to a closed-end scheme is liquidated and the proceeds are distributed among the unit holders.

(vii) From the investor's point of view, it may attract more tax since the entire capital appreciation is realized in toto at one stage itself.

(viii) If the market condition is not favourable, it may also affect the investor since he may not get the full benefit of capital appreciation in the value of the investment.

(ix) Generally, the prices of closed-end scheme units are quoted at a discount of upto 40 percent below their Net Asset Value (NAV).

(B) Open-ended Funds

It is just the opposite of close-ended funds. Under this scheme, the size of the fund and/or the period of the fund is not pre-determined. The investors are free to buy and sell any number of units at any point of time. For instance, the Unit Scheme (1964) of the Unit Trust of India is an open ended one, both in terms of period and target amount. Anybody can buy this unit at any time and sell it also at any time at his discretion.

The main features of the Open-Ended Funds are :

(i) The investor is assured of regular income at periodic intervals, say half-yearly or yearly and so on.

(ii) The main objective of this type of Fund is to declare regular dividends and not capital appreciation.

(iii) The pattern of investment is oriented towards high and fixed income yielding securities like debentures, bonds etc.

(iv) This is best suited to the old are retired people who may not have any regular income.

(v) It concerns itself with short run gains only.

(B) Pure Growth Funds (Growth Oriented Funds)

Unlike the Income Funds, Growth Funds concentrate mainly on long run gains i.e., capital appreciation. They do not offer regular income and they aim at capital appreciation in the long run. Hence, they have been described as "Nest Eggs" investments.

The main features of the Growth Funds are :

(i) The growth oriented fund aims at meeting the investors' need for capital appreciation.

(ii) The investment strategy therefore, conforms to the fund objective by investing the funds predominantly on equities with high growth potential.

(iii) The fund tries to get capital appreciation by taking much risks and investing on risk bearing equities and high growth equity shares.

(iv) The fund may declare dividend, but its principal objective is only capital appreciation.

(v) This is best suited to salaried and business people who have high risk bearing capacity and ability to defer liquidity. They can accumulate wealth for future needs.

(C) Balanced Funds

This is otherwise called income-cum-growth fund. It is nothing but a combination of both income and growth funds. It aims at distributing regular income as well as capital appreciation. This is achieved by balancing the investments between the high growth equity shares and also the fixed income earning securities.

(D) Specialised Funds

Besides the above, large number of specialised funds are in existence abroad. They offer special schemes so as to meet the specific needs of specific categories of people like pensioners, widows etc. There are also funds for investments in securities of specified areas. For instance, Japan Fund, South Korea Fund etc. In fact, these funds open the door for foreign investors to invest on the domestic securities of these countries.

Again certain funds may be confined to one particular sector or industry like fertilizer, automobiles, petroleum etc. These funds carry heavy risk since the entire investment is in one industry. But, there are high risk taking investors who prefer this type of fund. Of course, in such cases, the rewards may be commensurate with the risk taken. At times, it may be erratic. The best example of this type is the Petroleum Industry Funds in the U.S.A.

(E) Money-Market Mutual Funds (MMMFs)

These funds are basically open ended mutual funds and as such they have all the features of the open ended fund. But, they invest in highly liquid and safe securities like commercial paper, banker's acceptances, certificates of deposits, treasury bills etc. These instruments are called money market instruments. They take the place of shares, debentures and bonds in a capital market. They pay money market rates of interest. These funds are called 'money funds' in the U.S.A. and they have been functioning since 1972. Investors

generally use it as a "parking place" or "stop gap arrangement" for their cash resources till they finally decide about the proper avenue for their investment i.e., long term financial assets like bonds and stocks.

Since MMMFs are a new concept in India, the RBI has laid down certain stringent regulations. For instance, the entry to MMMFs is restricted only to scheduled commercial banks and their subsidiaries. MMMFs can invest only in specified short term money market instruments like certificate of deposits, commercial papers and 182 days treasury bills. They can also lend to call market. These funds go for safe and liquid investment. Frequent realization of interest and redemption of fund at short notice are the special features of the fund. These funds will not be subject to reserve requirements. The re-purchase could be subject to a minimum lock in period of 3 months.

(F) Taxation Funds

A taxation fund is basically a growth oriented fund. But, it offers tax rebates to the investors either in the domestic or foreign capital market. It is suitable to salaried people who want to enjoy tax rebates particularly during the month of February and March. In India, at present the law relating to tax rebates is covered under section 88 of the Income Tax Act, 1961. An investor is entitled to get 20% rebate in Income Tax for investments made under this fund subject to a maximum investment of Rs.10,000/- per annum. The Tax Saving Magnum of SBI Capital Market Limited is the best example for the domestic type. UTI's US $60 million India Fund, based in the USA, is an example for the foreign type.

OTHER CLASSIFICATION

(G) Leveraged Funds

These funds are also called borrowed funds since they are used primarily to increase the size of the value of portfolio of a mutual fund. When the value increases, the earning capacity of the fund also increases. The gains are distributed to the unit holders. This is resorted to only when the gains from the borrowed funds are more than the cost of borrowed funds.

(H) Dual Funds

This is a special kind of closed end fund. It provides a single investment opportunity for two different types of investors. For this purpose, it sells two types of investment stocks viz., income shares and capital shares. Those investors who seek current investment income can purchase income shares. They receive all the interest and dividends earned from the entire investment portfolio. However, they are guaranteed a minimum annual dividend payment. The holders of capital shares receive all the capital gains earned on those shares and they are not entitled to receive any dividend of any type. In this respect, the dual fund is different from a balanced fund.

(I) Index Funds

Index funds refer to those funds where the portfolios are designed in such a way that they reflect the composition of some broad based market index. This is done by holding securities in the same proportion as the index itself. The value of these index linked funds will automatically go up whenever the market index goes up and vice-versa. Since the construction of portfolio is entirely based upon maintaining proper proportions of the index being followed, it involves less administrative expenses, lower transaction costs, less number of portfolio managers etc. It is so because only fewer purchases and sales of securities would take place.

(J) Bond Funds

These funds have portfolios consisting mainly of fixed income securities like bonds. the main thrust of these funds is mostly on income rather than capital gains. They differ from income funds in the sense income funds offer an average returns higher than that from bank deposits and also capital gains lesser than that in equity shares.

(K) Aggressive Growth Funds

These funds are just the opposite of bond funds. These funds are capital gains oriented and thus the thrust area of these funds is capital gains. Hence, these funds are generally invested in speculative stocks. They may also use specialised investment techniques like short term trading, option writing etc. Naturally, these funds tend to be volatile in nature.

(L) Off-Shore Mutual Funds

Off-shore mutual funds are those funds which are meant for non-residential investors. In other words, the sources of investments for these funds are from abroad. So, they are regulated by the provisions of the foreign countries where those funds are registered. These funds facilitate flow of funds across different countries, with free and efficient movement of capital for investment and repatriation. Off-shore funds are preferred to direct foreign investment, since, it does not allow foreign domination over host country's corporate sector. However, these funds involve much currency and country risk and hence they generally yield higher return.

In India, these funds are subject to the approval of the Department of Economic Affairs, Ministry of Finance and the RBI monitors such funds by issuing directions then and there. In India, a number of off-shore funds exist. 'India Fund' and 'India Growth Fund' were floated by the UTI in U.K. and U.S.A. respectively. The State Bank of India floated the India Magnum Fund in Netherlands. 'The Indo-Suez Himalayan Fund N.V.' was launched by Canbank Mutual Fund in collaboration with Indo-Suez Asia Investment Services Ltd. It also floated 'Commonwealth Equity Fund'.

PART - B

4. i. Decline in the Death Rate:

The fall in death rates that is decline in mortality rate is one fundamental causes of overpopulation. Owing to the advancements in medicine, man has found cures to the previously fatal diseases. The new inventions in medicine have brought in treatments for most of the dreadful diseases. This has resulted in an increase in the life expectancy of individuals. Mortality rate has declined leading to an increase in population.

Owing to modern medications and improved treatments to various illnesses, the overall death rate has gone down. The brighter side of it is that we have been able to fight many diseases and prevent deaths. On the other hand, the medical boon has brought with it, the curse of overpopulation.

ii. Rise in the Birth Rate:

Thanks to the new discoveries in nutritional science, we have been able to bring in increase in the fertility rates of human beings. Medicines of today can boost the reproductive rate in human beings. There are medicines and treatments, which can help in conception. Thus, science has led to an increase in birth rate. This is certainly a reason to be proud and happy but advances in medicine have also become a cause of overpopulation.

iii. Migration:

Immigration is a problem in some parts of the world. If the inhabitants of various countries migrate to a particular part of the world and settle over there, the area is bound to suffer from the ill effects of overpopulation. If the rates of emigration from a certain nation do not match the rates of immigration to that country, overpopulation makes its way. The country becomes overly populated. Crowding of immigrants in certain parts of the world, results in an imbalance in the density of population.

iv. Lack of Education:

Illiteracy is another important cause of overpopulation. Those lacking education fail to understand the need to prevent excessive growth of population. They are unable to understand the harmful effects that overpopulation has.

They are unaware of the ways to control population. Lack of family planning is commonly seen in the illiterate lot of the world. This is one of the major factors leading to overpopulation. Due to ignorance, they do not take to family planning measures, thus contributing to a rise in population.

Viewing the issue of increasing population optimistically, one may say that overpopulation means the increase in human resources. The increase in the number of people is the increase in the number of productive hands and creative minds. But we cannot ignore the fact that the increase in the number producers implies an increase in the number of consumers. Greater number of people requires a greater number of resources.

Not every nation is capable of providing its people with the adequate amount of resources. The ever-increasing population will eventually leave no nation capable of providing its people with the resources they need to thrive. When the environment fails to accommodate the living beings that inhabit it, overpopulation becomes a disaster.

5. FEATURES:

a) Subsistence Agriculture: As mentioned earlier, most parts of India have subsistence agriculture. This type of agriculture has been practised in India for several hundreds of years and still prevails in a larger part of India in spite of the large scale change in agricultural practices after independence.

(b) Pressure of population on Agriculture: Despite increase in urbanization and industrialization, about 70% of population is still directly or indirectly dependent on agriculture.

(c) Mechanization of farming: Green Revolution took place in India in the late sixties and early seventies. After more than forty years of Green Revolution and revolution in agricultural machinery and equipments, complete mechanization is still a distant dream

(d) Dependence upon monsoon: Since independence, there has been a rapid expansion of irrigation infrastructure. Despite the large scale expansion, only about one third of total cropped area is irrigated today. As a consequence, two third of cropped areas is still dependent upon monsoon. As you know, monsoon in India is uncertain and unreliable. This has become even more unreliable due to change in climate.

(e) Variety of crops: Can you guess why India has a variety of crops? As mentioned in the beginning of the lesson, India has diversity of topography, climate and soil. Since India has both tropical and temperate climate, crops of both the climate are found in India. There are very few countries in the world that have variety comparable to that of India.

(f) Predominance of food crops: Since Indian agriculture has to feed a large population, production of food crops is the first priority of the farmers almost everywhere in the country. However, in recent years,

there has been a decline in the share of land used for food crops due to various other commercially most advantageous uses of these land.

(g) **Seasonal** patterns: India has three distinct agricultural/cropping seasons. You might have heard about *kharif, rabi* and *zaid.* In India there are specific crops grown in these three seasons. For example rice is a *kharif* crop whereas wheat is a *rabi* crop.

6. CLASSIFICATION OF LEASING

An equipment lease transaction can differ on the basis of (1) the extent to which the risks and rewards of ownership are transferred, (ii) number of parties to the transaction, (iii) domiciles of the equipment manufacturer, the lessor and the lessee, etc. Risk with reference to leasing refers to the possibility of loss arising on account of under-utilization or technological obsolescence of the equipment while reward means the incremental net cash flows that are generated from the usage of the equipment over its economic life and the realization of the anticipated residual value on expiry of the economic life. On the basis of these variations, leasing can be classified into the following types:

(a) Finance lease and operating lease

(b) Sales and lease back, and direct lease

(c) Single investor lease and leveraged lease

(d) Domestic lease and International lease

(a) Finance Lease and Operating Lease

Finance Lease : According to the International Accounting Standards (IAS-17), in a finance lease the lessor transfers to the lessee, substantially all the risks and rewards incidental to the ownership of the asset whether or not the title is eventually transferred. It involves payment of rentals over an obligatory non-cancelable lease period, sufficient in total to amortize the capital outlay of the lessor and leave some profit. In such leases, the lessor is only a financier and is usually not interested in the assets. It is for this reason that such leases are also usually not interested in the assests, It is for this reason that such leases are also called full payout leases as they enable a lessor to recover his investment in the lease and device a profit types of assets. Included under such lease are ships, aircraft, railway wagons, lands, building heavy machinery, diesel generating sets and so on.

The IAS-17 stipulates that a substantial part of the ownership related risks and rewards in leasing are transferred when :

(i) The ownership of the equipment is transferred to the lease by the end of the lease term or

(ii) The lease has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair market value at the date the option becomes exercisable and at the stipulation of the lease it is reasonable certain that the option will be exercise

(iii) The lease term is for a major part of the useful life of the asset. The title may not eventually be transferred. The useful life of an asset refers to the minimum of its :

1) Physical life in terms of the period for which it can perform its function,

2) Technological life in the sense of the period in which it does not become obsolete.

3) Product market life deemed as the period during which its product enjoys satisfactory market.

The criterion/cut-off point is that if the lease term exceeds 75 per cent of the useful life of the equipment, it is a finance lease.

(iv) The present value of the minimum lease payment is greater than, or substantially equal to, the fair market value of the asset at the inception of the lease (cost or equipment). The title may or may not be eventually transferred. The cut-off point is that the present value exceeds 90 per cent of the fair market value of the equipment. The present value should be computed using a discount rate equal to the rate implicit in the lease in the case of lessor and, in the case of the lessee, upon the incremental borrowing rate

In India, however, a lease is a finance lease, if one of the last two conditions, is satisfied. A lease agreement with any of the first two conditions is treated as hire-purchase agreement.

A finance lease is structured to include the following features :

(i) The lessee (the intending buyer) selects the equipment according to his requirement from its manufacturer or distributor.

(ii) The lessee negotiates and settles with the manufacturer or distributor, the price, the delivery schedule, installation, terms of warranties, maintenance and payment, etc.

(iii) The lessor purchases the equipment either directly from the manufacturer or distributor (under straight-forward leasing) or from the lessee after the equipment is delivered (under sale and lease back).

(iv) The lessor then leases out the equipment to the lessee. The lessor retains the ownership while lessee is allowed to use the equipment.

(v) A finance lease may provide a right or option, to the lessee, to purchase the equipment at a future date. However, this practice is rarely found in India

(vi) The lease period spreads over the expected economic life of the asset. The lease is originally for a non-cancelable period called the primary lease period during which the lessor seeks to recover his investment along with some profit. During this period cancellation of lease is possible only at a very heavy cost. Thereafter, the lease is subject to renewal for the secondary lease period, during which the rentals are substantially low.

(vii) The lessee is entitled to exclusive and peaceful use of the equipment during the entire lease period provided he pays the rentals and complies with the terms of the lease.

(viii) As the equipment is chosen by the lessee, the responsibility of its suitability, the risk of obsolescence and the liability for repair, maintenance and insurance or the equipment rest with the lessee.

Operating Lease: According to the IAS-17, an operating lease is one which is not a finance lease. In an operating lease, the lessor does not transfer all the risks and rewards incidental to the ownership of the asset and the cost of the asset is not fully amortized during the primary lease period. The lessor provides services (other than the financing of the purchase price) attached to the leased asset, such as maintenance, repair and technical advice. For this reason, operating lease include a cost for the services provided, and the lessor does not depend on a single lessee for recovery of his cost. Operating lease is generally used for computers, office equipments, automobiles, trucks, telephones, etc.

An operating lease is structured with the following features :

(i) An operating lease is generally for a period significantly shorter than the economic life of the leased asset. In some cases it may be even on hourly, daily, weekly or monthly basis. The lease is cancelable by either party during the lease period.

(ii) Since the lease periods are shorter than the expected life of the asset, the lease rentals are not sufficient to totally amortize the cost of the assets.

(iii) The lessor does not rely on the single lessee for recovery of his investment. He has the ultimate interest in the residual value of the asset. The lessor bears the risk of obsolescence, since the lessee is free to cancel the lease at any time.

(iv) Operating lease normally include maintenance clause requiring the lessor to maintain the leased asset and provide services such as insurance, support stair, fuel, etc.

Examples of Operating leases are:-

(a) Providing mobile cranes with operators,

(b) Chartering of aircraft and ships, including the provision of crew, fuel and support services.

(c) Hiring of computers with operators,

(d) Hiring of taxi for a particular travel, which includes service of driver, provision for maintenance, fuel immediate repairs, etc.

(b) Sale and Lease Back and Direct Lease

Sale and Lease back : In a way, it is an indirect from of leasing. The owner of an equipment/asset sells it to a leasing company (Lessor) which leases it back to the owner (lessee). A classic example of this type of leasing is the sale and lease back of safe deposits values by banks under which banks sell them in their custody to a leasing company at a market price substantially higher than the book value. The leasing company in turn offers these lockers on a long-term basis to the bank. The bank subleases the lockers to its customers. The lease back arrangement in sale and lease back type of leasing can be in the form of finance lease or operating lease.

Direct Lease : In direct lease, the lessee, and the owner of the equipment are two different entities a direct lease can be of two types : Bipartite and Tripartite Lease.

Bipartite Lease : There are two parties in the lease transaction, namely,

(i) equipment supplier-cum-lessor

(ii) lessee. Such a type of lease is typically structured as an operating lease with inbuilt facilities, like up gradation of the equipment (Upgrade Lease), addition to the original equipment configuration and so on. The lessor maintains the asset and, if necessary, replaces it with a similar equipment in working conditions (Swap Lease).

Tripartite Lease : Such type of lease involves three different parties in the lease agreement : equipment supplier, lessor and lessee. An innovative variant of tripartite lease is the sales-aid lease under which the equipment supplier arranges for lease finance in various company;

- Providing reference about the customer to the leasing company,

- Negotiating the terms of the lease with the customer and completing all the formalities on behalf of the leasing company,
- Writing the lease on his own account and discounting the lease receivables with the designated leasing company. The effect is that the leasing company owns the equipment and obtains an assignment of lease rental.

The sales-aid lease is usually with recourse to the supplier in the event of default by the lessee either in the form of offer from the supplier to buy back the equipment from the lessor or a guarantee on behalf of the lessee.

(c) Single Investor Lease and Leveraged Lease

Single Investor Lease : There are only two parties to the lease transaction – the lessor and the lessee. The leasing company (lessor) funds the entire investment by an appropriate mix of debt and equity funds. The debts raised by the leasing company to finance the asset are without recourse to the lessee, i.e. in the case of default in servicing the debt by the leasing company, the lender is not entitled to payment from the lessee.

Leveraged Lease : There are three parties to the transaction : (i) lessor (equity investor), (ii) lender and (iii) lessee. In such type of lease, the leasing company (equity investor) buys the asset through substantial borrowing. The lender (loan participant) obtains an assignment of the lease and a first mortgaged asset on the leased asset. The transaction is routed through a trustee who looks after the interest of the lender and lessor. On receipt of the rentals from the lessee, the trustee remits the debt service component of the rental to the loan participant and the balance to the lessor.

Like other lease transactions, leveraged lease entitles the lessor to claim tax shields on depreciation and other capital allowances on the entire investment cost including the non-recourse debt. The return on equity (profit after tax divided by net worth) is, therefore, high. From the lessee's point of view, the effective rate of interest implicit in the lease arrangement is less than on a straight loan as the lessor passes on the portion of the tax benefits to the lessee in the form of lower rental payments. Leveraged lease packages are generally structured for leasing investment-intensive assets like aircrafts, ships, etc,

(d) Domestic Lease and International Lease

Domestic Lease: A lease transaction is classified as domestic if all parties to the agreement, namely, equipment supplier, lessor and the lessee, are domiciled in the same country.

International Lease : If the parties to the lease transaction arc domiciled in different countries, it is known as international lease, This type of lease is further sub-classified into (I) Import Lease and (2) cross-border lease.

Import Lease : In an import lease, the lessor and the lessee are domiciled in the same country, but the equipment supplier is located in a different country The lessor imports the asset and leases it to the lessee.

Cross-border Lease : When the lessor and the lessee are domiciled in different countries, the lease is classified as cross-border lease, The domicile of the supplier is immaterial.

Operationally, domestic and international leases are differentiated on the basis of risk. The latter type of lease transaction is effected by two additional risk factors, i,e, country risk and currency risk. The country risk arises from the need to structure the lease transaction in the light of an understanding of the political and economic climate and a knowledge or the tax and regulatory environment governing them in the foreign countries concerned. As the payment to the supplier and the lease rentals are denominated in different currencies, any variation in the exchange rate will involve currency risk.

PART - C

7.a. Importance of Capital Market

Absence of capital market acts as a deferent factor to capital formation and economic growth. Resources would remain idle if finance are not funneled through capital market. The importance of capital market can be briefly summarized as follows :

(i) The capital market serves as an important source for the productive use of the economy's savings. It mobilizes the savings of the people for further investment and thus avoids their wastage in unproductive uses.

(ii) It provides incentives to saving and facilitates capital formation by offering suitable rates of interest as the price of capital.

(iii) It provides an avenue for investors, particularly the household sector to invest in financial assets which are more productive than physical assets.

(iv) It facilitates increase in production and productivity in the economy and thus enhance the economic welfare of the society. Thus, it facilitates "the movement of stream of command over capital to the point of highest yield" towards those who can apply them productively and profitably to enhance the national income in the aggregate.

(v) The operations of different institutions in the capital market induce economic growth. They give quantitative and qualitative directions to the flow of funds and bring about rational allocation of scarce resources.

b. Modern activities

Besides the above traditional services, the financial intermediaries render innumerable services in recent times. Most of them are in the nature of non-fund based activity. In view of the importance, these activities have been discussed in brief under the head 'New financial products and services'. However, some of the modern services provided by them are given in brief hereunder:

(i) Rendering project advisory services right from the preparation of the project report till the raising of funds for starting the project with necessary Government approval.

(ii) Planning for mergers and acquisitions and assisting for their smooth carry out.

(iii) Guiding corporate customers in capital restructuring.

(iv) Acting as Trustees to the debenture-holders.

(v) Recommending suitable changes in the management structure and management style with a view to achieving better results.

(vi) Structuring the financial collaboration/joint ventures by identifying suitable joint venture partner and preparing joint venture agreement.

(vii) Rehabilitating and reconstructing sick companies through appropriate scheme of reconstruction and facilitating the implementation of the scheme.

(viii) Hedging of risk due to exchange rate risk, interest rate risk, economic risk and political risk by using swaps and other derivative products.

(ix) Managing the portfolio of large Public Sector Corporations.

(x) Undertaking risk management services like insurance services, buy-back options etc.

(xi) Advising the clients on the question of selecting the best source of funds taking into consideration the quantum of funds required, their cost, lending period etc.

(xii) Guiding the clients in the minimization of the cost of debt and in the determination of the optimum debt-equity mix.

(xiii) Undertaking services relating to the capital market such as:

(a) Clearing services,

(b) Registration and transfers,

(c) Safe-custody of securities,

(d) Collection of income on securities.

(xiv) Promoting credit rating agencies for the purpose of rating companies which want to go public by the issue of debt instruments.

c. CONTENTS OF A LEASE AGREEMENT

The lease agreement specifies the legal rights and obligations of the lessor and the lessee. It typically contains terms relating to the following :

1. Description of the lessor, the lessee, and the equipment.
2. Amount, time, and place of rental payments.
3. Time and place of equipment delivery.
4. Lessee's responsibility for taking delivery and possession of the leased equipment.
5. Lessee's responsibility for maintenance, repairs, registration, etc and the lessor's right in case of default by the lessee.
6. Lessee's right to enjoy the benefits of the warranties provided by the equipment manufacturer/supplier.
7. Insurance to be taken by the lessee on behalf of the lessor.
8. Variation in lease rentals if there is a change in certain external factors like bank interest rates, depreciation rates, and fiscal incentives.
9. Option of lease renewal for the lessee.
10. Return of equipment on expiry of the lease period.
11. Arbitration procedure in the event of dispute.

d. BENEFITS OF CREDIT RATING

The following are the benefits of credit rating :

1. Low Cost Information

Credit rating is a source of low cost information to investors. The collection, processing and analysis of relevant information is done by a specialised agency which a group of investors can trust.

2. Quick Investment Decision

In the present day complex world ratings enable investors to take quickest possible decisions based on associated ratings.

3. Sources of Additional Certification

Credit rating agency provides additional certification to the issue of debt/financial instrument. A highly rated firm can enter the market with great confidence. Indian experience shows that individual companies that use credit rating, benefit a great deal by getting larger amount of money from a wider audience at a lower cost.

4. Increase the Investors Population

A sound credit rating system gives an alternative method to name recognition as a determining factor in making investment and helps increase the population of those investing in debt obligations of the company.

5. Forewarns Risks

Credit rating acts as a guide to companies which get a lower rating. It forewarns the management of the perception of risk in the market and prompts to take steps on their operating and marketing risks and thereby changes the perception in the market.

6. Encourages Financial Discipline

Rating also encourage discipline among corporate borrowers to improve their financial structure and performance to obtain better rating for their debt obligations.

7. Merchant Bankers Job Made Easy

Merchant bankers and brokers will be relieved of the responsibility of guiding investors as to the risk of a particular investment. Merchant bankers and brokers, in the absence of objective information, go on the basis of name recognition in guiding their clients. With the advent of credit rating, what they would be required to do is to bring to the attention of their clients the ratings of debt obligations.

8. Investors Protection

Hiring of credit agency implies that the management of the company is ready to show its operations for independent scrutiny. So, the investors who are not provided with confidential information can have overall assessment based on ratings. A credible and objective rating agency can provide increased disclosure, better accounting standard and improved investor protection.

9. Foreign Collaborations made Easy

The foreign collaborators always ask for credit rating while negotiating with an Indian company. Credit rating enables to identify instantly the relative credit standing of the company. The importance of credit rating is being increasingly recognized in the Euro-markets.

10. Benefits the Industry as a Whole

Relatively small and unknown companies use ratings to instill confidence in investors. Higher rate companies get larger amount of money at a lower cost. Thus the industry as a whole can benefit from ratings by direct mobilization of savings from individuals rather than from intermediary lending institutions.

e. IMPORTANCE OF MUTUAL FUNDS

The mutual fund industry has grown at a phenomenal rate in the recent past. One can witness a revolution in the mutual fund industry in view of its importance to the investors in general and the country's economy at large. The following are some of the important advantages of mutual funds :

(i) Channelising Savings for Investment

Mutual funds act as a vehicle in galvanizing the savings of the people by offering various schemes suitable to the various classes of customers for the development of the economy as a whole. A number of schemes are being offered by MFs so as to meet the varied requirements of the masses, and thus, savings are directed towards capital investments directly. In the absence of MFs, these savings would have remained idle. Thus, the whole economy benefits due to the cost efficient and optimum use and allocation of scarce financial and real resources in the economy for its speedy development.

(ii) Offering Wide Portfolio Investment

Small and medium investors used to burn their fingers in stock exchange operations with a relatively modest outlay. If they invest in a select few shares, some may even sink without a trace never to rise again. Now, these investors can enjoy the wide portfolio of th investment held by the mutual fund. The fund diversifies its risks by investing on a large varieties of shares and bonds which cannot be done by small and medium investors. This is in accordance with the maxim 'Not to lay all eggs in one basket'. These funds have large amounts at their disposal, and so, they carry a clout in respect of stock exchange transactions. They are in a position to have a balanced portfolio which is free from risks. Thus MF's provide instantaneous portfolio diversification. The risk diversification which a pool of savings through mutual funds can achieve cannot be attained by a single investor's savings.

(iii) Providing Better Yields

The pooling of funds from a large number of customers enables the fund to have large funds at its disposal. Due to these large funds, mutual funds are able to buy cheaper and sell dearer than the small and medium investors. Thus, they are able to command better market rates and lower rates of brokerage. So, they provide better yields to their customers. They also enjoy the economies of large scale and can reduce the cost of capital market participation. The transaction costs of large investments are definitely lower than that of small investments. In fact, all the profits of a mutual fund are passed on to the investors by way of dividends and capital appreciation. The expenses pertaining to a particular scheme alone are charged to the respective scheme. Most of the mutual funds so far floated have given a dividend at the rate ranging between 12% p.a. and 17% p.a. It is fairly a good yield. It is an ideal vehicle for those who look for long term capital appreciation.

(iv) Rendering Expertise Investment Service at Low Cost

The management of the fund is generally assigned to professionals who are well trained and have adequate experience in the field of investment. The investment decisions of these professionals are always backed by informed judgement and experience. Thus, investors are assured of quality services in their best interest. Due to the complex nature of the securities market, a single investor cannot do all these works by himself

or he cannot go to a professional manager who manages individual portfolios. In such a case, he may charge hefty management fee. The intermediation fee is the lowest being one per cent in the case of a mutual fund.

(v) Providing Research Service

A mutual fund is able to command vast resources and hence it is possible for it to have an in depth study and carry out research on corporate securities. Each fund maintains a large research team which constantly analyses the companies and the industries and recommends the fund to buy or sell a particular share. Thus, investments are made purely on the basis of a thorough research. Since research involves a lot of time, efforts and expenditure, an individual investor cannot take up this work. By investing in a mutual fund, the investor gets the benefit of the research done by the fund.

f. CONCEPT OF DEBT SECURITISATION

Securitisation of debt or asset refers to the process of liquidating the illiquid and long term assets like loans and receivables of financial institutions by issuing marketable securities against them. In other words, it is a technique by which a long term, non-negotiable and high valued financial asset like hire purchase is converted into securities of small values which can be tradable in the market just like shares.

Thus, it is nothing but a process of removing long term assets from the balance sheet of a lending financial institution and replacing them with liquid cash through the issue of securities against them. Under securitisation, a financial institution pools its illiquid, non-negotiable and long term assets, creates securities against them, gets them rated and sells them to investors. It is an ongoing process in the sense that assets are converted into securities, securities into cash, cash into assets and assets into securities and so on.

Generally, extension of credit by banks and other financial institutions in the form of bills purchase or discounting or hire purchase financing appears as an asset on their balance sheets. Some of these assets are long term in nature and it implies that funds are locked up unnecessarily for an undue long period. So, it carry on their lending operations without much interruptions, they have to rely upon various other sources of finance which are not only costly but also not available easily. Again, they have to bear the risk of the credit outstandings. Now, securitisation is a readymade solution for them. Securitisation helps them to recycle funds at a reasonable cost and with less credit risk: In other words, securitisation helps to remove these assets from the balance sheets of financial institutions by providing liquidity through tradable financial instruments.

g. Causes of Poverty in India

Poverty is not caused by any single reason. It is the outcome of the interaction of several factors; economic, non-economic, political, social, cultural, geographical etc.

1. 1. Underdevelopment

The most important cause for poverty is the underdevelopment of the economy. Due to Under development a large proportion of the people have go without even the basic necessities of life. With the low national income and per capita income the country cannot increase its aggregate consumption and investment. Hence the standard of living is also so low among the people. Even though there is much improvement in the development of the country after independence still we want to go a lot.

2. Inequality

The second important cause of poverty in India is inequality in income and wealth. Even the New Economic policies could not reduce the depth of inequality in India. Instead there is increase in inequality among the people.

3. Inadequate growth rate

In the early years of planning the growth rate of Indian economy is not high enough to check the problem of poverty. Even though economy railed in a high growth path in the mid of 2000 onwards the benefits are not trickle down to the poor sections of the society. Still the gap between rich and poor is increasing.

4. Large population

Even though the growth rate of population is coming down still the size of it is very large.

Therefore it is not capable to implement the poverty alleviation programmes successfully.

5. Unemployment

Another major cause for the growth of poverty is unemployment. The problem of unemployment is still so acute in the economy. Thus increasing unemployment and underemployment accentuate poverty.

6. Poor performance of agriculture sector

Still Indian agriculture is carried on largely with primitive techniques. High dependency on rain, small and scattered holdings, lack of inputs, exploitative land tenure system, competition from foreign markets, lack of storage and marketing facilities etc. are responsive to the poor performance of agriculture sector even after the Green Revolution.

7. Poor performance of industrial sector

In spite of much improvement in line with development of modern industries still performance is not up to the mark. Lack of dynamic entrepreneurs, lack of competitiveness, lack of skilled and trained workers, inadequate finance, irregular supply of power and raw materials, poor transport and methods of production etc. leads to slow industrialization of the country.

8. Inflation

Rise in price is an alarming problem to the economy. It is the poor who suffered a lot due to inflation. When prices are high the purch asing power of money falls and leads to impoverishment of the poor sections of the country.

PART – D

8.a. Financial Assets

In any financial transaction, there should be a creation or transfer of financial assets. Hence, the basic product of any financial system is the financial asset. A financial assets is one which is used for production or consumption or for further creation of assets. For instance, A buys equity shares and these shares are financial assets since they earn income in future.

b. Call Money Market : The call money market is a market for extremely short period loans say one day to fourteen days. So, it is highly liquid. The loans are repayable on demand at the option of either the lender or the borrower. In India, call money markets are associated with the presence of stock exchanges and hence, they are located in major industrial towns like Bombay, Calcutta, Madras, Delhi, Ahmedabad etc. The special feature of this market is that the interest rate varies from day to day and even from hour to hour and centre to centre. It is very sensitive to changes in demand and supply of call loans.

c. Consumer finance in the most basic sense of the word refers to any kind of lending to consumers. One of the best ways to get the unsecured loans is through the consumer finance.

Durables which are financed

- Television
- Washing Machine
- Air Conditioner
- DVD/VCD players
- Refrigerator
- Computers/laptops
- And other consumer durables

d. The type of factoring services varies on the basis of the nature of transactions between the client and the factor, the nature and volume of client's business, the nature of factor's security etc. In general, the factoring services can be classified as follows :

(i) Full service factoring or without recourse factoring

(ii) With Recourse Factoring

(iii) Maturity Factoring

(iv) Bulk Factoring

(v) Invoice Factoring

(vi) Agency Factoring

(vii) International Factoring

e. A currency swap (or a cross currency swap) is a foreign exchange derivative between two institutions to exchange the principal and/or interest payments of a loan in one currency for equivalent amounts, in net present value terms, in another currency. Currency swaps are motivated by comparative advantage. A currency swap should be distinguished from interest rate swap, for in currency swap, both principal and interest of loan is exchanged from one party to another party for mutual benefits. Currency swaps are over-the-counter (OTC) derivatives.

f. Money laundering is the process of transforming the proceeds of crime, corruption or kleptomania into ostensibly legitimate money or other assets. However, in a number of legal and regulatory systems, the term money laundering has become conflated with other forms of financial crime, and sometimes used more generally to include misuse of the financial system (involving things such as securities, digital currencies, credit cards, and traditional currency), including terrorism financing and evasion of international sanctions. Most anti-money laundering laws openly conflate money laundering (which is concerned with *source* of funds) with terrorism financing (which is concerned with *destination* of funds) when regulating the financial system.

g. HDI of India

Human Development Index was introduced by UNDP in 1990.The committee for the introduction of this index is headed by the Pakistani Economist Mahbub-Ul-Haq and helped by Amartya Sen. The Human Development Report2013,The Rise of the South: Human Progress in a Diverse World, notes that over the

last decades, all countries accelerated their achievements ineducation, health, and income dimensions as measured in the Human Development Index.

h. AGRICULTURAL CREDIT

The essence and significance of agricultural credit are determined by the character of the production relations. Under capitalism, agricultural credit is a form of investment of loan capital in agriculture. Only large capitalist farms can easily afford the high interest rates charged for credit or come up with the mortgage collateral required for loans, so that land tenure becomes increasingly concentrated, with ruination being the fate of the poorest peasants and farmers. In the United States, interest reaches 8–12 percent per annum on short-term loans and 5 percent on long-term loans. Agricultural credit is closely inter-twined with mortgage credit.