

A

LECTURE NOTE On

Indian financial system and services

3rd Semester

MBA



By

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Indian financial system and services

The Indian Financial System is one of the most important aspects of the economic development of our country. This system manages the flow of funds between the people (household savings) of the country and the ones who may invest it wisely (investors/businessmen) for the betterment of both the parties.

This is an important topic with respect to the various [Government exams](#) conducted in the country, and aspirants must carefully consider going through this article and prepare themselves accordingly.

In this article, you shall know about what the Indian Financial system is, its components and how it helps in the economic growth of a country. Also, get some Sample Questions on the Indian Financial System further below in this article.

Components of Indian Financial System

There are four main components of the Indian Financial System. This includes:

1. Financial Institutions
2. Financial Assets
3. Financial Services
4. Financial Markets

Let's discuss each component of the system in detail.

1. Financial Institutions

The Financial Institutions act as a mediator between the investor and the borrower. The investor's savings are mobilised either directly or indirectly via the Financial Markets.

The main functions of the Financial Institutions are as follows:

- A short term liability can be converted into a long term investment
- It helps in conversion of a risky investment into a risk-free investment
- Also acts as a medium of convenience denomination, which means, it can match a small deposit with large loans and a large deposit with small loans

The best example of a Financial Institution is a Bank. People with surplus amounts of money make savings in their accounts, and people in dire need of money take loans. The bank acts as an intermediate between the two.

The financial institutions can further be divided into two types:

- **Banking Institutions or Depository Institutions** – This includes banks and other credit unions which collect money from the public against interest provided on the deposits made and lend that money to the ones in need
- **Non-Banking Institutions or Non-Depository Institutions** – Insurance, mutual funds and brokerage companies fall under this category. They cannot ask for monetary deposits but sell financial products to their customers.

Further, Financial Institutions can be classified into three categories:

- **Regulatory** – Institutes that regulate the financial markets like RBI, IRDA, SEBI, etc.
- **Intermediates** – Commercial banks which provide loans and other financial assistance such as SBI, BOB, PNB, etc.
- **Non Intermediates** – Institutions that provide financial aid to corporate customers. It includes NABARD, SIDBI, etc.

2. Financial Assets

The products which are traded in the Financial Markets are called Financial Assets. Based on the different requirements and needs of the credit seeker, the securities in the market also differ from each other.

Some important Financial Assets have been discussed briefly below:

- **Call Money** – When a loan is granted for one day and is repaid on the second day, it is called call money. No collateral securities are required for this kind of transaction.
- **Notice Money** – When a loan is granted for more than a day and for less than 14 days, it is called notice money. No collateral securities are required for this kind of transaction.
- **Term Money** – When the maturity period of a deposit is beyond 14 days, it is called term money.
- **Treasury Bills** – Also known as T-Bills, these are Government bonds or debt securities with maturity of less than a year. Buying a T-Bill means lending money to the Government.
- **Certificate of Deposits** – It is a dematerialised form (Electronically generated) for funds deposited in the bank for a specific period of time.
- **Commercial Paper** – It is an unsecured short-term debt instrument issued by corporations.

3. Financial Services

Services provided by Asset Management and Liability Management Companies. They help to get the required funds and also make sure that they are efficiently invested.

The financial services in India include:

- **Banking Services** – Any small or big service provided by banks like granting a loan, depositing money, issuing debit/credit cards, opening accounts, etc.
- **Insurance Services** – Services like issuing of insurance, selling policies, insurance undertaking and brokerages, etc. are all a part of the Insurance services
- **Investment Services** – It mostly includes asset management
- **Foreign Exchange Services** – Exchange of currency, foreign exchange, etc. are a part of the Foreign exchange services

The main aim of the financial services is to assist a person with selling, borrowing or purchasing securities, allowing payments and settlements and lending and investing.

4. Financial Markets

The marketplace where buyers and sellers interact with each other and participate in the trading of money, bonds, shares and other assets is called a financial market.

The financial market can be further divided into four types:

- **Capital Market** – Designed to finance the long term investment, the Capital market deals with transactions which are taking place in the market for over a year. The capital market can further be divided into three types:
 - (a) Corporate Securities Market
 - (b) Government Securities Market
 - (c) Long Term Loan Market

- **Money Market** – Mostly dominated by Government, Banks and other Large Institutions, the type of market is authorised for small-term investments only. It is a wholesale debt market which works on low-risk and highly liquid instruments. The money market can further be divided into two types:

(a) Organised Money Market

(b) Unorganised Money Market

- **Foreign exchange Market** – One of the most developed markets across the world, the Foreign exchange market, deals with the requirements related to multi-currency. The transfer of funds in this market takes place based on the foreign currency rate.
- **Credit Market** – A market where short-term and long-term loans are granted to individuals or Organisations by various banks and Financial and Non-Financial Institutions is called Credit Market

• What are the functions of the financial system?

- The financial system performs several essential functions vital for the economy's functioning. Here's a list of these
- **1. Intermediation**
 - Financial systems act as intermediaries between savers and borrowers, channeling funds from those who have excess funds (savers) to those who need funds (borrowers). This intermediation process facilitates the efficient allocation of capital and promotes economic growth.
- **2. Mobilization of savings**
 - Financial systems provide a mechanism for individuals and businesses to save money and earn a return on their savings. Through banks, investment funds, and other financial institutions, savings are pooled together and made available for productive investments.
- **3. Facilitation of investments**
 - Financial systems enable individuals, businesses, and governments to access the capital needed for investment in productive activities. They provide various investment options such as stocks, bonds, and venture capital, allowing entities to raise funds to expand operations, launch new projects, or develop infrastructure.
- **4. Risk management**
 - Financial systems offer a range of risk management tools and instruments, such as insurance, derivatives, and hedging strategies. These mechanisms help individuals and businesses mitigate risks associated with fluctuations in interest rates, exchange rates, commodity prices, and other market uncertainties.
- **5. Price discovery**
 - Financial markets provide a platform for trading financial instruments, allowing buyers and sellers to determine fair prices based on supply and demand dynamics. This price discovery process ensures transparency and efficiency in the valuation of assets and facilitates the efficient allocation of resources.
- **6. Facilitation of payments**
 - Financial systems enable the smooth and secure transfer of funds between individuals, businesses, and institutions. They provide payment systems, such as electronic funds transfer, credit cards, and digital wallets, which facilitate the settlement of transactions and support economic activities.

- **7. Capital Formation**
- Financial systems play a crucial role in capital accumulation within an economy. By mobilizing savings, facilitating investments, and promoting efficient allocation of capital, they contribute to capital stock growth, which is essential for long-term economic development.
- **8. Monetary policy implementation**
- Central banks implement monetary policy as part of the financial system by controlling the economy's money supply, interest rates, and liquidity. They regulate and stabilize the financial system, ensuring price stability and fostering macroeconomic stability.
- **9. Financial inclusion**
- Financial systems aim to promote financial inclusion by providing access to financial services for individuals and businesses, including those in underserved or marginalized communities. This fosters economic participation, poverty reduction, and social development.
- **10. Safeguarding financial stability**
- The financial system maintains stability and mitigates systemic risks. Regulatory authorities monitor and supervise financial institutions, set prudential standards, and est

Reforms in the Financial System¶

Background¶

The pre-reforms period, spanning from the mid-1960s to the early 1990s, was characterized by administered interest rates, industrial licensing and controls, a dominant public sector, and limited competition in the Indian economy. This resulted in inefficient production systems with high costs, an inefficient allocation of resources, and high capital-output ratios. Despite increased saving rates, India remained heavily reliant on foreign aid. During this period, India's growth rate averaged less than 4% per annum, while many other developing countries achieved higher growth rates.

In the early 1990s, India faced a foreign exchange crisis due to rising world oil prices and a drop in remittances. This crisis highlighted the need for economic reforms to restore macroeconomic stability and accelerate economic growth.

Objectives of Economic Reforms¶

The government initiated economic reforms in June 1991 with two primary objectives:

1. **Reorientation of the Economy:** Transition from a statist, state-dominated, and highly controlled economy to a market-friendly one. This involved reducing direct controls, physical planning, and trade barriers.
2. **Macro-economic Stability:** Achieving macroeconomic stability by reducing fiscal deficits and the government's dependence on society's savings.

Reforms in the Financial System¶

The Indian government recognized the importance of an efficient financial system to support economic reforms. The reforms in the financial system included:

- Liberalization of domestic investment.
- Opening key infrastructure sectors to private sector participation.
- Opening the economy to foreign competition by reducing import controls and tariffs.
- Deregulation of interest rates.
- Encouraging direct foreign investment for technology upgradation and non-debt finance.
- Public sector reform to enhance efficiency.
- Disinvestment of public sector undertakings (PSUs).
- Tax system reform to broaden the tax base and moderate tax rates.

The Narasimham Committee ¶

In August 1991, the Indian government established a high-level committee chaired by M. Narasimham, a former RBI governor, to examine various aspects of the financial system and recommend comprehensive reforms. The committee submitted its report in November 1991, which included recommendations for reforming both the banking sector and financial markets. These recommendations were gradually implemented in 1992.

Indian Financial System in the Pre-Reforms Period ¶

In the pre-reforms period, the Indian financial system was characterized by:

- Being closed, highly regulated, and government-controlled.
- Lack of integration and segmentation.
- Limited pricing freedom.
- Restrictions on capital flows.
- Barriers to entry.
- High transaction costs.
- Low liquidity.

Objectives of Financial System Reforms ¶

Financial system reforms aimed to achieve the following objectives:

- Increase competitive efficiency in the operation of the system.
- Make the financial system healthy and profitable.
- Impart operational flexibility and autonomy for efficient functioning.
- Offer savers a wide choice of instruments and institutions.
- Enhance the accumulation of capital funds.

Financial Efficiency, Stability, and Integration¶

Financial system reforms focused on improving efficiency, stability, and integration. Key measures included:

- Liberalization of interest rates.
- Reduction of reserve requirements.
- Increasing competition through private sector participation.
- Adoption of technology.
- Introduction of prudential norms.
- Enhancement of transparency.
- Rationalization of tax structures.
- Introduction of electronic payment mechanisms.

What is Banking System in India?

Banking System in India or Indian Banking System or Banking Sector in India refers to a **network of financial institutions**, such as banks and credit unions, that handle financial transactions and provide financial services to individuals, businesses, and governments. These institutions, primarily, **act as intermediaries between** people with money i.e. **savers**, and those who need money i.e. **borrowers**. The types of services offered by the banking institutions, usually, include accepting deposits, lending money, facilitating transactions, and offering various financial products like savings accounts, loans, and credit cards.

Classification of Banks in India

Banks, forming part of the Banking System in India, can be divided into two categories – **Scheduled Banks and Non-Scheduled Banks**.

Scheduled Banks

Scheduled Banks under the Banking System in India refer to those financial institutions that are **listed in the 2nd Schedule of the Reserve Bank of India Act, 1934**. This inclusion signifies that they meet specific criteria set by the RBI and are subject to its stricter regulations.

A bank to be listed in the schedule has to satisfy the following 2 conditions:

1. It should have paid-up capital and reserves of not less than 5 lacs, and
2. It should satisfy the RBI that their affairs are not being conducted in a manner detrimental to the interest of their depositors.

If any Scheduled Bank violates these conditions, it gets de-listed from the schedule.

A Scheduled Bank gets the following **benefits**:

- Facility of loans on Bank Rate from RBI.
- Automatic membership of Clearing House.
- Facility of Re-Discount of first-class exchange bills from RBI.

Non-Scheduled Banks

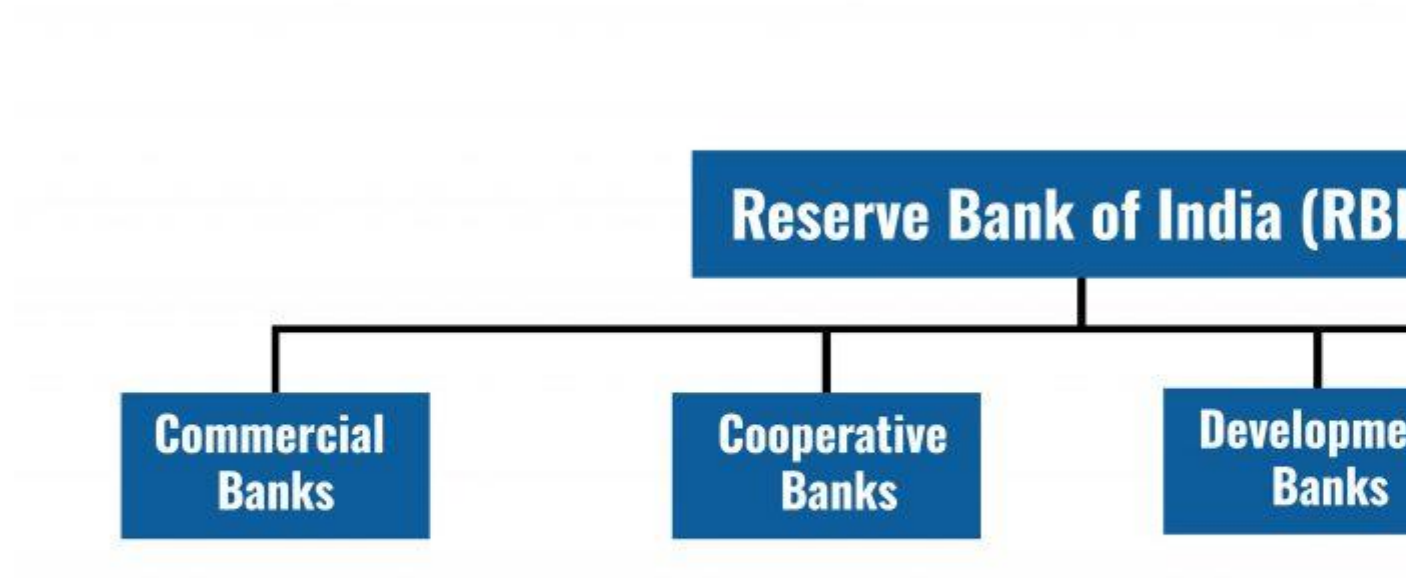
Non-Scheduled Banks under the Banking System in India refer to those financial institutions that **don't meet the criteria** to be included in the 2nd Schedule of the Reserve Bank of India Act, 1934. Being excluded from the schedule means they operate under a different set of regulations as compared to Scheduled Banks.

Difference between Scheduled Banks and Non-Scheduled Banks

Basis of Difference	Scheduled Banks	Non-Scheduled Banks
Meaning	A banking company under the Banking System in India which is listed in the second schedule of the RBI Act 1934.	A banking company under the Banking System in India that is not mentioned in the second schedule of the RBI Act 1934.
Criteria	<ul style="list-style-type: none"> – Should have a paid-up capital of `5 lakhs or more. – Have to ensure that its affairs are not conducted in a manner detrimental to the interest of its depositors. 	<ul style="list-style-type: none"> – No fixed criteria as such.
Regulatory Requirements	<ul style="list-style-type: none"> – Have to keep CRR deposits with the Reserve Bank of India. – Required to file their returns on a periodic basis. 	<ul style="list-style-type: none"> – Have to maintain CRR deposits with themselves. – No requirements of filing returns as such.
Rights Available	<ul style="list-style-type: none"> – Authorized to borrow funds from the RBI. – Can apply to join the clearinghouse. – Can avail of the facility of rediscount of first-class exchange bills from RBI. 	<ul style="list-style-type: none"> – Usually, not authorized to borrow funds from the RBI. However, they can borrow from the RBI under emergency conditions. – Not eligible for membership in the clearinghouse. – Facility of rediscounting exchange bills from RBI is not available for them.
Risk	They are financially stable and are unlikely to hurt the rights of the depositors.	These banks are riskier to do business.
Examples	Most of the banks under the Banking System in India are Scheduled Banks. For example, Commercial Banks, Private, and Public Sector Banks.	Only a few types of banks under the Banking System in India are Non-Scheduled Banks. For example, Local Area Banks (LABs), and some Urban Cooperative Banks (UCBs).

Structure of Banking System in India

The **Reserve Bank of India (RBI)** sits at the top of the structure of the Banking System in India and acts as the central bank of India. Beneath the central bank operates various types of banks as discussed in the sections that follow.



Reserve Bank of India (RBI)

- The **Reserve Bank of India (RBI)** is the Central Bank of India, meaning that it is the apex body in the Banking System in India.
- It is **owned** by the **Union Ministry of Finance**.
- It acts as a **regulatory body**, responsible for the regulation of the Indian banking system as well as the control, issuing, and maintaining money supply in the Indian economy.

Its Objectives, History, Structure, Functions, and Other Related Concepts can be studied in our detailed article on the [Reserve Bank of India \(RBI\)](#).

Commercial Banks

- Commercial Banks refer to those banks under the Banking System in India that **run on a commercial basis**. It means that they operate and offer services **to earn a profit**.
- They are regulated under the **Banking Regulation Act, 1949**.

Their Structure, Types, Importance, and Other Related Concepts can be studied in our detailed article on [Commercial Banks in India](#).

Cooperative Banks

- Cooperative Banks refer to those financial institutions under the Banking System in India that **operate on the principles of cooperation and mutual benefit for their members**.
- They belong to their members who are both the owners and customers of the bank.
 - Thus, it can be said that the **customers are the owners** of these banks.
- Cooperative Banks are named so because these have the cooperation of stakeholders as the motive.

Their Features, Regulations, Structure, Significance, and Other Related Concepts related to Cooperative Banks can be studied in our detailed article on [Cooperative Banks in India](#).

Development Banks

- Development Banks are also known as **Term-Lending Institutions (TLIs)** or **Development Finance Institutions (DFIs)**.
- They are specialized financial institutions under the Banking System in India that **provide long-term finance and support to the sectors** of the Indian economy **which possess higher risks** and cannot have access to adequate loans from Commercial Banks.

Their Types, Roles, and Other Related Concepts can be studied in our detailed article on [Development Banks in India](#).

Differentiated Banks

- Differentiated Banks under the Indian Banking System refer to those banks that **cater to a specific segment of customers**.
- The concept of Differentiated Banks was introduced in the Banking System in India by the RBI **based on the recommendations of the Nachiket Mor Committee** in 2013 in order **to offer specialized services or unique products** designed specifically **to suit a particular sector**.

Their Types, Roles, and Other Related Concepts can be studied in our detailed article on [Differentiated Banks in India](#).

Non-Banking Finance Companies (NBFCs)

- A Non-Banking Financial Company (NBFC) is a **company registered under the Companies Act, 1956** engaged in the **business of loans and advances, acquisition of shares/stocks/bonds/debentures/securities issued** by Government or local authority or other marketable securities of a like nature, leasing, hire-purchase, insurance business, chit business but does not include any institution whose principal business is that of agriculture activity, industrial activity, purchase or sale of any

goods (other than securities) or providing any services and sale/purchase/construction of immovable property.

- They are **not considered part of the traditional Banking System in India**, but they do operate within the larger financial system regulated by the RBI.
- NBFC's **financial assets should constitute more than 50% of the total assets** and income from financial assets should constitute more than 50% of the gross income.
- While **some NBFCs are regulated by the RBI, others** are regulated **by other regulatory bodies**.
 - For example, Merchant Banking Companies are regulated by SEBI, and Insurance Companies are regulated by IRDA.

Difference between NBFCs and Banks

Banks	Non-Banking Financial Companies (NBFCs)
Banks can accept Demand Deposits	NBFCs cannot accept Demand Deposits.
Banks are a part of the Payment and Settlement System (PSS), and hence can issue cheques drawn on itself.	NBFCs do not form a part of the Payment and Settlement System (PSS), and hence cannot issue cheques drawn on itself.
Bank Deposits are insured by the Deposit Insurance and Credit Guarantee Corporation (DICGC) .	Deposit insurance facility of Deposit Insurance and Credit Guarantee Corporation is not available to depositors of NBFCs.
Banks are required to maintain Reserve Ratios prescribed by the RBI, such as CRR, SLR, etc.	NBFCs are not required to maintain Reserve Ratios prescribed by the RBI, such as CRR, SLR, etc.
Banks are regulated under Banking Regulation Act, 1949.	NBFCs are regulated under Companies Act, 1956.
FDI is allowed upto 74% for Private Sector Banks.	FDI is allowed upto 100% for NBFCs.

Basel Norms or Basel Accords

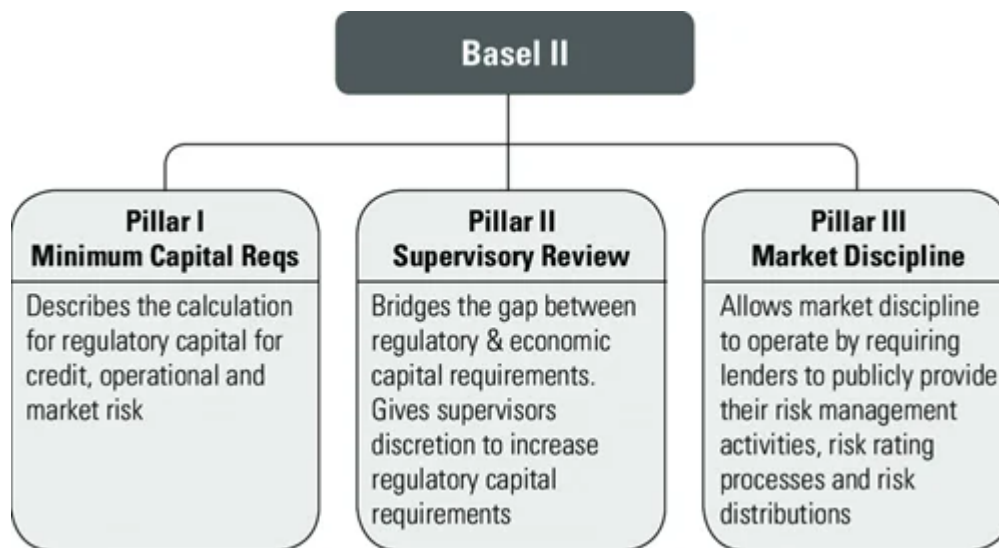
- In the era of globalization, there are many banks which operate internationally. Failure in any such banks may trigger a relatively large number of simultaneous failures within the financial sector. Basel Norms are devised to avoid this.
- They **aim to strengthen regulation, supervision, and risk management of the banking sector** in India and the world to improve its ability to absorb shocks arising from financial and economic stress.
- Basel Norms are **fixed by the Basel Committee on Banking Supervision (BCBS)** – a part of the Bank for International Settlements (BIS), Switzerland, which is a coordinating agency for Central Banks of various countries.
- These norms are **applicable to individual banks and Systemically Important Financial Institutions (SIFIs)**.
- Their **implementation is done by the Central Banks** of the respective countries.
- So far, **3 sets of Basel Norms** have been developed – Basel I, Basel II, and Basel III.

Basel I Norms

- The first Basel Accord, known as Basel I, was issued in 1988
- It focused on credit risks and defined capital and structure of risk weights for banks
- The minimum capital requirement was fixed at 8% of the Risk-Weighted Assets (RWA)

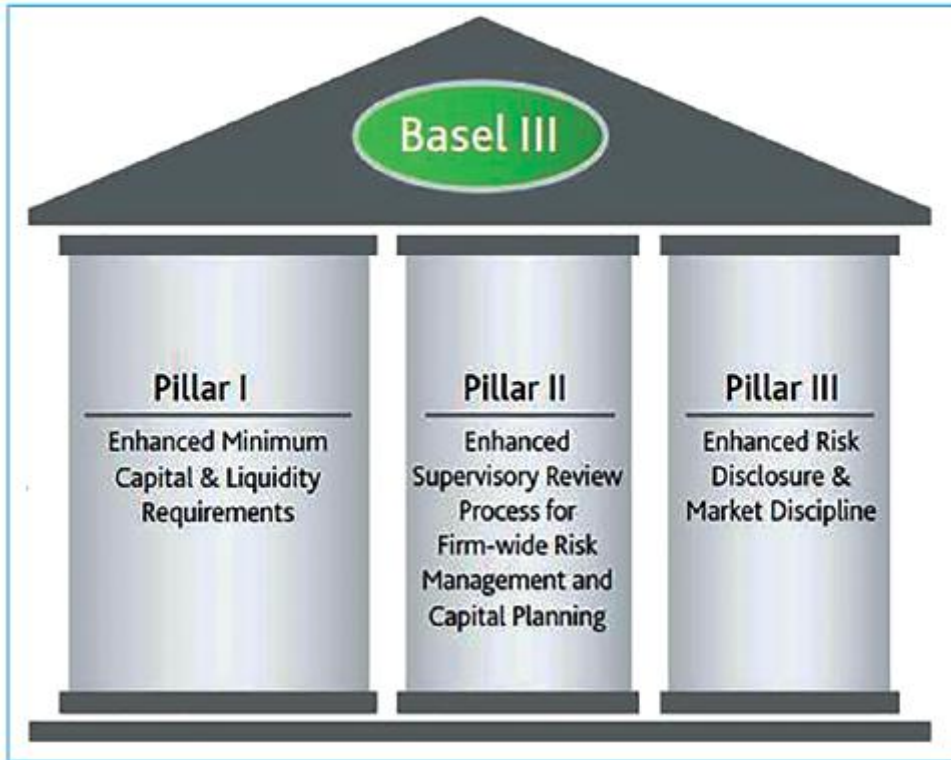
Basel II Norms

- It is the refined and reformed version of Basel I, which was published in 2004.
- It defined **3 types of risks** – Operational Risks, Capital Risks, and Market Risks.
- Its **3 main pillars of Basel II** were as follows:



Basel III Norms

- Basel III guidelines were released in December 2010 in the backdrop of the financial crisis of 2008.
- The guidelines aim to promote a more resilient banking system by focusing on four vital banking parameters viz. capital, leverage, funding, and liquidity.
- The **3 main pillars of Basel III** are as follows:



Capital-to-Risk Weighted Asset Ratio (CRAR) or Capital Adequacy Ratio (CAR)

- Capital-to-Risk Weighted Asset Ratio (CRAR) or Capital Adequacy Ratio (CAR) refers to the availability of sufficient **capital as a % of risk-weighted assets**. Thus,

$$\text{CRAR} = (\text{Total Capital} / \text{Total Risk-Weighted Assets}) * 100$$

- Where, Total Risk-Weighted Capital = Weighted average of total capital assets held by the bank.
- CRAR is **fixed under Basal Norms**.
- The principle behind fixing CRAR is that banks should have an adequate amount of their own capital to cover risks arising from Bad Assets (Bad Loans)
- For the calculation of CRAR, the loan amount given in each sector is to be multiplied by the presumed risk percentage of a specific sector. The product gives the amount of risk-weighted assets. For example,

Purpose of Loan	Loan Amount (in ₹)	Risk Percentage	Risk Weighted Assets (RWA) (in ₹)
Agriculture	100	20%	20
Industry	200	17.5%	35
Government	100	5%	5
Total	400		60

Related Concepts

Domestic Systemically Important Banks (D-SIBs)

- Domestic Systemically Important Banks (D-SIBs) under the Banking System in India refer to those banks that are '**Too Big to Fail (TBTF)**'.
 - Due to this perception, these banks enjoy certain advantages in the funding markets.
- D-SIBs in India are recognized by the RBI under its framework issued in 2014.
 - Usually, the banks whose **assets exceed 2% of the GDP of India** are considered as D-SIBs.
- **As of now**, the **State Bank of India (SBI)**, **ICICI Bank**, and **HDFC Bank** have been identified as D-SIBs by the RBI.

Neo Banks

- Neobanks refers to the '**fintech firms**' that solely have a digital presence, without any physical branches.
- Neobanks aims to give customers a **cheaper alternative to traditional banks by leveraging technology** to offer personalized services to customers while minimizing operating costs.
- There are **2 types** of Neobank models in India:
 - Neobank doesn't have a banking license themselves and instead partners up with a traditional bank to provide their products,
 - Neobanks obtain banking licenses themselves to operate fully on their own.
- **Examples** of neobanks in India include – RazorpayX, Jupiter, Neo, Epifi, and Open.

Banking System in India or Indian Banking System is a dynamic and evolving entity, continuously adapting to meet the changing needs of the economy and its citizens. As India marches towards a more digital and inclusive future, the Banking System in India will undoubtedly play a critical role in ensuring sustainable

Insurance Sector in India

Insurance Sector in India comprises 58 domestic insurance companies, with 24 specializing in life insurance and 34 in non-life insurance. The Life Insurance Corporation of India (LIC) is the sole public-sector entity providing life insurance, while six other public-sector insurers cover different types of coverage. The General Insurance Corporation of India (GIC Re) serves as the country's sole national reinsurer. The insurance ecosystem also includes various stakeholders such as agents (both individual and corporate), surveyors, brokers, and third-party administrators responsible for managing health insurance claims.... Read more at: <https://vajiramandravi.com/upsc-exam/insurance-sector-in-india/>

What is Insurance?

Insurance is a financial safeguard that helps individuals and organizations manage risks by providing protection against unforeseen losses. It functions as a contract in which an insurer offers financial compensation for specific damages, such as property loss, injuries, or health-related expenses. Essentially, insurance serves as a security measure, ensuring financial

stability in the face of unexpected events like accidents, theft, fire, or other uncertainties. It is a structured financial product designed to minimize the impact of potential risks.... Read more at: <https://>

Indian Insurance Sector Timeline

The development of Indian Insurance Sector begins back to the early 19th century when British colonial rulers introduced formal insurance practices. Below is an Indian Insurance Sector Timeline highlighting major milestones in the sector's history.

Indian Insurance Sector Timeline

Year	Important Milestones
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1818	
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	Oriental Life Insurance Company, the first life insurance company in India, was established in Kolkata (then Calcutta) by Anita Bhavsar and others. It primarily catered to European customers.
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1850	
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	Triton Insurance Company, the first general insurance company, was set up in Kolkata to provide non-life insurance services.
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1870	
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	The Bombay Mutual Life Assurance Society, the first Indian-owned life insurance company, was founded in Mumbai (then Bombay).
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1907	
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The Indian Mercantile Insurance Company and the United India Insurance Company were established, marking the entry of Indian companies into the insurance market.

1912

The Indian Life Assurance Companies Act was passed, which laid the foundation for the regulation and supervision of insurance companies in India.

1928

The Indian Insurance Companies Act was enacted, introducing comprehensive regulations for insurance companies operating in India.

1938

The Insurance Act was passed, leading to the nationalization of life insurance in India. The government established the Life Insurance Corporation of India (LIC) as a statutory body to take over and consolidate various life insurance companies.

1956

The General Insurance Business (Nationalization) Act was enacted, leading to the nationalization of the general insurance sector. The government established the General Insurance Corporation (GIC) and four subsidiary companies to handle different classes of general insurance.

1991

The government initiated economic reforms, including liberalization and opening up of the insurance sector to private players. The Insurance Regulatory and Development Authority of India (IRDAI) was established as the regulatory authority for the insurance sector.

2000

Private insurance companies were allowed to operate in India, leading to the entry of various domestic and foreign players. This brought increased competition, product innovation, and improved customer services.

2002

The IRDAI issued guidelines for the introduction of unit-linked insurance plans (ULIPs), a type of life insurance policy linked to the performance of investment funds. ULIPs gained popularity due to their investment and insurance benefits.

2013

The Insurance Laws (Amendment) Act was passed, increasing the foreign direct investment (FDI) limit in the insurance sector from 26% to 49%. This allowed foreign insurance companies to have a higher stake in Indian insurance ventures.

2020

The government increased the FDI limit in the insurance sector to 74%, further opening up the sector to foreign investors.

Types of Insurance

Life Insurance: This insurance ensures the financial well-being of the policyholder's family in the event of their passing, providing monetary support to dependents.

Property Insurance: Designed to safeguard an individual's or organization's real estate and assets, this insurance offers compensation for damages caused to insured properties.

Marine Insurance: This coverage protects against the loss of goods transported via ships, as well as damages to vessels, cargo, or port terminals.

Fire Insurance: Provides financial protection for property or goods damaged due to fire incidents, ensuring compensation for the insured.

Liability Insurance: Shields businesses from financial losses arising from legal claims, including those related to negligence, injuries, or misconduct.

Guarantee Insurance: Ensures advance payments or financial commitments outlined in a contractual agreement, offering security to both parties.

Health Insurance: Covers medical expenses incurred due to illness or injury, reducing the financial burden of healthcare costs.

Insurance Sector in India Regulatory Body

The Insurance Regulatory and Development Authority of India (IRDAI) is the apex body responsible for regulating and supervising the Insurance Sector in India. It was established to ensure the orderly growth of the insurance industry while protecting the interests of policyholders.

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Formation and Reason for Formation

The Insurance Regulatory and Development Authority of India (IRDAI) was established in 1999 based on the recommendations of the Malhotra Committee, which was formed in 1993

to assess and suggest reforms for India's insurance sector. The committee highlighted the necessity of an independent and autonomous regulatory body to oversee the Insurance Sector in India, safeguard policyholder's interests, ensure transparency, encourage fair competition, and facilitate sustainable growth.

Insurance Sector in India Reforms

Since the establishment of the autonomous body, the Insurance Sector of India has seen various reforms. Below in the table we have included the Insurance Sector in India Reforms:

Insurance Sector in India Reforms

Year	Reform/Formation	Details
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1999		
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Formation of the Insurance Regulatory and Development Authority of India (IRDAI)

The IRDAI was established as an autonomous regulatory body in 1999 to oversee and regulate the insurance sector in India. Its primary role is to protect the interests of policyholders and ensure the orderly growth of the insurance industry.

2000		
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Introduction of Unit-Linked Insurance Plans (ULIPs)

In 2000, the IRDAI issued guidelines for ULIPs, which combined investment and insurance benefits. ULIPs allowed policyholders to invest in various funds and participate in the market's ups and downs while providing life insurance coverage.

2002		
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Bancassurance Guidelines

The IRDAI introduced guidelines for bancassurance, which enabled banks to sell insurance products. This partnership between banks and insurance companies expanded the distribution network, making insurance products more accessible to customers.

2005

Compulsory Listing of Insurance Companies

In 2005, the IRDAI made it mandatory for insurance companies to be listed on the stock exchanges. This move aimed to increase transparency, improve corporate governance, and enhance market discipline within the insurance sector.

2007

Introduction of Health Insurance Portability

Health insurance portability was introduced, allowing policyholders to switch between insurance companies without losing the benefits earned under their existing policies. This reform increased competition among insurers and provided greater choice and flexibility to policyholders.

2010

Introduction of Point of Sales (POS) Products

The IRDAI introduced POS products in 2010, allowing insurance policies to be sold through authorized intermediaries at designated points of sale. POS products simplified the sales process and made insurance more accessible to customers.

2013

Increase in Foreign Direct Investment (FDI) Limit

The Insurance Laws (Amendment) Act was passed in 2013, increasing the FDI limit in the insurance sector from 26% to 49%. This reform aimed to attract foreign investment, bring in expertise, and promote the growth of the insurance industry.

2016

Introduction of E-insurance Policies

The IRDAI mandated the issuance of electronic insurance policies in 2016. E-insurance policies eliminated the need for physical documents, reduced paperwork, and provided convenience to policyholders.

2017

Standardization of Health Insurance Products

The IRDAI introduced guidelines for standardization of health insurance products in 2017. This reform aimed to simplify policy comparisons, increase transparency, and facilitate informed decision-making for customers.

2020

Increase in FDI Limit to 74%

In 2020, the government raised the FDI limit in the insurance sector from 49% to 74%. This move was intended to attract more foreign investment, enhance capital inflow, and foster growth in the insurance industry.

Top 10 Insurance Companies in India

Below we have shared the Top 10 Insurance Companies in India and a brief description about each company:

HDFC Life Insurance

Established in 2000, HDFC Life Insurance is a joint venture between Housing Development Finance Corporation Limited (HDFC) and Standard Life Aberdeen PLC. The company provides a wide range of insurance solutions, including security plans, pension plans, health policies, and specialized plans for women and children. It also allows policyholders to enhance coverage with additional riders and is known for its efficient claims settlement process.

Max Life Insurance

Founded in 2000, Max Life Insurance is among India's top life insurance providers. It focuses on ensuring long-term financial security for its policyholders. The company offers various insurance products, including child insurance, investment plans, protection schemes, and group solutions, all tailored to individual needs.

Life Insurance Corporation of India (LIC)

LIC is India's largest and only government-owned life insurance company, dominating the life insurance sector. Established with the mission to provide financial security to citizens, LIC channels its funds into government securities and global financial markets. Despite competition from around 25 private insurers, LIC remains the most trusted life insurance provider, particularly among rural and underprivileged communities.

Reliance Nippon Life Insurance

A joint venture between Reliance Capital and Nippon Life, Reliance Nippon Life Insurance commenced operations in 2001. With over 10 million customers, it is one of the largest private life insurers. The company offers a diverse range of insurance plans across five segments: pension, protection, child, health, and savings, catering to both individuals and corporate entities.

AEGON Life Insurance

Launched in 2008, AEGON Life Insurance is recognized for its customer-centric approach and innovative solutions. The company employs a multi-channel marketing strategy to educate individuals on financial planning. Its offerings include term insurance, ULIP plans, endowment policies, group plans, and savings schemes, making it a comprehensive service provider.

Bajaj Allianz Life Insurance

A collaboration between Bajaj Finserv Limited and Allianz SE, Bajaj Allianz Life Insurance is a leading private insurer in India. It provides a broad portfolio of life insurance solutions, designed to meet the evolving financial requirements of customers.

Kotak Mahindra Life Insurance

Kotak Mahindra Life Insurance, a joint venture between Kotak Mahindra Bank Limited and Old Mutual Limited, is one of the fastest-growing insurance providers in India. The company offers diverse financial products, catering to both businesses and individual investors. Its policies focus on future security, wealth creation, and investment growth through affordable life insurance plans.

Bharti AXA Life Insurance

A joint venture between Bharti Enterprises and AXA Group, Bharti AXA Life Insurance provides an array of insurance policies, including savings plans, term life insurance, ULIP plans, and child education policies. The company integrates financial services with its expertise in agriculture and telecommunications to offer long-term value to policyholders.

Pramerica Life Insurance

Established in 2013 as a partnership between Prudential International Insurance Holdings Limited and Dewan Housing Finance Corporation Limited (DHFL), Pramerica Life Insurance has expanded to 138 branches across India. It provides life insurance solutions for individuals and groups, specializing in retirement planning, child education security, wealth accumulation, and savings plans.

Exide Life Insurance

Previously known as ING Vysya Life Insurance, Exide Life Insurance is a well-established private insurer headquartered in Bengaluru. A subsidiary of Exide Industries Limited, the company serves over 15 million customers. It has a strong traditional product portfolio, offering consistent bonus payouts and reliable long-term protection and savings plans.... Read more at: <https://vajiramandravi.com/upsc-exam/insurance-sector-in-india/>

Banking products are a diverse range of financial instruments and services offered by institutions to help customers manage their money, save for the future, borrow funds, and invest. These products can be broadly categorized into three main areas: **deposit products, lending products, and investment products.**

Deposit Products

These products allow customers to securely store money and often earn interest.

- **Checking/Current Accounts:** Designed for frequent, daily transactions and managing everyday spending. Businesses often use current accounts, which may include overdraft facilities.
- **Savings Accounts:** A secure place to keep money while earning interest, generally with a lower transaction frequency than checking accounts.
- **Money Market Accounts (MMAs):** Savings accounts that often pay higher interest rates than typical savings accounts, usually requiring a higher minimum balance.
- **Certificates of Deposit (CDs) / Fixed Deposits (FDs):** Allow customers to deposit a fixed sum of money for a predetermined period at a fixed interest rate. Withdrawing the money before the term ends usually incurs a penalty.
- **Recurring Deposits (RDs):** Allow customers to make regular, fixed contributions over a set period to save up a lump sum.

Lending Products

These products involve the bank providing funds to a customer, which must be repaid over time with interest.

- **Personal Loans:** Unsecured loans for various personal needs, such as consolidating debt or covering unexpected expenses.

- **Home Loans/Mortgages:** Long-term loans specifically for purchasing real estate, using the property as collateral.
- **Auto/Car Loans:** Loans for purchasing a vehicle, using the car as collateral.
- **Education/Student Loans:** Loans specifically designed to finance educational expenses.
- **Business Loans:** Loans provided to entrepreneurs and businesses to finance operations, expansion, or a startup.
- **Credit Cards:** Allow customers to make purchases on credit up to a certain limit, with the option to pay the balance in full or in installments with interest.
- **Overdraft Facilities/Lines of Credit:** Allow customers to withdraw more money than is currently in their account, up to an approved limit, for a fee or interest charge.

Investment and Wealth Management Products

Modern banks often offer access to a variety of investment opportunities and related services.

- **Mutual Funds, Bonds, and Stocks:** Banks act as intermediaries or offer third-party products, facilitating customer investments in various securities.
- **Demat Accounts:** Accounts that help investors hold securities (like stocks and bonds) in electronic form.
- **Retirement Plans:** Products such as IRAs (Individual Retirement Accounts) or government-sponsored schemes (e.g., PPF in India) to help save for retirement.
- **Insurance Products:** Banks often partner with insurance companies to distribute life, health, home, and travel insurance policies.
- **Wealth Management:** Specialized services for high-net-worth individuals, providing professional advisory and portfolio management.

Ancillary Services and Digital Banking

Banks also provide numerous service-based products that support core activities.

- **Debit Cards:** Payment cards linked directly to a checking account.
- **ATMs:** Automated Teller Machines for cash withdrawals, deposits, and transfers.
- **Online/Mobile Banking:** Digital platforms enabling remote account management, bill payment, and fund transfers.
- **Foreign Exchange Services:** Services such as currency exchange, traveler's cheques, and travel cards for international travel or business.
- **Safe Deposit Lockers:** Secure physical storage for valuables.

Recent trends in Indian banking are primarily defined by accelerated **digital transformation**, the integration of advanced technologies like **AI and blockchain**, a strong focus on **financial inclusion**, and a push towards **sustainable finance (ESG)**.

Key Recent Trends

- **Hyper-Digitalization & Mobile-First Services:** India accounts for nearly half of the world's digital transactions, driven by the massive success of the Unified Payments Interface (UPI). Banks are investing in "super-apps" (like SBI's YONO) that offer a wide range of services, from payments to insurance and e-commerce, all within a single interface.
- **Artificial Intelligence (AI) & Machine Learning (ML):** AI and ML are used for personalizing customer experiences, advanced fraud detection, credit risk modeling using alternative data (like GST filings for SMEs), and powering efficient chatbots/voice assistants (e.g., HDFC's EVA). Generative AI is also being explored for creating financial plans and internal productivity tools.
- **Open Banking & Embedded Finance:** The open banking framework, supported by RBI's Account Aggregator system, allows secure data sharing (with customer consent) between banks and fintechs. This has led to the rise of embedded finance, where financial services (like BNPL or insurance) are integrated directly into non-financial platforms (e.g., e-commerce apps), creating seamless user experiences.
- **Blockchain Technology & CBDCs:** Banks are using distributed ledger technology for enhanced security, transparency, and faster cross-border transactions and trade settlements. The Reserve Bank of India (RBI) has also launched a pilot for its Central Bank Digital Currency (CBDC), the "Digital Rupee" (₹).
- **Focus on Cybersecurity and RegTech:** With increased digitization, cybersecurity is a top priority. Banks are implementing advanced measures like biometric authentication, multi-factor verification, and AI/ML for real-time threat detection. Regulatory Technology (RegTech) solutions are also being adopted to automate compliance checks (KYC, AML).
- **Financial Inclusion & Digital Banking Units (DBUs):** Government initiatives like Jan Dhan Yojana have significantly improved financial inclusion. The government's plan to expand the network of full-service Digital Banking Units (DBUs) in underserved areas is further driving accessibility and promoting paperless, cost-efficient banking in rural India.
- **ESG and Sustainable Finance:** There is a growing emphasis on Environmental, Social, and Governance (ESG) principles. Banks are launching "green finance" products, such as loans for renewable energy projects and green bonds, to meet customer and investor demand for responsible banking.
- **Cloud Computing and Infrastructure Modernization:** To support these technological advancements, banks are migrating their legacy core banking systems to more flexible, scalable, and cost-efficient cloud-based platforms.

What is Insurance?

Represented in a form of policy, Insurance is a contract in which the individual or an entity gets the financial protection, in other words, reimbursement from the insurance company for the damage (big or small) caused to their property.

The insurer and the insured enter a legal contract for the insurance called the insurance policy that provides financial security from the future uncertainties.

In simple words, insurance is a contract, a legal agreement between two parties, i.e., the individual named insured and the insurance company called insurer. In this agreement, the insurer promises to help with the losses of the insured on the happening contingency. The insured, on the other hand, pays a premium in return for the promise made by the insurer.

The contract of insurance between an insurer and insured is based on certain principles, let us know the principles of insurance in detail.

Principles of Insurance

The concept of insurance is risk distribution among a group of people. Hence, cooperation becomes the basic principle of insurance.

To ensure the proper functioning of an insurance contract, the insurer and the insured have to uphold the 7 principles of Insurances mentioned below:

1. Utmost Good Faith
2. Proximate Cause
3. Insurable Interest
4. Indemnity
5. Subrogation
6. Contribution
7. Loss Minimization

Let us understand each principle of insurance with an example.

Principle of Utmost Good Faith

The fundamental principle is that both the parties in an insurance contract should act in good faith towards each other, i.e. they must provide clear and concise information related to the terms and conditions of the contract.

The Insured should provide all the information related to the subject matter, and the insurer must give precise details regarding the contract.

Example – Jacob took a health insurance policy. At the time of taking insurance, he was a smoker and failed to disclose this fact. Later, he got cancer. In such a situation, the Insurance company will not be liable to bear the financial burden as Jacob concealed important facts.

Principle of Proximate Cause

This is also called the principle of 'Causa Proxima' or the nearest cause. This principle applies when the loss is the result of two or more causes. The insurance company will find the nearest cause of loss to the property. If the proximate cause is the one in which the property is insured, then the company must pay compensation. If it is not a cause the property is insured against, then no payment will be made by the insured.

Example –

Due to fire, a wall of a building was damaged, and the municipal authority ordered it to be demolished. While demolition the adjoining building was damaged. The owner of the adjoining building claimed the loss under the fire policy. The court held that fire is the nearest cause of loss to the adjoining building, and the claim is payable as the falling of the wall is an inevitable result of the fire.

In the same example, the wall of the building damaged due to fire, fell down due to storm before it could be repaired and damaged an adjoining building. The owner of the adjoining building claimed the loss under the fire policy. In this case, the fire was a remote cause, and the storm was the proximate cause; hence the claim is not payable under the fire policy.

Principle of Insurable interest

This principle says that the individual (insured) must have an insurable interest in the subject matter. Insurable interest means that the subject matter for which the individual enters the insurance contract must provide some financial gain to the insured and also lead to a financial loss if there is any damage, destruction or loss.

Example – the owner of a vegetable cart has an insurable interest in the cart because he is earning money from it. However, if he sells the cart, he will no longer have an insurable interest in it.

To claim the amount of insurance, the insured must be the owner of the subject matter both at the time of entering the contract and at the time of the accident.

Principle of Indemnity

This principle says that insurance is done only for the coverage of the loss; hence insured should not make any profit from the insurance contract. In other words, the insured should be compensated the amount equal to the actual loss and not the amount exceeding the loss. The purpose of the indemnity principle is to set back the insured at the same financial position as he was before the loss occurred. Principle of indemnity is observed strictly for property insurance and not applicable for the life insurance contract.

Example – The owner of a commercial building enters an insurance contract to recover the costs for any loss or damage in future. If the building sustains structural damages from fire,

then the insurer will indemnify the owner for the costs to repair the building by way of reimbursing the owner for the exact amount spent on repair or by reconstructing the damaged areas using its own authorized contractors.



Principle of Subrogation

Subrogation means one party stands in for another. As per this principle, after the insured, i.e. the individual has been compensated for the incurred loss to him on the subject matter that was insured, the rights of the ownership of that property goes to the insurer, i.e. the company.

Subrogation gives the right to the insurance company to claim the amount of loss from the third-party responsible for the same.

Example – If Mr A gets injured in a road accident, due to reckless driving of a third party, the company with which Mr A took the accidental insurance will compensate the loss occurred to Mr A and will also sue the third party to recover the money paid as claim.

Principle of Contribution

Contribution principle applies when the insured takes more than one insurance policy for the same subject matter. It states the same thing as in the principle of indemnity, i.e. the insured cannot make a profit by claiming the loss of one subject matter from different policies or companies.

Example – A property worth Rs. 5 Lakhs is insured with Company A for Rs. 3 lakhs and with company B for Rs.1 lakhs. The owner in case of damage to the property for 3 lakhs can claim the full amount from Company A but then he cannot claim any amount from Company B. Now, Company A can claim the proportional amount reimbursed value from Company B.

Principle of Loss Minimisation

This principle says that as an owner, it is obligatory on the part of the insurer to take necessary steps to minimise the loss to the insured property. The principle does not allow the owner to be irresponsible or negligent just because the subject matter is insured.

Example – If a fire breaks out in your factory, you should take reasonable steps to put out the fire. You cannot just stand back and allow the fire to burn down the factory because you know that the insurance company will compensate for it.

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These trends indicate a shift towards a more customer-centric, efficient, and technologically integrated banking ecosystem, with strong policy support from the government and the RBI

What is the Definition of Insurance?

Insurance is a legal contract between a person and an insurance business in which the insurer promises to provide financial protection (Sum guaranteed) against unforeseen events for a certain price (premium). The many types of [insurance plans](#) available today may be grouped into two groups :

- Life Insurance
- General Insurance

1. General Insurance

Some of the kinds of general insurance offered in India are as follows :

- Health Care Coverage
- Automobile Insurance
- Homeowners' Insurance
- Insurance against fire
- Insurance for Travel

2. Life Insurance

[Life insurance](#) comes in a variety of forms. The most prevalent types of life insurance policies offered in India are as follows :

- Term Life Insurance
- Unit-Linked Insurance Plans

- Whole Life Insurance
- Endowment Plans
- Child Plans for Educations

General Insurance

General insurance plans are one of the types of policies that provide coverage in the form of sum assured against damages besides the policyholder's demise. In general, general insurance refers to a variety of insurance plans that provide financial protection against losses caused as a result of liabilities such as a bike, automobile, house, or health. The following are examples of several types of general insurance policies :

Health Care Coverage

Health insurance is a form of insurance policy that covers the costs of medical treatment. Health insurance policies either cover or repay the cost of treatment for any included disease or injury. Various forms of health insurance cover a wide range of medical bills.

It typically provides defence against :

- Inpatient care
- Critical illness treatment
- post-hospitalization medical bills
- Procedures for day-care

A few types of health insurance policies also cover resident care and pre-hospitalization costs. The following are some of the several types of health insurance policies available in India :

1) Individual Health Insurance

Provides coverage to a single person.

2) Family Floater Insurance

This type of insurance allows your complete family to be covered under one policy, which often includes the husband, wife, and two children.

3) Critical Illness Coverage

A sort of health insurance that covers a variety of life-threatening illnesses such as stroke, heart attack, renal failure, cancer, and other comparable conditions. When a policyholder is diagnosed with a serious illness, they get a lump sum payment.

4) Senior Citizen Health Insurance:

These insurance policies are designed for people over the age of 60.

5) Group Health Insurance

This is a type of insurance that a business provides to its employees.

Automobile Insurance

Motor insurances are forms of insurance that provide financial help in the event that your automobile is involved in a crash. In India, there are several types of motor insurance coverage available, including :

1) Car Insurance

This plan covers privately owned four-wheelers. There are two kinds of automobile insurance plans: third-party insurance and extended coverage policies.

2) Bike Insurance

These are forms of automobile insurance that protect privately-owned two-wheelers in the event of an accident.

. 3) Commercial Vehicle Insurance :

A sort of automobile insurance that covers any vehicle utilized for commercial purposes.

Homeowners' Insurance

A homeowner's insurance, as the name implies, provides full coverage for the belongings and infrastructure of your property against physical destruction or damage. In other words, house insurance protects you from both natural and man-made disasters such as fire, earthquake, tornado, burglary, and robbery.

The following are examples of several types of house insurance policies :

1) Home Building Insurance

Serves to protect the house's foundation from destruction in the event of a disaster.

2) Public Liability Coverage

Protects the insured residential property from any harm caused by a visitor or third-party while on the premises.

3) Standard Fire and Special Perils Policy

Protection against fires, natural disasters (e.g., earthquakes, landslides, and storms, and floods), and anti-social human-caused activities (e.g., strikes, and riots)

Life Insurance

Life insurance policies provide protection against unforeseen circumstances such as the policyholder's death or incapacity. Aside from providing financial security, many [types of life insurance plans](#) enable policyholders to optimize their savings by making recurring payments to various equity and debt fund alternatives.

You may get a [life insurance policy](#) to protect your family's financial future against the ups and downs of life. The insurance coverage includes a substantial sum that will be paid to your loved ones if something occurs to you. Based on your financial needs, you may pick the length of the life insurance policy, the amount of coverage, and the payment choice. The following are the many types of life insurance policies :

- [Term Life Insurance](#)
- Unit-Linked Insurance Plans
- Whole Life Insurance
 - Endowment Plans
 - [Child Plan for Educations](#)
 - Retirement Plans

1. Term Life Insurance

[Term insurance](#) is the purest and most inexpensive type of life insurance, allowing you to choose a high level of coverage for a certain period of time. With a low-cost term life insurance policy, you can protect your family's financial future (term insurance plans generally do not have any cash value, and thus, are available at lower rates of premium as compared to other life insurance products.)

If you die within the policy time, your nominees will get the agreed sum Assured, depending on the payment type you choose (some term insurance plans offer multiple payout options as well)

2. Whole Life Insurance

Whole life insurance plans, often known as 'conventional' life insurance plans, give protection for the policyholder individual's complete life (typically till age 100), as opposed to any other type of life insurance that only provides coverage for a set number of years.

While a whole life insurance policy pays a death benefit, it also has a savings component that helps the policy accumulate cash value over time. Whole life insurance policies have a 100-year maturity period. If the insured person survives beyond the maturity age, the entire life insurance policy becomes a matured endowment.

3. Endowment

Endowment plans fundamentally give financial protection against life's risks while also allowing policyholders to save consistently over a certain length of time. If the policyholder survives the policy term, the endowment plan matures, and the policyholder receives a lump sum payment.

If something occurs to you (as the life insured), the life insurance endowment policy pays your family (beneficiaries) the whole sum assured.

4. Unit-Linked Insurance Plan (ULIP)

ULIPs are insurance policies that combine investment and insurance advantages into one contract. A portion of your payment for a Unit Linked Insurance Plan is invested in a range of market-linked equities and debt instruments.

The leftover premium is used to provide life insurance coverage for the duration of the policy. ULIPs provide you with the freedom to allocate premiums to different instruments based on your financial needs and market risk tolerance.

5. Plans for Children

Child plans are life insurance policies that assist you in financially securing your child's life goals, such as higher education and marriage, even if you are not there. To put it another way, child plans combine savings and insurance benefits to help you prepare for your child's future requirements at the appropriate age.

The money obtained on maturity can be utilized to help your child meet his or her financial needs.

Microfinance is a banking service that provides a range of financial services to low-income individuals or groups who lack access to traditional banking systems. It aims to alleviate poverty, promote entrepreneurship, and empower marginalized populations, especially women and the rural poor, by providing them with the necessary financial resources to improve their livelihoods and become self-sufficient.

Key Services

Microfinance encompasses more than just loans; it offers diverse financial tools to meet the needs of the poor:

- **Microcredit/Microloans:** Small loans, often collateral-free, for starting or expanding small businesses or for other needs like education or housing. Loan amounts can range from as little as \$50 to tens of thousands, with short, fixed repayment schedules, often on a weekly or monthly basis.
- **Savings Accounts:** Secure places for clients to save money and build assets, which helps them manage economic shocks and plan for the future.
- **Microinsurance:** Insurance products that protect clients' livelihoods against unforeseen events like illness, crop failure due to climate issues, or death, which can be devastating for low-income families.
- **Money Transfers/Remittances:** Services for transferring funds, which are vital for clients who rely on remittances from family members.
- **Training and Support:** Many microfinance institutions (MFIs) also provide non-financial support, such as financial literacy training, business skill development, and mentoring, to enhance the impact of their financial services.

Principles of Operation

Key principles guiding the microfinance sector include:

- **Financial Inclusion:** Serving the unbanked or underbanked population who are typically excluded from formal banking due to lack of collateral or credit history.
- **Poverty Alleviation:** Utilizing financial services as a powerful instrument to help clients increase income, build assets, and reduce their vulnerability to external shocks.
- **Sustainability:** Building strong, permanent local financial institutions that can cover their operating costs without depending solely on donor funds, thus ensuring long-term reach and impact.
- **Client Focus:** Offering services that are convenient, flexible, and tailored to the specific circumstances and diverse needs of low-income individuals.
- **Group Lending:** Often utilizing group structures with joint liability, where group members monitor each other's repayments and provide support, effectively substituting for physical collateral.

History and Evolution

The concept of providing small credit has existed for centuries in informal forms. Modern microfinance gained prominence in the 1970s through the pioneering work of **Muhammad Yunus** and the establishment of the **Grameen Bank** in Bangladesh in 1983. Yunus and the Grameen Bank were awarded the Nobel Peace Prize in 2006 for their efforts. The sector has evolved from a focus on donor-subsidized microcredit to an emphasis on providing a full range of sustainable financial services through formal and regulated institutions.

Challenges

Despite its success, the sector faces several challenges, including:

- **High Operational Costs:** Serving clients in remote, rural areas can be expensive without sufficient digital infrastructure.
- **Client Over-indebtedness:** A significant concern where borrowers take multiple loans to cover existing debts, leading to increased default rates.
- **Regulatory Pressures:** Evolving government regulations and interest rate caps can impact MFI margins and operational sustainability.
- **Economic and Climate Risks:** Clients, many of whom are in agriculture, are vulnerable to economic instability and climate change impacts, which affect their repayment capacity.
- **Competition:** Increased competition from traditional banks and fintech companies poses a challenge to MFIs.

What is Microfinance?

Microfinance is a term for financial services that are offered to individuals of lower socioeconomic backgrounds or those who lack access to traditional financial services. Microfinance includes a number of services, such as [savings accounts](#), checking accounts, fund transfers, microinsurance, and microcredit.

Microfinance originally started with microcredit, which is the practice of providing extremely small loans to those who do not have a steady source of income, [collateral](#), or any credit history. It also aims to support and kickstart entrepreneurs who do not have the financial backing to begin a small business or capitalize on an idea.

The objective of microfinance is similar to that of microcredit; its goal is to provide financial services to help encourage entrepreneurs in impoverished nations to act on their ideas and obtain the financial tools available to do so and to eventually become self-sustainable. A few more of its overarching goals include to promote economic development, decrease unemployment, and boost small businesses.

Additionally, some microfinance institutions provide financial and business education in order to best position their clients for starting up a small business or to act efficiently as an [entrepreneur](#).

Microfinance Models

Two models outline how microfinance is operated:

1. Banking for individual entrepreneurs and small businesses revolved around relationship-based banking.
2. Services for a group, where multiple individuals come together to form a group to collectively apply for a loan.

When applying for microcredit, individuals may not get a large loan – loans range from \$10 to \$2,000 – thus, they may decide to come together and form a group to qualify for a larger loan.

History of Microfinance

Upon the creation of microcredit by Bangladeshi social entrepreneur Muhammad Yunus in 1983, microfinance was simultaneously created. In 1983, Yunus established Grameen Bank in Bangladesh. The goal of Grameen Bank was to initially provide small loans to entrepreneurs.

Yunus' vision for microcredit was inspired when he witnessed women who made bamboo stools in Bangladesh making two cents a day. He decided that if the women were able to fall back on a loan, they would be able to improve their margins and gain a more substantial profit. After issuing them a loan of \$27, following the group model, the women were able to repay the loan and keep their business running.

Microfinance's aspect of a savings account can also tie into microcredit; creditors may choose to include a [loan covenant](#). The loan covenant states that the borrower must set aside a portion of profits in a savings account with the financial institution to be held as collateral until the loan is paid. Thus, it provides some protection for creditors, and if the loan is repaid, the borrower would've earned savings interest on the money that was deposited in the savings account.

In 2006, Yunus received the [Nobel Peace Prize](#) for his efforts with Grameen Bank. The bank currently oversees 12,500 operational locations and employs about 22,000 individuals. Furthermore, there are currently 10,000 microfinance institutions.

Pros and Cons of Microfinance

Many argue that microfinance is very beneficial, as it provides financial opportunities for those in impoverished nations or those with lower socioeconomic backgrounds. Another benefit of microfinance is that it encourages people to be financially independent and provides them financial resiliency to be able to cover any large unforeseen expenses.

Additionally, microfinance helps to provide financial services to those in remote locations where traditional financial institutions do not have operations. It also provides education. Finally, microfinance can encourage entrepreneurial activity and business development in poverty-stricken areas.

Some downsides of microfinance include claims that it can take advantage of those in tough economic situations, a situation similar to loan sharks. Some microfinance loans may include interest that can be as high as 30% or even higher. Furthermore, according to several studies, recipients of microfinance loans did not realize an improvement in their annual net income.

The **Self-Help Group (SHG) approach** is a community-based strategy where a small, informal group of people from a similar socio-economic background voluntarily join to solve

common problems through self-help and mutual support. The core idea is: "You alone can do it—but you can't do it alone".

Key Principles

The SHG approach is founded on several core principles, often called the "Panchasutras" (Five Principles):

- **Regular Meetings:** The group meets consistently (usually weekly) to discuss issues, share experiences, and plan activities.
- **Regular Savings (Thrift):** Members agree to save a small, regular amount of money and contribute to a common fund. This inculcates financial discipline.
- **Regular Internal Lending:** The pooled savings are used to provide small, collateral-free loans to needy members, with the terms (purpose, amount, interest rate, repayment schedule) decided democratically by the group.
- **Timely Repayment:** Members ensure prompt repayment of loans, fostering a sense of responsibility and building a good credit history for the group.
- **Up-to-date Bookkeeping:** Proper records and accounts are maintained to ensure transparency and build trust among members.

How it Works

1. **Formation:** Members, typically 10-20 individuals with similar backgrounds, are mobilized, often with the help of a facilitator from an NGO or government agency.
2. **Capital Formation:** The group builds its own capital through consistent internal savings and lending.
3. **Bank Linkage:** After demonstrating financial discipline and a good track record, the SHG can link with formal banks. The bank provides larger, often collateral-free, loans to the group based on their collective guarantee, which the group then disburses to individual members for income-generating activities or other needs.
4. **Empowerment and Development:** Beyond finance, regular meetings provide a platform to discuss and act on social issues like health, education, domestic violence, and environmental sanitation, leading to collective action and social empowerment.
5. **Federation:** Successful SHGs often federate at village or cluster levels to enhance their collective strength, share resources, and influence local policy and development efforts.

Benefits

The SHG approach offers multifaceted benefits:

- **Poverty Alleviation:** Provides access to micro-credit for self-employment and income-generating activities, reducing dependence on exploitative moneylenders.
- **Financial Inclusion:** Bridges the gap between marginalized populations and formal banking institutions.

- **Women's Empowerment:** The majority of SHGs are women-centric and help them gain financial independence, confidence, leadership skills, and decision-making power within their households and communities.
- **Social Development:** Fosters social cohesion, mutual support, and a collective voice to tackle social ills like dowry and alcoholism.
- **Community Building:** Utilizes local knowledge and resources, promoting a sense of ownership and collective responsibility for community development initiatives.

MODUULE 2

The main features of a money market are high liquidity and short maturity, where short-term debt instruments (under one year) are traded to meet immediate cash needs. It is a low-risk market with stable returns, often involving direct negotiation between participants like banks, corporations, and governments. Transactions are typically wholesale, and participants use it to park surplus funds or cover short-term deficits.

Key features of the money market

- **High liquidity:** Instruments are easily and quickly converted into cash with minimal loss.
- **Short-term maturity:** Instruments have a maturity period of one year or less, making them suitable for managing short-term cash flow.
- **Low risk:** Investments are generally considered secure because they are issued by entities with high credit ratings, and the short maturity period limits risk.
- **Stable and fixed returns:** The return on investment is predictable, often determined at the time of purchase.
- **Wholesale market:** Transactions are typically conducted in large denominations.
- **Direct transactions:** Many deals are made directly between participants, such as banks, corporations, and governments, often over-the-counter, rather than through a central exchange.
- **Diverse participants:** The market includes a wide range of participants, including central banks, commercial banks, non-banking financial companies, and corporations, who use the market to borrow or lend.
- **Facilitates monetary policy:** Central banks use the money market as a tool to implement monetary policy and manage liquidity in the economy.

The composition of the money market is primarily defined by the participants involved and the specific short-term, highly liquid financial instruments they trade.

Key Components

- **Participants:** Various entities use the money market to manage their immediate cash flow needs, either borrowing to cover shortfalls or lending out surplus funds for a return.
- **Central Banks** (e.g., the RBI, Federal Reserve): Play a crucial role in regulating the market, implementing monetary policy, and managing overall liquidity in the economy.
- **Commercial Banks and Financial Institutions:** Are central players, borrowing and lending to each other (in the interbank market) to manage their reserves and meet regulatory requirements.
- **Governments** (National and Local): Issue short-term debt to finance immediate operational needs and bridge fiscal gaps.
- **Large Corporations:** Issue commercial paper to raise working capital for expenses like payroll or inventory management.
- **Institutional Investors:** Include entities like mutual funds (specifically money market funds), insurance companies, and pension funds that invest in money market instruments for safety and liquidity.
- **Individual Investors:** Primarily participate indirectly through money market mutual funds or by purchasing instruments like certificates of deposit (CDs) or Treasury bills through banks/brokerage firms.
- **Instruments:** These are highly liquid, low-risk debt securities with maturities typically of one year or less.
 - **Treasury Bills (T-Bills):** Short-term debt issued by the national government, considered nearly risk-free due to government backing.
 - **Commercial Paper (CP):** Unsecured promissory notes issued by large, financially stable corporations to meet short-term liabilities.
 - **Certificates of Deposit (CDs):** Time deposits offered by banks with a fixed maturity date and interest rate, which are negotiable in the secondary market.
 - **Repurchase Agreements (Repos):** Short-term, collateralized loans where one party sells a security and agrees to repurchase it at a predetermined price and future date.
 - **Banker's Acceptances (BAs):** Time drafts guaranteed by a commercial bank, often used to finance international trade transactions.
 - **Call/Notice Money:** Overnight (one day) or short-notice (2-14 days) borrowing and lending between banks to manage immediate liquidity.

The money market operates primarily Over-The-Counter (OTC) through electronic platforms and direct communication between participants, rather than on a formal exchange like the stock market.

The main players in the money market include banks, corporations, governments, and financial institutions like insurance companies and mutual funds. Other participants are money managers, broker-dealers, and individual investors, who use the market for short-term borrowing and lending to manage liquidity or earn returns on surplus cash.

Major players

- **Banks:** Use the market for inter-bank lending to balance daily cash requirements.
- **Corporations:** Borrow short-term funds to meet working capital needs or invest surplus cash.
- **Governments:** Participate in the market to manage short-term financing needs.
- **Financial Institutions:** This category includes non-banking financial companies (NBFCs), insurance companies, and mutual funds, which actively participate for liquidity management and investment.
- **Money Managers:** Manage large portfolios and use the money market for safe, liquid, short-term investments.
- **Broker-dealers:** Act as intermediaries in money market transactions.
- **Individuals:** Can participate, though their role is often limited due to the high-value nature of many money market transactions.

Central Bank

- **Central Banks (e.g., the Reserve Bank of India):** Often act as a key player by regulating the market and using it to implement monetary policy.

The main instruments of the money market are short-term, highly liquid financial tools that provide a way for governments, banks, and corporations to borrow and lend money for periods typically less than one year.

Key instruments include:

- **Treasury Bills (T-Bills):** Short-term debt securities issued by national governments to cover shortfalls. They are considered very low-risk and highly liquid, with maturities often of 91, 182, or 364 days.
- **Commercial Paper (CP):** Unsecured, short-term promissory notes issued by large corporations and financial institutions to meet their immediate funding needs. They usually have maturities ranging from a few days to several months.
- **Certificates of Deposit (CDs):** Time deposits with a fixed interest rate and maturity date, issued by banks and financial institutions. They can often be traded in the secondary market.
- **Repurchase Agreements (Repos):** Short-term agreements where a seller of securities (typically government bonds) agrees to repurchase them at a pre-determined price and date. This is essentially a collateralized short-term loan.

- **Banker's Acceptances:** A short-term credit investment created by a non-financial firm and guaranteed by a bank. They are used primarily to finance trade, especially international trade.
- **Call and Notice Money:** Very short-term loans between financial institutions, primarily banks, to maintain their cash reserve requirements. Call money is typically overnight, while notice money can be for up to 14 days.
- **Money Market Mutual Funds:** Investment funds that pool money from investors to buy a range of short-term, high-quality money market instruments. This allows individual investors access to the money market.
- **Commercial Bills:** Bills of exchange used to finance the working capital needs of businesses, typically related to trade transactions.

The primary institutions operating in the money market include **central banks, commercial banks, governments/treasuries, corporations, and various institutional investors** like mutual funds and insurance companies. These entities use the market to manage their short-term liquidity needs.

Key institutions are:

- **Central Banks:** The central bank (e.g., the Reserve Bank of India (RBI) or the Federal Reserve in the U.S.) is a pivotal participant, regulating the money supply, implementing monetary policy, and acting as a lender of last resort to commercial banks.
- **Commercial Banks:** These are the core participants in the money market, active as both borrowers and lenders of short-term funds. They use the interbank market (call money market) to manage their daily cash reserve requirements and liquidity positions.
- **Governments (and government agencies):** National and local governments issue short-term debt instruments, such as Treasury bills, to raise funds for immediate cash flow needs or to finance short-term fiscal gaps.
- **Corporations:** Large, creditworthy corporations issue commercial paper (unsecured promissory notes) to meet their working capital requirements and other short-term liabilities.
- **Non-Banking Financial Companies (NBFCs):** These institutions, along with other financial and investment institutions like the Life Insurance Corporation (LIC) or General Insurance Corporation (GIC), participate in the market, often as lenders of funds.
- **Money Market Mutual Funds:** These pooled investment vehicles gather money from individual and institutional investors and invest in a diversified portfolio of short-term, low-risk money market instruments, providing an accessible way for individuals to participate.
- **Primary Dealers (PDs):** These are designated financial institutions that play a key role in the government securities market, participating in debt auctions and maintaining secondary market liquidity.

- **Brokers and Dealers:** These financial intermediaries facilitate transactions between buyers and sellers in the over-the-counter (OTC) market.

The money market also includes an unorganised sector in some countries, which involves local moneylenders and indigenous bankers, whose activities are not formally regulated by the central bank.

What is the Primary Market

The primary market, also referred to as the new issue market, is a segment of the capital market where issuers, including corporations, governments, or institutions, sell newly created securities directly to investors. These securities encompass stocks, bonds, and other financial instruments.

The primary market allows issuers to raise capital for various purposes, such as business expansion, infrastructure development, or debt financing. In the primary market, the funds raised go directly to the issuer, making it a crucial mechanism for capital formation.

For example, when a company launches an Initial Public Offering (IPO) to sell its shares to the public for the first time, it operates in the primary market. Similarly, when a government issues treasury bonds to finance public projects, it also does so through the primary market.

Types of Primary Market Offerings

The primary market includes various types of security issuances, each designed to meet specific funding needs and investor preferences. The main types are:

1. Initial Public Offering (IPO)

An IPO occurs when a private company offers its shares to the public for the first time, transitioning into a publicly traded entity. IPO is a significant milestone for companies, as it provides access to a large pool of capital and enhances visibility in the market. Investors purchase shares directly from the company, and the proceeds are used for business growth, debt repayment, or other strategic initiatives.

2. Follow-on Public Offering (FPO)

An FPO is when a publicly traded company issues additional shares to raise more capital. FPO can be dilutive or non-dilutive. FPO is mostly used to fund expansion or pay off debt.

3. Rights Issue

In a rights issue, a company offers additional shares to its existing shareholders at a discounted price from the current market price, typically in proportion to their current holdings.

This allows shareholders to maintain their ownership percentage and provides the company with additional capital. Rights issues are a cost-effective way to raise funds without relying on external investors.

4. Private Placement

A private placement involves issuing securities to a select group of accredited investors, such as institutional investors, venture capitalists, or high-net-worth individuals.

Private placements are faster and less regulated than public offerings, making them suitable for companies seeking quick access to capital without involving the general public.

5. Preferential Allotment

In a preferential allotment, a company issues shares or convertible securities to a specific group of investors, such as promoters or strategic partners, at a predetermined price. This method is often used to strengthen the company's financial position or bring in strategic investors.

6. Debt Issuance

Governments, corporations, and institutions issue bonds or debentures in the primary market to raise debt capital. Investors purchase these debt instruments, and the issuer promises to pay interest periodically and return the principal upon maturity. Examples include government treasury bonds, corporate bonds, and municipal bonds.

7. Qualified Institutional Placement (QIP)

A QIP is a method used by listed companies to raise capital by issuing securities to qualified institutional buyers (QIB), such as mutual funds or insurance companies. QIP are quicker and less cumbersome than public offerings, as they do not require extensive regulatory approvals.

Functions of the Primary Market

The primary market serves several critical functions in the financial system, contributing to economic development and investor opportunities. These functions include:

1. Capital Formation

The primary market enables issuers to raise funds for productive purposes, such as starting new projects, expanding operations, or upgrading infrastructure. By channeling investors' savings into productive investments, the primary market fosters economic growth.

2. Liquidity Creation

By issuing new securities, the primary market provides investors with opportunities to invest in a diverse range of assets. Once issued, these securities can be traded in the secondary market, ensuring liquidity for investors.

3. Price Discovery

The primary market facilitates the determination of the fair value of securities through mechanisms like book building (where investor demand determines the issue price) or fixed-price offerings. This ensures that securities are priced efficiently based on market dynamics.

4. Risk Diversification

The primary market offers investors a variety of securities, such as equity, debt, and hybrid instruments, allowing them to diversify their portfolios and manage risk effectively.

5. Economic Development

By providing capital to businesses and governments, the primary market supports job creation, innovation, and infrastructure development, driving overall economic progress.

6. Investor Access to New Opportunities

The primary market allows retail and institutional investors to participate in the growth of companies and governments by investing in newly issued securities, democratizing access to wealth-building opportunities.

Mechanisms of the Primary Market

The primary market operates through structured processes to ensure transparency, efficiency, and investor protection. Key mechanisms include,

1. Underwriting

Underwriting is a process where investment banks or financial institutions (underwriters) guarantee the sale of securities by purchasing them from the issuer and selling them to investors. Underwriters assume the risk of unsold securities and assist in pricing and marketing the issue.

2. Book Building

In book building, the issuer and underwriters collect bids from investors to determine the demand and price of the securities. This process helps set an optimal issue price based on investor interest, ensuring efficient capital raising.

3. Fixed-Price Offering

In a fixed-price offering, the issuer sets a predetermined price for the securities, and investors apply for shares at that price. This method is simpler but may not reflect real-time market demand.

4. Green Shoe Option

A green shoe option allows underwriters to issue additional shares (up to a certain percentage) if demand exceeds expectations during an IPO or FPO. This stabilises the share price in the secondary market and ensures smooth issuance.

5. Prospectus and Disclosures

Issuers are required to provide a detailed prospectus, a legal document outlining the company's financials, business model, risks, and use of proceeds. This ensures transparency and helps investors make informed decisions.

Advantages of the Primary Market

The primary market offers numerous benefits to issuers, investors, and the economy as a whole.

Access to Capital:

Companies and governments can raise large amounts of capital without relying on loans, reducing debt burdens.

Cost-Effective Financing:

Equity issuance in the primary market does not involve interest payments, unlike debt financing.

Enhanced Visibility:

Public offerings, such as IPO's, increase a company's visibility, credibility, and brand recognition.

Investor Opportunities:

Investors gain access to new investment opportunities with potential for high returns, especially in growing companies.

Economic Growth:

Funds raised in the primary market fuel business expansion, job creation, and infrastructure development.

Challenges of the Primary Market

Despite its advantages, the primary market faces several challenges:

High Costs:

Issuing securities involves significant costs, including underwriting fees, legal expenses, and marketing costs, which can be a burden for smaller companies.

Regulatory Compliance:

Issuers must comply with stringent regulations, which can be time-consuming and complex.

Market Volatility:

Economic or market uncertainties can affect investor demand, leading to under-subscription or pricing challenges.

Risk of Overvaluation/Undervaluation:

Incorrect pricing of securities can lead to losses for investors or insufficient capital for issuers.

Information Asymmetry:

Investors may lack sufficient information to evaluate new securities, increasing the risk of poor investment decisions.

Regulatory Framework Governing the Primary Market

The primary market is heavily regulated to protect investors and ensure market integrity. Regulatory bodies oversee the issuance process, enforce disclosure requirements, and prevent fraudulent practices. Key regulators include:

Securities and Exchange Commission (SEC):

In the United States, the SEC regulates the primary market, ensuring that issuers provide investors with accurate and complete information.

Securities and Exchange Board of India (SEBI):

In India, SEBI oversees the issuance of securities and sets guidelines for IPO's, FPO's, and other offerings.

Financial Conduct Authority (FCA):

In the United Kingdom, the FCA regulates the primary market to promote transparency and investor protection.

Other Global Regulators:

Countries like Canada (Ontario Securities Commission), Australia (ASIC), and Japan (FSA) have their own regulatory frameworks.

Regulations typically cover prospectus requirements, pricing mechanisms, investor eligibility, and post-issue reporting to ensure fair and transparent operations.

Role of the Primary Market in the Global Economy

The primary market is a cornerstone of the global financial system, driving economic growth and development in several ways:

Facilitating Corporate Growth:

By providing access to capital, the primary market enables companies to innovate, expand, and compete globally.

Supporting Government Financing:

Governments issue bonds in the primary market to fund public projects such as roads, schools, and healthcare systems.

Promoting Financial Inclusion:

Public offerings allow retail investors to participate in wealth creation, fostering financial inclusion.

Encouraging Entrepreneurship:

The primary market supports startups and small businesses by providing access to venture capital and private placements.

Stabilising Financial Markets:

By channelling savings into productive investments, the primary market reduces speculative activities and promotes stability.

Primary Market vs. Secondary Market

To fully understand the primary market, it's essential to distinguish it from the secondary market:

Aspect	Primary Market	Secondary Market

Definition	Where new securities are issued and sold.	Where previously issued securities are traded.
Participants	Issuers and investors.	Investors trading among themselves.
Purpose	Raise capital for issuers.	Provide liquidity to investors.
Pricing	Determined by the issuer/underwriters.	Determined by market supply and demand.
Examples	IPO's, bond issuances, rights issues.	Stock exchanges

The primary and secondary markets are interdependent, as securities issued in the primary market gain liquidity through trading in the secondary market.

Future Trends in the Primary Market

The primary market is evolving rapidly, driven by technological advancements and changing investor preferences. Key trends include:

Digitalisation and Blockchain:

Blockchain-based platforms are streamlining securities issuance, reducing costs, and enhancing transparency through tokenisation.

SPAC:

SPAC's have emerged as an alternative to traditional IPO. They allow companies to go public faster by merging with a publicly traded shell company.

Crowdfunding Platforms:

Equity crowdfunding is democratizing access to the primary market, enabling startups to raise funds from a broader investor base.

Sustainable Finance:

The rise of green bonds and ESG (Environmental, Social, Governance) securities reflects growing investor demand for sustainable investments.

Globalization:

Cross-border issuances are increasing, allowing companies to tap into international capital markets.

An **initial public offering (IPO)** or **stock launch** is a [public offering](#) in which shares of a company are sold to [institutional investors](#)^[2] and usually also to retail (individual) investors.^[2] An IPO is typically [underwritten](#) by one or more [investment banks](#), who also arrange for the shares to be listed on one or more [stock exchanges](#). Through this process, colloquially known as **floating**, or **going public**, a privately held company is transformed into a [public company](#). Initial public offerings can be used to raise new equity capital for companies, to [monetize](#) the investments of private shareholders such as company founders or [private equity](#) investors, and to enable easy trading of existing holdings or future capital raising by becoming publicly traded.

After the IPO, shares are traded freely in the open market at what is known as the free float. [Stock exchanges](#) stipulate a minimum free float both in absolute terms (the total value as determined by the share price multiplied by the number of shares sold to the public) and as a proportion of the total share capital (i.e., the number of shares sold to the public divided by the total shares outstanding). Although IPO offers many benefits, there are also significant costs involved, chiefly those associated with the process such as banking and legal fees, and the ongoing requirement to disclose important and sometimes sensitive information.

Details of the proposed offering are disclosed to potential purchasers in the form of a lengthy document known as a [prospectus](#). Most companies undertake an IPO with the assistance of an investment banking firm acting in the capacity of an underwriter. Underwriters provide several services, including help with correctly assessing the value of shares (share price) and establishing a public market for shares (initial sale). Alternative methods such as the [Dutch auction](#) have also been explored and applied for several IPOs.

History

The earliest form of a company which issued *public shares* was the case of the [publicani](#) during the [Roman Republic](#), although this claim is not shared by all modern scholars.^[3] Like modern joint-stock companies, the *publicani* were legal bodies independent of their members whose ownership was divided into shares, or *parts*.^[4] There is evidence that these shares were sold to public investors and traded in a type of [over-the-counter](#) market in the [Forum](#), near the [Temple of Castor and Pollux](#). The shares fluctuated in

value, encouraging the activity of speculators, or *quaestors*. Mere evidence remains of the prices for which *parts* were sold, the nature of initial public offerings, or a description of stock market behavior. *Publicani* lost favor with the fall of the [Republic](#) and the rise of the [Empire](#).^[5]

In the United States, the first IPO was the public offering of [Bank of North America](#) around 1783.^[6]

Advantages and disadvantages

Advantages

When a company becomes publicly listed, the money paid by the investing public for the newly issued shares goes directly to the company (primary offering) as well as to any early private investors who opt to sell all or a portion of their holdings (secondary offerings) as part of the larger IPO. An IPO, therefore, allows a company to tap into a wide pool of potential investors to provide itself with capital for future growth, repayment of the debt, or working capital. A company selling common shares is never required to repay the capital to its public investors. Those investors must endure the unpredictable nature of the open market to price and trade their shares. After the IPO, when shares are traded in the market, money passes between public investors. For early private investors who choose to sell shares as part of the IPO process, the IPO represents an opportunity to [monetize](#) their investment. After the IPO, once shares are traded in the open market, investors holding large blocks of shares can either sell those shares piecemeal in the open market or sell a large block of shares directly to the public, at a [fixed price](#), through a [secondary market offering](#). This type of offering is not dilutive since no new shares are being created. Stock prices can change dramatically during a company's first days in the public market.^[7]

Once a company is listed, it is able to issue additional common shares in a number of different ways, one of which is the [follow-on offering](#). This method provides capital for various corporate purposes through the issuance of equity (see [stock dilution](#)) without incurring any debt. This ability to quickly raise potentially large amounts of capital from the marketplace is a key reason many companies seek to go public.

An IPO accords several benefits to the previously private company:

- Enlarging and diversifying equity base
- Enabling cheaper access to capital
- Increasing exposure, prestige, and public image
- Attracting and retaining better management and employees through liquid equity participation
- Facilitating acquisitions (potentially in return for shares of stock)
- Creating multiple financing opportunities: equity, [convertible debt](#), cheaper bank loans, etc.
- Benefits for pre-IPO owners in the form of Tax Receivable Agreements^[8]

Disadvantages

There are several disadvantages to completing an initial public offering:

- Significant legal, accounting, and marketing costs, many of which are ongoing
- Requirement to disclose financial and business information
- Meaningful time, effort, and attention required of management
- Risk that required funding will not be raised
- Public dissemination of information that may be useful to competitors, suppliers and customers.

- Loss of control and stronger [agency problems](#) due to new shareholders
- Increased risk of litigation, including private securities class actions and shareholder derivative actions^[9]

Procedure

IPO procedures are governed by different laws in different countries. In the United States, IPOs are regulated by the [United States Securities and Exchange Commission](#) under the [Securities Act of 1933](#).^[10] In the United Kingdom, the [UK Listing Authority](#) reviews and approves prospectuses and operates the listing regime.^[11]

Planning

Planning is crucial to a successful IPO. One book^[12] suggests the following seven planning steps:

1. develop impressive management and professional team
2. grow the company's business with an eye to the public marketplace
3. obtain audited financial statements using IPO-accepted accounting principles
4. clean up the company's act
5. establish antitakeover defenses
6. develop good corporate governance
7. create insider bail-out opportunities and take advantage of IPO windows.

Retention of underwriters

IPOs generally involve one or more [investment banks](#) known as "[underwriters](#)". The company offering its shares, called the "issuer", enters into a contract with a lead underwriter to sell its shares to the public. The underwriter then approaches investors with offers to sell those shares.

A large IPO is usually underwritten by a "[syndicate](#)" of investment banks, the largest of which take the position of "lead underwriter". Upon selling the shares, the underwriters retain a portion of the proceeds as their fee. This fee is called an [underwriting spread](#). The spread is calculated as a discount from the price of the shares sold (called the [gross spread](#)). Components of an underwriting spread in an initial public offering (IPO) typically include the following (on a per-share basis): manager's fee, underwriting fee—earned by members of the syndicate, and the concession—earned by the broker-dealer selling the shares. The manager would be entitled to the entire underwriting spread. A member of the syndicate is entitled to the underwriting fee and the concession. A broker-dealer who is not a member of the syndicate but sells shares would receive only the concession, while the member of the syndicate who provided the shares to that broker-dealer would retain the underwriting fee.^[13] Usually, the managing/lead underwriter, also known as the [bookrunner](#), typically the underwriter selling the largest proportions of the IPO, takes the highest portion of the [gross spread](#), up to 8% in some cases.

Multinational IPOs may have many syndicates to deal with differing legal requirements in both the issuer's domestic market and other regions. For example, an issuer based in the E.U. may be represented by the major selling syndicate in its domestic market, Europe, in addition to separate group corporations or selling them for US/Canada and Asia. Usually, the lead underwriter in the head selling group is also the lead bank in the other selling groups.

Because of the wide array of legal requirements and because it is an expensive process, IPOs also typically involve one or more [law firms](#) with major practices in [securities law](#), such as the [Magic Circle](#) firms of London and the [white-shoe firms](#) of New York City.

Financial historians [Richard Sylla](#) and [Robert E. Wright](#) have shown that before 1860 most early U.S. corporations sold shares in themselves directly to the public without the aid of intermediaries like investment banks.^[44] The [direct public offering](#) (DPO), as they term it,^[45] was not done by auction but rather at a share price set by the issuing corporation. In this sense, it is the same as the fixed price public offers that were the traditional IPO method in most non-US countries in the early 1990s. The DPO eliminated the agency problem associated with offerings intermediated by investment banks.

Allocation and pricing

The sale (allocation and pricing) of shares in an IPO may take several forms. Common methods include:

- [Best efforts contract](#)
- [Firm commitment contract](#)
- [All-or-none contract](#)
- [Bought deal](#)

Public offerings are sold to both institutional investors and retail clients of the underwriters. A licensed securities salesperson ([Registered Representative](#) in the US and Canada) selling shares of a public offering to his clients is paid a portion of the selling concession (the fee paid by the issuer to the underwriter) rather than by his client. In some situations, when the IPO is not a "hot" issue (undersubscribed), and where the salesperson is the client's advisor, it is possible that the financial incentives of the advisor and client may not be aligned.

The issuer usually allows the underwriters an option to increase the size of the offering by up to 15% under a specific circumstance known as the [greenshoe](#) or over-allotment option. This option is always exercised when the offering is considered a "hot" issue, by virtue of being oversubscribed.

In the US, clients are given a preliminary prospectus, known as a [red herring prospectus](#), during the initial quiet period. The red herring prospectus is so named because of a bold red warning statement printed on its front cover. The warning states that the offering information is incomplete, and may be changed. The actual wording can vary, although most roughly follow the format exhibited on the Facebook IPO red herring.^[46] During the quiet period, the shares cannot be offered for sale. Brokers can, however, take [indications of interest](#) from their clients. At the time of the stock launch, after the Registration Statement has become effective, indications of interest can be converted to buy orders, at the discretion of the buyer. Sales can only be made through a final prospectus cleared by the Securities and Exchange Commission.

The final step in preparing and filing the final IPO prospectus is for the issuer to retain one of the major financial "printers", who print (and today, also electronically file with the [SEC](#)) the registration statement on Form S-1. Typically, preparation of the final prospectus is actually performed at the printer, wherein one of their multiple conference rooms the issuer, issuer's counsel (attorneys), underwriter's counsel (attorneys), the lead underwriter(s), and the issuer's accountants/auditors make final edits and proofreading, concluding with the filing of the final prospectus by the financial printer with the Securities and Exchange Commission.^[47]

Before legal actions initiated by New York Attorney General [Eliot Spitzer](#), which later became known as the [Global Settlement](#) enforcement agreement, some large [investment firms](#) had initiated favorable research coverage of companies in an effort to aid [corporate finance](#) departments and retail divisions engaged in the marketing of new issues. The central issue in that enforcement agreement had been [judged](#) in court previously. It involved the conflict of interest between the [investment banking](#) and [analysis](#) departments of ten of the

largest investment firms in the United States. The investment firms involved in the settlement had all engaged in actions and practices that had allowed the inappropriate influence of their research analysts by their investment bankers seeking lucrative fees.^[18] A typical violation addressed by the settlement was the case of [CSFB](#) and [Salomon Smith Barney](#), which were alleged to have engaged in the inappropriate spinning of "hot" IPOs and issued fraudulent research reports in violation of various sections within the [Securities Exchange Act of 1934](#).

Pricing

A company planning an IPO typically appoints a lead manager, known as a [bookrunner](#), to help it arrive at an appropriate price at which the shares should be offered. There are two primary ways in which the price of an IPO can be determined. Either the company, with the help of its lead managers, fixes a price ("fixed price method"), or the price can be determined through analysis of confidential investor demand data compiled by the bookrunner ("[book building](#)").

Historically, many IPOs have been underpriced. The effect of underpricing an IPO is to generate additional interest in the stock and a rapid rise in share price when it first becomes publicly traded (known as an "IPO pop"). [Flipping](#), or quickly selling shares for a [profit](#), can lead to significant gains for investors who were allocated shares of the IPO at the offering price. However, underpricing an IPO results in lost potential capital for the issuer. One extreme example is [theglobe.com](#) IPO which helped fuel the IPO "mania" of the late 1990s internet era. Underwritten by [Bear Stearns](#) on 13 November 1998, the IPO was priced at \$9 per share. The share price quickly increased 1,000% on the opening day of trading, to a high of \$97. Selling pressure from institutional flipping eventually drove the stock back down, and it closed the day at \$63. Although the company did raise about \$30 million from the offering, it is estimated that with the level of demand for the offering and the volume of trading that took place they might have left upwards of \$200 million on the table.

The danger of overpricing is also an important consideration. If a stock is offered to the public at a higher price than the market will pay, the underwriters may have trouble meeting their commitments to sell shares. Even if they sell all of the issued shares, the stock may fall in value on the first day of trading. If so, the stock may lose its marketability and hence even more of its value. This could result in losses for investors, many of whom being the most favored clients of the underwriters. Perhaps the best-known example of this is the Facebook IPO in 2012.

Underwriters, therefore, take many factors into consideration when pricing an IPO, and attempt to reach an offering price that is low enough to stimulate interest in the stock but high enough to raise an adequate amount of capital for the company. When pricing an IPO, underwriters use a variety of key performance indicators and non-GAAP measures.^[19] The process of determining an optimal price usually involves the [underwriters](#) ("syndicate") arranging share purchase commitments from leading institutional investors.

Some researchers (Friesen & Swift, 2009) believe that the underpricing of IPOs is less a deliberate act on the part of issuers and/or underwriters, and more the result of an over-reaction on the part of investors (Friesen & Swift, 2009). One potential method for determining to underprice is through the use of [IPO underpricing algorithms](#). Other researchers have discovered that firms with higher revenues from licensing-based technology commercialization exhibit greater IPO underpricing, while a firm's stock of patents mitigates this effect.^[20]

Dutch auction

A [Dutch auction](#) allows shares of an initial public offering to be allocated based only on price aggressiveness, with all successful bidders paying the same price per share.^{[21][22]} One

version of the Dutch auction is [OpenIPO](#), which is based on an auction system designed by economist [William Vickrey](#). This auction method ranks bids from highest to lowest, then accepts the highest bids that allow all shares to be sold, with all winning bidders paying the same price. It is similar to the model used to auction [Treasury bills](#), notes, and bonds since the 1990s. Before this, Treasury bills were auctioned through a discriminatory or pay-what-you-bid auction, in which the various winning bidders each paid the price (or yield) they bid, and thus the various winning bidders did not all pay the same price. Both discriminatory and uniform price or "Dutch" auctions have been used for IPOs in many countries, although only [uniform price auctions](#) have been used so far in the US. Large IPO auctions include Japan Tobacco, Singapore Telecom, BAA Plc and Google (ordered by size of proceeds).

A variation of the Dutch auction has been used to take a number of U.S. companies public including [Morningstar](#), [Interactive Brokers Group](#), [Overstock.com](#), Ravenswood Winery, Clean Energy Fuels, and [Boston Beer Company](#).^[23] In 2004, Google used the Dutch auction system for its initial public offering.^[24] Traditional U.S. investment banks have shown resistance to the idea of using an auction process to engage in public securities offerings. The auction method allows for equal access to the allocation of shares and eliminates the favorable treatment accorded important clients by the underwriters in conventional IPOs. In the face of this resistance, the Dutch auction is still a little used method in U.S. public offerings, although there have been hundreds of auction IPOs in other countries.

In determining the success or failure of a Dutch auction, one must consider competing objectives.^{[25][26]} If the objective is to reduce risk, a traditional IPO may be more effective because the underwriter manages the process, rather than leaving the outcome in part to random chance in terms of who chooses to bid or what strategy each bidder chooses to follow. From the viewpoint of the investor, the Dutch auction allows everyone equal access. Moreover, some forms of the Dutch auction allow the underwriter to be more active in coordinating bids and even communicating general auction trends to some bidders during the bidding period. Some have also argued that a uniform price auction is more effective at [price discovery](#), although the theory behind this is based on the assumption of independent private values (that the value of IPO shares to each bidder is entirely independent of their value to others, even though the shares will shortly be traded on the aftermarket). Theory that incorporates assumptions more appropriate to IPOs does not find that sealed bid auctions are an effective form of price discovery, although possibly some modified form of auction might give a better result.

In addition to the extensive international evidence that auctions have not been popular for IPOs, there is no U.S. evidence to indicate that the Dutch auction fares any better than the traditional IPO in an unwelcoming market environment. A Dutch auction IPO by WhiteGlove Health, Inc., announced in May 2011 was postponed in September of that year, after several failed attempts to price. An article in [the Wall Street Journal](#) cited the reasons as "broader stock-market [volatility](#) and uncertainty about the global economy have made investors wary of investing in new stocks".^{[27][28]}

Quiet period

Main article: [Quiet period](#)

Under American securities law, there are two-time windows commonly referred to as "quiet periods" during an IPO's history. The first and the one linked above is the period of time following the filing of the company's [S-1](#) but before SEC staff declare the registration statement effective. During this time, issuers, company insiders, analysts, and other parties are legally restricted in their ability to discuss or promote the upcoming IPO (U.S. Securities and Exchange Commission, 2005).

The other "quiet period" refers to a period of 10 calendar days following an IPO's first day of public trading.^[29] During this time, insiders and any underwriters involved in the IPO are restricted from issuing any earnings forecasts or research reports for the company. When the quiet period is over, generally the underwriters will initiate research coverage on the firm. A three-day waiting period exists for any member that has acted as a manager or co-manager in a secondary offering.^[29]

Delivery of shares

Not all IPOs are eligible for delivery settlement through the [DTC system](#), which would then either require the physical delivery of the [stock certificates](#) to the clearing agent bank's custodian or a [delivery versus payment](#) (DVP) arrangement with the selling group firm.

Stag profit (flipping)

"Stag profit" is a situation in the stock market before and immediately after a company's initial public offering (or any new issue of shares). A "stag" is a party or individual who subscribes to the new issue expecting the price of the stock to rise immediately upon the start of trading. Thus, stag [profit](#) is the financial gain accumulated by the party or individual resulting from the value of the shares rising. This term is more popular in the United Kingdom than in the United States. In the US, such investors are usually called flippers, because they get shares in the offering and then immediately turn around "[flipping](#)" or selling them on the first day of trading.

The main functions of the secondary market are providing **liquidity** by allowing investors to easily buy and sell existing securities, enabling **price discovery** through supply and demand, and facilitating the **transfer of ownership** between investors. It also creates a platform for trading that is transparent, promotes an active primary market by creating a place to trade existing shares, and helps assess the overall economic condition.

Key functions of the secondary market

- **Liquidity:** Provides a marketplace where investors can easily buy or sell previously issued securities like stocks and bonds, allowing them to exit their investment positions quickly.
- [Price discovery](#): Determines the fair market value of securities based on the forces of supply and demand, ensuring that prices reflect current valuations.
- [Transfer of ownership](#): Allows for the seamless transfer of ownership of assets between investors without the involvement of the original issuing company.
- **Transparency and information:** Provides a transparent trading environment where prices and transaction information are publicly available, helping investors make informed decisions.
- **Economic indicator:** The performance of securities in the secondary market can act as an indicator of overall economic health, as trends in stock prices often reflect economic growth or decline.
- [Investment outlet](#): Offers a place for investors, including smaller ones who may not have had access to the initial issuance, to buy and sell securities of established companies.

- **Support for the primary market:** By providing liquidity and a continuous market for existing securities, it encourages new companies to issue securities in the primary market to raise capital.

The main instruments traded in the **secondary market** are a wide variety of previously issued financial securities, including **stocks (equities), bonds, and derivatives**. These instruments are categorized as fixed-income, variable-income, and hybrid instruments:

Equity Instruments (Variable Income)

- **Stocks/Shares:** These represent ownership in a publicly listed company and are the most common instrument associated with the secondary market (e.g., major stock exchanges like the NYSE, NASDAQ, BSE, NSE).
- **Preference Shares:** These also represent ownership but offer a more predictable income stream through fixed dividends, and holders have a priority claim on assets over common stockholders in case of liquidation.

Debt Instruments (Fixed Income)

- **Bonds:** Debt securities issued by governments (e.g., Treasury bills, government bonds/securities) and corporations to raise capital. Once issued, they are actively traded among investors in the bond market (often over-the-counter).
- **Debentures:** Similar to bonds, these are debt instruments (typically unsecured) that offer regular interest payments and repayment of the principal at maturity.

Other Instruments

- **Derivatives:** These are financial contracts (such as futures and options) that derive their value from an underlying asset like stocks, commodities, or currencies. They are actively traded on both exchanges and over-the-counter (OTC) markets for hedging or speculation purposes.
- **Exchange-Traded Funds (ETFs):** These funds hold a diversified basket of assets (e.g., stocks, bonds, commodities) and are traded on stock exchanges just like individual stocks.
- **Mutual Fund Units:** While most mutual fund transactions are directly with the fund house, units of certain listed or close-ended funds can also be traded in the secondary market.
- **Foreign Exchange (Forex):** Currencies are traded in the foreign exchange market, which is a decentralized over-the-counter market.
- **Commodities:** Physical assets like gold, silver, or oil are traded in commodity exchanges or OTC markets.
- **Hybrid Instruments:** These combine features of both debt and equity, such as convertible debentures, which can be converted into equity shares after a certain period.

The secondary market provides crucial liquidity for these instruments, enabling investors to buy and sell them easily and quickly, and facilitating price discovery based on supply and demand.

The trading mechanism in the secondary market involves investors placing buy or sell orders through a brokerage firm, which then transmits them to a stock exchange. The exchange's automated system matches the orders based on price and time priority, executing the trade electronically. After the trade, a [clearing and settlement](#) process transfers the funds and securities between the buyer and seller, typically within a few business days (T+1).

Step-by-step trading process

- **Place an order:** An investor places a buy or sell order through a broker. This can be a [market order](#) (at the current price) or a [limit order](#) (at a specific price).
- **Transmit to the exchange:** The brokerage firm sends the order to the stock exchange, such as the [National Stock Exchange \(NSE\)](#) or [Bombay Stock Exchange \(BSE\)](#).
- **Order matching:** The exchange's automated, [screen-based trading system](#) matches the buy and sell orders electronically. This is done by prioritizing the highest bid price and the lowest ask price, then by time.
- **Trade execution:** Once a match is found, the trade is executed, and ownership of the security changes hands.
- **Clearing and settlement:** A clearinghouse (like NSDL or CDSL) is responsible for the final settlement. It ensures that the buyer receives the shares and the seller receives the money. In many markets, this process is completed in a T+1 (trade date plus one day) cycle.

Key participants

- **Investors:** Individuals or institutions who buy and sell securities.
- **Brokers:** Intermediaries who execute trades on behalf of investors.
- **Exchanges:** Centralized, regulated platforms where trading occurs.
- **Regulators:** Bodies like the [Securities and Exchange Board of India \(SEBI\)](#) that oversee the market to ensure fair and transparent practices.
- **Clearing Corporation/Depositories:** Entities that manage the clearing and settlement process to finalize the transaction.

What Is Online Trading?

Online trading, often referred to as e-trading or electronic trading, is the act of purchasing and selling financial instruments through an online platform. These platforms are typically provided by brokerage firms and accessible to anyone with an internet connection.

In the context of the Indian financial market, online trading has seen a significant surge in popularity over the past few decades, reshaping how investors and traders interact with the [stock market](#).

How Does Online Trading Work?

Diving into the mechanics of online trading, the process is underpinned by a combination of technology, financial regulations, and market dynamics.

The Initial Setup

To commence online trading, an individual must open a trading account with a registered brokerage firm.

In India, the [Securities and Exchange Board of India](#) (SEBI) oversees and regulates these brokerage firms and the stock market, ensuring they adhere to stringent standards to safeguard investor interests.

Execution of Trades

Once the account is active, traders can access the platform to view live market data, analyse charts, and place orders. When a trader decides to buy or sell a particular financial instrument, the order is sent electronically to the exchange.

The exchange then matches the order with a corresponding one, completing the transaction. It's worth noting that all these processes, from order placement to execution, can transpire within mere seconds.

Settlement Process

After a trade is executed, there's a settlement process where the actual transfer of assets takes place. In India, the settlement cycle for most equity trades is T+2, meaning the transfer occurs two business days after the trade date.

Types of Online Trading

1. **Day Trading:** [Day trading](#) involves buying and selling financial instruments on the same day. Day traders capitalise on small price movements and typically close all positions by the end of the trading session to avoid overnight risks. This type of trading requires a deep understanding of market trends, quick decision-making skills, and a high tolerance for risk.
2. **Swing Trading:** [Swing trading](#) involves holding positions for several days to weeks to profit from expected price swings. This method requires less

constant monitoring than day trading and is suitable for those who cannot dedicate full-time to trading but still want to capitalise on short- to medium-term market movements.

3. **Scalping:** [Scalping trading](#) is a high-frequency trading strategy where traders make dozens or even hundreds of trades within a single day, aiming to profit from small price changes. Scalpers need to have a robust trading platform, low transaction costs, and the ability to make quick decisions.
4. **Position Trading:** [Position trading](#) is a long-term strategy where traders hold positions for several months to years. This type of trading is based on thorough fundamental analysis and is less concerned with short-term price fluctuations. Position traders focus on the overall trend and the long-term potential of the asset.
5. **Algorithmic Trading:** [Algorithmic trading](#) uses automated software to execute trades based on predefined criteria. This method can analyse multiple markets and assets simultaneously, making it possible to execute trades at the best possible prices with minimal human intervention. It's suitable for experienced traders with knowledge of programming and quantitative analysis

A dematerialization (demat) account is an electronic account for holding securities like stocks, bonds, and mutual funds, similar to a bank account for money. It stores these assets in digital form, eliminating the need for physical paper certificates and simplifying transactions such as buying, selling, and transferring securities. Demat accounts are opened through a Depository Participant (DP) and are required for most stock market transactions, storing investments electronically and automatically crediting dividends and other benefits.

What a demat account does

- **Holds securities:**

It acts as a digital vault for shares, debentures, government bonds, mutual funds, and other securities.

- **Simplifies trading:**

It eliminates the need for physical paperwork, making the process of buying and selling securities quicker and more convenient.

- **Receives credit:**

When you buy securities, they are credited to your demat account, and when you sell, they are debited.

- **Receives benefits:**

Dividends, bonuses, and other corporate actions are automatically credited to the demat account.

- **Secures investments:**

It protects your investments from the risk of physical certificates being lost, stolen, damaged, or forged.

Dematerialization

- **The process:**

Dematerialization is the process of converting physical share certificates into an electronic balance.

- **How it works:**

You surrender the physical certificates to your Depository Participant, which then requests the conversion from the company or its registrar. The securities are then held electronically in your account.

- **Mandatory in many cases:**

In many markets, dematerialization is mandatory for all stock market trades to ensure efficiency and security.

How it is different from a trading account

- A demat account holds the securities electronically, while a trading account is used to place buy and sell orders for those securities.
- You need both a demat account and a trading account to transact in the stock market.

Key features

- **Unique number:** A demat account is identified by a unique 16-digit number, which is used for all electronic transactions.
- **Nomination facility:** You can appoint a nominee to inherit the securities in the account in case of your death.
- **Other services:** Some accounts also allow you to take loans against your securities.

- **What Is a Broker?**

- A broker is an individual or firm that acts as an intermediary between an investor and a securities exchange, charging fees or commissions for their services. There are two types of brokers: full-service brokers, which offer a variety of services, and discount brokers, which provide more limited services at lower costs. Both types of brokers are available online, making broker services more accessible to ordinary investors.
- Securities brokers must be registered with the Financial Industry Regulatory Authority, and real estate brokers must be registered with state agencies; they both must adhere to certain standards.

A **broker** is an individual or firm that acts as an intermediary, organizing and executing transactions (such as buying and selling securities, real estate, or insurance) on behalf of another party, typically in return for a commission or fee. Brokers are essential because individual investors and consumers generally cannot directly access major exchanges or markets, as these require specific licenses.

Brokers exist in various industries, and their functions can range from simple trade execution to comprehensive advisory services.

Kinds of Brokers

Brokers can be categorized in two primary ways: by the **level of service** they offer and by the **industry or asset class** they deal in.

By Level of Service (Primarily in Finance)

- **Full-Service Brokers:** These traditional brokers offer a wide array of services beyond just executing trades, including personalized investment advice, financial planning (retirement, estate, tax), in-depth market research, and portfolio management. They provide a high degree of "hand-holding" and often cater to high-net-worth individuals or those who prefer expert guidance. Due to their extensive services, they charge higher fees or commissions, often as a percentage of assets under management.
- **Discount Brokers:** These brokers focus primarily on executing buy and sell orders at a lower cost. They typically do not offer personalized investment advice, research reports, or in-depth financial planning. They rely heavily on technology, providing online trading platforms for self-directed investors who are comfortable making their own decisions.
- **Online Brokers / Robo-Advisors:** These are modern types of discount brokers that operate almost entirely through digital platforms. Robo-advisors use algorithms to create and manage investment portfolios automatically based on a client's risk tolerance and goals, offering a low-cost, hands-off approach.

By Industry or Asset Class

- **Stockbrokers:** Act as intermediaries between investors and stock exchanges, managing and executing the buying and selling of stocks, bonds, mutual funds, ETFs, and other securities.
- **Real Estate Brokers:** Licensed professionals who act as intermediaries in property transactions, representing either the buyer or the seller. They determine property values, list and advertise properties, manage inspections, and negotiate deals. Real estate brokers have a higher level of licensing than real estate agents and can supervise agents.
- **Forex Brokers:** Facilitate the buying and selling of foreign currencies on behalf of clients, providing access to the 24-hour global currency market.
- **Insurance Brokers:** Work with clients to find the best insurance policies to meet their needs, comparing products from multiple insurance providers to ensure optimal coverage and competitive rates.
- **Commodity Brokers:** Execute orders to buy and sell commodity contracts (such as oil, gold, or agricultural products) on behalf of clients, often dealing in futures and options contracts.
- **Mortgage Brokers:** Act as an intermediary between a borrower and potential lenders, helping the borrower find the best mortgage product and interest rate for their

6. MODULE 3

A mutual fund is an investment vehicle that pools money from many investors to buy a diversified portfolio of stocks, bonds, and other securities. These funds are managed by professional money managers who invest according to specific objectives, and each investor owns "units" of the fund, which represent a proportional share of the total holdings. This structure provides diversification, which can help reduce risk, and offers accessibility to professional management even for those with small amounts of money.

How a mutual fund works

- **Pooling money:** The fund collects money from many individual investors.
- **Professional management:** An asset management company (AMC) hires professional fund managers to oversee the portfolio.
- **Diversification:** The pooled money is invested in a wide range of securities to spread out risk.
- **Unit ownership:** Investors buy units in the fund, and their value is based on the performance of the underlying assets.
- **Profit/Loss sharing:** Profits or losses are shared proportionally among the unitholders based on their investment.

Key benefits

- **Professional expertise:** Investors benefit from the knowledge of professional fund managers without having to manage their own investments.
- **Diversification:** The fund's investments are spread across various assets, which helps to reduce risk compared to investing in a single stock or bond.
- **Accessibility:** It allows individuals with small sums of money to invest in a diversified portfolio, making it suitable for new or smaller investors.
- **Convenience:** It provides a straightforward way to invest in a professionally managed, diversified portfolio without the hassle of picking individual securities.

What are different types of mutual funds?

When you enter a car showroom, you see lots of different cars. There are hatchbacks, sedans, SUVs and maybe even sports cars. Each car in the showroom serves a different purpose. An adventurous person may prefer a sports car while a family man with kids (and a pet) may opt for an SUV. In the same way, there are different types of mutual funds in India.

Each fund type aims to achieve specific goals. Here are the most popular [types of mutual funds](#) you can find:

Types of funds based on asset class:

1. Debt funds

Debt funds (also known as fixed income funds) invest in assets like government securities and corporate bonds. These funds aim to offer reasonable returns to the investor and are considered relatively less risky. These funds are ideal if you aim for a steady income and are averse to risk.

2. Equity funds

In contrast to debt funds, equity funds invest your money in stocks. Capital appreciation is an important objective for these funds. But since the returns on equity funds are linked to market movements of stocks, these funds have a higher degree of risk. They are a good choice if you want to invest for long term goals such as retirement planning or buying a house as the level of risk comes down over time.

3. Hybrid funds

What if you want equity as well as debt in your investment? Well, hybrid funds are the answer. Hybrid funds invest in a mix of both equity and fixed income securities. Based on the allocation between equity and debt (asset allocation), hybrid funds are further classified into various sub-categories.

Types funds based on structure:

1. Open-ended mutual funds

Open-ended funds are mutual funds where an investor can invest on any business day. These funds are bought and sold at their [Net Asset Value \(NAV\)](#). Open-ended funds are highly liquid because you can redeem your units from the fund on any business day at your convenience.

2. Close-ended mutual funds

Close-ended funds come with a pre-defined maturity period. Investors can invest in the fund only when it is launched and can withdraw their money from the fund only at the time of maturity. These funds are listed just like shares in the stock market. However, they are not very liquid because trading volumes are very less.

Types of funds based on investment objective:

Mutual funds can also be classified basis investment objectives.

1. Growth funds

The main objective of growth funds is capital appreciation. These funds put a significant portion of the money in stocks. These funds can be relatively more risky due to high exposure to equity and hence it is good to invest in them for the long-term. But if you are nearing your goal, for example, you may want to avoid these funds.

2. Income funds

As the name suggests, income funds try to provide investors with a stable income. These are debt funds that invest mostly in bonds, government securities and certificate of deposits, etc. They are suitable for different -term goals and for investors with a lower-risk appetite.

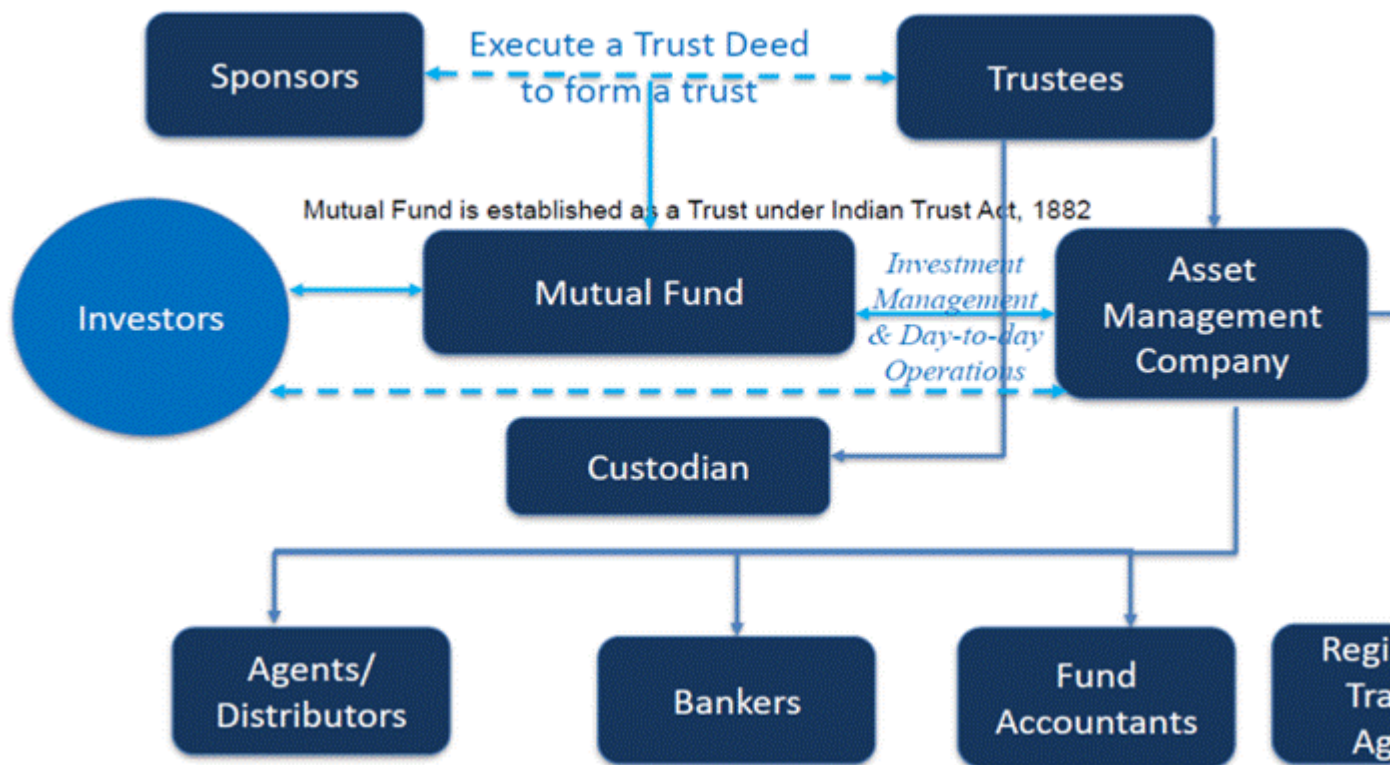
3. Liquid funds

Liquid funds put money in short-term money market instruments like treasury bills, Certificate of Deposits (CDs), term deposits, commercial papers and so on. Liquid funds help to park your surplus money for a few days to a few months or create an emergency fund.

4. Tax saving funds

Tax saving funds offer you tax benefits under Section 80C of the Income Tax Act. When you invest in these funds, you can claim deductions up to Rs 1.5 lakh each year. Equity Linked Saving Scheme (ELSS) are an example of tax saving funds.

Structure of a mutual fund organisation



Source: <https://jupiter.money/blog/structure-of-mutual-funds-in-india/>

The Securities and Exchange Board of India (SEBI) is the regulatory body that manages all mutual funds in India. It has mandated a three-tiered structure for any fund house in India. These tiers are as follows -

- Sponsor
- Trustee
- Asset Management Company (AMC)

Each of these tiers has specific responsibilities and specific eligibility criteria. Let's take a better look at each of them.

1. **Sponsor (or guarantor)**

In simple terms, a fund sponsor or guarantor is anyone who starts a mutual fund. This could be an individual or an individual partnered with another entity (associate company). The primary roles of a fund sponsor include:

- setting up a mutual fund
- approaching the SEBI for permissions
- promoting the associate company handling the fund
- recruiting people to ensure the fund house functions efficiently (appointing the AMC, custodian, transfer agent, auditor, and registrar)

Wondering about the eligibility requirements to become a sponsor? Well, here are the main criteria specified by the SEBI. Keep in mind that these criteria also apply to entities functioning as sponsors.

- The sponsor must have at least five years of hands-on experience in the financial services and products business, with a net positive Total Worth.
- The sponsor's net worth in the previous year should be more than the wealth contributed to setting up the fund house.
- The sponsor should be able to put in at least 40% of their net worth while setting up the fund house.
- The sponsor should have good returns in the past three to five years before setting up the fund house.

2. **Trustees**

After the sponsor creates the trust through a trust deed, the AMC appoints the board of trustees to keep track of the activities of the fund house and preserve the investor's faith in it. A trustee from the board of

trustees could be a member of the board of directors, a bank, or a company approved by the Securities and Exchange Board of India.

Most fund houses appoint a minimum of four trustees to handle operations, or they select a trustee company with no less than four directors to run the fund. Of these, two-thirds will have to be independent. Additionally, the AMC cannot appoint trustees from the same group. This ensures there is no partiality involved during the appointment.

The primary functions of the trustees include:

- Ensuring the fund house undertakings are compliant with SEBI guidelines
- Ensuring proper selection of other fund members (AMC, CEO, fund managers, CIO, registrar, etc.) based on their skills
- Validating schemes published by the fund house
- Ensuring the company's worth is as per the rules
- Reporting to the Securities and Exchange Board of India twice a year
- Ensuring the fund house is following compliance
- Appointing distributors and brokers

And that's not all. Since the trustees are directly responsible for upholding the trust of investors, their functions also include the following:

- Requesting information about fund operations, whether SIP investments, equity funds, or other fund types, as required.
- Punishing and initiating strict action if the AMC board members do not comply with the Securities and Exchange Board of India regulations, or when the interests of the investors are not protected.
- Dismissing the AMC in case of prolonged non-compliance with policies, etc.

Now that we know about the middle tier of the 3-tier mutual fund structure, it's time to uncover the final tier: AMCs or Asset Management Companies. Let's get into it.

3. **Asset Management Companies (AMCs)**

The [Asset Management Company \(AMC\)](#) or the Fund Management Firm is also the functioning investment manager of the trust. But before that, it needs to get registered with the Government of India.

At present, there are three kinds of AMCs in India:

- Private Companies
- A Public Limited Company associated with a Wholly-Owned Subsidiary
- Joint Ventures

Here are the roles of AMCs:

- Launch and initiate mutual fund schemes
- Generate funds with trustees and founders, and monitor their development
- Manage funds and solicit associate services with bankers, brokers, lawyers, registrars, etc.

In addition, the government's supervisory body has mandated a few extra rules to ensure businesses and roles of AMC employees do not clash. These include:

- AMCs cannot make decisions regarding fund house functions on their own. In most cases, they can provide services like portfolio management, asset management, etc.
- The AMC cannot nominate a trustee on any mutual fund house of which they are a part.

Other participants in the structure of mutual funds

Employee	Role
<i>Overseer or custodian</i>	They are responsible for the safety of the securities of the mutual fund. They also deliver and transfer fund securities to investors. This means if an investor is looking to upgrade their SIP investment to an equity fund, they can do it with the custodian's help.

Auditors	The main role of the auditor is to check the record books and annual reports and keep track of the finances of the fund house. Note that every AMC hires an independent auditor for this purpose.
Registrars and transfer agents (RTA)	The RTAs act as middlemen between the investors and the fund managers . They give fund managers details about investors and tell investors the advantages of investing in the fund.
Brokers, agents, dealers	Like brokers in real estate, these entities bring new investors to fund houses, keep track of market trends, and give recommendations to fund houses.

Example of the structure of the mutual fund

Here's the complete list of participants in the Tata mutual fund structure:

- **Sponsor** – Tata Sons Limited & Tata Investment Corp. Ltd.
- **Trust** – Tata Trustee Company Private Limited
- **AMC** – Tata Asset Management Limited
- **Custodian** – Deutsche Bank; HDFC Bank; Standard Chartered Bank; ICICI Bank; Orbis Financial Corporation Ltd
- **RTA** – Computer Age Management Services (CAMS) Limited
- **Auditor** – Kalyaniwalla & Mistry LLP and S.R. Batliboi & CO. LLP

Mutual Funds vs. Stocks: Which is Better Investment?

1) Professional Management

Leveraging the expertise and knowledge of a mutual fund expert to is one of the primary reasons why individuals consider investing in mutual funds. Investment in shares without prior experience or knowledge about the working of the financial markets can be quite disastrous. It could even easily drain your capital. Hence, experts often advise those new to the investing world to invest in mutual funds via a fund manager.

2) Save tax on mutual fund

When it comes to [ELSS mutual funds](#), Section 80C of the Income Tax Act, 1961, offers tax deduction on investments up to Rs1.5 lakh towards such schemes. Individuals and HUF can use this deduction to reduce their tax liabilities. You can save up to Rs46,800 by investing in ELSS mutual funds. This is one way you save tax on mutual fund investments.

3) Disciplined investment

Another major advantage of investing in mutual funds is financial discipline, which you get to learn by investing through the SIP (Systematic Investment Plan). When it comes to investing, mutual funds tend to have certain advantages over stocks. One such advantage is the SIP mode of investment. One can use [SIP calculator](#) to determine potential returns. This automated form of investing in a mutual fund requires an individual to decide the quantum of payment and the frequency of the investment at the start of the SIP investment tenure.

Venture capital is a type of financing for new, high-growth potential businesses, provided by investors in exchange for equity or an ownership stake. Types of venture capital are often categorized by the company's stage of development, including **seed funding**, **early-stage funding**, **bridge funding**, and **mezzanine funding**.

Meaning of venture capital

- **Funding source:** It is a form of private equity where investors provide capital to startups and small businesses that may not yet be profitable but have long-term growth potential.
- **Investment model:** Instead of a loan that requires repayment, VCs invest for a share of the company's ownership (equity).
- **Risk and reward:** This model involves sharing both the high risk of a startup failing and the potential for high rewards if the company succeeds.
- **Beyond money:** Venture capital can also include valuable expertise, technical knowledge, and managerial guidance.

Types of venture capital

Venture capital is often broken down by the company's stage of growth, with different rounds of funding providing capital for specific milestones:

- **Seed funding:** The earliest stage of financing, used to fund the initial stages of a startup, like market research or product development.
- **Early-stage funding:** Capital for companies that have a basic business model and are ready to start operations and build their customer base.
- **Bridge funding:** A round of financing to help a company "bridge the gap" between early stages and a larger, later-stage funding round, or before an initial public offering (IPO).
- **Mezzanine funding:** A later-stage investment that combines debt and equity features, used for companies that are nearing profitability and are ready for significant expansion.

On the other hand, investing in stocks this way can be quite tricky as each transaction would need to be timed and initiated by the investor himself.

4) Cost of Investing

Unlike stocks, which you can buy individually, actively managed mutual funds demand a small fee to be paid to the fund manager(s). However, one often forgets the concept of 'economies of scale' that tips their weight in the favour of mutual funds. Active management of funds surely requires extra capital from the investor's pockets, but due to their large size, mutual funds only ask a insignificant fraction of the brokerage charge from an individual shareholder.

5) Investment Horizon

Mutual fund investments often require a tenure of 5-7 years or more to generate considerate returns. This is because these investment vehicles have a long-term growth trajectory. On the other hand,

investing in stocks can fetch you quick and substantial returns if you choose the right stocks and time the buying and selling part correctly.

Whether you decide to invest in mutual funds or stocks entirely depends on your knowledge and expertise of the market and the amount of time and effort you are willing to spare. Mutual funds can prove to be a great investment instrument if you are an amateur and aim for steady returns. However, if you are a stock market guru with ample time on your hands, investing in stocks is a better choice.

The main stages of venture capital financing are pre-seed, seed, Series A, Series B, and later-stage rounds (Series C, D, and beyond), each with different objectives like initial product development, scaling operations, or preparing for an exit such as an IPO or acquisition. Pre-seed and seed stages focus on validating the business idea, while later rounds provide capital to scale the business, expand market reach, and achieve profitability.

1. Pre-seed stage

- **Goal:** To validate the business concept and build a minimum viable product (MVP).
- **Funding:** Smallest amounts, often from angel investors or personal funds.

2. Seed stage

- **Goal:** To fund initial product development and conduct market research.
- **Funding:** Still early-stage, but a larger amount than pre-seed, typically from angel investors and early-stage venture capital firms.

3. Series A

- **Goal:** To scale the business and grow the team and operations after demonstrating market traction and a solid business model.
- **Funding:** The first significant venture capital round, provided by venture capital firms.

4. Series B

- **Goal:** To scale operations, enhance products, and expand market reach after proving market fit.
- **Funding:** From venture capital firms to support growth-oriented companies.

5. Later-stage rounds (Series C, D, E, F)

- **Goal:** To prepare for an IPO or acquisition by scaling the business further, achieving profitability, or expanding into new markets.
- **Funding:** Larger and later funding rounds, often involving private equity or multiple venture capital firms.

6. Mezzanine financing

- **Goal:** A later-stage financing option that combines features of both debt and equity, often used to fund a major expansion or bridge the gap to an IPO.

Leasing is a contractual agreement where an asset's owner (lessor) grants another party (lessee) the right to use the asset for a set period in exchange for periodic payments. The two main classifications are [finance lease](#), which is a long-term arrangement transferring most ownership risks and benefits, and [operating lease](#), a shorter-term contract where the lessor retains risks and benefits and the asset is returned at the end of the term.

Leasing concept

- A lease is a contract where the owner of an asset (the lessor) allows another party (the lessee) to use the asset for a specific period in exchange for regular payments called lease rentals.
- This arrangement effectively separates the ownership of an asset from its economic use.
- Lessee can use valuable assets without the upfront cost of purchasing them.
- Leases cover a wide range of assets, including property, machinery, and vehicles.

Leasing classification

1. Finance Lease

- **Duration:** Typically long-term, covering a significant portion of the asset's useful life.
- **Ownership Risks & Benefits:** The lessee assumes most of the risks and benefits of ownership, including maintenance and insurance.
- **Asset Return:** At the end of the lease, the lessee may have an option to buy the asset for a nominal amount, or the lease may include a bargain purchase option.
- **Accounting:** Often treated like a purchase on the balance sheet, where the lessee shows the asset and a corresponding liability.

2. Operating Lease

- **Duration:** Generally short-term.
- **Ownership Risks & Benefits:** The lessor retains the risks and benefits of ownership.
- **Asset Return:** The asset is returned to the lessor at the end of the lease term.
- **Accounting:** The asset does not appear on the lessee's balance sheet, and lease payments are recognized as an operating expense.

Other types of leases

- **Sale and Leaseback:** A company sells an asset it owns and then leases it back, often to raise capital.
- **Leveraged Lease:** Involves three parties (lessee, lessor, and a lender) and uses debt to finance the lease.
- **Cross-border Lease:** Involves parties in different countries.

- **Net Lease:** A lease where the lessee is responsible for some or all of the property's operating expenses, such as taxes, insurance, and maintenance.

A hire purchase conceptual framework involves an agreement where a buyer takes possession of goods immediately but only becomes the legal owner after making all installment payments. The buyer pays in installments, and each payment is considered a hire charge until the final payment, at which point ownership transfers. The vendor can repossess the goods if the buyer defaults on any payment.

Key components and characteristics:

- **Immediate possession, delayed ownership:** The buyer gets immediate possession and can use the goods, but the vendor retains ownership until the last installment is paid.
- **Installment payments:** The total price, which includes the principal and interest, is paid over a specified period in regular installments.
- **Repossession right:** The vendor can take back the goods if the buyer fails to make a payment, and the vendor is not required to refund any money already paid.
- **Termination option:** The buyer has the right to terminate the agreement at any time, although doing so will likely result in the loss of payments made up to that point.
- **Credit purchase:** It is a form of credit purchase where the buyer pays for the asset over time.
- **Written agreement:** The agreement must be in writing and signed by all parties to be legally binding.
- **Asset capitalization:** In accounting, the hirer capitalizes the cash purchase price of the asset and records a liability for the amount owed.

LEASING VS HIREPURCHASE

The main difference is ownership: **hire purchase** includes a final payment to own the asset, while **leasing** is a rental agreement where the owner (lessor) retains ownership. Hire purchase is a form of installment credit leading to ownership, and is often used for longer-term asset needs, whereas leasing is a temporary use contract with a fixed term, often used by businesses to avoid ownership responsibilities.

Feature	Hire Purchase	Leasing
Ownership	Transfers to the buyer after the final payment	Remains with the owner (lessor) throughout the term
Primary Goal	To own the asset	To use the asset for a specific period
Term	Longer, from months to years	Shorter and customizable

End of Term Options	Ownership is fully transferred; you own the asset	Return the asset, extend the lease, or purchase it at a residual value
Maintenance	Typically the responsibility of the buyer/hirer	Can be the lessor's responsibility, depending on the agreement
Tax Implications	The hirer can claim depreciation and interest deductions	Lease payments are often deductible as operating expenses

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