

Course title: International financial regulation

Lesson 12. The lender-borrower relationship

Lecturer: PhD. Nargiza Dalmuradova

Financial System

- An institutional framework existing in a country to enable financial transactions
- Three main parts
 - Financial assets (loans, deposits, bonds, equities, etc.)
 - Financial institutions (banks, mutual funds, insurance companies, etc.)
 - Financial markets (money market, capital market, forex market, etc.)
- Regulation is another aspect of the financial system (RBI, SEBI, IRDA, FMC)

Financial assets/instruments

- Enable channelising funds from surplus units to deficit units
- There are instruments for savers such as deposits, equities, mutual fund units, etc.
- There are instruments for borrowers such as loans, overdrafts, etc.
- Like businesses, governments too raise funds through issuing of bonds, Treasury bills, etc.
- Instruments like PPF, KVP, etc. are available to savers who wish to lend money to the government

Financial Institutions

- Includes institutions and mechanisms which
 - Affect generation of savings by the community
 - Mobilisation of savings
 - Effective distribution of savings
- Institutions are banks, insurance companies, mutual funds- promote/mobilise savings
- Individual investors, industrial and trading companies- borrowers

Financial Markets

- Money Market- for short-term funds (less than a year)
 - Organised (Banks)
 - Unorganised (money lenders, chit funds, etc.)
- Capital Market- for long-term funds
 - Primary Issues Market
 - Stock Market
 - Bond Market

Organised Money Market

- Call money market
- Bill Market
 - Treasury bills
 - Commercial bills
- Bank loans (short-term)
- Organised money market comprises RBI, banks (commercial and co-operative)

Purpose of the money market

- Banks borrow in the money market to:
 - Fill the gaps or temporary mismatch of funds
 - To meet the CRR and SLR mandatory requirements as stipulated by the central bank
 - To meet sudden demand for funds arising out of large outflows (like advance tax payments)
- Call money market serves the role of equilibrating the short-term liquidity position of the banks

Call money market (1)

- Is an integral part of the Indian money market where day-to-day surplus funds (mostly of banks) are traded.
- The loans are of short-term duration (1 to 14 days). Money lent for one day is called 'call money'; if it exceeds 1 day but is less than 15 days it is called 'notice money'. Money lent for more than 15 days is 'term money'
- The borrowing is exclusively limited to banks, who are temporarily short of funds.

Call money market (2)

- Call loans are generally made on a clean basis- i.e. no collateral is required
- The main function of the call money market is to redistribute the pool of day-to-day surplus funds of banks among other banks in temporary deficit of funds
- The call market helps banks economise their cash and yet improve their liquidity
- It is a highly competitive and sensitive market
- It acts as a good indicator of the liquidity position

Call Money Market Participants

- Those who can both borrow and lend in the market – RBI (through LAF), banks and primary dealers
- Once upon a time, select financial institutions viz., IDBI, UTI, Mutual funds were allowed in the call money market only on the lender's side
- These were phased out and call money market is now a pure inter-bank market (since August 2005)

Developments in Money Market

- Prior to mid-1980s participants depended heavily on the call money market
- The volatile nature of the call money market led to the activation of the Treasury Bills market to reduce dependence on call money
- Emergence of market repo and collateralised borrowing and lending obligation (CBLO) instruments
- Turnover in the call money market declined from Rs. 35,144 crore in 2001-02 to Rs. 14,170 crore in 2004-05 before rising to Rs. 21,725 crore in 2006-07

Bill Market

- Treasury Bill market- Also called the T-Bill market
 - These bills are short-term liabilities (91-day, 182-day, 364-day) of the Government of India
 - It is an IOU of the government, a promise to pay the stated amount after expiry of the stated period from the date of issue
 - They are issued at discount to the face value and at the end of maturity the face value is paid
 - The rate of discount and the corresponding issue price are determined at each auction
 - RBI auctions 91-day T-Bills on a weekly basis, 182-day T-Bills and 364-day T-Bills on a fortnightly basis on behalf of the central government

Money Market Instruments (1)

- Money market instruments are those which have maturity period of less than one year.
- The most active part of the money market is the market for overnight call and term money between banks and institutions and repo transactions
- Call money/repo are very short-term money market products

Money Market Instruments(2)

- Certificates of Deposit
- Commercial Paper
- Inter-bank participation certificates
- Inter-bank term money
- Treasury Bills
- Bill rediscounting
- Call/notice/term money
- CBLO
- Market Repo

Certificates of Deposit

- CDs are short-term borrowings in the form of UPN issued by all scheduled banks and are freely transferable by endorsement and delivery.
- Introduced in 1989
- Maturity of not less than 7 days and maximum up to a year. FIs are allowed to issue CDs for a period between 1 year and up to 3 years
- Subject to payment of stamp duty under the Indian Stamp Act, 1899
- Issued to individuals, corporations, trusts, funds and associations
- They are issued at a discount rate freely determined by the market/investors

Commercial Papers

- Short-term borrowings by corporates, financial institutions, primary dealers from the money market
- Can be issued in the physical form (Usance Promissory Note) or demat form
- Introduced in 1990
- When issued in physical form are negotiable by endorsement and delivery and hence, highly flexible
- Issued subject to minimum of Rs. 5 lacs and in the multiple of Rs. 5 lacs after that
- Maturity is 7 days to 1 year
- Unsecured and backed by credit rating of the issuing company
- Issued at discount to the face value

Market Repos

- Repo (repurchase agreement) instruments enable collateralised short-term borrowing through the selling of debt instruments
- A security is sold with an agreement to repurchase it at a pre-determined date and rate
- Reverse repo is a mirror image of repo and reflects the acquisition of a security with a simultaneous commitment to resell
- Average daily turnover of repo transactions (other than the Reserve Bank) increased from Rs.11,311 crore during April 2001 to Rs. 42,252 crore in June 2006

Collateralised Borrowing and Lending Obligation (CBLO)

- Operationalised as money market instruments by the CCIL in 2003
- Follows an anonymous, order-driven and online trading system
- On the lenders side main participants are mutual funds, insurance companies.
- Major borrowers are nationalised banks, PDs and non-financial companies
- The average daily turnover in the CBLO segment increased from Rs. 515 crore (2003-04) to Rs. 32,390 crore (2006-07)

Indian Banking System

- Central Bank (Reserve Bank of India)
- Commercial banks (222)
- Co-operative banks

Banks can be classified as:

- Scheduled (Second Schedule of RBI Act, 1934) - 218
- Non-Scheduled - 4
- Scheduled banks can be classified as:
 - Public Sector Banks (28)
 - Private Sector Banks (Old and New) (27)
 - Foreign Banks (29)
 - Regional Rural Banks (133)

Indigenous bankers

- Individual bankers like Shroffs, Seths, Sahukars, Mahajans, etc. combine trading and other business with money lending.
- Vary in size from petty lenders to substantial shroffs
- Act as money changers and finance internal trade through hundis (internal bills of exchange)
- Indigenous banking is usually family owned business employing own working capital
- At one point it was estimated that IBs met about 90% of the financial requirements of rural India

RBI and indigenous bankers (1)

- Methods employed by the indigenous bankers are traditional with vernacular system of accounting.
- RBI suggested that bankers give up their trading and commission business and switch over to the western system of accounting.
- It also suggested that these bankers should develop the deposit side of their business
- Ambiguous character of the hundi should stop
- Some of them should play the role of discount houses (buy and sell bills of exchange)

RBI and indigenous bankers (2)

- IB should have their accounts audited by certified chartered accountants
- Submit their accounts to RBI periodically
- As against these obligations the RBI promised to provide them with privileges offered to commercial banks including
 - Being entitled to borrow from and rediscount bills with RBI
- The IBs declined to accept the restrictions as well as compensation from the RBI
- Therefore, the IBs remain out of RBI's purview

Development Oriented Banking

- Historically, close association between banks and some traditional industries- cotton textiles in the west, jute textiles in the east
- Banking has not been mere acceptance of deposits and lending money; included development banking
- Lead Bank Scheme- opening bank offices in all important localities
- Providing credit for development of the district
- Mobilising savings in the district. 'Service area approach'

Progress of banking in India (1)

- Nationalisation of banks in 1969: 14 banks were nationalised
- Branch expansion: Increased from 8260 in 1969 to 71177 in 2006
- Population served per branch has come down from 64000 to 16000
- A rural branch office serves 15 to 25 villages within a radius of 16 kms
- However, at present only 32,180 villages out of 5 lakh have been covered

Progress of banking in India (2)

- Deposit mobilisation:
 - 1951-1971 (20 years)- 700% or 7 times
 - 1971-1991 (20 years)- 3260% or 32.6 times
 - 1991- 2006 (11 years)- 1100% or 11 times
- Expansion of bank credit: Growing at 20-30% p.a. thanks to rapid growth in industrial and agricultural output
- Development oriented banking: priority sector lending

Progress of banking in India (3)

- Diversification in banking: Banking has moved from deposit and lending to
 - Merchant banking and underwriting
 - Mutual funds
 - Retail banking
 - ATMs
 - Internet banking
 - Venture capital funds
 - Factoring

Profitability of Banks(1)

- Reforms have shifted the focus of banks from being development oriented to being commercially viable
- Prior to reforms banks were not profitable and in fact made losses for the following reasons:
 - Declining interest income
 - Increasing cost of operations

Profitability of banks (2)

- Declining interest income was for the following reasons:
 - High proportion of deposits impounded for CRR and SLR, earning relatively low interest rates
 - System of directed lending
 - Political interference- leading to huge NPAs
- Rising costs of operations for banks was because of several reasons: economic and political

Profitability of Banks (3)

- As per the Narasimham Committee (1991) the reasons for rising costs of banks were:
 - Uneconomic branch expansion
 - Heavy recruitment of employees
 - Growing indiscipline and inefficiency of staff due to trade union activities
 - Low productivity
- Declining interest income and rising cost of operations of banks led to low profitability in the 90s

Bank profitability: Suggestions

- Some suggestions made by Narasimham Committee are:
 - Set up an Asset Reconstruction Fund to take over doubtful debts
 - SLR to be reduced to 25% of total deposits
 - CRR to be reduced to 3 to 5% of total deposits
 - Banks to get more freedom to set minimum lending rates
 - Share of priority sector credit be reduced to 10% from 40%

Suggestions (cont'd)

- All concessional rates of interest should be removed
- Banks should go for new sources of funds such as Certificates of Deposits
- Branch expansion should be carried out strictly on commercial principles
- Diversification of banking activities
- Almost all suggestions of the Narasimham Committee have been accepted and implemented in a phased manner since the onset of Reforms

NPA Management

- The Narasimham Committee recommendations were made, among other things, to reduce the Non-Performing Assets (NPAs) of banks
- To tackle this the government enacted the Securitization and Reconstruction of Financial Assets and Enforcement of Security Act (SARFAESI) Act, 2002
- Enabled banks to realise their dues without intervention of courts

SARFAESI Act

- Enables setting up of Asset Management Companies to acquire NPAs of any bank or FI (SASF, ARCIL are examples)
- NPAs are acquired by issuing debentures, bonds or any other security
- As a second creditor can serve notice to the defaulting borrower to discharge his/her liabilities in 60 days
- Failing which the company can take possession of assets, takeover the management of assets and appoint any person to manage the secured assets
- Borrowers have the right to appeal to the Debts Tribunal after depositing 75% of the amount claimed by the second creditor

The Indian Capital Market (1)

- Market for long-term capital. Demand comes from the industrial, service sector and government
- Supply comes from individuals, corporates, banks, financial institutions, etc.
- Can be classified into:
 - Gilt-edged market
 - Industrial securities market (new issues and stock market)

The Indian Capital Market (2)

- Development Financial Institutions
 - Industrial Finance Corporation of India (IFCI)
 - State Finance Corporations (SFCs)
 - Industrial Development Finance Corporation (IDFC)
- Financial Intermediaries
 - Merchant Banks
 - Mutual Funds
 - Leasing Companies
 - Venture Capital Companies

Industrial Securities Market

- Refers to the market for shares and debentures of old and new companies
- New Issues Market- also known as the primary market- refers to raising of new capital in the form of shares and debentures
- Stock Market- also known as the secondary market. Deals with securities already issued by companies

Financial Intermediaries (1)

- Mutual Funds- Promote savings and mobilise funds which are invested in the stock market and bond market
- Indirect source of finance to companies
- Pool funds of savers and invest in the stock market/bond market
- Their instruments at saver's end are called units
- Offer many types of schemes: growth fund, income fund, balanced fund
- Regulated by SEBI

Financial Intermediaries (2)

- Merchant banking- manage and underwrite new issues, undertake syndication of credit, advise corporate clients on fund raising
- Subject to regulation by SEBI and RBI
- SEBI regulates them on issue activity and portfolio management of their business.
- RBI supervises those merchant banks which are subsidiaries or affiliates of commercial banks
- Have to adopt stipulated capital adequacy norms and abide by a code of conduct

Conclusion

- There are other financial intermediaries such as NBFCs, Venture Capital Funds, Hire and Leasing Companies, etc.
- India's financial system is quite huge and caters to every kind of demand for funds
- Banks are at the core of our financial system and therefore, there is greater expectation from them in terms of reaching out to the vast populace as well as being competitive.

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- Thank you