

CORPORATE GOVERNANCE

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INTRODUCTION

There is now an increasing realisation among modern and progressive companies that ethics and corporate social responsibility make good business sense. An ethical and socially responsible company generally conforms to the standards of good corporate governance. Good governance is essential to build goodwill and credibility, manage companies efficiently and transparently and prevent a variety of corporate crimes like embezzlement, *money laundering*, kickbacks, expense account padding and price and bid rigging. It is a *sine qua non* for establishing and promoting healthy corporate culture and values. *In recent years, there has been a growing concern towards corporate governance and the pressure for good governance from various stakeholders of companies is growing. There is now a widely held belief that good governance is essential to prevent financial crises and bankruptcies and to encourage investment, both domestic and foreign, in the corporate sector.*

CORPORATE GOVERNANCE: THE CONCEPT

Corporate governance basically refers to a set of systems and subsystems by which a company is controlled and directed. It prescribes a set of standards in terms of the company's efficiency, integrity, transparency, accountability and overall image and goodwill in society. *Organisation for Economic Cooperation and Development (OECD)* defines the concept as:

'...the system by which organisations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants of the corporation such as board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set and the means of attaining those objectives and monitoring performance.' (OECD, 1999).

In a broader context, the basic purpose of corporate governance is to maximise the long run interests of the various stakeholder groups and resolve the conflict in their mutual interests. In a narrow sense, it seeks to maximise the long run shareholders' value through sound and effective governance practices. The concept and the concerns relating to corporate governance are built around the role, responsibility and functioning of the board of directors as representatives of shareholders and its existence as a check on the management of the company. *The concept therefore derives its significance from the separation of owners and managers of the modern companies and conflicts between the goals of these two major interest groups.* Corporate governance deals with such conflicts and attempts to resolve them in the best interest of the company. Box 21.1 provides a primer on the board of directors as per provisions of the companies Act to highlight its institutional significance in corporate governance.

HALLMARKS OF GOOD CORPORATE GOVERNANCE

Some of the generally accepted hallmarks of good corporate governance are the following:

- It seeks to maximise the long run corporate value, the interest of various stakeholders and particularly the stockholders who are residual claimants.
- It is transparent and effective.
- It is able to prevent corporate crimes.
- It promotes competitiveness and overall growth of the organisation. It is fully accountable to the various stakeholders of the company.
- It maintains a healthy corporate culture that meshes well into the socio-economic and cultural profile of the society.
- It is able to resolve successfully the conflicts between the various categories of stakeholders within and outside the company, particularly between the owners and the managers of the company.
- It is ethical and socially responsible.
- It is flexible and dynamic, capable of adjusting to the changing context and times.
- It provides adequate avenues to shareholders for effective contribution to the governance of the company without getting involved in the day-to-day functioning of the economy.

It is very difficult for a company to acquire all of the above hallmarks. Most of these are qualitative in nature and cannot be measured in precise terms. Nevertheless, these set the objectives that a corporate governance system must strive to achieve.

BOX 21.1

Company Board of Directors: A Primer

Board of Directors lies at the centre of corporate governance. Board directors are representatives of the shareholders and are expected to provide corporate leadership and strategic and competent guidance independent of the management of the company. All along, they remain accountable to the shareholders. The board does not merely fulfill the various statutory requirements; it is actually conscious of its responsibilities towards the company, its stakeholders and the society at large. The basic function of the board is to direct, supervise and control the company in the furtherance of the mission that the company has established for itself.

Given this role and responsibility, discussion on corporate governance predominantly revolves round the board of directors. In India, the various provisions relating to the board of directors is provided in the **Companies Act (1956)**. Some of the main provisions of the Act relating to the board of directors are as follows:

- The number of directors cannot less than three for a public limited company and two in case of a private limited company. The maximum number of directors that a company can have is 12; beyond that, permission of the central government is required. The actual number of directors within these limits is provided in the Articles of the Company.

Contd...

- All the directors are elected and appointed as shareholders' representatives at the Annual General Meeting (AGM) of the shareholders. Board decisions are taken collectively; no individual director has authority to take a decision or act on behalf of the company (unless the power is conferred by a resolution of the board or under the Articles).
- A public limited company (or a private limited company which is a subsidiary of public limited company) can appoint a maximum of 1/3 of the total as permanent directors. Of the remaining directors (i.e. 2/3), one-third must retire every year. Those having longest stay since last appointment, will be retired first. A director appointed by nomination by a lending financial institution (like IDBI, IFCI etc) is not liable to retire by rotation and is not counted in the number of directors liable to be retired. Such directors are called **nominee directors**.
- A board can have both **executive and non-executive directors**. Executive directors are those who are in whole time appointment or are entrusted with day-to-day operations of a company. Non-executive directors are from outside the company and work on part-time basis after periodic intervals when required and attend the board meetings. Such directors are retained because of their professional advice, external contacts or for their objective and independent opinion in board meetings. *The liabilities of a non-executive director are the same as that of an executive director in the eyes of law.*
- There are no qualifications or age limits for the appointment of a director. However, he must not be of unsound mind, undischarged, insolvent or a person convicted by a court for an offence relating to the promotion, formation or wind-up of a company. Further, a person cannot be a director in more than 20 companies (excluding private limited companies which are subsidiaries of a public limited company; an unlimited company or a non-profit organisation).
- The board of a company can appoint, as per Articles, an alternate director in place of an original director when latter is out of the state or the country for a period of more than three months. The appointment of the alternate director stands terminated when the appointment of the original director is terminated.
- Whole time (executive) directors, like employees of a company, get monthly remuneration. Part-time (non-executive) directors get sitting fee (per meeting) for attending board meetings and remuneration as a small percentage of net profits of the company, (if its Articles so provide). Non-executive directors who attend the meetings only are entitled to just 'sitting fee' per meeting. A board provides stewardship to the company, assumes collective responsibility for its well being and is continuously engaged in maximising value to stakeholders, particularly the shareholders.

LEADING INDICATORS OF CORPORATE GOVERNANCE

A large number of indicators of corporate governance can be set up bearing upon various aspects or issues of the subject. Ever since the revival of interest in the subject, a number of best-practice codes and recommendations have been developed by various committees, association of business enterprises as well as individual scholars. These codes and recommendations make use of identified indicators of corporate governance and set-forth certain principles and practices that a modern company must follow in the interest of the company, its stakeholders and the society in general.

Some of the main indicators of corporate governance are as follows.

- **Existence of Good Governance Code.** It is a primary and most fundamental indicator of good corporate governance. There must exist a widely-accepted good governance or best practices code produced by the government, a business association, a social organisation or a corporate stakeholders group. Mere existence of a code is not enough. It must serve as a

reference and a benchmark for a modern company to measure the adequacy and quality of its actual governance against it. It may not be entirely legally enforceable but must have a wide acceptability and appreciation. Simultaneously, there must exist code of conduct for the board of directors.

- ***The Role, Responsibility and Competence of the Board.*** The role and responsibility of a corporate board are broadly provided in the corporate legislation of almost all the countries. What is important is that how competently, effectively and to what extent the board actually takes up its role and responsibilities in running the company well. Essentially, it must provide stewardship to the company and plan an efficient and effective role in the company's functioning. *There has to be a system that ensures that the board is empowered, informed, competent and effective on a continuous basis.*
- ***Involvement of Non-Executive or Independent Directors.*** As mentioned in Box 21.1, non-executive directors are appointed on the boards to provide independent, objective and professional opinion in the board meeting on matters which are of important concern to the companies (Box 21.2). Almost all the governance and best-practices codes recommend a larger proposition of non-executive directors on company boards. A higher proportion is viewed more favourably by shareholders and financiers as well, though such directors may not necessarily be independent or even competent. *Much depends on how they are appointed, by whom they are influenced and what financial interest do they have in the company.*
- ***Dissemination of Material Information.*** Another indicator of quality of corporate governance lies in the timeliness of the dissemination of material information, which is meant for the public. Any delay in dissemination puts 'insiders' in a state of information advantage over 'outsiders' and may get inclined to such transactions as in company securities to take advantage of future developments about which they already have advance knowledge. A company's governance standard can, therefore, be assessed from the timeliness and adequacy of disclosures, the quality and credibility of the reporting system and the inbuilt mechanism to check insider trading.
- ***Distinction Between the Role and Responsibilities of the Board and the Management.*** Governance standard of a company is basically judged from the split between the role and responsibilities of the board and the management. The board is expected to steward the company, set the strategic objectives, provide guidance and judgment independent of management, and exercise control over the company, remaining all along accountable to the shareholders in particular and stakeholders in general. The management of the company is expected to run the company under the guidance, objectives, strategy and control of the board remaining all the time accountable to the board and, of course, ultimately the shareholders and the stakeholders. The two functions must be distinct to be meaningful. Correspondingly, the positions of the board chairman and the chief executive officer (CEO) of a company must be distinct with separate responsibilities and role and should be held by two separate individuals. The distinctions are necessary as management is subservient to the board and must operate within the policy framework of the board.

BOX 21.2**Who is an Independent Director on a Company Board?**

According to **California Public Employees' Retirement System (CaLPERS)**, an independent director is the one who:

- has not held an executive position in the company during the last five years;
- is not associated with a company as consultant, adviser or part of its management;
- is not related to a significant customer or supplier of the company or to a non-profit entity that receives significant contributions from the company;
- has not had any business relation with the company (other than as director) which is covered under disclosure norms, during the last five years;
- is not employed in a public company at which an executive officer of the company serves as director; and
- has not had any of the above relationships with any affiliate of the company.

According to **Kumar Mangalam Committee on Corporate Governance (1999)**, independent directors are defined as 'the directors who, apart from receiving director's remuneration, do not have any material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries, which in the judgment of the board may affect their independence of judgment...' The committee believes that 'non-executive directors bring an independent judgment to bear on board's deliberations especially on the issues of strategy, performance, management of conflicts and standards of conduct.' The committee lays emphasis on the caliber of independent directors. Detailed recommendations of the Committee are given in subsequent sections.

- **Specialised Board Committees.** The quality of a board increases if some of the key decisions requiring specialised expertise are entrusted to various committees constituted by the board. The specialised committees may handle such important matters as nomination of directors, according standards and procedures, audit system, reporting system, compensation of company executives and the like. Among these committees, audit committee is especially important to maintain accountability within the corporate system (accountability of the management to the board and of the board to the shareholders) through supervision and monitoring of the system of financial reporting. The governance standard can, therefore, be judged from the effectiveness of such specialised committees.
- **Disclosure of Remuneration Package.** Shareholders, as owners of a company have full right to know about the compensation policies and packages of the directors as well as executives. Extraordinarily high remuneration packages drain the company's resources at the expense of shareholders. Shareholders are generally concerned that the packages of the directors, managers or executives should not exceed the industry average by unreasonable margins. Institutional investors are often interested that the packages, in order to attract talents, should be linked to the performance of the company. Quality of governance is also indicated by the extent to which the information about compensation packages and policies, alongwith their breakup and details is made available to the shareholders. The information must cover details on *stock options*, if any, non-cash incentives and facilities and service contracts.

- **Accounting Standards and Financial Reporting.** Standard of governance is also reflected by the accounting standards and norms and the quality of financial reporting system. Accounting norms and procedures of a well-governed company tend to move towards international standards. Companies at high and common standards of accounting can be easily compared to one another and ranked. A good financial reporting system is necessary for transparency and credibility.

These are the broad indicators of the quality and adequacy of corporate governance. Various codes of governance established in different countries highlight these indicators in their various aspects. All these indicators occupy a place of high importance in the overall governance code though their weights may vary depending upon the subjective assessment of the code developers and the circumstances of the country in which a code is developed.

CORPORATE GOVERNANCE NORMS IN INDIA

During the last decade, there has been significant revival of interest in corporate governance in various parts of the world. Among the major reasons for the revival have been a spate of corporate frauds and corporate failures. In the process a number of codes have been developed (Box 21.3). In India, interest in corporate governance was revived with the onset of the process of economic reforms in 1991. Deregulation, privatisation, marketisation and globalisation trends unleashed in the process of reforms led to renewed interest and need for good governance in the country's corporate sector. There is a widely held belief that the standards of corporate governance must match with the spirit of the new economic policy and reforms so that the interests of the various stakeholder groups particularly the shareholders and lenders are adequately protected. A number of established and progressive companies maintain their voluntary codes of governance.

Companies Act 1956 is the principal legal instrument which contains provisions with regard to the role and functioning of the board of directors and the governance of companies (see, Box 21.1). Development of the governance codes in other countries, rising expectations of the various stakeholder groups and rising incidence of corporate frauds have mounted pressure in the country for the development of a governance code which could serve as a model for adoption by Indian corporates or against which their actual standards of performance could be judged. In this circumstance, three codes have been recently evolved viz.:

- ***Desirable Corporate Government in India-A code***, by Confederation of Indian Industry (CII), 1997.
- ***Kumar Mangalam Committee Report on Corporate Government*** (appointed by SEBI under the Chairmanship of Kumar Mangalam Birla, 1999)
- ***Naresh Chander Committee on Corporate Governance***

BOX 21.3**Some International Codes on Corporate Governance**

There has been a global wave of corporate governance in the recent years. The revival of interest in corporate governance, a mentioned in the text, has been sparked off by the Corporate frauds and failures, there has also been a growing realisation that corporate ethics and social responsibility make good business sense as these generate and accumulate goodwill and credibility assets which, in turn, generate financial returns in the long run. Some of the major efforts in the direction of prescribing codes of good governance are the following:

- **Report of the Cadbury Committee (UK)**
- **OECD Code of Corporate Governance.**
- **Combined Code of London Stock Exchange.**
- **Blue Ribbon Committee on Corporate Governance (USA).**
- **Report of the Greenbury Committee.**

The spirit of the most of the international reports is reflected in the governance codes recommended by the CII and Kumar Mangalam Birla Committee.

The development of these codes also owes to the weak provisions with regard to the role and responsibilities of board of directors and corporate governance system as laid down in the Companies Act, as amended to date. Due to this weakness, a number of undesirable characteristics and practices have got entrenched in the country's corporate environment. Some of these are as follows:

- High incidence of corrupt practices in the corporate sector.
- Widely scattered and unorganised shareholders have little information about the actual working and problems of the companies at the time of annual general meetings and readily consulting to the various resolutions.
- Small share but dominant role of family stockholdings.
- General lack of accountability and transparency of the board and management functions.
- Short sightedness and general indifference towards long term maximisation of shareholder value.

SOME WEAKNESS OF THE COMPANIES ACT

The existing Companies Act providing the formal structure of corporate governance does not address these problems squarely. Some of main weaknesses of the provisions of the Act with regard to the basic concerns of corporate governance are the following.

- No formal role is assigned to the non-executive directors though they can play an important role in providing independent and objective opinion in discussions on many strategic areas in board deliberations. The Act makes no distinction between executive and non-executive directors so far as their role and responsibilities are concerned. The effective control is in the hands of executive, whole time and managing directors.
- In most cases, non-executive directors have only ornamental value and lack a sense of commitment as the Act allows them to be on the boards of as many as 20 companies.
- Under the existing provisions, the approach to financial reporting is highly rule-based and ritualistic and lacks transparency.
- There are no formal qualifications prescribed for a director in the Act as a result of which, there is great scope of induction of mediocrity and incompetence in the corporate boards.

- The Act formally provides for the appointment of auditors by the shareholders but practically auditors work more closely with the company management and the shareholders hardly have any link with the auditors. The management–auditor closeness or collusion is often cited as a reason for the corporate malpractices and the Act contains little to prevent such likely connections.
- A large number of companies hardly provide any service to investors, particularly with regard to redressal of grievances on to delays in share transfers and dispatch of dividend warrants and share certificates.

The recent governance codes seek to remove a number of inadequacies in the Act with regard to corporate governance. *None of these have any mechanism for legal enforcement; nevertheless, these serve as benchmarks, which a company can strive to achieve.* The codes, themselves, have been challenged on the grounds of practicality and the philosophy on which these are based.

It is extremely difficult to achieve unanimity on governance code but its importance lies in the fact that they increase public and corporate awareness regarding the need for good governance and, if the process continues to gain momentum, might induce legislative changes in the times to come.

THE CII CODE

As mentioned above, the CII code was brought out in 1997. It made as many as 17 specific recommendations. The main recommendations of the code are as follows:

- A single well performing board is desirable. The full board should meet at least 6 times a year preferably at an interval of 2 months.
- A listed company with annual turnover of Rs. 100 crore and above should have professionally competent and acclaimed non-executive directors. Such directors should constitute at least 30 per cent of the board if the chairman of the company is a non-executive director and at least 50 per cent if the chairman and the managing director is the same person. Non-executive directors should play an active role in boards, have clearly defined responsibilities and have adequate knowledge of accounting and finance.
- No single person should hold directorship in more than 10 companies. The limit excludes directorship in subsidiaries where the group has at least 50 per cent equity stake or associate companies where the group has 25-50 per cent equity stake.
- In order to get better inputs from non-executive directors they should be paid a commission over and above sitting fees for their professional services. The present rates of commission are adequate. The commission can be appropriately combined with stock options for a better package of compensation.
- While reappointing members of a board, companies should furnish attendance record of directors. As a general practices, a non-executive director should not be reappointed if he did not have the time even to attend 50 per cent of the meetings.

- Listed companies with a turnover of Rs. 100 crore and above or a paid up capital of Rs. 20 crore, whichever is less, should set up Audit Committees within 2 years. An audit committee should have at least 3 members, all non-executive directors, having adequate knowledge of finance, accounts and company law. The committee should assist the board in fulfilling its functions relating to corporate accounting, reporting practices, financial and accounting controls and financial statements and proposals. The committee should have periodical interaction with statutory auditors and internal auditors for quality and credibility of company's accounts. For effective functioning of the committee, the management must make available financial data of the company and associated companies, particularly relating to investments, debt, contingent liabilities, current liabilities and debt. Lastly, listed companies (turnover above Rs. 100 crore or paid up capital of Rs. 20 crore whichever is less) should maintain a strong internal audit department or keep an external auditor to do internal audit.
- Under its standard disclosure practice, a listed public company provides additional information to its shareholders. The information should give data on high and low monthly averages of share price in all the stock exchanges where the company is listed, for the representing year, a statement on value added and fuller details on business segments and divisions. Consolidation of group accounts should be optional and subject to the permission of the financial institutions for allowing a company to leverage on the basis of group assets and of the income tax department using the group concept in assessing corporate income tax.
- Major Indian stock exchanges should insist on a compliance certificate (signed by CEO and CFO) stating that:
 - The management is responsible for the preparations, integrity and fair presentation of financial statements and other information contained in the Annual Report.
 - The company will continue business in the following year.
 - The accounting policies and principles conform to standard practices and that the board has overseen the company's system of internal accounting and administrative control system either directly or through audit committees.
- For listed companies with paid-up capital to Rs. 20 crore or above, the quality and quantity of disclosure that accompanies a GDR (Global Depositor Receipts) issue should also be the norm for a domestic issue.
- The government must permit greater funding to the corporate sector against shares and other papers.
- It would be desirable if financial institutions as pure creditors rewrite their covenants to eliminate the provision of having nominee directors, except in cases of serious debt default and when the company does not provide requisite periodic operation data to the lending institution as per contract. The Institutions should withdraw from company boards where equity holding is 5 per cent less or where total holding is less than 10 per cent.
- If a company gets its bonds, debentures or equity issues rated by more than one rating agency, then the rating information along with relative rating on the full rating scale should be given in the prospectus and the issue documents. In case of foreign and domestic issues, similar disclosure norms should be followed.

- Companies defaulting on fixed deposits should not be allowed to accept further deposits and make inter-corporate loans and investments till the default is made good. It should further be disallowed to declare dividend till default is removed.

KUMAR MANGALAM BIRLA REPORT

Kumar Mangalam Birla Committee appointed by the *Securities and Exchange Board of India (SEBI)* dwelt on the various aspects of corporate governance. A number of recommendation made by the Committee are common or similar to the CII Code described above, but in certain respects it has given more specific recommendations. However, in basic spirits both the reports are quite similar. In accordance with its terms of reference, the task of the committee was to suggest:

- Amendment to listing agreement and other measures to improve the standard of corporate governance;
- A code of corporate best practices; and
- Safeguards to deal with insider trading.

The report lays down that its recommendations should be made applicable to all listed companies including their directors, managements, employees and professionals associated with the company. *The committee identifies shareholders, board of directors and management as the three constituents of corporate governance and identifies rights, roles, responsibility and accountability of these constituents.* The committee before making recommendations examined the current status of governance standards and the provisions of existing laws, rules and regulations. The committee also considered certain critical issues relating to the quality of financial reporting, including consolidation of the accounts of subsidiaries, segment reporting when a company has multiple lines of business, disclosure and treatment of related party transactions and treatment of **deferred taxation**. Some of these issues were addressed by CII as well while formulating its governance code. The Committee has divided its measures into mandatory and recommendatory categories and regards its code as the first formal and comprehensive attempt in corporate governance.

The major recommendations of the committee are as follows.

Board of Directors

- The board of a company should have an optimum combination of executive and non-executive directors with 50 per cent of the board consisting of non-executive directors. The number of independent directors (box 21.2) would depend upon the Chairman of the board. In case of non-executive chairman, at least one-third of the board should comprise of independent directors. In case of an executive chairman, at least 50 per cent of the board should be independent. The tenure of the directors should be as per Companies Act.
- Financial institutions should have no direct role in managing the company and should normally not have nominees on the board merely by virtue of their financial exposure in the company. However, a nominee director would be justified in case of loan default (actual or potential) or for protecting their interest as shareholders. Such decisions should be left to the lending institutions themselves.

- Chairman's role in principle should be different from that of the chief executive. A non-executive chairman should be entitled to maintain a chairman's office at the company's expense.
- A director should not be a member in more than ten committees or act as chairman of more than five committees across all companies in which he is a director.

Audit Committee

- Standards of government applicable to the full board should be applicable to the audit committee as well. The board of a company should set up a qualified and independent audit committee to enhance the credibility of the financial disclosures of the company.
- The composition of the Audit Committee should be as follows:
 - a) At least three non-executive directors as members (majority being independent and at least one having financial and accounting knowledge).
 - b) One of the independent directors as Chairman.
 - c) The finance director, head of the internal audit and a representative of external auditor as invitees at the meetings of the audit committee.
 - d) The company secretary as the secretary of the committee.
- The committee should meet at least thrice in a year. One meeting must be held before finalisation of annual accounts and one necessarily after 6 months.
- The Committee must have the power to seek information from any employee, obtain outside legal or other professional advice and secure attendance of outsiders with relevant expertise, if necessary.

Director's Remuneration

- The remuneration of the non-executive directors should be decided by the entire board.
- Shareholders should be fully informed about the remuneration of directors. The following disclosures must be made in the section on corporate governance of the annual report of the company.
 - a) All the elements of remuneration package (like salary, benefits, bonus, stock option, pension etc.)
 - b) Details of fixed component of remuneration and performance linked incentives (including performance criteria).
 - c) Service contract details.
 - d) Stock option details, if any.

Accounting Standards and Financial Reporting

The companies should be required to give consolidated accounts in respect of all of its subsidiaries in which they hold 51 per cent or more share capital. Further, to obtain an overall financial position of the company, financial reporting for each product segment should be available to the shareholders and the market.

The committee refrained from making recommendations in areas, which were already being considered by SEBI or the **Institute of Chartered Accountants of India**. The areas included, among others, matters pertaining to related-party transactions and deferred taxation.

Company Management

- The board must clearly define the role of the management. Management is defined to comprise the Chief executive, executive directors and the key managers of the company, involved in the day-in-day activities of the company. The functions of management as recommended by the Committee are given in Box 21.4.
- The management must disclose to the board all material financial and commercial transactions where they have personal interest, that may have a potential conflict with the interest of the company (e.g. dealing in company shares, transactions with organisations which have shareholding of the management or their relatives etc.).
- As a part of management disclosure, in addition to the Director's Report, **Management Discussion and Analysis Report (MDAR)** should form a part of the annual report to the shareholders. MDAR should include the following:
 - a) Industry structure and developments;
 - b) Opportunities and threat, risks and concerns;
 - c) Segment-wise or product-wise performance;
 - d) Adequacy of internal control system;
 - e) Financial performance vis-à-vis operational performance; and
 - f) Material development in human resources and industrial relations.

BOX 21.4

Functions of Management as Recommended by Kumar Mangalam Committee on Corporate Governance (1999)

The distinction between the functions of board of directors and company management (consisting of Chief Executive, Executive Directors and key managers) lies at the heart of corporate governance. The committee recommends that the following main function should be carried out by the management.

- Assisting the board in its decision-making process for formulating the company's strategy, policies, code of conduct and performance targets and in the implementation of the same by managing the day-to-day affairs of the company. The management must attempt at maximisation of shareholder value.
- Providing all material and substantial financial and operating information in a timely and accurate manner to the board of directors.
- Ensuring compliance to all regulations, laws of the government and the code of ethics laid down by the board.
- Maintaining effective internal control system commensurate with business requirements.
- Providing efficient and timely service to shareholders and to protect their rights and interests. Facilitating efficient working of board committees.

Shareholders

- In case of appointment or re-appointment of a director, shareholders must be provided with a brief resume of the person concerned, his expertise in specific functional areas, names of the companies in which he holds the directorship and the names of the board committees of which he is a member.
- Shareholders should have right to participate in and have sufficient information on :
 - a) Decisions concerning basic corporate changes;
 - b) **Takeovers**, sale of assets or division of the company.
 - c) Changes in **capital structure** which has the potential to bring about a change in control of the company.
- Half-yearly declaration of financial performance and summary of significant developments in the company over the last six month period should be sent to each shareholder.
- A separate board committee should be set up under the chairmanship of a non-executive director to take care of the shareholders complaints relating to transfer of shares, non-receipt of balance-sheet, declared dividend etc. To expedite the process of share transfer, the board of the company should delegate the power of share transfer to the registrars and share transfer agents.

NARESH CHANDRA COMMITTEE REPORT, 2002

The committee was appointed by the **Securities and Exchange Board of India (SEBI)** to make recommendations on the representation of independent directors on company boards and the composition of audit committees. The Committee in his report submitted in December 2002, has taken forward some of the recommendations of the Kumar Mangalam Birla committee .

The major highlights and recommendations of the committee report are as follows.

- It makes no distinction between a board with an executive Chairman and a non-executive chairman.
- It is sufficient to have compulsory rotation of audit partners in every five years.
- Independent directors should play a larger role to ensure that corporate governance practices are improved and that the interests of stakeholders other than promoters are protected.
- There should be increased level of disclosure by a company and its auditors. The disciplinary mechanism for audit and related professionals should be overhauled.
- At least 50 per cent of the directors on the board of any listed company and unlisted public limited company with paid-up share capital and free reserves of Rs. 10 crore or more or turnover of Rs 50 crore or more should be independent. The boards of these companies should have atleast independent four independent. Audit committees of these companies should be made up entirely of independent directors.

CONCLUSION

During the last seven years, there has been increasing concern for corporate governance. The issues of government heats up particularly at times when corporate frauds are detected and reported. *According to KMPG's Fraud Survey 2002, the fraud areas where majority of cash losses occur are expense accounts, secret commission and kickbacks, forged documents, misappropriation or diversion of funds and false or misleading information. It must be emphasised that mere drafting of governance codes can't restore ethical standards. An honest corporate culture and an internal ethical environment in an organisation are pre-conditions for a successful governance code.* Foreign investment is generally shy of flowing to countries which don't have meaningful and effective governance standards. Similarly, organisations in countries with poor governance practices find it difficult to globalise and enter foreign markets for business. There are ticklish issues but an environment has to be created where unethical practices are detected and dealt with seriously.

Key Terms

Bond	Dividend	Money laundering
Capital structure	Executive director	Non-executive director
Corporate governance	Global Depository Receipts (GDRS)	Share transfer agent
Debenture	Insider trading	Stock options
Deferred taxation		Takeover

Supplementary Readings

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Long Questions

1. What is the significance of corporate governance? Why is it important for a modern corporate organisation to follow the prevailing governance code?
2. Compare the governance codes of (a) CII (b) Kumar Mangalam Birla Committee and (c) Naresh Chandra Committee. What have been the central concerns of these committees?
3. Why are non-executive directors considered essential for company boards? How can their role be made more effective?
4. Comment upon the state of corporate governance in India. How can a governance code be enforced effectively?

Short Questions

1. Distinguish between corporate governance and corporate management.
2. Give five leading hallmarks of good governance.
3. What is the role of the Board of Directors in Corporate management?
4. What is a corporate governance code? What does it certify?
5. Who are the non-executive directors on a company board? What is their importance?
6. What are the tests of independence of a non-executive director on a company board?
7. What is the significance of standard disclosure practices of a company?
8. What is the role and significance of Audit Committee in corporate governance?

Practical Assignments

1. Hold a group discussion on 'Do Independent Directors Really Play the Role they are Expected to?' Present the report to the class to suggest ways to make the role of non-executive directors more effective.
2. Browse the business deals of the last quarter and prepare a list of corporate frauds. Discuss the list in the class with a view to find out the ways of eliminating these.
3. Organise a mock meeting of the board of directors to discuss the adoption of a governance code.

CONSUMER PROTECTION

Chapter Outline :

- Introduction
- Common Ways of Consumer Exploitation
- Legislative Measures for Trade Regulation and Consumer Protection
- The Consumer Protection Act, 1986
 - Consumer Rights
 - General Characteristics
 - Institutional Arrangements
 - Consumer Protection Councils
 - Three-tier Consumer Dispute Redressal System
 - Latest (2003) Amendments to Act
- Role of Voluntary Consumer Organisations
- Consumer Protection through Product Quality Standards
- Protection Through Standards of Weights and Measures
- Consumer Duties and Responsibilities
- Conclusion

INTRODUCTION

The entire marketing effort of a business organisation revolves around the consumer. Marketing strategies and programmes of progressive and professionally managed firms seek to deliver full expected value for money to the consumer and take care of him even in the post-purchase stage. Simultaneously, however, a large number of firms have the tendency to exploit the consumer taking advantage of his poor knowledge and urgent or basic need for the product. *Producers and distributors vis-à-vis consumers are, on the whole more organised and have better knowledge about the market. Even then, the consumer is often called 'sovereign' or the 'king' as he commands the ultimate veto power to reject the product. It can send a chill down the spine of a producer who has big financial stake in business.* It is for this reason that the firms, which thrive on consumer exploitation, devise deceptive, misleading, luring and indirect ways of coaxing them into buying their products. The ways are craftily developed so as to escape the eye of the laws aimed at consumer protection.

Wide prevalence of unethical or unfair practices in business has led to what is known as *consumerism. It is an organised movement that seeks to protect the interests and rights of consumers, both individual and institutional, against irresponsible, unethical or unfair practices of business firms both in the public and private sectors.* Such movements have taken place in a number of countries and have led to various legislations seeking to protect the customers' interests and rights. These movements have been forcing the business firms to be socially responsible and responsive. At the rising tide of consumerism, business managers should hang their heads in shame and revise their marketing concepts. Consumerism, by itself, is a testimony that the standard textbook concepts of marketing are yet to be adopted by a number of business organizations.

COMMON WAYS OF CONSUMER EXPLOITATION

The various ways adopted by business firms to exploit the consumer are the following:

- Fixation of prices at levels which are not justified by production and marketing costs.
- Offering false discounts preceded by a rise in price.
- Undisclosed reduction in quality for the same or even higher price.
- False product differentiation.
- Sale of products, which are hazardous to health, life and property, without the consumer knowing about it.
- Suppression of material information about the quality, purity, standard or performance of the product.
- Reduction in competition through producer or trader collusion, which reduces product alternatives for the consumer.
- False, misleading or luring claims through advertisements.

- Supply of adulterated or spurious products.
- Giving guarantees or warranties, which, are not honored by producers or sellers.
- Giving less quantity by using inappropriate weights and measures.
- Not listening to or redressing the genuine grievances of the consumers.
- Creating artificial shortages (through hoarding etc.) to increase prices.
- Making false or misleading representation about the need or utility of a product.
- Manipulating the conditions of delivery by imposing unnecessary cost, or restriction or inconvenience to the customer.

LEGISLATIVE MEASURES FOR TRADE REGULATION AND CONSUMER PROTECTION

Most of these practices are mentioned in a number of business laws aimed at regulating trade and providing justice to the consumer and protecting his rights and interests. Most of these exploitative practices were dealt with in **MRTTP Act (1969)** (now repealed) and **Consumer Protection Act (1986)** as amended from time to time. Other laws seeking to regulate trade and protect the basic rights and interests of consumers are the following:

- The Sales of Goods Act, 1930
- Agricultural Produce (Grading and Marketing) Act, 1937
- The Food and Drugs Act
- The Essential Commodities Act
- Standards of Weights and Measures Act, 1976
- The Trading Stamps Act
- The Cigarettes (Regulation, Production, Supply and Distribution) Act, 1975
- Prevention of Food Adulteration Act, 1954
- The Railway Claims Tribunal Act, 1987
- The Drugs and Cosmetics Act, 1940
- Fruit Products Order, 1955
- Prevention of Black Marketing and Maintenance of Supplies of Essential Commodities Act, 1980
- Hire-Purchase Act, 1972
- The Drugs and Magical Remedies (Objectionable Advertisements) Act, 1954
- Bureau of Indian Standards Act, 1986
- Narcotic Drugs and Psychotropic Substances Act, 1985

- The Emblems and Names (Prevention of Improper Use) Act
- Packaged Commodities (Regulation) Order
- The Trade and Merchandise Marks Act, 1958
- Household Electrical Appliances (Quality Control) Order, 1976.

A number of objectives of the above pieces of legislation overlap. The multiplicity of laws for trade regulation and consumer protection has been characterised by weak implementation as a result of which unfair and exploitative practices abound in the Indian markets. Lack of competition in a number of product areas, consumers' illiteracy, consumer indifference towards products, weak consumer organisations and lack of consumerism in the country are among the major factors that further enable erosion of consumer rights by business firms.

THE CONSUMER PROTECTION ACT, 1986: MAIN PROVISIONS

It is the most important and comprehensive legislation for the protection of consumer rights and interests. It underwent major amendments through *Consumer Protection (Amendment) Act 1993*. It is operationalised through *Consumer Protection Rules, 1989*, that were later amended five times during 1993-98. The major components of the Act, as amended to date, are discussed in the following sub-sections.

THE SIX CONSUMER RIGHTS

The Act (Chapter II, Sec. 6) identifies the following six rights of the consumers and seeks to protect them through various legislative measures and institutional arrangements.

- The right to be protected against goods and services that are hazardous to life and property;
- The right to be informed about the quality, quantity, potency, purity, standard and price of goods or services so as to protect the consumer against unfair trade practices;
- The right to assured, wherever possible, access to a variety of goods and services at competitive prices;
- The right to be heard and to be assured that consumers' interests will receive due consideration at proper forums;
- The right to seek redressal against unfair trade practices or unscrupulous exploitation of consumers; and
- The right to consumer education.

GENERAL CHARACTERISTICS

The general characteristics of the Act providing its broad nature are the following

- The Act applies to the whole of India (except the State of J&K) and to all the goods and services except those specified in the Government of India notification issued from time to time;

- It is basically compensatory in character (i.e. provides compensation to the consumer) Many other laws seeking to protect the consumer have punitive provisions
- It is supplementary to (rather than in derogation of) other existing laws;
- If a consumer dispute is already pending in a civil court, it cannot be adjudicated by a Consumer Forum set up under the Act;
- It seeks to provide cheap and speedy redressal mechanism to the consumers.

Some basic definitions in the Act are given in **Box 22.1**.

BOX 22.1

Some Basic Definitions in the Consumer Protection Act, 1986

Some basic concepts used in the Act are given below. Some of these don't conform to the standard textbook definitions but have been retained for operational convenience or for maintaining conformity, parity or uniformity with other pieces of economic legislation. The concepts provide a guide to taking appropriate decisions.

Consumer. A person who buys goods for a consideration, which has been paid or promised or partly paid and partly promised. It includes a user of such goods who uses the product with the permission of the buyer or hirer, a person who obtains the goods on hire-purchase or lease. *A person who buys goods for resale or commercial purpose is not a consumer. However, a person buying goods for self-employment is a consumer.*

Goods: Defined in the same way as in *Sale of Goods Act*. It includes even stocks and shares, growing crops and things attached to land but meant to be severed from land. Patents, copyrights, trademarks, water, gas and electricity are also included among goods. Contracts for supply of goods are also covered in the definition. *Land and immovable property are excluded from the definition.*

Service: Service means service of any description which is made available to potential users and includes such activities as banking, insurance, financing, transport, processing, entertainment, information etc. and *excludes all those which are rendered free of charge.*

Product Defect: Any fault, imperfection or shortcoming in the quality, quantity, potency, purity or standard that is required to be maintained by the supplier or under the law.

Service Deficiency: Defined in the same manner as product defect but the expression is used for fault, imperfection or shortcoming in a service.

INSTITUTIONAL ARRANGEMENTS

The institutional arrangements made under the Act to protect and promote consumer rights (as described above) and to redress consumer grievances are discussed in the following sections.

Consumer Protection Councils

These Councils are established under the Act at the central and state levels to promote and protect the rights of the consumers. At the national level, it provides for the establishment of **Central Consumer Protection Council** with a term of three years and membership not exceeding 150. The council is basically advisory in nature. It is required to meet, under the Act, at least once in a year. It may, from within its members, constitute working groups to perform assigned functions and report the same to the Council for deliberations. The minister-in-charge of consumer affairs

in the central government acts as the chairman. Its membership comprises of various ministers, Members of Parliament and representatives of various central government departments, concerned autonomous organisations, consumer organisations, women, farmers, trade and industry as well as persons representing consumer interest. The secretary in charge of the consumer affairs in the central government acts as the member-secretary.

In a similar manner, the Act provides for the establishment of one Council in each state. The council consists of official and non-official members representing consumer interest, as may be nominated or appointed by the state government. The minister in charge of consumer affairs in the state government chairs a State Council. The State Council under the Act meets at least twice in a year.

Three-tier Consumer Dispute Redressal System

The Act (Sec. 9) provides for a three-tier system for the redressal of consumer disputes at the district, state and national levels in the ascending order of hierarchy. The system seeks to provide cheap and quick consumer justice with minimum legal formalities and technicalities. Under the Act, a complaint relating to any goods sold or delivered (or agreed to be sold or delivered), or any service provided (or agreed to be provided) can be filed. The complaint can be filed by an individual consumer, a recognised association of consumers or by a state or central government (the government itself may not be an aggrieved party). *There can also be a class action in which one or more consumers can file a complaint on behalf of all interested or involved consumers. Such an action can be filed only with the permission of the District Forum concerned* (see the following section).

At present, there are 32 state commissions and 543 district forums besides the *National Commission*. These institutions are described as follows.

- a) **District Forum.** The Act provides for the establishment of **Consumer Redressal Forum** in each district. The main institutional, structural and functional aspects of a District Forum are the following.
 - In its **compositional pattern**, it has three members, appointed by the state government on the recommendation of a committee consisting of (i) the President of the State Commission (Chairman); (ii) Secretary, Law Department of the State; and (iii) Secretary in charge of the Department of Consumer Affairs of the State. The President of the Forum should be a person who has been, or is qualified to be, the District Judge. The other two members, one of whom should be a woman, should have adequate knowledge of law, commerce, accountancy, industry, public affairs and administration.
 - The **term of appointment** of each member of the Forum is five years or up to the age of 65 years whichever is earlier and the member is not eligible for re-appointment. The remuneration and service conditions of the members are prescribed by the state government.
 - In its **monetary jurisdiction**, the Forum which has been substantially raised to Rs. 20 lakh in the latest amendment introduced in March 2003 earlier accepted complaints involving claimed compensation upto Rs. 5 lakh. Where amount of claimed compensation is not stated in the complaint, the value of the goods and services and

jurisdiction would serve as a guide to compensation and jurisdiction. The Forum has its territorial jurisdiction if (i) when the opposite party or parties reside or carry out business for gain or has a branch office in the district of the Forum or (ii) when one of the opposite parties resides or carries out business for gain or has a branch office and other opposite parties, if any, reside outside the territorial jurisdiction but have no objection to the complaint being heard in the district jurisdiction of the Forum, or (iii) where the cause of action (wholly or partly) arose. In case the opposite party is a company issuing shares at the national level, the complaint can be lodged at the district where the headquarter of the company is located.

- If a complainant alleges a **product defect**, the Forum may, if it considers necessary, send the product for testing and analysis in an 'appropriate' laboratory (which is usually a laboratory set up or recognised or approved or aided by the state or central government). Where no such test is required, the case is decided on the basis of available evidence. *Proceedings of the forum in this regard are not questionable in any court of law on the ground that the principle of natural justice was not followed. Oral submissions of the respondent (or opposite) party are acceptable.*
- The Forum has the same powers as vested in a Civil Court under the **Code of Civil Procedures, 1908**. It has the additional power to require any person to produce related documents or products in his custody, furnish any information that may be required or authorise any officer to search any premise and seize concerned documents and goods which are likely to be destroyed, altered or secreted.
- If the complaint of a consumer is proved in his favour, then, by way of **relief or compensation**, the opposite party may be ordered to (i) remove the defect or deficiency from the good or service (ii) replace the good with a new one which is free from the defect (iii) refund the prices or charges required from the consumer (iv) pay a compensation to the consumer for loss, cost, injury or damage incurred (v) cease and desist from the restrictive or unfair trade practices, or (vi) withdraw the supply of the hazardous good from the market.

The Forum can order one or more of the above types of actions. There have been many cases where the Forum has ordered immediate compensation to the consumer for mental harassment and agony suffered, out of the public funds, but subsequently recovery of the same from the persons responsible for causing the agony or the harassment.

- Appeal against the order of the District Forum can be filed in the State Commission within 30 days of the order. In such cases, no further appeal against the order of the State Commission (on an appeal) is permitted. This provision is made basically to cut down delay in the grant of consumer justice.
- b) **State Commission:** Full nomenclature of State Commission is **State Consumer Dispute Redressal Commission**. It is set up under the Act in each state by the state government. The main institutional and operational characteristics of the Commission are as follows.
- The Commission has a President and two other members, one of whom is a woman. The President is appointed by the State Government in consultation with the Chief Justice of High Court (who in fact, suggests the name of the President to be appointed). The President is a person who is or has been the judge of a High Court. The members

are appointed again by the state government on the recommendation of the selection committee consisting of (i) President of the state commission (Chairman of the committee); (ii) Secretary of the Law Department of the state government; and (iii) Secretary in charge of the department dealing with the consumer affairs of the state. The members have to be persons of ability, integrity and standing and who have adequate knowledge and experience in such areas as economics, law, commerce, industry and administration.

- The **remuneration, allowance and terms and conditions** of the service of the members are determined by the state government.
 - The **term of office** of each member is five years or till the attainment of the age of 67 years (whichever is earlier) and he/she shall not be eligible for re-appointment.
 - The **jurisdiction** of the Commission has three dimensions. Earlier, in its **monetary jurisdiction** (also called **original jurisdiction**), it could entertain complaints. The range has been scaled up to Rs. 20 lakh-Rs. 1 crore in the latest amendment to the Act made in March 200 involving compensation exceeding Rs. 5 lakh but less than Rs. 20 lakh. In its **appellate jurisdiction**, it can entertain appeals against the orders of a District Forum in the state. In its revision are (also called **supervisory**) **jurisdiction**, it can take a case pending at a District Forum in its own hands if the state government is of the view that the Forum is exceeding its jurisdiction or committing material irregularity in that case. Such cases are however, rare.
 - The **rules, procedures and manner of disposal of a complaint** by a State Commission are similar to those in case of a District Forum.
 - State Commission is the **apex body** in the state and its orders are binding on all the District Forums in the state.
 - **Appeals** against the orders of the Commission (except on appeals against the orders of a District Forum) can be filed in the National Commission within 30 days of the order.
 - The State commission has **administrative control** over the District Forums through (i) calling of periodic returns on its cases dealt by them (ii) issuance of instructions on procedural matters and (iii) supervision of the functioning of the forums to ensure that the provisions of the Act are appropriately observed.
- c) **National Commission:** The central government, under the Act, has established the **National Consumer Disputes Redressal Forum** as the apex body at the national level on consumer matters. The main institutional and functional features of the Commission are as follows:
- The commission has a President and four other members one of whom is a woman. The President is appointed by the central government in consultation with the Chief Justice of India. Members are also appointed by the central government on the recommendation of a selection committee consisting of (i) a judge of the Supreme Court nominated by the Chief Justice of India (Chairman of the selection committee) (ii) Secretary, Department of Legal Affairs, Government of India and (iii) Secretary of the Department dealing with consumer affairs in the Government of India. The members of the National Commission must be persons of ability, integrity and standing and should have good knowledge and experience in the areas of economics, commerce, accountancy, industry or public administration.

- The term of office of a member is five years or till the age of 70 years, whichever is earlier.
- The remuneration, allowances and other service conditions are decided by the central government.
- Initially, the monetary jurisdiction, of the commission was above Rs. 20 lakh. Its appellate jurisdiction includes all appeals against the orders of the State Commission (except those which are on appeals against the order of a District Forum). In its revisional or supervisory jurisdiction, it can call records and pass orders in the case of a consumer dispute which is pending before a State Commission or has been decided by it, if it is found that it has failed to exercise its jurisdiction, or has exercised it illegally or with material irregularity.
- The manner of disposal of a complaint is the same as that of a District Forum. The nature of powers of the National Commission is the same as that of a District Forum. It is obligatory for the parties involved (or their agents) to appear in person before the Commission.
- The commission possesses and exercises administrative control over the State Commissions and District Forums in the same manner as described for the state commission, to ensure that the provisions of the Act are suitably observed.
- Appeals against the orders of the National Commission can be filed in the Supreme Court within 30 days of its orders.

At all levels of the three-tier consumer dispute redressal system, orders are considered final if no appeal is made against them. These orders are enforceable in the same manner as that of a civil court. These orders can be lawfully sent to the Civil Courts for execution in their territorial jurisdiction. *Non-compliance of the orders by the concerned person (against whom the case has been decided) is punishable with imprisonment ranging from one month to three years or fine or both. Costs are also awarded to the winning complainants. If it is found that the complaint is frivolous and vexatious and the complainant has taken advantage of the opposite party, the complaint can be dismissed and the complainant fined upto Rs. 10,000.*

The disposal of cases by the consumer courts is monitored by the **Ministry of Food and Consumer Affairs**. The central government maintains a scheme for strengthening of infrastructure of consumer courts. Total number of cases filed and disposed in various courts is given in **Table 22.1**.

Table 22.1: Total Number of Cases Filed and Disposed in Various Consumer Courts till March 2002

Level	Total no. of cases ('000)		
	Filed	Disposed	Pending
National Commission	25.1	17.7	67.4
State Commissions	267.4	168.2	59.2
District Forums	1578.1	1334.4	243.7
All levels	1870.6	1520.3	310.3

Source: Government of India (2000), *India 2003: A Reference Annual* (N.Delhi: Govt. of India).

The Department of Consumer Affairs in the Ministry of Consumer Affairs, Food and Public Distribution Monitors the disposal of cases by the consumer courts through National Commission.

Latest (2003) Amendments to the Act

In order to remove various weaknesses of the Act, a comprehensive Act of amendment were introduced with effect from March 15, 2003 to make the Act effective in terms of its objectives. *The amendments basically seek to simplify, streamline and expedite the process of consumer justice and to give more powers to the consumer courts in dealing with violation of consumer rights.* The major amendments are the following.

- A specific time frame of 21 days is provided within which the court has to decide admissibility of a complaint. It further provides for a period of three months for final decision (additional two months if product testing is involved).
- It prohibits adjournment during the course of hearing of the case.
- Any party wishing to appeal against the order of the Forum has to deposit 50 per cent of the amount that has been directed to pay to the consumer.
- If the number of cases are large, additional benches may be provided.
- The courts can issue interim orders. Under the new law, the court can award punitive damages.
- Services hired for commercial purposes are outside the purview of consumer courts (goods for commercial purposes are already excluded).
- If a person fails to pay compensation, the court can order recovery in the same manner as arrears of land revenue.
- The pecuniary jurisdiction of District Forum has been increased from Rs. 5 lakh to Rs. 20 lakh, for State Commission to Rs. 20 lakh-Rs. 1 crore and for National Commission to above Rs.. 1 crore.

The amendment give more teeth to the Act.

ROLE OF VOLUNTARY CONSUMER ORGANISATIONS

Legislative arrangements for consumer protection are not enough by themselves. Consumers have to help themselves individually as well as through organised efforts such as through voluntary consumer organisations. Through organised action, consumers are empowered to safeguard their interests in a much better and more effective way. A voluntary consumer organisation is formed by a number of consumers voluntarily with the purpose to protect and promote their rights, save themselves from exploitation by sellers and to promote their collective welfare. The organisations are instrumental in spreading consumer awareness and education and try to resolve consumer disputes before going to the consumer forums for adjudication. The function of a consumer organisation is summed up in Box 22.2. Such organisations are generally assisted by the government because of their important role in consumer welfare.

BOX 22.2**Basic Functions of a Consumer Organisation**

The basic activities of a well-established consumer organisation are to:

- Protect and promote the economic and related interests of the consumers;
- Detect malpractices relating to price, quantity, quality, reliability, safety and guarantee of a product and pass on the information and its advice or recommendations to the members;
- Scrutinise the genuineness of grand clearance sales, substantial discount offers, and lottery like sales promotion measures, reduction or discount sales and advise the members to take necessary precautions;
- Facilitate or initiate action as per law to protect the consumers;
- Enlighten and mobilise public opinion towards consumer concerns and problems and to pressurize the government through representations to take further legislative measures for consumer protection;
- Conduct or sponsor training, research, surveys etc. on matters of consumer interest; and
- Disseminate consumer information, awareness and education through publications, presentations, seminars etc. to promote consumer interest.

In India, a consumer organisation, depending on its nature, can be registered under the Companies Act, 1956 or under any other law in force such as Societies Registration Act, 1860, Indian Trust Act, 1908, or Cooperative Societies Act. The central government established the Consumer Welfare Fund in 1992 to provide financial assistance to the registered consumer organisations. Assistance from the Fund is provided to any agency or organisation, which is engaged in consumer welfare activities for a period of three years and is registered under any law in force. The assistance is mainly available for:

- Creating consumer awareness;
- Spreading consumer education;
- Preparing publicity material;
- Setting up facilities for training, research or community-based rural awareness projects; and
- Facilities for setting up testing laboratories.

The total quantum of assistance to an individual organisation is restricted to Rs. 5 lakh and 10 per cent of the contribution is to be borne by the applicant organisation. In certain cases, even 100 per cent assistance is admissible. Assistance is also available to any industry as defined in the Industrial Disputes Act, 1947 which has been engaged in viable and useful research activity at least for a period of five years and which has made or is likely to make significant contribution to the formulation of standard makes of the products of mass consumption. Such organisations have the potential to play a powerful role in promoting and protecting the rights and interests of consumers, but the performance of these institutions in the country is quite low. Some of the leading problems faced by the institutions are:

- Lack of interest or indifference of the members in the organisation;
- Shortage of funds;
- Lack of knowledgeable or professionally competent office-bearers;

- Influence of politicians and businessmen; and
- Lack of cooperation from the complainants.

At the national level, the **Confederation of Indian Consumer Organisations (CICO)** exists at Delhi to coordinate the activities of the consumer organisations and lead the consumer movement in the country. It facilitates the formation of state-level federations. To streamline its operations, it has constituted four working groups that take care of matters relating to public utilities, pricing, public distribution systems, product standards, quality control, product safety, consumer protection laws and the grievance redressal machinery. At the international level, **The International Organisation of Consumers' Union (IOCU)** exists as the world federation. Founded in 1960 and based in The Hague, Netherlands, it links the activities of consumer organisations in about 75 countries.

CONSUMER PROTECTION THROUGH PRODUCT QUALITY STANDARDS

A major cause of consumer complaints relates to the quality of products that consumers buy. One of the effective ways, therefore, is to establish quality standard and to develop systems to ensure that these systems are implemented. In a competitive environment, firms themselves are concerned with their product quality to maintain or extend their position in the market. Under monopolistic or imperfectly competitive market situations, firms may dump products of doubtful quality on consumers.

The national standards body in India is the **Bureau of Indian Standards (BIS)**. With a national network of regional offices and branches, it is engaged in developing need-based standards with the help of about 30,000 technical experts represented on a number of technical committees. The main functions of the Bureau include;

- Preparation and implementation of quality standards;
- Operation of certification schemes both for products and quality systems;
- Organisation and management of testing laboratories;
- Spreading consumer awareness;
- Maintaining close liaison with international standards bodies;
- Conducting search and seize operations to curb misuse of standards and to protect the consumer from spurious products; and
- Organising training programmes on quality control and development.

In 1998-99, more than 17000 Indian Standards existed serving as benchmarks for major industrial segments in the country and helping the firms to upgrade the quality of their manufacturing process and products. It has harmonised or aligned more than 3500 Indian standards with international standards to enhance the acceptability of Indian products both in home and foreign markets.

In order to provide assurance on quality conforming to national standards, the Bureau maintains **BIS Product Certification Marks Scheme**. As on March 31, 1999, total number of

operative licenses was more than 13,000 covering a wide range of consumer products. Though the scheme is basically voluntary, it has mandatory standards for 135 products like cement, steel, LPG cylinders and food colours, which are important from the point of view of product safety or as items of mass consumption. Under the BIS Quality System Certification Scheme based on **International Standards of Quality Management (ISO 9000 series)**, the Bureau had 438 operative licenses as on March 31, 2000. The scheme has international accreditation in a number of technology areas. The Bureau has recently collaborated with **World Gold Council** to hallmark jewellery in India both for domestic consumption and exports. It is worth mentioning that India is the world's largest buyer of gold and a leading manufacturer of jewellery.

PROTECTION THROUGH STANDARDS OF WEIGHTS AND MEASURES

A large number of consumer grievances are related to weights, measures and packaging of products. Realising the significance of standardisation of weights and measures, both to regular trade and to protect the consumer from trade malpractices, **Standards of Weights and Measurements Act** was passed in 1956. It was later replaced by **Standards of Weights and Measurements Act, 1976** to remove the deficiencies of the earlier Act and align or harmonise Indian standards with international standards prescribed by **International Bureau of Weights and Standards**. The Act also covers related areas like metrology, interstate verification and stamping and numeration of products. The subject of 'Enforcement of Weights and Measures' was shifted from the 'State List' to the 'Concurrent List' with the 42nd Amendment of the Constitution. The Act is administered by the ministry of civil supplies. The Act is supplemented by the **Standards of Weights and Measures (Enforcement) Act, 1985** and a number of sets of rules. The Act also contains provisions with regard to pre-packaged products.

The major features of standards of weights and measures as adopted under the **Weights and Measures Act, 1976** and related rules are the following.

Standard Units. The Act follows the metric system for weights, measures and numeration (see, **Table 22.2**). These measures are adopted for convenience and easy calculation of the buyers. Use of such non-standard units as dozens, yards, acres and seers are not allowed, except under certain conditions allowed by the government. **Agreements based on non-standard weights are void in the eyes of the law.** Numerals must be in international form 1,2,3.... etc.

Table 22.2: Some Base Units of Measurement Under the Weights and Measures Act, 1976

Variable for measurement	Unit
1. Mass	Gram, Kilograms, Tonne
2. Volume	Millilitre, Litre, Kilolitre, Cubic centimetre, Cubic metre
3. Area	Square centimetre, square metre, etc.
4. Time	Seconds, minutes, hours etc.
5. Electric current	Ampere
6. Thermodynamic temperature	Kelvin
7. Amount of substance	Mole
8. Numeration	Multiples of 5, 10, 50, and 100

- **Performance.** The central government is empowered to prescribe units for performance, tolerance, strength, and viscosity etc. alongwith standard materials to be used for the purpose. The government can also prescribe the standards of material testing and product performance or product life.
- **Licensing and Stamping.** Manufacturers of weights and measures have to obtain a license from the government and also obtain approval for their models. The measures are stamped with a seal by impressing, casting, engraving, etching or branding or any other process.
- **Other Product Related Measures.** Some products, by virtue of their nature, fall outside the purview of the base units. Such products may include readymade garments, shoes, bags, crockery etc. In many cases quantitative measures like 'small', 'medium', and 'large' may have to be used. For certain food items (like soup powder), number of servings may have to be indicated. For photographic films, the total number of exposures possible would be specified.
- **Declaration on Packages.** Under **Packaged Commodities Rules**, packages or labels attached to the packages must contain the following information.
 - Identity of the product in the package;
 - Net quantity in terms of standard units;
 - If sold by numbers, the number of units of the product in the package;
 - Name of the manufacturer, marketer or packer; and
 - Price of the product..

For weights and measures, no qualifying words such as 'approximately', 'up to', 'less than' or 'more than' are allowed to be mentioned along with quantities. However, such expressions as '100 gms, when packed (as in case of toilet soaps) are permitted when a product is likely to lose weight due to loss of moisture or other climatic factors. A small and reasonable margin of variation may also be allowed in such cases as batteries or electronic weighing scales or in cases when the dimensions of a product may increase or decrease according to temperature variations. 'Net quantity' refers to gross quantity minus the weight of packaging. Retail price is indicated as Maximum Retail Price (MRP) which is inclusive of all taxes (except in case of medicines where it is exclusive of total taxes under Drug (Price Control) Order issued from time to time. If relevant, size of the product is also mentioned. There is provision of penalty as well as imprisonment for offences under the Act. Minor offences can also be compounded.

CONSUMER DUTIES AND RESPONSIBILITIES

It must be emphasised that legislative measures and consumer organisations by themselves cannot guarantee consumer protection. *The consumer himself has to observe necessary precautions and take appropriate buying decisions. He must gain sufficient knowledge about the market and the product before making a purchase decision.* Before claiming any rights, a consumer must be aware of his duties and responsibilities. He must:

- Plan his purchase, survey the market, gain knowledge about alternatives, have an idea of quality and price and make a purchase decision in relation to his needs or problems;
- Make the final decision himself though his friends relatives, neighbours, sellers or the advertisements may influence his decision;
- Buy the product from genuine or authorised sellers against appropriate bills and after paying due taxes. This is also necessary for filing a complaint, if any, with a consumer court;
- Not misuse his rights to exploit or embarrass the seller and he must read and understand the terms of sale;
- Not be indifferent to or party to any malpractices of the seller(s). He should give first opportunity to redress his complaint to the seller himself, then to the consumer organisation (if any) of which he is a member and finally to the consumer court, as last resort.
- Must be genuine in his claims.
- Not make speculative purchases or hoardings causing shortage to others.
- Must caution others against the malpractices of a seller.
- Not pollute the environment while disposing waste materials.

These are the duties and responsibilities, which must be voluntarily shouldered by a consumer. It is not possible to take care of him if he does not take care of himself.

CONCLUSION

While consumer movement is sweeping across major parts of the world, the movement is quite weak in India. A large number of cases are pending in consumer courts- a fact which itself defeats the purpose for which the nation-wide quasi-judicial system was established. Most of the consumer organisations are defunct or play a marginal role due largely to the paucity of funds and indifference of the consumers both towards their purchases as well as their organisations. By and large, it is true both of illiterate and educated consumers. *The level of product awareness even among educated customers is low. The general tendency to buy cheap sub-standard products and products without bills to evade taxes has led to a vast gray and black market in respect of a large number of products which serve as an excellent ground for the sale of spurious or counterfeit products with unknown risk levels. Lack of market vigilance and intelligence on the part of the administrative machinery make such markets thrive fast.* These factors highlight the need for a sustained campaign for consumer education to make people conscious of their rights, responsibilities and duties and the dangers, which might result when these are not exercised. There is a dire need to go beyond passive consumer protection and towards pro-active consumer empowerment.

Key Terms

Consumer empowerment
Consumer justice

Consumer protection
Consumerism

Supplementary Readings

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Long Questions

1. How do producers and sellers often exploit the consumers? Explain the main legislative measures for the protection of consumers in the country.
2. Explain the major provisions of the Consumer Protection Act, 1986 as amended to date. Has the Act been able to protect the rights and interests of the consumers?
3. What are the main consumer rights? Discuss the role and limitations of consumer organisations in protecting the interests of consumers in the country.
4. What are the major consumer problems? How will you identify and solve such problems?
5. 'You can't help a consumer if he does not help himself'. Discuss. Highlight the need and role of consumer education in protecting consumer interests.
6. Explain the main structure of the legislative machinery for consumer grievance redressal in India. What are the main hurdles in the way of consumer justice?
7. How are product standards used to promote and protect the interests of consumers? How can we generate awareness about such standards?
8. Why are weight and measures standards necessary? How are the standards used to safeguard the interests of consumers in the country?
9. Is consumer a king in the market? What are the threats to his position? How can he protect himself?

Short Questions

1. Name five ways in which consumers are often cheated.
2. Name five important pieces of legislation, which protect consumer interest.
3. What is the basic consumer right enshrined in the Consumer Protection Act, 1986?

4. Give three leading characteristics of the consumer Protection Act, 1986.
5. What is the role of a consumer protection council?
6. Explain the jurisdiction of a District Consumer Redressal Forum.
7. What forms of relief or compensation can be awarded by a consumer court to an aggrieved consumer?
8. Explain the revisional jurisdiction of a State Commission or the National Commission.
9. List the powers of a consumer court.
10. Give four major features of a consumer organisation.
11. What are the main functions of the Bureau of Indian Standards?
12. What are the norms for pre-packaged commodities under the Standards of Weights and Measurements Act, 1976?

Practical Assignments

1. Conduct a survey of 50 consumers and prepare a list of common complaints. Find out what action should have been taken by the consumers to redress the complaints. If no action was taken, find out the reasons for non-action.
2. Prepare a questionnaire designed to check the awareness about consumer rights and Consumer Protection Act, 1986. Discuss the results in the class with a view to find out the ways in which consumer awareness can be increased.
3. Make a visit to the office of the District Forum covering your area and classify the cases according to the nature of complaints which were decided by the forum during the last one year. Develop case studies of the major complaints decided.

COMPETITIVE ENVIRONMENT

Chapter Outline :

- Introduction
- The Concept and Logic of Competition
- Competition vs Contestability
- Benefits of Competition
- Regulation of Competition
 - Tests of a Good Competition Policy
 - Policy Effectiveness and the Concept of Regulatory Capture
- Factors Contributing to Competitive Environment in India
 - Public Sector Disinvestment and Privatisation
 - Opening up of New Sectors to Private Enterprise
 - Delicensing
 - Dereservation of SSI Items
 - Liberalisation of Foreign Direct Investment
 - Infrastructure Deregulation and Facilitation
 - Import Competition
- High Growth Industry Segments
- India's Present Competition Policy

INTRODUCTION

An important hallmark of the process of economic reforms initiated in the country in 1991 is that it has made the economy more competitive as compared to the pre-reform period. Though the degree of competitiveness in the business environment in India is much less as compared to a number of industrial market economies in Europe and North America and a number of emergent market economies in east-Asia and elsewhere, there have been clear signs of movement towards market system and competition in recent years. The movement towards greater competition in various sectors of the economy including manufacturing, infrastructure and services has taken place through deregulation, privatisation and globalisation. *The present stance of various macroeconomic policies, as discussed in the various preceding chapters, has been in the direction of marketisation of the economy, encouragement to private enterprise and opening up of the economy to foreign competition through international trade and investment. In the process, the structure of government controls has been diminishing and private capital is being increasingly substituted for public capital in various sectors of the economy. Chapter 30 exclusively deals with public sector disinvestment in the context of public enterprise reforms.*

THE CONCEPT AND LOGIC OF COMPETITION

There is enormous literature on the rationale and benefits of market competition or competitive markets. Standard managerial economics tells us that given the resources and technology, an economy is efficient when it is able to provide its consumers with the most desired range of products at minimum cost and this is possible under the mechanism of a competitive market. An economy is in competitive equilibrium when the forces of demand and supply are exactly balanced, leading to the determination of equilibrium price. In a particular product segment, marginal cost and marginal value or utility of a product are exactly balanced at the equilibrium price. Once the efficiency is achieved, it is not possible to reorganise production in order to make someone better off without making someone else worse off in that particular situation.

As a reference point, standard managerial economics visualises a situation called perfect competition which, in practice, is difficult to realise but describes an ideal market form characterised by the following features:

- A large number of buyers and sellers (or producers) so that no individual buyer or seller can affect the market price or working of the market by varying individual demand and supply.
- All the firms in a particular industry produce homogenous products, the homogeneity being in respect of technical characteristics of the product, services associated with the sale or delivery of the product to the consumer.
- A uniform price rules throughout the market and is determined by industry demand and supply. This price is given for an individual firm, which merely has the status of a price taker and can sell any amount at the prevailing price.
- There are no barriers to entry or exit from the industry and any firm can move in or out, depending upon its business prospects.

- All the firms pursue the goal of profit maximisation.
- There is no government intervention, regulation or control by way of tariffs, subsidies, rationing etc.
- Perfectly competitive conditions exist in the markets for factors of production as well.
- All buyers and sellers have complete knowledge of market conditions and flow of information (relating to present as well as future) is free and costless.

In real life, however, competition has a different connotation as the markets are imperfect and take such forms as monopoly, monopolistic competition and oligopoly. The firms *compete on the basis of price, product quality, after-sale services, product delivery, product information and positioning, advertising and associated services. Competition is characterised by inter-firm rivalry, competitive strategies and the degree of competition is closely related to number of firms in the market and the distribution of market share between them.* Government interventions and controls, barriers to entry and exit, legislative control, immobility of the factors of production, dominance of public sector firms and obstructions in the free flow of market knowledge or information tend to reduce the degree of competition and increase market imperfection. The extent of market imperfection can be gauged in terms of the divergence between the actual price and the competitive price in a particular product market. There is, however, an important exception. Sometimes, a monopolist, through a practice known as **limit pricing**, sets such a low price for its products so as to prevent the entry of new firms in the market. Potential firms find it commercially unviable to operate at the prevailing price of the monopolist. Similarly, existing firms, through price leadership, can reduce competition or tacit collusion through such forms as trade associations, cartels, market sharing or strategic alliances. *Sometimes competition creates a paradoxical situation in which competition is self-killing. It happens when the firms with widely divergent competitive strengths compete with one another forcing the marginal firms to go out of business. The end result could be monopoly or oligopoly. This situation may also result through corporate takeovers, mergers, or amalgamations between rival firms.*

COMPETITION VERSUS CONTESTABILITY

Competition may be distinguished from **contestability**. In standard managerial economics, **contestability** refers to the ease with which a firm can enter or leave the industry. Firms enter the industry as they are attracted by profits and tend to leave when they are not able to recover the normal price or the average variable cost at prevailing level of output. Under perfect contestability there are no barriers to entry and exit and the total number of firms in the industry is unstable and uncertain. In this situation, it is possible that monopoly exists with limit pricing. This point has been referred to earlier also. Under threat of potential competition, the monopolist is compelled to set a competitive price which is low enough to make the entry of other firms unviable. In practical world, however, business decisions are affected more by actual rather than potential competition and there exist significant barriers to entry.

Some of the major benefits expected from competitive markets are the following:

- Growth of entrepreneurial culture leading to increase in the number of producers and sellers in the market.

- Increase in investment and capital formation leading to increase in the supply capabilities.
- A strong incentive for developing cost-cutting technologies through sustained research and development efforts.
- Reduction in wastage and improvement in efficiency and productivity.
- Greater customer focus and orientation.
- Increased possibility for entering and tapping foreign markets.
- Conducive environment for growth of international trade and investment.
- Better resource and capacity utilisation.
- Wider range of availability of goods and services and wider choice for consumers.

On account of these perceived benefits, the governments of different countries take steps to generate and promote competition. This however, requires a suitable economic system and the constitutional framework as well as an appropriate macroeconomic policy set-up. In centrally controlled, planned or socialist economies the shift to a free enterprise system, is not easy. It requires major shift in the institutional systems and structure, production systems, socio-economic policies and the fundamental philosophy of the government itself. For this, the transition period could be long. A number of economies in Eastern Europe are facing serious transition problems in the gradual process of liberalisation towards market-oriented systems. The movement towards market-based systems is generally slow and has to be based on adaptive processes.

REGULATION OF COMPETITION

As already pointed out, market competition, particularly between firms of highly unequal, competitive strength, can be self-destructive. In unregulated markets, there can be widespread negative spillover effects called 'competitive externalities'. *The negative effects could be in the form of information asymmetries, unethical collusions, hostile takeovers, malicious interlocking directorates in companies, transfer pricing, strategic market alliances, unjustified market segmentation and differential pricing and a number of other monopolistic and unfair trade practices.* These factors result in anticompetitive outcomes, which underscore the need for regulation of competition (Box 23.1).

BOX 23.1

Examples of Some negative Spillover Effects of Competition

One type of negative spillover effect takes place when a particular technology or standard developed by a company gets an edge over competitors and becomes widely prevalent. Microsoft's Windows operating system has now become universal for personal computers. It can be used to lock out competition in related markets. Microsoft has already faced an allegation that it was tweaking its operating system to perform optimally by using its own Internet browser software and rejected those developed by rival companies. There is similarly a possibility that a camera manufacturer designs the product in such a way that film cartridge of a particular size would fit and an electric company may decide to make power point which would fit only a particular plug manufactured by the same company. Such anticompetitive behaviour needs to be regulated.

The regulation and protection of competition usually requires a competition (or antimonopoly) policy backed by an appropriate legislation. There are three basic areas of competition policy:

- Control of dominant firms by regulation.
- Control of mergers to prevent the possibility of monopolies
- Control of anti-competitive acts like full line forcing and predatory pricing (see Box 23.2)

In India, we had a long tenure of Monopolies and Restrictive Trade Practices (MRTP) Act, 1969 replaced recently by Competition Act, 2002 which was passed in December 2002 (see, chapter 19). In the UK, Competition Act, 1980 empowers the office of Fair Trading (OFT) to investigate anti-competitive practices. In the USA, the Anti-Trust Legislation seeks to control monopoly and restrictive practices in favour of competition. It specifically deals with price discriminations, exclusive dealings and interlocking directorates and shareholdings among competing companies.

TESTS OF A GOOD COMPETITION POLICY

The competition policy of a country generally refers to a set of government measures aimed at stimulating competition, encouraging growth, preventing monopolistic, restrictive and unfair trade practices, promoting efficiency and protecting the rights of the consumers. The policy should take into account not only the present state of competition but also potential competition and future prospects. It must discourage speculation and facilitate the building up of rational and healthy expectations with regard to the future. A good competition policy continuously monitors the competitive actions, reactions, strategies and counter-strategies of various firms in different market segments and must be able to distinguish between healthy and unhealthy (or unethical) practices. Corresponding to the dynamic character of competition, the competition policy has to be flexible to respond to the genuine needs and expectations of the producers, sellers, consumers and economic growth in general. In the present era of globalisation, the competition policy must be cast in the international, rather than national context. A good competition policy, broadly speaking, is expected to have the following contours:

- It should be capable of controlling the misuse of the market power of dominant firms. It should have a clear perception of dominance and should develop unambiguous criteria for determining the abuse of dominance.
- It should be able to identify the anti-competitive effects of mergers and acquisitions and provide a prescription to deal with the same.
- It should check barriers to entry subject to the provisions of industrial policy.
- It should be able to identify and monitor collusion, cooperation or alliances between independent firms in various institutional forms (like cartels and trade associations) to restrict, suppress or modify competition. Collusion may take a number of tacit or explicit forms and may involve output restriction, price fixation, distribution controls or market sharing. In many cases, collusions are designed to prevent the entry of potential firms.

- It should be capable of monitoring and preventing anti-competitive agreements between business organisations.
- It should be able to identify restrictive and unfair trade practices and provide a continuous mechanism to prevent the same. **Box 23.2** provides some main anti-competitive and unfair trade practices that a competition policy must deal with.
- It must ensure that competition leads to better productivity and efficiency and wider choice to the consumer.
- The policy should apply to all the major segments of the economy including agriculture, agribusiness, manufacturing, infrastructure, utilities and services.
- It must provide suitable defenses and protection measures to the marginal, vulnerable or weaker enterprises in the small-scale sector, which have national importance.
- The policy must accommodate international factors and influences in the national interest.
- The policy should be able to create a level playing field for various categories of enterprises and must target an optimum degree of competition, which is in the best interest of the economy from the point of view of growth, equity and social justice.

POLICY EFFECTIVENESS AND THE CONCEPT OF REGULATORY CAPTURE

As already pointed out, the competition policy must be flexible and adaptable to changing circumstances. Quantitative restrictions and limits often erode the basic spirit of the policy and sometimes prove counter-productive. For example, a ceiling of 30 per cent on the market share as part of definition of a dominant firm may deny it scale economies that may be necessary for it to be competitive in the global market. An investment ceiling, similarly, may discourage the flow of foreign direct investment. Limits on the size of employment to prevent a firm from obtaining a dominant position may compel firms to prefer capital-intensive technology leading to greater industrial unemployment. *The rules of the competition game have to be set prudentially, lest the policy may itself start generating anti-competitive effects.*

A feeble policy implemented with loopholes and indifference can create a worse situation magnifying the negative externalities of competition. *A situation called 'regulatory capture' arises when business organisations are successful in corrupting the regulators and obtain the official stamp of sanction on their anti-competitive and anti-consumer practices.* The regulatory watchdog must be effective and professionally managed with legislative support. It has to be kept free from political interference and the competition legislation and policy must be founded on logical, clear and realistic concepts and procedures.

BOX 23.2**Some Anti-Competitive and Anti-Consumer Practices that a Competition Policy Must deal with**

There has been great proliferation of anti-competitive and anti-consumer practices in the wake of growing competition all over the world. A large number of such practices are difficult to identify or simply go unnoticed due to the absence of complaints or indifference of regulatory agencies. Detection of such practices requires consumer awareness, alertness of regulatory authorities and reliable market intelligence and database systems. Different countries have different provisions to deal with such practices, the main types of which are the following:

- **Predatory Pricing** - Setting pricing at very low levels with the objective of weakening or eliminating competitors or to keep out new entrants. The prices are later raised after the above objectives are achieved. It helps in establishing and maintaining the monopoly power and exploiting the consumer.
- **Full-Line Forcing** - The exercise of market power to force a buyer to take a full range of products rather than only one or few actually demanded. Its another variant is tie-in sales in which the sale of a product carries with it a condition that some other product has to be purchased at the same time.
- **Vertical Restraints** - Restrictions or conditions imposed on the seller or buyer of an item (for example, the condition of buying a telephone handset from the same agency which provides the telephone connection).
- **Resale Price Maintenance** - The practice in which a manufacturer requires its distributors to resell the product at certain prices or at not less than minimum prices which he has set for his products. In UK, Resale Prices Act was passed in 1964 whereby the practice was stated to be against public interest.
- **Exclusive Dealing** - The restriction by a manufacturer on the distributors that they will not deal in the products of other manufacturers producing the same product or its substitutes.
- **Collective Price Fixation** - An agreement between sellers or buyers collectively to sell or buy products at pre-determined prices.
- **Market Sharing** - An agreement between independent sellers to divide the total market and allocate different segments between themselves to prevent competition and charge higher prices or fix arbitrary terms of sale.
- **Manufacturing Process Control** - An agreement between producers not to employ a particular technology or machinery so as to gain a competitive edge over others. This prevents adoption of better or new technology.
- **Association Boycott** - An agreement between the members of a business association providing expulsion or boycott of a member whose actions are in contravention to the purposes with which the association is formed.
- **Price Control Arrangement** - An agreement between independent firms through an institutional arrangement like a trade association or otherwise to sell products at predetermined prices so as to eliminate price competition.
- **Limiting Technical Development** - Measures undertaken by a firm to prevent technological development or capital investment by other firms so that competition is circumscribed.
- **Deceptive Practices** - Deceptive, unfair or veiled actions by a firm which have the effect of preventing or reducing competition in production, supply or distribution of a product.
- **Output Restriction** - Restricting or controlling the production or flow of goods and services causing unreasonably high prices.
- **Veiled Quality Deterioration** - Unreasonably lowering the quality of product in a veiled manner and selling the inferior product at same or higher prices.
- **False Representation** - Misleading actions, giving wrong impressions about product price, quality, discount, free gifts, renovated second hand goods passed as new, quality certification or sponsorship or usefulness of the product.

FACTORS CONTRIBUTING TO COMPETITIVE ENVIRONMENT IN INDIA

Since the beginning of economic reforms in 1991, there has been a gradual build up of the competitive environment in the country. The degree of competition in terms of various parameters, has increased in the various sectors of the economy including industry, finance markets, infrastructure and a large number of service areas. Competition has increased both in terms of the number of competing entities in most of the sectors as well as the role of the market mechanism. There has been a general trend towards deregulation and withdrawal of the government from the economic field. However, movement in this direction is slow and gradual but the signs are definite.

The major factors contributing to the competitive environment are the following:

PUBLIC SECTOR DISINVESTMENT AND PRIVATISATION

Since the beginning of the reform process in 1991, there has been an almost consistent programme of privatisation through public sector disinvestment. During 1991-2003, the sum total of the annual disinvestment targets was Rs. 78,300 crore of which, however, about 38 per cent was realised. Privatisation, as a matter of policy, is expected to spur competition leading to higher efficiency and productivity. In the early nineties, privatisation programme involved sale of minority stakes in some public sector undertakings. Towards the late nineties, the focus shifted towards **strategic sales**. In the year 2002-03, there was 100 per cent disinvestments in the ten hotels of India Tourism Development Corporation and one hotel of Hotel Corporation of India. Equity disinvestment was 26 per cent each in Hindustan Zinc Ltd., IPCL and Modern Food Industries (India) Ltd. The main objective of the privatisation policy was to unleash the productive potential of the public sector, preventing at the same time, emergence of private monopolies. The disinvestments programme is discussed in detail in Chapter 30.

OPENING UP OF NEW SECTORS TO PRIVATE ENTERPRISE

Another factor adding directly to competition has been the opening up of sectors earlier reserved for the public sector to private enterprise. During the last two decades, the number of Industries Exclusively reserved for the public sector has been gradually declining. In the new industrial policy of 1991, only eight industries were kept reserved for public sector operation and the number has now come down to only four viz. defense products, atomic energy, railway transport and specified minerals – the rest being open to the private or cooperative sectors. This de-reservation has led to increase in the number of firms in various segments where earlier only few public enterprises operated.

DELICENSING

Competitive environment in the country has significantly increased with delicensing of a large number of industries. *Delicensing reduces entry barriers, encourages the flow of private investment* and encourages competition. The new Industrial Policy of 1991 abolished the requirement of industrial licensing for all industries except 18 specified industries in which case compulsory licensing was retained due to their strategic, social and environmental importance. The exempted list was reduced to nine in 1997-98 and further to five later. Earlier, license was

mandatory for establishing a new industrial unit, expanding the capacity of an existing unit, changing the location of an existing unit or continuation of business units in certain cases. Under the present policy, freedom from licensing is available for substantial expansion of existing units. Further, industrial units enjoy broad-banding facility, which gives product flexibility to producers (Box 23.3). Greater freedom of entry into a large number of industrial segments has substantially brightened up the competitive environment in the country.

BOX 23.3

What is broad banding?

Broad banding refers to increase in the number of items that a licensed industry can produce within the licensed range of products. This facility is provided by specifying a broad or generic product group rather than specific products within a general category. *An industrial license for the manufacture of motorcycles, when broad-banded as two-wheelers, would include scooters and mopeds as well. Similarly, an industrial license for chemicals is much wider than license for manufacture of pharmaceuticals.* With broad banding, new firms can enter the industry and existing firms can expand their product lines and become more competitive through economies of scope (or diversification economies).

DE-RESERVATION OF SSI ITEMS

During the period 1996-2003, about 100 items earlier reserved for exclusive production by the small scale industries were de-reserved and allowed for production by medium and large industrial units as well. Some of the major items in the de-reserved list are garments, leather goods, sports goods and toys. *Not only this, about 600 items on the list of reserved products are now freely importable. These measures have increased competition not only between the domestic and foreign firms but also between small and large firms within the domestic economy.* The trend towards de-reservation started on a significant note following the recommendations of the **Abid Hussain Committee Report (1997)**, which, among other measures, recommended abolition of reservation. *The Second Census of Small Scale Industries revealed that 233 items, reserved for the SSI sector, were either not produced at all or were produced in insignificant volumes. Further, as many as 90 products in the SSI reservation segment were produced by only one firm each.* The de-reservation of a growing number of items has created conditions for greater competition in the economy as more medium and large firms can take up the production of de-reserved areas (also see Chapter 29).

LIBERALISATION OF FOREIGN DIRECT INVESTMENT (FDI)

Though the inflow of foreign direct investment in the country has been weak in spite of economic reforms and liberalisation of FDI policy, still the sustained rise in FDI brought in by the MNCs has added to the competitive environment. *There is, in fact, a two-way relationship between FDI and competition. FDI contributes to competition and existence of competitive conditions induces FDI inflow and MNC entry.* During 1991-2002, about 16,000 FDI proposals involving FDI amount only of Rs. 2,84,812 crore were approved. Against this approved amount, the actual inflow was Rs. 1,29,838 crore. In addition, about 7500 foreign technology agreements were approved as a result of which a number of firms with foreign technical collaboration with a wide range of

industrial segments have been established adding to competition. The favourite sectors of FDI and foreign technical collaborations have been energy (including power and petroleum refining), telecommunications (including basic telephone services, cellular mobile and radio paging), electrical equipment (including computer software and electronics, transportation, chemicals (excluding fertilizers), food processing industries and various services, the first three segments accounting for about one-half of the total FDI inflow during 1991-2002. These flows are more fully discussed in Chapter 35.

INFRASTRUCTURE DEREGULATION AND FACILITATION

Infrastructure deregulation has produced a twin effect from the point of view of competition:

- Increase in the number of firms engaged in infrastructure projects and related services; and
- Corporatisation of a number of public utilities and their functioning along modern corporate lines.

The government is in the process of setting up an equity fund of Rs.. 1000 crore to help equity investment in infrastructure projects. **Industrial Development Finance Corporation (IDFC)** has been entrusted with the responsibility of developing an institutional mechanism to coordinate debt financing by banks and All India financial institutions providing long-term finance in case of projects involving investment of Rs.. 250 crore and above.

In the power sector, by the year 2002, twenty two states had either set up or were in the process of setting up **State Electricity Regulatory Commissions** and nine State Electricity Boards had been corporatised. In telecommunications, competition has been introduced in almost all the service segments. The international long distance business has been opened up for unrestricted entry of new firms. The monopoly of VSNL over international long distance has ended. In its review of the competitive conditions in the cellular market, **Telecom Regulatory Authority of India (TRAI)** has recommended deregulation of the cellular tariff. The ambitious **National Highway Development Project (NHDP)** involving strengthening or multiple laning of about 13,000 km lengths of highways banks on private developers with market driven allocative mechanism and compensation systems.

In order to encourage private investment in major sea ports, bidding procedures and documentation and bid selection criteria have been streamlined and made transparent. Under the scheme of private sector privatisation for port development, more than 40 projects involving port capacity addition of about 160 million tonnes per annum and private investment of about Rs.. 10,800 crore are at various stages of evaluation and implementation.

In the civil aviation sector, there are two scheduled private airlines and 40 non-scheduled operators providing air taxi and air transport services. The annual number of passengers availing air services of the private operators increased from just 15,000 in 1990 to about 6.7 million in 2001. At present, private operators account for more than one-half of the total air traffic of passengers. Disinvestment of Air India and Indian Airlines is already on the cards. In urban infrastructure, there is provision of 100 per cent FDI but there has been hardly any inflow of foreign investment in this segment. *These aspects are discussed in greater details in Chapter 31.*

IMPORT COMPETITION

During the reform years, competition has increased not only between the domestic enterprises but also between domestic and foreign firms via imports. With the gradual progress towards trade liberalisation under the WTO regime, the level of imports in a number of product areas has increased consistently, changing the competitive scenario in the country. The country's imports, which were \$ 24.1 billion in 1990-91, stood at \$44.9 billion in 2001-02. Most of the imports are industrial goods so that import competition is more intense in capital goods and raw materials. Of late, import competition has increased in electronic goods and small valued products, which are of concern to small-scale industries. Some of the major products in which import competition has substantially increased are food and allied products, chemicals, iron and steel, medicinal products, computer software (physical form) and professional equipment (Table 23.1). *The rise in imports in recent years has been mainly due to falling import tariffs, removal of quantitative restrictions and overall liberalisation of the import regime. The mean collection rate (defined as the ratio of realised import revenue including additional custom duty, countervailing duty and special additional duty) to the value of imports, which was 47 per cent in 1990-91 consistently declined to 16 per cent in 2001-02.* A large number of items, which were on the negative import lists earlier, are now freely importable. Trends in India's foreign trade are more fully discussed in Chapter 34.

Table 23.1: Composition of India's Import Basket 2001-02

Sr.No.	Product	% Share in total imports
1	POL ¹	27.2
2	Capital goods	11.4
3	Pearls, precious stones	9.0
4	Gold and silver	8.8
5	Electronic goods	7.4
6	Chemicals	5.4
7	Professional equipment and optical goods	2.0
8	Others	28.8
All Products		100

Note: ¹Petroleum, oil and lubricants.

Source: Govt. of India, *Economic Survey*, 2002-03, Table 6.8, p. 108

HIGH-GROWTH INDUSTRY SEGMENTS

A competitive environment is characterised by a large number of firms in each product category. The smaller the number of firms, the narrower is the competition. Competition in a market in which there are few firms (called **non-collusive oligopoly**) is generally more intense as compared to competition between a large numbers of firms. A strategic action taken by one firm induces

matching competitive reaction from the rival firms, which are always alert to maintain or even increase their market share. Then there are market situations in which a few firms dominate the market with substantial market shares and a large number of smaller firms together claim a small market share. The firms with high monopoly power are in close competition with each other while others operate within narrow local or regional markets or are content in their respective niche areas. These are hybrid market forms, which depict the characteristics of both oligopoly and monopolistic competition.

The decade of 1990s witnessed intensification of competition in a large number of consumer and industrial product areas. The degree of competition has been varying between different industrial segments as well as within segments over the years. In the competitive process, a large number of firms entered, made exit or underwent mergers or acquisitions. The growth has been relatively faster in such products as automobiles, washing machines, air-conditioners, communication products (like mobile handsets), TVs, computers and peripherals. In the intermediate products category, polyester filament yarn and packaging products have registered imperative growth. In terms of growth of domestic consumption, most of the top 20 items were in the category of consumer durables. To a good extent, it reflects the rise of consumerism in the wake of growing competition, which has brought forth a large number of new and innovative consumer products generating consumer interest. Table 23.2 lists the industries that have experienced annual growth rate of 20 per cent or above during 1991-2001.

Table 23.2: List of industries which have experienced annual growth rate of 20% or above in increased competition during the reform years 1991-2001

(% per annum)

Industry	Growth rate	Industry	Growth rate
Acetic acid	20.8	Energy metals	24.4
Printing ink	25.8	TV picture tubes	20.3
PVC	24.7	Medical equipments	20.4
Synthetic resins	21.0	Process control equipments	22.0
Polyester films	25.3	Computers and peripherals	27.9
Packaging goods	27.7	Passenger cars	23.1
Plastic tanks, containers etc.	20.3	Multi utility vehicles	24.7
Rubber contraceptives	20.5	Motor cycles	23.4
Cycle tubes	21.0	Three wheelers	24.6
Floor, wall tiles	20.9	Piston rings	22.6
Ophthalmic glass and contact lenses	29.6	Gaskets	20.7
Sponge iron	21.1	Carburetors	24.7
Copper and products	20.0	Steering gear	22.9
Air-conditioning equipment	22.9	Shock absorbers	22.7
Washing machines	112.7	Brake rings	20.0

Source: Extracted from CMIE (2002), *Industry Market size and Shares*, August pp. 3-6

There are however an equally large number of industries where the impact of better competitive environment on growth is not realised. This can be related to a number of factors such as failure to attain cost competitiveness, lack of product innovation, technological stagnation or stickiness of demand. Such factors vary widely across industries.

INDIA'S PRESENT COMPETITION POLICY

India's present competition policy is contained in the latest **Competition Act 2002**. The basic objectives of the Act are:

- to prevent practices having adverse effect on competition;
- to promote and sustain competition in markets;
- to protect the interests of consumers; and
- to ensure freedom of trade carried on by other participants in one market.

The Act covers the whole of India except the state of Jammu and Kashmir and replaces the earlier MRTP Act (see **Chapter 19**). The Act prohibits anti-competitive agreements or arrangements as mentioned in **Box 23.2**. It further prohibits the abuse of dominant position of a firm which enables it to operate independently of competitive forces prevailing in the relevant market or affects its competitors, consumers or the relevant market in its favour. The Act seeks to regulate takeovers, mergers and amalgamations between firms which have the effect of reducing competition.

Competition Commission of India (CCI) is established under the Act which he entrusted with the task of eliminating practices having adverse impact on competition, protecting the interests of consumers and ensuring freedom of trade carried on by other participant. Under the Act, while determining the adverse effect or competition, the following six factors or criteria are taken into account:

- Creation of barriers to new entrants in the market;
- Driving existing competitors out of the market;
- Foreclosure of competition by hindering entry into the market;
- Accrual of benefits to consumers;
- Improvement in production or distribution of goods and services; and
- Promotion of technical, scientific or economic development by means of production or distribution of goods and services.

The commission further has the responsibility of providing advice to the government on matters relating to competition policy. It is obliged to take suitable measures for the promotion of competition advocacy, creating awareness and imparting training on competition issues.

Key Terms

Amalgamation	Interlocking directorates	Regulatory capture
Broadbanding	Limit pricing	Resale price maintenance
Collective price fixation	Merger	Strategic alliance
Contestability	Monopolistic competition	Strategic sale
Exclusive dealership	Oligopoly	Takeover
Foreign direct investment	Perfect competition	Vertical restraints
Full-line forcing	Predatory pricing	

Supplementary Readings

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Long Questions

1. Discuss how liberalization, privatisation and globalisation have contributed to the growth of competitive environment in India since 1991. What has been the effect on increased competition on growth?
2. What are the tests of a good competition policy? Assess India's competition policy as reflected in the competition act on the basis of such tests.
3. Discuss how public sector disinvestment and foreign direct investment have affected competitive environment in the country.

Short Questions

1. What is competition? Distinguish between competition and contestability
2. What are the benefits and wastes of competition?
3. Should the concept of competition be applied to the public sector as well?
4. What is perfect competition? What is the use of the concept?
5. Why should competition be regulated? What are the disadvantages of unbridled or cut-throat competition?
6. Identify five industrial segments in Indian economy where the level of competition is high.
7. What are the tests of a good competition policy?
8. Explain and illustrate the concept of 'regulatory capture'.
9. List five major factors that have contributed to the growth of competitive environment in India.
10. Give salient characteristics of competition policy in India.

Practical Assignments

1. Make a survey of the wholesale or retail trade in selected products in your region and collect atleast two cases in respect of each of the following:
 - a) Full-line forcing
 - b) Vertical restraints
 - c) Tie-in sales
 - d) Resale price maintenance
 - e) Collective price fixationDiscuss these cases in the class and suggest ways to control such practices.
2. Hold a group discussion on '*Has Public Sector Disinvestment led to Increased Competition in India?*' Record the outcome of the discussion.
3. Identify some areas of regulatory capture in India and suggest ways to deal with the problem.

MONEY MARKET IN INDIA

Chapter Outline :

- Introduction
- What is a Financial System?
 - Nature of Financial Intermediation
 - The three Pillars of a Financial System
 - Basic Functions
 - Hallmarks of a Developed Financial System
- Indian Money Market: Institutional Structure and Instruments
 - Call Money Market
 - The Bill Market
 - Commercial Bill Market
 - Treasury Bill and REPOs Market
 - Market for Certificates of Deposit
 - Commercial Paper Market
- Recent Developments
- Conclusion

INTRODUCTION

The financial system of a country can be divided into financial markets, financial institutions and financial instruments. A financial market is generally divided into money market and capital market; the former being the market for liquid or short-term assets and the latter for long-term assets. The money market itself is a system of interrelated sub-markets, which generate liquidity in the economy. An efficient and developed money market is essential for the smooth operation of the monetary and credit policy and for overall economic growth. The instruments traded in the market are, in general, highly liquid, have short-term character and involve low degree of risk. Before studying the Indian money market, it would be useful to look into the broad nature of a financial system within which it operates.

WHAT IS A FINANCIAL SYSTEM?

Financial system is the institutional arrangement for efficient transfer of financial surplus from the savers (predominantly in the household sector) to the deficit-spenders (particularly the business sector and the government). The task is performed by a large variety of financial institutions through a number of financial instruments using innovative financial technology. This important function is known as 'financial intermediation and the institutions are termed as 'financial intermediaries', which can be classified in a number of ways. The institutions derive their existence from the basic fact that it is very difficult or expensive for the deficit spenders to reach out to the widely dispersed millions of surplus savers to meet their financial requirements and they invariably and indispensably require the intermediation of the financial institutions. Surplus savers also prefer to lend their funds to financial institutions, particularly to the established ones in the organised sector, rather than lending directly to the deficit spenders as it involves lower risk, provides greater liquidity and convenience and makes available various services provided by financial institutions. Borrowers, while dealing with the institutions, have greater certainty about the availability of required finance at relatively lower interest. This, however, is not necessarily the case when the financiers are in the unorganised sectors.

NATURE OF FINANCIAL INTERMEDIATION:

While there are strong reasons for borrowers and lenders to operate through financial intermediaries, there is a sound economic rationale for financial institutions to take up this type of business activity. The logic can be seen in the following points:

- **Economies of Scale.** Since financial institutions, particularly in the organised sector, operate on a large scale. They reap substantial economies of scale which lowers their transaction costs and extends profit margins.
- **Liquidity Pricing.** Financial institutions can convert a primary security with longer maturity into another security of their own with shorter maturity, generating liquidity in the process, which can be of value to the holder of the short-maturity security. The institutions can charge a price for the liquidity so produced.

- **Risk Reduction.** The institutions have fund operations on a large scale which enable them to diversify their portfolios and thus reduce risk. It is difficult for the small investor or wealth-holder to spread risk, as his resources are limited.
- **Satisfying Diverse Investor Preferences.** Financial institutions have the potential or capability to satisfy diverse investor choices and preferences as they can produce and market a customer-focussed set of securities with different characteristics suited to saver or investor preferences. Much, of course, depends on the institutions' understanding of the savers or potential investors, innovativeness of financial products, risk and return characteristics of the securities developed and marketing skills.
- **Professionalisation of Financial Management.** The institutions are in a better position to engage finance professionals and experts to take care of the management of funds and financial services. They can offer various combinations of risk, return, liquidity and tradability of the securities they develop to prospective investors and in the process enable the investors to take advantage of the skills of these professionals' financial managers. This assures the institutions about the market for their securities.
- **Small Investors' Convenience.** The operations of the financial institutions make prudent investment by small investors quite convenient as the schemes of the institutions are generally well advertised and are available to prospective investors through a widespread network of agents. It saves the investors from the need to spend time and incur cost of making investments directly on their own.

THE THREE PILLARS OF A FINANCIAL SYSTEM

The institutional structure of the financial system of a country rests on three pillars.

1. **Financial Market.** A financial market refers to the interacting groups of borrowers and lenders and to the mechanism through which funds are transferred or transacted between them. In this market, financial assets are traded and yield rates are determined. Depending upon the nature and extent of financial development, a range of financial sub-markets exist which are often interrelated and deal with different types of financial assets. Nevertheless, all types of financial markets can be classified into money markets and capital market, the former being the market for liquid or short-term assets and the latter for long-term assets (as mentioned earlier). These markets, in India, are detailed in subsequent sections.
2. **Financial Institutions.** As already discussed, the basic function of financial institutions is to connect the classes of lenders and borrowers and, through an institutional arrangement, facilitate movement of funds from the former to the latter. They convert direct securities issued by the business firms into indirect securities to large classes of individual and institutional investors through their intermediation function. Depending upon the types of assets or securities dealt with, these institutions participate in money market or capital market or both. These institutions play a great role in converting savings into investment - a process that is called capital formation. These institutions reduce financial constraints to economic growth, improve liquidity in the economic system and absorb risk thereby creating favourable conditions for business.

3. **Financial Assets or Securities.** The range of financial assets, securities or instruments used or traded in the financial market is a leading indicator of its state of development and maturity. The larger the variety of the securities, the more adequately are the requirements of diverse groups of investors met. These assets or securities are the creation of the borrowers including the financial institutions (which are lenders as well). The various securities can be ownership securities involving risk (like ordinary shares), creditorship securities (like debentures), which entitle the holder to a pre-determined rate of interest and interest income, or hybrid securities (like preference shares), which contain elements of the both. In addition, there are a variety of innovative financial instruments catering to specialised requirements of borrowers and lenders. Such instruments are discussed in the subsequent sections.

BOX 24.1**What are Financial Securities?**

'Security' is a widely used term. In a wider sense, securities are the documents that give title to property or claims on income, which can be lodged, for availing credit or loans. These are also income-yielding assets which are traded in the secondary market like a stock exchange. Securities are tradable or saleable and include such assets as shares, debentures, bonds, bills of exchange and warrants. Securities issued by the government are called gift-edged securities and have low or no risk.

BASIC FUNCTIONS

The basic functions of a financial system may now be summarised as follows:

- **Motivation for Savings.** It provides motivation for savings by offering a wide variety of securities to cater to a variety of savers' or investors' preferences. The securities provide a wide choice of portfolios with different combinations of risk, return, maturity and liquidity. The securities are divisible, convenient to hold, storable and provide hedge against inflation. These savings are extremely important from the point of view of economic growth.
- **Mobilisation of Savings.** The system mobilises the savings to enable the subsequent financing function. Ability to mobilise savings depends upon the quality of securities issued and marketing skills of the financial institutions. The mobilisation takes place through bank deposits, equity shares, bonds, life insurance policies, units of mutual funds etc.

Saving mobilisation can be direct as well as indirect. Mobilisation is direct when ultimate borrowers (like government or companies) issue and sell their securities (called primary securities) like bills, fixed deposits, equity shares or bonds directly to the surplus holders or prospective investors. Mobilisation is indirect when financial institution as intermediaries buy primary securities of the ultimate borrowers and issue secondary securities to the ultimate savers, lenders or prospective investors. This is also called transmutation of securities, which is a highly skilled work and requires the development and application of a sophisticated financial technology. Indirect mobilisation is generally much more effective than indirect mobilisation. Much, of course, depends upon the state of development and regulation of the primary and secondary security markets.

- **Fund Allocation.** The financial system allocates the funds mobilised from the lenders and investors to the ultimate borrowers or deficit spenders by subscribing their primary securities or through direct lending. In this process, the ultimate lenders (in case of direct financing) and financial institutions (in case of indirect financing) have to bear the risk at their own level. Financial institutions in case of indirect financing are far more capable than individual lenders to assess and cover the risk of financing. Whether the financial system is able to cater to the financial requirements of a large number of highly dispersed firms depends upon its allocative efficiency. The allocative function, in itself, depends upon the degree of development and reach of the system. A developed financial system is able to mobilise and allocate funds of different sizes, types and maturities from a wide variety of lenders and allocates the same to equally diverse groups of borrowers.
- **Risk Absorption.** A financial system is not merely involved in the fund transfer process but also absorbs risk particularly through financial intermediation. The risk is made possible through the development of sophisticated financial technologies, innovative financial instruments and professionalisation of financial services. Failure to absorb risk can seriously hamper the growth of financial markets and keep the overall financial system in a state of backwardness. Risk absorption is an important function of the financial system, which creates favourable conditions for the growth of business.

These are the basic functions of a financial system. *How well these functions are discharged, depends upon the status of the financial markets, the saving capacity of the individual lenders, the efficiency of the financial institutions, the quality of financial market regulation and, of course, the demand for new investment in the business sector which itself depends upon the state of business environment.* From the macroeconomic point of view, the existence of a well-developed financial system is a sine qua non for accelerated economic growth.

HALLMARKS OF A DEVELOPED FINANCIAL SYSTEM

A well developed financial system has the following distinctive characteristics.

- **Equity.** It must be equitable in the sense that it takes care of the interests of the borrowers and lenders in a balanced manner and is not prejudicial or detrimental to the interest of one section or the other.
- **Allocative Efficiency.** The system is capable of transferring the funds efficiently and adequately to the different classes of deficit spenders so that no particular segment of the business sector is starved of funds. The system has a wide reach and is able to use modern technology to push the funds to the various segments where these are required. Failure to do this can create imbalances in the growth process.
- **Efficacy.** The system is effective in the mobilisation and allocation of funds. The system is actually capable of siphoning off funds from the surplus savers and lenders to where these are required.
- **Transaction Costs.** The system is capable of keeping the transaction costs minimum. This enables the financial institutions as well as the ultimate borrowers to maintain competitiveness.

- Risk Absorption. As already pointed out, risk absorption is an important function of the financial system. The system, through innovative financial technologies, products and services is able to minimise the risk and create favourable conditions for business growth.
- Adequacy of Returns. The system is able to provide adequate financial returns to lenders as well as to the intermediating financial institutions. This pre-requires that the value addition in the financial sector is substantial and that the funds are deployed in areas where risk is low and return is high. When returns are low, incentive to save is dampened and financial operations become less attractive.

These hallmarks also serve as the criteria or the benchmarks against which the soundness and the degree of development of a financial system can be assessed. It must be commented that no financial system can grow in isolation. It requires a favourable business environment, both for financial and non-financial organisations, and enabling macroeconomic policy framework and existence of profitable opportunities. Private enterprise, competitive conditions and globalisation of the financial markets spur the growth of the system. A number of developing countries like India have initiated a series of financial reforms in the above areas.

INDIAN MONEY MARKET: INSTITUTIONAL STRUCTURE AND INSTRUMENTS

Simply stated, money market is the market for money and short-term financial assets, which are close substitutes for money and are highly liquid. Box 24.2 gives the characteristics of a developed money market.

BOX 24.2

Hallmarks of a Developed Money Market

The hallmarks of a developed money market are the following:

- Existence of a well-developed and highly organised commercial banking system.
- Existence of a strong central bank as the money market regulator.
- Availability of a wide variety of financial instruments for both borrowers and lenders.
- Existence of a number of highly developed and specialised sub-markets, which are closely integrated.
- Existence of a large number of players in a competitive environment.
- Prevalence of a developed information and communication network.
- Minimum government intervention and restrictions in the money market.

Money market generally does not have a formal place of transactions like a stock exchange. Most of the transactions are initiated through oral or telephonic communication, which are subsequently confirmed and documented. The central bank, along with the network of commercial banks, plays a central role in the money market functioning. The central bank acts as the creator and regulator of liquidity while the commercial banks are the predominant creators of short-term assets. The two institutions together are highly instrumental in the implementation of the monetary policy.

The Indian money market mainly consists of the call money market, bill market and the markets for certificates of deposits, commercial papers and repurchase options (REPOs). The call money and bill markets have been the traditional components while the other components are relatively recent in origin. RBI has been regulating the money market through the REPOs and thus controlling the liquidity conditions. Following the recommendations of the Chakravarty Committee and the Vaghul Working Group, efforts have been made to broad-base the money market. The relative growth of the different components of the sub-markets of the Indian money market is shown in Table 24.1. The Table shows the outstanding amounts in the instruments of the different segments of the market in recent years.

Table 24.1: Growth of the Different Components of the Money Market, 1991-99

(Amount Outstanding in Rs' 000 Cr)

Year	Money at call and short notice	Treasury bills	Bills purchased discounted	Bills rediscounted	Certificates of deposit	Commercial papers
1991-92	3.1	12.6	14.5	3.9	5.7	0.3
92-93	4.6	10.1	14.7	0.8	9.8	0.6
93-94	4.2	15.2	18.2	0.6	6.0	3.3
94-95	4.6	8.9	25.1	1.2	8.0	0.6
95-96	6.3	8.9	29.6	0.4	16.3	Neg.
96-97	9.3	14.7	26.8	1.0	12.1	0.6
97-98	23.6	18.1	n.a.	0.3	14.3	1.5
98-99	33.0	11.9	n.a.	0.5	3.7	4.8

Source: Annual Reports of the Reserve Bank of India, various years

The Indian money market has both organised and in organised components. The various components of the market are discussed below.

CALL MONEY MARKET

It is the principal component of the Indian Money market. It is the market for loans of very short maturity ranging from overnight loans to loans with short maturity. Such funds are called money at call and short notice. One distinctive feature of such funds and loans is that they can be withdrawn by the lender immediately or at periods of notice of up to fourteen days. Commercial banks are the predominant players in this market. Borrowings in the market are for short period and are raised to meet transitory requirements of the funds.

Call money centres are mainly located in Mumbai, Kolkata, Delhi, Chennai, Ahmedabad and Mangalore. Most of the funds are lent on overnight basis and the rest mostly at a short notice of about two weeks. During the decade 1989-99, the RBI has been permitting more and more players in the call money market. However, since the year 1999, on the recommendation of the Narasimham Committee, the market has been restricted only to commercial banks, Discount and Finance House of India (DFHI), Securities Trading Corporation of India (STCI) (Box 24.3) and primary dealers as the market makers. Because of the leading position of banks, it is called Interbank Call Market.

BOX 24.3**The Basic Nature of the Discount and Finance House of India (DFHI) and the Securities Trading Corporation of India (STCI)**

The DFHI was set up on the recommendations of the Working Group on the Money Market by the RBI jointly with public sector banks and all India financial institutions to deal in money market instruments. It was incorporated on March 8, 1988 under the Companies Act 1956 with an authorised capital of Rs. 100 crore. Its basic purpose is to provide greater liquidity to money market instruments and operates as a professional dealer in the market. It is an active trader in various instruments like commercial and treasury bills, certificates of deposit and commercial papers. Its cumulative turnover from inception to the year 2001-02 has exceeded Rs. 5,00,000 crore. It regularly quotes bid and offer rates for the rediscounting of treasury and commercial bills. It has refinance limits from the RBI and also has an overdraft limit from a consortium of banks which provide it investible resources. Its activities broaden the secondary money market with assured liquidity to the instruments. It is also authorised to undertake transactions in REPOs.

STCI started operations from June 1994. It basically deals in government securities to broaden and deepen the market and also has operations in call money market. Over the years, its business turnover has appreciably increased.

Banks are in a lending position when their reserves are in excess of the minimum Cash Reserve Ratio (CRR) requirements set by the RBI or when they have surplus funds due to low credit-deposit ratio. Conversely, they turn out as borrowers when their reserves fall below CRR requirements or when their credit-deposit ratio is high. Asset-liability mismatches are also among the reasons for the banks to lend or borrow in the market. **Box 24.4** exemplifies the operation of the inter-bank call market.

BOX 24.4**How Do Banks Determine their Borrowing or Lending Position in the Inter-Bank Call Market?**

Borrowing or lending position of a bank in inter-bank call market is determined by its head office. The position is estimated on the basis of projection or extrapolation of its cash-reserve position calculated on a fortnightly basis taking into account its net demand and time liabilities. Alternatively or complementarily, banks also determine their surplus (lending) or deficit (borrowing) position on the basis of information obtained through a number of pre-identified critical branches. In this way, the banks assess their daily position and enter the market the next day to discharge their position. The adjustment is made before the market closes. In order to avoid penalty on default on CRR requirements as laid down by the RBI, the banks generally maintain a safety margin as a result of which their actual ratio is more than what is required.

Call market rates are inherently volatile. However, the arbitrary operations of the DFHI, as market makers, have a cooling effect on volatility. The gradual broadening of the interbank call market has also brought stability to the call rates which is important for the growth of the market.

Indian interbank call market is characterised by a large number of borrowers and a few lenders. The State Bank of India is the leading lender which alone accounts for more than 50 per cent lending in the market. Variations in the call rate depend, among other factors, upon the liquidity conditions of the market. In this regard, RBI plays an important role through its various

liquidity facilities offered to banks. Fluctuations in call rates are induced mainly on account of the following factors:

- Changes in the cash reserve ratio of the banks on a day-to-day basis.
- Asset-liability mismatches.
- Variations in credit-deposit ratio.
- Variations in cash balance of the banks.
- Periodic advance tax payments by business firms leading to substantial fund withdrawals from the banks compelling the latter to borrow from the market.
- Bunching of oil payments abroad, which reduce the ability of SBI to lend in the market.

During 1996-2000, the interbank call money lending rates fluctuated between 52.2 percent and 0.1 percent on the basis of monthly weighted averages. The coefficient of variation was highest at 86 percent in 1997-98 compared to 12.7 percent in 1999-2000.

The fund and liquidity position in the market is also significantly impacted by the borrowing operations of the government and transactions in the foreign exchange market (i.e. the transactions of foreign currency against rupee).

The growth of the call market was nearly stagnant during the period 1992-95 (Table 24.1) Since the year 1994-95, there has been rapid growth of the market. It has been largely due to the entry of more participants as a result of financial sector liberalisation that has taken place over the last decade. Operations of the Discount and Finance House of India and Securities Trading Corporation of India have also significantly contributed to the growth of the market. These institutions are described later in the Chapter.

THE BILL MARKET

Bill market is another important component of the Indian money market which meets the credit requirements of private trade and industry as well as the government and, at the same time, facilitates an efficient system of payments (Box 24.5).

BOX 24.5

Nature of a Bill

A bill is a document, which provides an evidence of indebtedness of one party to some other. It can simply be in the form of a written order for products, which can be used by the seller as a security to obtain loan from a financial institution. A commercial bill (also called Bill of Exchange) is a written and unconditional undertaking by the drawee (buyer of products) to pay to the drawer (seller of products) a sum of money at a given date in future. It can be endorsed for payment to the bearer or any named person other than the original drawee. A commercial bill becomes a trade bill when it is accepted by a trader and a bank bill when accepted by a bank. Once accepted, it can be sold in the money market at a small discount. Another important type is a treasury bill, which is an instrument for short-term borrowing by the government.

COMMERCIAL BILL MARKET

The commercial bill market in India has existed in the traditional Hundi form. The market has been developed, reformed and regulated, following the recommendations of a number of committees and provisions of schemes such as RBI's Bill Market Scheme 1952, Narasimham Committee (1970), the Bill Rediscounting Scheme (also called New Bill Market Scheme which continues to-date though in modified form), Sukhmoy Chakravarty Committee and Vaghul Working Group.

Commercial bills are like postdated cheques drawn by the sellers on buyers for the value of the products transacted. In general, commercial bills have a maturity period of up to three months. These are important instruments of short-term finance to industry and trade. These bills are tradable and can be resold any number of times in the money market. The bills can be categorised into demand or sight bills and time or usance bills. The former are payable on demand or at the time of presentation whereas the latter are payable after a certain period of time (generally 30, 60 or 90 days). This maturity period is specified in the usance bill itself. Thus, demand bill entails no credit for the buyer of products though it allows time for transit of the products.

Banks are an integral part of the commercial bill market. Demand bills are purchased by the banks on behalf of the customers (generally the supplier business firms) subject to a maximum limit granted in each case. The bank, in the process of bill purchase, retains possession of documents of ownership of goods (like railway receipt or lorry receipt which is endorsed in the name of the bank) till the payment of bill is made by the customer party. The banks discount time or usance bill. Discounting refers to the purchase of a bill at its discounted value, the discount being equivalent to the amount of interest due on it. The discounted price is obviously less than the face value of the bill. As it involves the risk of default, a bank generally accepts and discounts bills of the business firms having good market standing and creditworthiness. The market, however, is not well developed in India mainly because of the following reasons:

- There is lack of bill culture in the business sector.
- A large number of business firms do not accept the payment discipline of the bill market.
- There is absence of a separate specialised class of discount houses.
- There is widespread prevalence of cash-credit system, which discourages the growth of bill business.

In spite of the above constraints, the commercial bill market is larger than the call market. The growth of the market has been slow as can be seen in Table 24.1. The value of bills purchased and discounted stagnated during 1991-93, but rose significantly during 1993-96.

TREASURY BILL AND REPOS MARKET

Treasury bills (T-bills) in the money market are the instruments of short-term finance and have a maturity period of 91 days and 182 days. The government issues these bills to meet its short-term liquidity requirements. They are also a handy and useful fiscal instrument which enable the banks to meet their statutory liquidity ratio and CRR requirements as they can park their funds in these instruments to meet the statutory ratios. T-bills combine in them the features of liquidity and

safety for which reason they are also referred to as gilt-edged securities. Though originally intended to be used as instruments to meet temporary shortfalls in revenue receipts, these have become a permanent source of borrowings.

Treasury bills are also sold on a discount basis, the rate of discount being the rate of yield. The sale of T-bills is generally through auctions, which take place frequently. The yield rate is determined at the auctions. Since 1987, RBI has been providing refinance facility in order to provide easy liquidity to the bills. DFHI is an active participant in the T-bills auctions and trades in the secondary market for the bills by providing bid (buy) and offer (sell) rates on a daily basis with small spreads. In addition to direct buying and selling of bills, DFHI operates REPO (Repurchase Options) facility under which it undertakes to buy and sell T-bills, the commitment varying for periods up to 14 days (Box 24.6). The commitments are given to banks, financial institutions and other permitted organisations at interest rates which are negotiated in advance. The REPOs, thus, become an additional instrument available with the banks to adjust their SLR and CRR to the RBI requirements. The RBI signals its intentions for the short-term money market by changing the amount and rate of interest of refinance to the DFHI. REPO facility has considerably eased the pressure of demand on RBI refinance from banks and financial institutions. The T-bill market has now been considerably broadened. Earlier, the participants in the market were the RBI (a major holder of T-bills), banks and term-finance institutions like IDBI, IFCI, ICICI, LIC and UTI. Now a number of corporate organisations and other entities have been allowed to play in the T-bill market. Foreign institutional investors are also allowed to buy and sell T-bills subject to certain limitations.

BOX 24.6

What are Repos? How are they useful?

Generally speaking, a REPO (Repurchase Option) is a contract or agreement between a seller and a buyer under which the seller sells a security with a commitment to repurchase or buy-back the same at an agreed price and date. The security can be a loan, a commercial bill, a treasury bill or any other instrument, which is generally of a short-term nature and is issued as a collateral. The agreement binds the buyer to sell the security to the same party from whom he had bought it earlier at the price and date as per contract. Repos impart liquidity and tradability to the securities transacted and serve as a hedging instrument for both the parties in the transaction against any volatility in the price of security. Repos have a large potential to contribute to the development of the money market.

Repos were first developed in the US. These are widely used as a method of borrowing by large corporations, banks and non-bank institutions. The sale and repurchase agreements concerning government securities are called gilt repos.

MARKET FOR CERTIFICATES OF DEPOSIT (CDs)

A certificate of deposit is a negotiated claim issued by a bank in return for a time deposit. CDs, as securities, are generally purchased at a discount (i.e. at a price less than its face value) and in this way a bank promises to repay the deposit offering a yield to maturity (see Box 24.7). The advantage to a depositor is that he can sell his CD in the market. If this market is well developed,

he will be willing to park his deposit with banks for long periods. This market imparts liquidity and tradability to the term deposits. CDs were first developed and issued in New York, USA in the 1960s. Sterling CDs were later issued in 1968.

In India, CDs as an instrument for the money market were evaluated by the Tambe Working Group (the working group on money market constituted by the RBI which submitted its report in 1987). The Group did not favour the introduction of CDs because of (a) absence of secondary market (b) administered interest rate structure on bank deposits and, (c) possibility of fake and fraudulent transactions. Later, in 1987, Vaghul Working Group looked into the desirability of introducing the instrument. The Group felt that for the instrument to be meaningful, it was necessary to link the deposit rates with the remaining interest rate structure of the financial system. The Group underscored the significance of the instrument but did not recommend the introduction of the same, like the earlier Group, unless appropriate conditions were created for the same.

The market for CDs was firmly set up in India when the RBI scheme on CDs was announced in its credit policy in March 1989. The scheme has been amended and reformed a number of times since then. The main characteristics of the present CD market are as follows:

- CDs can be issued only by scheduled commercial banks with a minimum value of Rs. five lakh and in subsequent multiples of Rs. one lakh.
- The maturity period of a CD ranges from three months to one year.
- CDs can be subscribed by individuals, corporates, trusts, funds, associations and NRIs on a non-repatriable basis.
- CDs are freely transferable by endorsement.
- CDs cannot be used as security against loans.
- Issuing bank cannot buy back a CD before maturity.
- Banks have to maintain statutory reserve ratio requirements on the issue price of the CD.

BOX 24.7

Calculating Effective Discount on a Certificate of Deposit

As already pointed out in the text, certificates of deposit are issued at a discount on the face value. The discount can be either front-end or rear end. In case of front-end discount, effective rate of discount works out to be higher than the nominal or quoted rate of discount. Effective discount can be computed with the help of the following formula:

$$De = \left[\left(1 + \frac{D_n}{100t} \right)^t - 1 \right] \cdot 100$$

Where De = effective discount; D_n = nominal discount rate; t = time period.

In case of rear end discount, a certificate of deposit yields only the nominal rate on maturity. In this case, the formula is

$$De = \frac{t \cdot F}{D_n t + 100t} \cdot 100 = \frac{100F}{100 + D_n}$$

Where F = face value of the certificate.

The growth of the market for certificates of deposit has taken place at a highly uneven pace. In fact, there have been sharp upswings and downswings in the CDs market since its development. The fluctuating growth of the market can be seen in Table 24.1. In terms of outstanding amounts of the CDs, there has been sharp growth during 1991-93. After slump in 1993-94, there has again been sharp growth during 1994-96. Thereafter, there has been decline till 1997-98. The outstanding amount nose dived from about Rs. 14300 crore at the end of 1997-98 to just about 3,700 crore at the end of 1998-99. The sharp variation in the market turnover is closely related to the liquidity conditions. Under conditions of excess liquidity, the CDs market plunges into slump. The secondary market in CDs is just in a stage of infancy and will require quite some time to develop.

COMMERCIAL PAPERS MARKET

A commercial paper is a special form of promissory note usually issued by large corporate houses. However, in countries like Spain and Japan, these are commonly used by small business as a means of finance. These papers have a short-term and fixed maturity period and are unsecured. Commercial papers were first introduced in India on the recommendation of the Vaghul Working Group in 1987. As commercial papers are unsecured, the lending banks have only a general (rather than specific) claim upon the assets of the issuing company. A few banks maintain lines of credit for commercial papers. Under a line of credit, a lending bank has pre-arrangement with a borrowing company under which the latter can borrow upto a certain pre-arranged limit. The papers are issued by non-banking companies and all India financial institutions of high market credibility and standing and the interest rate offered on the papers is generally less than the average interest rate offered by banks on their credit.

The commercial paper scheme was formally launched by the RBI in January 1990 with guidelines which have been modified and liberalised according to the conditions and developments in money market from time to time. The present guidelines are as follows:

- The net worth of the issuing company should not be less than Rs. four crore and the same limit applies to fund-based working capital.
- Shares of the issuing company should have been listed in atleast one of the stock exchanges. Government companies and closely-held companies are exempted from this provision.
- The issuing companies should enjoy good credit rating.
- The bank advance of the issuing company must be classified as standard asset.
- The minimum amount of commercial paper issue should be Rs. five lakh.
- The maturity period of the papers should be in the range of 91 days to six months.
- Commercial papers, like certificates of deposit, should be issued at a negotiated discount rate.
- The issuing company must maintain a current ratio 1.33:1.

The rate of interest or discount on a commercial paper generally lies between the mean lending rate of the commercial banks and mean interest rate in the money market.

The yield to the investor on a commercial paper with a front end discount is calculated by the following formula:

$$Y = \left[\left(1 + \frac{D_n}{100t} \right)^t - 1 \right] \cdot 100$$

Where Y = yield rate (%); D_n = nominal or negotiated discount rate inclusive of stamp duty and other charges; and t = time period of discount compounded for one year.

Like the CDs market, there have been wide fluctuations in the growth of the commercial paper market over the last decade (Table 24.1). In terms of year-end outstanding amount, the market had a low profile till 1992-93. The year 1993-94 recorded an explosive growth to Rs. 3264 crore as compared to just Rs. 577 crore in the preceding year. The amount fell abysmally to Rs. 76 crore in 1995-96 and again zoomed to Rs. 4770 crore in 1998-99.

Banks' investment in commercial papers is basically driven by their surplus fund position. In times of high liquidity, commercial papers are a better place, as compared to inter-bank call market, to park their funds as the interest rate available is higher. These papers provide a readymade investment opportunity at low risk which enables them to avoid marketing and transactional costs as in the case of their direct lending. Most commercial papers in India have a maturity period of less than three months; this immensely suits the banks with excess reserves. In tune with the general interest rate structure, the interest rate on commercial papers has been gradually declining.

RECENT DEVELOPMENTS

Indian money market has undergone a number of changes in the course of financial sector reforms. Though the market is much less developed as compared to the money markets of the USA, UK, Germany, Australia, Canada, Sweden and other developed market economies, it has acquired greater liquidity and vibrancy. There have been efforts in the direction of broadening and deepening the market through larger number of players and financial instruments. In addition to that, forces of competition have been introduced. The major developments in the market that have taken place may be briefly described as follows.

- **Development of the Secondary market.** The development of the secondary component of the Indian money market, in a formal sense, began from the year 1988 with the setting up of Discount and Finance House of India (DFHI). The nature and functions of the DFHI have already been explained in preceding sections. The operations of DFHI were supplemented by the Securities Trading Corporation of India (STCI) in 1994, which have led to the emergence of the secondary market in treasury bills and Government of India securities. The RBI intervenes in the market to inject or suck liquidity consistent with the growth requirements of the market.
- **Deregulation.** There has been a trend towards deregulation of the Indian money market since 1988, which escalated, in the subsequent years. This has led to greater competition and smaller dispersion in the rates of the various sub-markets. Not only that, there has been gradual decline in the money market rates. The mean rate prevailing in the money market,

which stood at 13.6 per cent in 1992, gradually came down to less than 9 per cent in 2002 with a few exceptions like the year 1996 when it was about 15 per cent. The standard deviation of the mean rate, which was about 5 per cent in 1992 gradually, came down to 1.5 per cent in 2002. With deregulation, greater freedom has been given to the commercial banks and other money market institutions with regard to their basic operations. The growing stability of the money market is attributed largely to RBI regulation.

- **Development of the REPO Market.** In recent years, steps have been taken to impart liquidity to the treasury bill through Repurchase Options (REPOs). The nature of the REPOs market has already been explained in the preceding sections. With the March 2000 amendment to the Securities Contracts (Regulation) Act, 1956, the RBI has been empowered to regulate dealings in government and money market securities. The RBI has permitted, under its new powers, to allow selected categories of entities to enter the market of REPOs in treasury bills and dated securities of the central and state governments.
- **Negotiated Dealing System (NDS).** NDS was established in 2001 in order to facilitate electronic bidding in auctions and transactions in the secondary market in government securities. It also disseminates information on trades on a real time basis. This not only facilitates smooth operation of the market but also reduces transaction cost and time. The system, when fully developed, will support transactions in REPOs, call money, commercial papers, certificates of deposit and interest rate derivatives. It is also being used for operating Liquidity Adjustment Facility (LAF; see the following sections). The main participants in the NDS are banks, primary dealers and financial institutions, which maintain Subsidiary General Ledger (SGL) accounts and current accounts with the RBI. The system is proving instrumental in expanding the transaction base of the money market and is reducing the extent of idle funds.
- **Clearing Arrangements.** In order to clear the transactions in money and foreign exchange markets, the Clearing Corporation of India Limited (CCIL) was established in April 2001 under the Companies Act, 1956 with the State Bank of India as the main promoter. The basic function of the corporation is to clear all transactions in government securities and REPOs as conducted through the Negotiated Dealing System of the RBI. It also provides clearing arrangement for exchange transactions between the rupee and US dollar in spot and forward markets. The government has made it mandatory to settle all trades in government securities below Rs. 20 crore through the CCIL. However, trades with values exceeding Rs. 20 crore may be settled either through the CCIL or the RBI.
- **Proactive Role of Open Market Operations (OMOs).** Recent years have witnessed a proactive role of OMOs of the RBI towards liquidity adjustment in the economy and fine-tuning of temporary asset-liability mismatches. The RBI closely watches the liquidity conditions in the economy as it affects the price level and cost of capital to business through changes in interest rate structure. The RBI conducts such transactions every month. Over the last few years, the RBI has been resorting to net sale of government securities. The type of security to be purchased or sold is selected by the RBI keeping in view the nature of asset-liability mismatches. During April-December 2001, the RBI sold government securities aggregating more than Rs. 30,000 crore. Changes in the liquidity condition are quickly reflected in changes in the REPOs rate.
- **Liquidity Adjustment Facility (LAF).** The facility was introduced with effect from June 2000 to contain market volatility through liquidity adjustment. The facility provided by the RBI

involves absorption or injection of liquidity on a day-to-day basis. This facility was recommended by the Committee on Banking Sector Reforms (Narsimham Committee II, 1998) as a means to develop the short-term money market. As a consequence, the RBI introduced Interim Liquidity Adjustment Facility (LAF) in April 1999, which provided a mechanism of liquidity management through a mix of REPOs, export credit refinance and collateralised lending facilities supported by open market operations at predetermined rates of interest. The interim facility has been phased out and has been replaced by full-fledged LAF.

Under the present facility, the standing liquidity facilities are divided into two parts. The first part consists of a normal facility constituting about two-thirds of the limit at the bank rate. The second part exists as a backstop facility comprising of about one-third of the limit at a variable daily rate linked to the cut-off rates prevailing at regular LAF auctions. When these rates don't exist, the backstop facility is linked to the Mumbai Inter-bank Offer Rate (MIBOR). The quantum of adjustment and the rates under LAF are flexible and responsive to the circumstances in the money market. The funds made available by the RBI through LAF are meant basically to meet day-to-day liquidity mismatches rather than to meet normal financial requirements of participating institutions. LAF was earlier based on a system of auctions on a uniform price basis so that a single REPO rate was applied to all the successful bidders. Now, there exists a system of multiple price auctions. The weighted average cut-off yield is conveyed to the public, which, along with the cut-off price, serves as a benchmark band for the call money market to operate.

CONCLUSION

The above are the major developments in the money market that have taken place in recent years. However, the Indian money market has a long way to develop. In particular, there is need for a larger number of players in the market and a greater variety of instruments. There is a dire need to promote the bill culture which may be promoted both through inducement measures and legislative provisions. In any case, the role of the RBI will continue to be of paramount importance. The globalisation of the financial markets can go a long way in developing the market further. Further measures are required to secure a larger degree of integration and coordination between the various sub-markets.

Key Terms

Bank bill	Commercial paper	(OMOS)
Bid and offer, rates	Current ratio	Promissory note
Bill market	Debentures	Rediscounting
Bill of exchange	Economics of scale	Repurchase option (REPO)
Call money market	Equity	Risk
Capital formation	Financial intermediation	Statutory Liquidity Ratio (SLR)
Capital market	Liquidity	Trade bill
Cash Reserve Ratio (CRR)	Money market	Treasury bills
Certificate of deposit	Net worth	Yield rate
Clearing	Open market operations	

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Long Questions

1. Explain the structure of Indian financial system. What is its significance in relation to economic growth and business environment of the country?
2. What are the various sub-markets of the Indian money market? Comment on the state of development of the money market in relation to the characteristics of a developed money market.
3. What are the main money market instruments? Explain the mechanism and significance of REPOs in Indian money market.
4. What are the various money market instruments? What measures have been taken in recent years to widen and deepen Indian money market?
5. Discuss major developments that have taken place in the Indian money market in recent years. What are the main weaknesses of the market?
6. Discuss the role of the Reserve Bank of India in the development and regulation of the Indian money market. What steps would you suggest to develop the market further?

Short Questions

1. What are the three basic pillars of a financial system?
2. Explain the nature of financial intermediation.
3. List five major hallmarks of a developed financial system.
4. What is the basic function of the Discount and Finance House of India?
5. Why are call money rates generally volatile?

6. Give main reasons for the underdeveloped state of the inter-bank call money market in India.
7. How does a bank determine its borrowing or lending position in a call money market?
8. Give three leading characteristics of bill market in India.
9. Explain the significance of REPOs in Indian money market.
10. Why is the market for certificates of deposit weak in India?
11. What factors determine interest rate on a commercial paper?

Practical Assignments

1. Select a particular commercial bank and find out in what ways changes in the money market condition affect its working and performance.
2. Visit the Head office of a private commercial bank and find out how does it determine its borrowing or lending position in the inter-bank call market.
3. Organise a role play demonstrating transactions in the REPOs market.
4. Write a term paper on the 'Impact of Financial Sector Liberalisation on the State of Money Market in India'.

INDIAN CAPITAL MARKET

Chapter Outline :

- Introduction
- The Primary or the New Issues Market
 - Main Activities
 - Major Intermediaries
 - Merchant Bankers
 - Underwriters
 - Bankers to an Issue
 - Brokers to an Issue
 - Registration and Share Transfer Agents
 - Portfolio Managers
- The Issue Mechanism in the Primary Market
 - Public Issue Through Prospects
 - Sale Offer
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 - Rights Issue
 - Book Building Method
- SEBI Guidelines on New Issues
 - Public Issue of Equity Shares
 - Minimum Size of Public Offer and Subscription
 - Reservation in Security Issue and Allotment
- The Secondary Market
 - Stock Brokers and Sub-Brokers
- Working of the Bombay Stock Exchange
 - Membership
 - BSE's On-line Trading System
 - Trading and Settlement System
 - Bad Deliveries
 - Basket Trading System
- Conclusion

INTRODUCTION

As distinct from the **money market**, which deals in short-term funds, **capital market** deals in long-term loanable funds. Generally speaking, capital market funds are used by industry and trade for making fixed investments. The main participants in the market are mutual funds, insurance companies, development banking institutions, foreign institutional investors, corporate organisations as well as individuals. To some extent, commercial banks also participate in the market though their main concern is money market activities.

Capital market has two principal segments (a) **the primary or the new issues market** and (b) **secondary market** including predominantly the stock market. The primary market deals with new securities issued by corporate organisations that are offered to individual and institutional investors for the first time. This market is a direct source of funds to the business units. However, specialised financial institutions are often engaged in the **underwriting**, distribution and sale of securities to the prospective investors. This market is the primary source of **capital formation** and has an important role in financing the developing of a country.

Secondary market is the market for securities which have already been issued and are listed on various **stock exchanges**. It is a highly organised market and it provides liquidity to the long-term securities already issued. Unlike the primary market, it has a specific transaction place in the form of stock exchanges where the securities are traded on a continuous basis generating price movements of the listed securities. An unorganised component of the secondary market also exists though its size is much smaller than the organised market. The security prices, as determined in the stock exchanges, are governed by the conditions of demand and supply, which are affected both by the financial strength and performance of the companies as well as speculative forces.

THE PRIMARY OR NEW ISSUES MARKET

MAIN ACTIVITIES

This market, as already pointed above, provides channels for the transfer of investible funds from individuals and organisations to business enterprises. The institutional structure of the market can be described in terms of its three major functions, viz., (a) origination (b) underwriting and (c) distribution. **Origination** refers to the preliminary work relating to the assessment and formulation of new proposals. In connection with a proposal for setting up a new unit, expanding an existing unit or for diversification of the existing business, a firm conducts technical, economic, financial, marketing and legal analysis of the new project and decides the magnitude and pattern of financing. It may engage specialised agencies to provide services relating to the type of securities to be issued, price and timing of issue, method of floatation and marketing and related matters.

Underwriting is a very important function in the primary market. It eliminates uncertainty with regard to the public response to a new issue of securities (equity shares, debentures, bonds etc.). If the public does not fully subscribe to an issue, the balance is taken up by the underwriters. Due to the underwriting function, an issuing company is ensured that the required amount will be

raised in the market. The underwriter charges an underwriting commission for the service and might end up having a shareholding in the company.

There are, however, limits to underwriting imposed by the government through its regulatory agency viz. **Securities and Exchange Board of India (SEBI)**. The securities have to be sold in the public which requires an effective marketing strategy covering advertising, distribution and personal selling. Advertising function is taken care of by the issuing company itself, distribution and personal selling functions are performed by a wide network of brokers, dealers and agents. The success of the marketing effort greatly depends upon the investors' perception of the company's present performance, future prospects, strengths and weaknesses and opportunities and threats. The expected risk and return factors are of critical importance behind an investor's decision.

MAJOR INTERMEDIARIES

The major intermediaries that make up the structure of the primary segment of the capital market are as follows.

Merchant Bankers

Merchant banks, also known as **issuing houses**, constitute an important pillar of the primary capital market. They provide a range of specialised financial services to their client companies which are as given below:

- Pre-investment studies for companies planning new projects;
- Developing and assisting comprehensive package for project funding;
- Determining the composition of the securities to be issued and arranging listing of securities;
- Drafting of issue prospectus.
- Arranging underwriting services and loan syndication including foreign currency finance;
- Placing of issues;
- Selection of **brokers**, bankers to the issue, advertising agencies etc.; and
- Appointment of registrars to deal with share application and transfers.

In addition, merchant banks provide a number of other services relating to the practical aspects of floatation of security issues and mobilisation of funds from the public. At present, it is mandatory that all public issues are managed by merchant bankers, which act as lead managers to the issue. The SEBI has a comprehensive regulatory framework for merchant bankers. The major aspects of regulation are as follows:

- Merchant bankers require compulsory registration to carry out their activities. Only those merchant bankers are recognised which conform to **capital adequacy norms** (in terms of **net-worth** including **paid-up capital** and **free reserves** laid down and revised by the SEBI from time to time).
- All issues should be managed by at least one authorised merchant banker functioning as the sole or **lead manager** of the issue. Ordinarily, not more than two should be associated as

lead managers, advisers and consultants. In case of large issues, stake of merchant bankers go up (Table 25.1).

Table 25.1 Maximum Permitted Number of Lead Managers According to Size of Issue under SEBI Norms

Issue Size (Rs. Crore)	Number of lead managers
<50	2
50-100	3
100-200	4
200-400	5
>400	>5

- To ensure a direct stake of a merchant banker in the issue managed by it, the lead managers are required to accept a minimum 5 percent underwriting obligation subject to a ceiling.
- The involvement of the merchant bankers shall continue till the process of listing of the instrument and dispatch of certificates or refunds is over.
- The bankers have to follow the SEBI code of conduct and must exercise due diligence independently in all the aspects of the security issue.
- The banker will have to submit to the SEBI any such information or documents relating to the securities issue.

Underwriters

Underwriters are appointed on the basis of their financial strength and ability to meet obligation by the issuing companies on the advice of their merchant bankers or lead managers. Underwriters, like merchant bankers, are required to be registered by the SEBI. The certificate of registration is granted on the basis of their financial position, infrastructure, past experience and ethical standards. An underwriter, as per the SEBI Code, must:

- Observe high standards of integrity and fairness in his conduct of business.
- Observe high standards of ethics and morality with respect to the issuing company, lead manager and other clients.
- Provide high quality of service with diligence, care and professional independence.
- Maintain necessary secrecy and confidential business information about the issuer.
- Not suppress or hide any material information or documents of required by the SEBI.

As a general principle, an underwriter should not benefit from the underwriting commission. As per the SEBI guidelines, the maximum commitment or obligation of an underwriter should not exceed twenty times his net worth. The records and documents of the underwriter can be inspected by the SEBI at any time and in case of default, non compliance or contravention of the SEBI regulations or guidelines, his registration may be cancelled or suspended, depending upon the seriousness of offence.

Bankers to the Issue

The basic function of the bankers to the issue is to accept applications (alongwith the application money) from the investors for the issue of securities and to refund the same if the need arises. Again, the bankers must be registered with the SEBI. The certificate of registration is granted keeping in view the infrastructure, manpower, data communication and processing facilities and the general business ethical standards of the applicant institution. As a general case, scheduled banks are allowed to act as bankers to an issue. The general obligation or responsibilities of the bankers are as follows:

- The banker has to maintain books of accounts and records for at least three years which would relate to the number and names of investors, the time taken for forwarding the received applications to the issuing company and the details of refund, if any, made to investors.
- The banker has to sign an agreement with the issuing company stating the network of its collection centres for the receipt of applications and the manner of sending applications and the money to the issuing company.
- The banker will have to furnish any information relating to its functions and performance to the SEBI, whenever required.
- The banker has to observe the code of conduct and guidelines as adopted by the SEBI and the RBI from time to time. The banker is expected to maintain high standard of diligence, integrity and fairness and conduct its business in an efficient and cost effective way. It must maintain necessary business secrecy and confidence and must not do anything which harms the interests of the small investor.

The records as well as functioning of the banker can be inspected by the RBI at the behest of the SEBI. On the basis of the inspection report, the SEBI can order the bank to undertake the specific measures in the interest of the securities market and in compliance of the SEBI rules, regulations and guidelines. The SEBI has the power to suspend or cancel the certificate of registration issued to the banker in case of any one or more of the following types of default:

- Violation of the provisions of the SEBI Act or the Code of Conduct.
- Failure to furnish the required information or the supply of wrong information.
- Any activity of the banker, which is against the interest of the small investors.
- Weakening of the financial position of the banker to the extent that the interests of the investors may be adversely affected.

SEBI registration automatically stands cancelled if the banker has been prohibited from carrying on his activities as a result of a disciplinary action by the RBI.

Brokers to the Issue

Brokers are involved in the distribution process for securities. Brokers intermediate between the issuing company and are prospective investors and engaged in procurement of subscription to securities issued from the latter. Brokers can be individuals or firms and work on a commission called **brokerage**. Appointment of brokers to an issue is not mandatory and the issuing companies are free to engage any number of brokers as they consider appropriate. Brokers are generally appointed by an issuing company on the advice of its merchant bankers who act as the managers to the issue. Issuing companies generally identify experienced brokers active in stock exchanges. The stock exchange brokers have to obtain permission from their respective stock exchanges which may be granted subject to certain conditions or stipulations. Without the consent of the stock exchange, no person can act as a broker to the issue; nor can he engage himself in any preliminary work relating to the floatation of the issue. The names of the brokers to the issue have to be disclosed in the prospectus.

A brokerage of 1.5 per cent is prescribed for various types of issues of securities and the various expenses in connection with the distribution of securities have to be borne by the brokers. For the private placement of listed companies, the brokerage is limited to 0.5 per cent. Brokerage is not payable on subscription to securities under underwriting commitments, promoters' quotas, subscription by directors of the company and their relatives and **stock options** as it is assumed that distribution effort or cost is involved in such cases. Brokerage is payable within two months of the date of allotment. SEBI has developed detailed guidelines for brokers and sub-brokers.

Registrars and Share Transfer Agents

Registrars to an issue deal with the procedural matters relating to the issue. Their main functions are:

- Assistance to the issuing companies in the finalisation of the basis of allotment of securities as per SEBI norms;
- Finalisation of the allotment of securities;
- Collection of applications along with application money and keeping records to money received and paid to the sellers of securities; and
- Dispatch of various documents like allotment letters, certificates or refund orders.

The intermediaries are divided into two categories:

Category-I includes registrars to an issue, which also function as **share transfer agents**;

and

Category-II includes those which function either as registrars or as share transfer agents.

In order to be eligible to discharge these functions, the intermediaries are required to be registered with the SEBI. As in case of underwriters, registration is decided on the basis of capital adequacy, infrastructure, past experience and ethical standards. *Independence of the intermediary is also emphasised and registration is generally not provided if the applicant is connected with the issuing company in any capacity.* Like others, these intermediaries are also subject to code of

conduct and are expected to act with diligence, care and good faith and must maintain business secrecy and confidence of the client company and work in the interest of the small investor. They are particularly expected to handle enquiries efficiently and avoid delays in the securities allotment or refund of money, if need be. They can be punished for **insider trading, price rigging** or market manipulation. A person cannot act as registrar for issue of securities by a company in which he possesses direct or indirect control by holding at least 10 per cent of voting power or in which he is already a director. Books, records and documents of the intermediaries can be inspected by SEBI and failure to comply with the SEBI rules and norms or the code of conduct can lead to the cancellation of registration.

Portfolio Managers

These intermediaries manage the portfolio of securities on behalf of the clients and provide various portfolio management services. To act as portfolio managers, a certificate of registration is required. However, no separate registration is required if the function is to be performed by an already registered merchant bank. The intermediaries have to enter into a contract with the clients which specifies a number of points like the range of services to be provided, the objectives of investment, investment conditions or restrictions with regard to investment in specific companies, procedure for settling clients account, custody of securities and remuneration or fees of the managers. The extent of discretion of portfolio managers are contained in the code of conduct according to which a portfolio manager must:

- Provide a high standard of diligent, careful and professionally independent service to his client;
- Not retain the money received for investment from the client and payable to the client for unreasonably long period;
- Obtain formally the interest of his client in various corporate bodies for investment and disclose conflict between his own duties and interests to the client;
- Maintain business confidence of the client;
- Ensure promptness, efficiency and cost-effectiveness in his professional service;
- Not do anything to damage competition in the market or harm the interest of other professional managers; and
- Provide adequate information to the client about the market reality and risks before taking or assisting investment decision for the client.

As a portfolio manager can only provide professional services and cannot guarantee any particular return on investment, his fees are independent of returns to the client and therefore cannot be on return sharing basis. A portfolio manager can have more than one client but he has to maintain separate accounts of the clients. As portfolio manager is a capital market intermediary, he accepts portfolio funds and securities for at least one year. The funds or securities, however, can be withdrawn by the client in such extreme situations as the termination of portfolio management services by the provider, as a result of his insolvency, bankruptcy or cancellation of his license by the SEBI or by any other reason. The manager can invest funds also in the money market instrument to the extent specified in the contract.

A portfolio manager must maintain all the necessary records relating to his investment transactions and returns including tax deductions at source. All these records have to be annually audited by a qualified auditor and a certificate in this regard is required to be sent to SEBI. In addition, the manager is obliged to provide to SEBI the information regarding portfolio management. As in case of other intermediaries, the records of the portfolio managers can be inspected by SEBI and default by way of non-compliance or contravention of SEBI norms is punishable with suspension or cancellation of registration.

THE ISSUE MECHANISM IN THE PRIMARY MARKET

There are five principal ways in which securities can be issued in the primary market.

1. **Public Issue through Prospectus.** This is the most common method for the issue of securities by any corporate organisation. Detailed SEBI guidelines exist in this regard, which are explained in subsequent sections. In this method, ordinary shares are issued to the general public for subscription by issuing a prospectus. The prospectus contains the necessary information about the company, the opening and closing dates of subscription, the names of brokers, underwriters and agents, the minimum subscription required and the underwriters obligation. The minimum disclosure requirements of the issue are prescribed in the **Companies Act 1956** and additional requirements, if any, are mandated by the SEBI. As a matter of general principle, the share issue is widely diffused and the fixed number of shares are allotted among the applicant investors in a non-discriminatory manner. Such issues are high publicized for good response and transparency. The shares may be issued at par or at a premium as per SEBI guidelines.
2. **Sale Offer.** In this method, the issuing company offers shares to the public not directly but indirectly through some intermediary like a merchant bank, or an issuing house or stockbrokers. In this method too, prospectus is issued and underwriter is involved to prevent any monopolistic shareholding by the intermediary institution. *Fixed quantum shares are first sold by the issuing company to the intermediary institution at a mutually agreed price; the latter then sells the shares to the alternate investing public at a higher price. The difference, called turn, is the margin available to the intermediary out of which it meets various expenses associated with the marketing of shares.* The method proves convenient to the issuing companies which is spared of the time, cost and botheration of mobilising funds from the public.
3. **Placement.** In this method, a capital market intermediary, like an issuing house acquires securities from an issuing company but sells (or technically, *places*) these securities to his own clients who have previously subscribed rather than the general public. The clients consist of both individual and institutional investors. The method is broadly similar to the offer sale method. The necessary disclosures have to be made in the placement letter. Since the sale of securities is almost certain, underwriting arrangements are generally not required. When the placement is quoted on a **stock exchange**, it is called **stock exchange placing**; placing of unquoted securities is called **private placement**. Again, the method proves very convenient to the issuing company but has the drawback that it raises the concentration of

shareholding in a few hands. This method can be the compulsion of small companies which are not in a position to shoulder the high cost involved in a public issue. This method may also be preferred when companies are not sure of raising the required amount through public issue.

4. **Rights Issue.** Rights issue (also called Rights offer or Privileged Subscription Issue) is the offer of new shares to existing share-holders, generally in a particular proportion to the existing share holding. This method is generally adopted by reputed and well-established companies the shares of which are widely held and listed on a stock exchange. The companies generally ensure that the issue is completely sold and quite often the shares are offered at a discount to the current market price. In most of the cases, such issues are not underwritten but sometimes companies take an extra precaution by making standby or underwriting agreement to secure the confidence of existing shareholders. Such shares are known as subscription warrants in the USA. The rights value (RV) is calculated by the following formula:

$$RV = \frac{MV - SP}{n + 1}$$

Where MV = Market price of the shares; SP = the rights price and n= the number of existing shares required for each new share i.e. the ratio of new for old shares. For example, if the share price is Rs. 204 and is offered at a price of Rs. 174 under the rights issue offering one new share for five existing shares, then

$$RV = (204 - 174)/(5+1) = 5$$

This method of floatation of securities, like the earlier two methods, causes concentration of shareholding in the hands of existing shareholders. Under Section 81 of the **Companies Act, 1956**, a company can expand its capital base by issuing new shares after two years of its formation or one year after the first issue of shares (whichever is earlier) through rights issue.

5. **Book Building Method.** In this method, the lead manager to a new issue estimates market demand for the securities and accordingly sets the offer price. In the demand estimation exercise, surveys are carried out to find out the amounts and prices at which they would subscribe to the securities. Sometimes, shadow auctions are conducted in which prospective investors are given incentives to participate and reveal their investment behaviour. In many countries, it is emerging as a popular method to facilitate decisions about setting the issue price for large initial public offerings. This method has not gained popularity in India.

SEBI REGULATIONS AND GUIDELINES ON NEW ISSUES

In order to streamline the working of the primary capital market, introduce transparency and to protect the interest of the investors, SEBI has developed a set of regulations and guidelines for the issue of equity shares, rights shares and debentures in the primary market. These provisions have to be complied with by the issuing companies and the intermediaries. These are in addition to the requirements of the **Companies Act, 1956** as amended from time to time.

PUBLIC ISSUE OF EQUITY SHARES

The companies issuing equity shares may be new companies or existing private companies which are closely held or unlisted or existing listed companies. A new company is one which has not completed one year of commercial operation or the audited operative results of which are not available. No previous track record of the promoters or entrepreneurs is required for new issuing companies. In such cases, shares can be issued only at par and the promoters' contribution must be 20 per cent of the total issued capital with a **lock-in period** of three years. The promoters have to bring in their share subscription in advance and in full before the public issue is made.

If a new company is established by a promoting company or promoters with a track record of performance in terms of consistent profitability, the company can issue the shares at a **premium**. In such cases, the promoter must acquire at least 50 per cent of the equity of the new company at the same price, which is uniformly offered to all new investors. In this case, too, the lock-in period is three years from the date of allotment or the commencement of commercial production, whichever is later.

An existing private or closely held or unlisted company is eligible to go for a public issue if it has three-year track record of consistent profitability. Other eligible firms are (a) partnership firms converted into companies; (b) companies carved out of an existing company through division; and (c) companies without a three-year track record subject to certain conditions. Partnership firms converted into companies and having three-year track record can freely price their issues subject to certain procedural formalities. Similarly, a company formed through division of an existing company can freely price the issue if it meets the three-year track record condition. Companies without track record can price their issue, provided they meet the disclosure norms of the SEBI. The conditions regarding promoters' contribution and lock-in period are the same as in case of new companies. The shares of the above categories of companies can be listed on any stock exchange including Over-The-Counter Exchange of India (OTCEI).

Existing listed companies can freely price their issues subject to certain standard conditions. The **issue price**, however, has to be justified in the prospectus or offer document. The prospectus must show the high and low prices of shares over a period of last two years. No condition regarding promoters' contribution is applicable if it has a three-year track record of consistent profitability in the preceding five years. **Differential pricing** is permitted for rights and public issues when the issue is composite in nature.

MINIMUM SIZE OF PUBLIC OFFER AND SUBSCRIPTION

The minimum size of the public offer cannot be less than that prescribed for listing purposes which is 25 per cent of the securities issued by the company. The limit does not apply to government companies, public financial institutions and a few other specified categories of companies. Issuing companies must receive at least 90 per cent of the issued capital through public subscription, development from underwriters or from other sources if the issue is undersubscribed. Failure to achieve the minimum subscription puts the issuing company under the obligation to refund the amount to the investors within a period of 60 days from the date of closure of the issue. With this requirement intact, underwriting has been made optional. In case of offer for sale of the securities, the mandatory requirement of 90 per cent subscription does not apply.

RESERVATION IN SECURITY ISSUES AND ALLOTMENT

In case of firm allotment of equities and convertible debentures, reservations in public issues are allowed to the following categories:

- i) Permanent employees including working directors;
- ii) Shareholders of the group/promoters companies on a preferential basis;
- iii) NRIs and other categories as permitted by the RBI;
- iv) Indian mutual funds and other financial institutions; and
- v) Foreign institutional investors.

For promoters, there is a requirement of lock-in period for three years. The firm allotment along with promoters' contribution should not exceed 75 per cent of the total issue.

THE SECONDARY MARKET

As already pointed out, it is the market for long-term securities, which are already issued, and functions principally through various stock exchanges of the country. Its main role is to provide liquidity to the securities, a function through which it plays an indirect role in encouraging the primary market and corporate financing. It is the index of the state of the industrial economy and an important indicator of overall business environment. It has further two components viz. the *stock exchanges* which represent the organised segment of the market and deal with the securities of corporate organisations which are listed on stock exchange, and *over-the-counter market* in which securities of the smaller companies are traded on the basis of direct negotiations between brokers (rather than through open bidding as in stock exchanges).

STOCKBROKERS AND SUB-BROKERS

A stockbroker is a member of a stock exchange who buys or sells securities on his own account or for non-member clients in return for a commission on the price of the securities traded. In order to operate in a stock exchange, a broker must be registered with SEBI, which grants registration subject to fulfillment of certain conditions relating to his financial position, infrastructure, past experience and ethical standards. Further, a broker must obtain membership of the stock exchange where he intends to operate. As a stockbroker is a major intermediary in the secondary market, he has to observe a comprehensive code of conduct which has evolved as a result of implementation of recommendations of a number of committees on stock market reforms (Box 25.1) and a number of guidelines issued by SEBI, the government and stock exchanges for smooth and orderly functioning of stock exchanges. He has to maintain various books, records and documents relating to his transactions in the market. These records can be inspected by SEBI for the compliance of various rules and provisions. Any violation, contravention or non-compliance of norms, guidelines or code of conduct can lead to cancellation or suspension of his registration.

A broker has to meet the minimum capital adequacy norms which cover the basic minimum capital and additional capital relating to his transactions or turnover. *The basic capital includes security deposit and is kept partly in cash with the stock exchange, partly in the form of long-term fixed deposits in a bank (with unconditional lien to the stock exchange) and the rest in the form of securities with a specified margin pledged in favour of the stock exchange.* There are further provisions to prevent broker failure and monopolistic tendencies in the stock market. The basic plus additional capital, at no point of time, should be less than eight per cent of the gross outstanding business. In other words, gross outstanding business should not exceed 12.5 (i.e. 100/8) times the basic plus addition capital; if it does the broker will have to provide additional capital to maintain the ratio.

Sub brokers act on behalf of brokers and are subject to similar discipline and regulation. They are not members of any stock exchange but require SEBI registration. There also exist foreign brokers with a different set of guidelines to encourage the participation of foreign institutional investors in Indian stock exchanges.

BOX 25.1

Major Elements of the Code of Conduct to be Observed by Stockbrokers

As stockbrokers are the major operators in the secondary segment of the capital market, a comprehensive code of conduct exists for them in order to ensure smooth working of the stock market:

- **General Code.** A stockbroker must maintain high standard of integrity, professionalism, diligence and fairness in his conduct of business. He must not be manipulated, deceptive and fraudulent and should not collude with others to create a false market. He must not engage in excessive speculation or any activity which is detrimental to investors' interest.
- **Obligation Towards the Investors.** In his dealings, a stockbroker should faithfully execute the orders of his clients, prevent breach of trust, avoid dealings with persons of doubtful integrity and commitment, disclose full information to his client and make prompt payment for securities sold and quick delivery of securities bought. He must maintain the necessary business confidence of his client and should provide fair, prompt and competent service.
- **Obligation Towards other Stockbrokers.** He must co-operate with other brokers in matching and settling transactions and preventing **bad deliveries**. He must not do anything, which spoils or distorts competition and should not adopt any unfair means to snatch the clients of other brokers.

Finally, he must maintain regular, proper and complete records of his transactions as per norms of the SEBI and the stock exchange.

THE WORKING OF BOMBAY STOCK EXCHANGE

The Stock Exchange Mumbai, popularly called **Bombay Stock Exchange (BSE)** is the leading stock exchange of the country which was established as far back as in 1875. It is the oldest in Asia, even older than Tokyo Stock Exchange which has established in 1878.

It has a governing body consisting of elected directors (one-third retiring every year by rotation), two nominees from Securities and Exchange Board of India (SEBI), seven public representatives and an Executive Director. It is the apex body which determines the policies and regulates the working of the stock exchange. During 2001-02, the mean daily turnover of BSE was about Rs 4000 crore with daily trades about 5.7 lakh. The daily turnover declined steeply to Rs 1250 crore

though the number of trades was relatively stable at 5.2 lakh. The major aspects of the working of the exchange are briefly discussed below.

MEMBERSHIP

The prospective investors can trade at the exchange either through the members of the exchange or sub-brokers who are registered with the SEBI. The membership is available to both individuals (subject to qualifications) and companies formed in compliance with the provisions of Section 12 or Section 322 of the Companies Act 1956.

A corporate member must have a paid-up capital of Rs 30 lakh and at least two of its directors should be appointed as designated directors fulfilling the criteria for individual members (except relating to citizenship).

BOX 25.2

How can an Individual become a Member of the Bombay Stock Exchange?

The membership of the BSE is open to both individuals and companies fulfilling certain criteria. An individual, in order to be a member, must fulfil the following eligibility conditions:

- Minimum age of 21 years;
- Citizen of India (relaxable);
- Not been adjudged bankrupt or insolvent;
- Not compounded with his creditors;
- Not been convicted in a case of fraud or dishonesty;
- Not engaged as principal or employee in any business other than that of securities;
- Not been expelled or declared defaulter by any other stock exchange; and
- At least 10th standard pass, though preference is given to professionally qualified person.

The members are required to maintain a Base Minimum Capital Rs 10 lakh in the form of cash (at least 12.5%), fixed deposit receipts (at least 12.5%) and balance in the form of securities or bank guarantees.

The corporate members can also hold multiple membership right in a single company. Such members are called **Composite Corporate Members**. Selected members have to obtain registration with SEBI and is subsequently required to comply with the requirements of network connectivity, insurance, maintenance of base minimum capital, opening of accounts with clearing house, clearing bank etc. After these requirements are met, the member can commence business.

As on March 31, 2002, there were 711 members in all out of which 215 were individual and 996 corporate members. Of the total 711 members, only 532 were identified by the BSE as active members.

Individuals, partnership firms and corporate bodies can become sub-brokers on fulfilling certain conditions. They are also required to be registered by SEBI. A subbroker acts as an agent of a member and is authorised to issue confirmation memos to his clients for transactions done by him through the main member-broker.

Recently BSE has introduced another category called remisiers. A remisier brings business to a member-broker and gets commission for the same. An individual or a partnership firm can apply to the exchange for position of a remisier. A remisier is not allowed to handle the securities and the money of the clients. These are directly exchanged by the clients with the member-brokers. The exchanges has membership services department which provide one-window services to member-brokers and their associates.

BSE'S ON-LINE TRADING SYSTEM (BOLT)

The exchange introduced on-line trading system on March 14, 1995. The automated trading environment is designed to make the deals transparent, improve liquidity, increase market depth through continuity of quote and orders, eliminate mismatches, reduce settlement risk and to disseminate information instantaneously. This system has replaced the traditional outcry system. With the commencement of electronic trading, the securities market is available to investors even in far-flung areas. The major advantages of the system are the following:

- It means trading system available and accessible at all the places all the times.
- Its communication facilities ensure fast response.
- The system provides facility to create new system and products.
- It provides global connectivity.

The BOLT is interfaced with various other information vendors like Bloomberg, Bridge and Reuters. *BOLT network extends beyond Mumbai and members of the exchange can set up their trading terminals at any place in the country.* In order to expand the reach of the BOLT network BSE has admitted subsidiary companies formed by 13 Regional Stock Exchanges as members. The members of the regional exchanges work as sub-brokers of the member-brokers of BSE.

TRADING AND SETTLEMENT SYSTEM

Securities trading under the BOLT system is basically order-driven (earlier it was quote-driven as well), facilitating more efficient processing, automatic order matching and faster and transparent execution of orders. The scripts traded on the Exchange are categorised as 'A', 'B1', 'B2', 'F' and 'Z', of which F category scripts represent the debt market (fixed income securities) while others are in the equity segments. There also exists 'C' category which covers **odd lot securities** in the equity segment. Trading facility in this category enables investors to dispose off odd lots of securities as well as consolidate them with **market lots**.

From December 31, 2001 it has been made mandatory that trading in all securities listed in the equity segment of the exchange take place in compulsory rolling settlement segment. *The closing price of scrip is calculated on the basis of weighted average price of all trades in the last minutes of the continuous trading session.* Compulsory Rolling Settlement conforms to best international trading practices and with effect from April 1, 2002, trades are settled on 7+3 basis as per SEBI guidelines. *7+3 settlement cycle means that final settlement of transactions done on the trade (T) day (by exchange of money and securities), is made on the fifth (2+3) day (2 days being considered as the initial accounting period) after the day of*

trade. Securities in Demat mode are settled on net basis i.e. buy and sell positions in the same scrip are netted and only the net amounts and securities are settled. All deliveries of securities are routed through the **clearing house** which is an independent company promoted jointly by Bank of India and Bombay Stock Exchange for clearing and settlement of trades on day-to-day basis.

The major benefits of the 7+3 system of settlement are the following:

- Reduction in settlement risk
- Early receipts of securities and moneys by the trading parties.
- Conformity of India capital market to international standards of settlement

BAD DELIVERIES

'Bad delivery' is one of the major problems of stock market investors. *Bad delivery refers to a situation when the shares sent by buyers in physical form are rejected by the companies for registration.* BSE has set up a separate **Bad Delivery Cell (BDC)** which deals with both inter-exchange and intra-exchange bad delivery cases.

According to SEBI guidelines, the receiving members of the securities are required to lodge their claims against bad deliveries through BDC on introducing members which the later are required to rectify or replace within a period of 21 days from the date of receipt of the objected documents. The bad delivery claims which are uncertified or the rectification of which is invalid, go for auction or close out as per rules of the BSE the receipt and delivery of securities related to bad deliveries takes place through the clearing house. The bad delivery cell maintains database of missing, lost, stolen, defaced or forged shares on the basis of information received from the companies, so that the circulation of bad securities is prevented. SEBI has mandated that the trading of securities should be settled in *dematerialised* form. As a result of the progress made in the direction of dematerialization, the problem of bad deliveries has considerably reduced.

BASKET TRADING SYSTEM

In order to enable the investors to hedge risk, BSE has commenced trading in the derivatives segment from June 9, 2000. Earlier, the facility of trading in derivatives was confined to **Index Futures**; now the exchange has introduced **Index Options and Futures** in selected individual securities. In order to provide the investors the facility of creating Sensex-linked portfolios, BSE has provided the facility of **Basket Trading System** (from August 2000) on BOLT. In this system, the investors are allowed to buy or sell all 30 scripts of Sensex in one go in the proportion of their respective weights in the Sensex. This saves the investors of the need to calculate the quantity of sensex scrips to be bought or sold for creating sensex-linked portfolios. The basket system takes care of this function. The system also permits the investors to alter to the weights of securities in the basket and enter their own weights. The trades conducted under the system are subject to intra-day trading and gross exposure limits and daily margins as applicable to normal trades.

CONCLUSION

A business manager must understand and monitor developments in the capital market. Capital market changes throw up important clues about the present state of the business environment and its projection atleast in near future. These variations not only reflect changes in business conditions but also provide direct information to the business manager about the cost of capital and liquidity. Good finance managers find it prudent to make matching adjustments in their internal policies particularly relating to debt-equity mix corresponding to capital market developments.

Key Terms

Differential pricing Over-the-counter (OTC) market	Issue prospectus	Brokerage
New Issues Market (or primary capital market)	Net worth	Rights offer (or privileged subscription issue)
Underwriting	Capital adequacy	Price rigging
Stock exchange	Free reserves	Subscription warrant
Secondary Capital market	Paid-up capital	Share premium
Merchant bank (or issuing house)	Share transfer agent	Lock-in period
Stock broker	Lead manager of an issue	Private placement
	Insider trading	Issue price
	Loan syndication	
	Portfolio manager	

Supplementary Readings

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Long Questions

1. Explain the institutional structure of Indian Capital Market. What are the main capital market instruments?
2. Discuss the nature, working and instruments of the new issues market in India. How can this market be further developed?
3. Explain the code of conduct for various participants in the Indian capital market. Why do scams occur in the Indian stock market in spite of the code of conduct?

4. In what ways do changes in the capital market affect business environment? Give suggestions for improvement in the working of the Indian capital market.

Short Questions

1. Distinguish between money market and capital market.
2. Give the three basic functions of a new issues market.
3. What are merchant bankers? How are they different from bankers to an issue?
4. Explain the role of underwriters in the Indian capital market.
5. Distinguish between brokers and agent in a capital market.
6. What is the basic job of a portfolio manager in secondary capital market?

Practical Assignments

1. Organise a management game demonstrating the working of a stock exchange.
2. Prepare flow charts relating to various types of transactions in primary and secondary capital markets.
3. Prepare a list of the recent stock market scams and hold a group discussion with the objective of finding ways to prevent the scams in future.

