1.1) Introduction to Indian Financial System

A Financial System of any country refers to a system that provides smooth and efficient relationship between the borrowers and the lenders. This system aims at establishing effective medium for generating funds from various sources. ***A financial system may be defined as a set of institutions, instruments and markets which fosters savings and channels them to their most efficient use[1].*** The main function of this financial system is to assemble wide spread savings from household individuals and industrial firms. Also, it helps to gather other productive investments in a country. This system helps in fastening the process of capital formation. This further accelerates process of economic prosperity of any nation. Financial System includes various aspects such as financial markets, financial institutions, banking firms, financial services, financial intermediaries, financial assets and instruments, etc. All these are closely related and work in combination with each other. Financial System through their huge network of elements helps to serve needs of different individuals, institutions and companies.

An efficient and innovative financial system is very essential for fast and continuous growth of the economy. Financial system provides a useful link between investors and depositors. It encourages both rates of savings as well as investments. Overall economic activities are highly benefited by the development of financial system. This is because efficient financial markets help to mobilize hard earned savings and allocate those savings among the

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[1]Machiraju H R, *"Indian Financial System",* Third Edition, Vikas Publishing House Pvt. Ltd., Noida, 2007, p1

competing users. The financial system promotes adequate allocation of monetary resources among economically desirable and available investment alternatives. An efficient financial system influences the quality as well as rate of economic growth and development. A well developed and properly regulated financial system ensures transfer of limited financial resources from different sections of the society. Thus, it plays a very important role in overall functioning of whole economy. Dynamic and flexible financial markets are essential for creating balance and successful growth in financial system in a country.

In India since independence, financial sector has been operating under strong Government control. For a period of more than four decades, Government had direct control over all the financial institutions and financial markets, which includes capital market and money market. During this period, Government of India directed various credit programs, control pricing of financial assets, framed different bank regulations and formed number of barriers for entering into different sectors. Government also restricted number of financial transactions as well as flow of funds within and outside the economy. All these resulted in growth of highly segmented, but inefficient financial markets. Both the money markets and capital markets remained underdeveloped. Foreign exchange market was extremely narrow. This is mainly because of inflexible and strict restrictions under Foreign Exchange Regulation Act (FERA). Although financial sector grew significantly in regulated environment, it failed to achieve the expected level of efficiency and competency. Financial markets in India were highly segmented until the financial reforms were implemented from 1992 – 93.

Large number of financial sector reforms was undertaken during 1990s on the basis of recommendations given by Narasimhan Committee, 1991. The main objective was to build an effective and operationally efficient financial market in India. These reforms targeted fundamental restructuring in Indian economic system. These reforms included industrial deregulation, liberalization of policies relating to foreign direct investments, foreign institutional investments, trade liberalization, public enterprise reforms, etc. These transformations were initiated since 1992 after the implementation of new industrial and economic policy. The reforms were undertaken in various segments such as commercial banking, capital markets, foreign exchange management, mutual funds, investor protection, stock markets, non-banking financial services, etc.

Primary focus of these reforms was to remove structural weaknesses and increase competitiveness. This would ensure development of domestic financial markets in order to link it to the global economy. These reforms also aimed at improving market efficiency, adequate and timely distribution of required information, market orientation for financial institutions, deregulation of interest rates, reduction of transaction costs, proper allocation of scare capital in productive avenues, reducing government intervention, improving financial feasibility and lastly, strengthening up financial institutions. The convertibility of Indian rupee on current account as well as dilution of FERA and its substitution by FEMA activated foreign exchange market in India. Further, these reforms also seek to build up an integrated financial market in order to reduce the speculative opportunities. This also helped in achieving higher level of efficiency in market operations. It increased effectiveness of monetary policies implemented in India.

Past two decades have seen an exceptional growth in the geographical coverage of financial sector in India. Many reforms were undertaken for removing number of institutional barriers for free flow of capital across financial markets. But still, this has not been converted into complete integration of the markets. Even though, there is relatively free movement of capital and reduction of speculative opportunities, but still there are numerous corrections required. These corrections are required in both capital market as well as money market. Certain developments are also required in financial market.

1.2) Overview of Indian Financial Market

A market is an institution or arrangement that facilitates the purchase and sale of goods, services and other such commodities. Similarly, financial market is an institution that facilitates exchange of financial instruments. These instruments include government bonds, deposits and loans, corporate stocks & debentures, futures and options and other such financial securities. Financial market is a market which facilitates buying / purchasing and selling of financial instruments such as financial claims, assets, services and securities. These transactions may take place either at a specific place or through other modern electronic mechanism. A financial market may or may not have any particular physical existence. In other words, it exists where financial transactions take place. In financial market, monetary funds i.e. savings are transferred from surplus units to deficit units. A financial market comprises of different players that includes borrowers, lenders, banking institutions, non banking organizations, investors and depositors, agents and brokers, dealers, etc.

According to Brigham, Eugene F, *"The place where people and organizations wanting to borrow money are brought together with those having surplus funds is called a financial market."* [2] Financial markets play an important role in collecting and arranging investible funds for those units which are in need of the same. Normally, household individuals and units have excess funds in the form of savings. They lend these savings to borrowers in corporate and public sectors. ***According to Wikipedia, 'Financial market is a market in which people and entities can trade financial securities, commodities and other fungible items of value at low transaction costs and at prices that reflect supply and demand. Securities include stocks and bonds, and commodities include precious metals or agricultural goods.'*** [3] Financial market plays a significant role in growth and development of any country. They ensure free and unrestricted flow of surplus funds and other financial resources into productive investments.

Main function of financial markets includes providing appropriate and sufficient funds to borrowers for enabling them in carry out their investment activities. On other hand, it provides required expected returns to the lenders of funds. This enables them to earn wealth by investing their funds in productive projects. In simple words, the financial markets facilitate proper and timely transfer of real economic resources from lenders to the ultimate borrowers. However, this helps to increase both National Income as well as

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[2] Gurusamy S., *"Financial Markets and Institutions"* Third Edition, Tata McGraw Hill Education Private Limited, New Delhi, 2009, p3

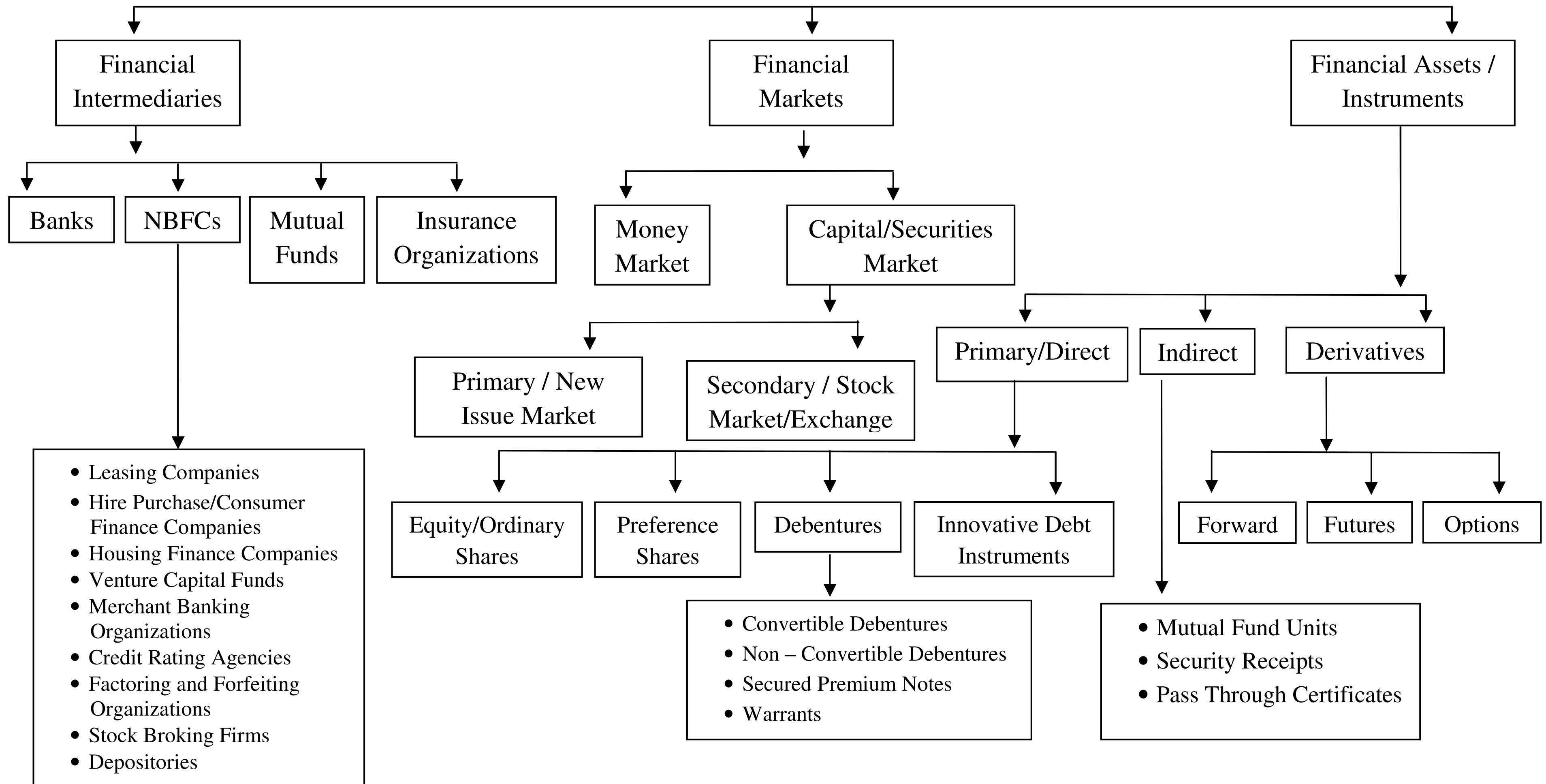
[3] www.wikipedia.com/shrr125/financial_market.definition/98cxsl/aspx (Retrieved on 15th December 2010)

Gross National Production. Financial markets ensure easy liquidity of financial assets to facilitate adequate trading of funds. Various activities are carried on by different players in financial markets. This results in generation and distribution of valuable information to various segments of markets. This shall help in reducing cost of transactions of financial assets.

Financial market plays an important role in economic development of a country. It helps in allocation of scare financial and economic resources. It directs the resources in productive sectors by transferring them from savers to borrowers. Thus, it increases overall investment activities in the country. However since 1991, financial reforms have successfully removed various entry barriers in the country. As a result today, there are both domestic as well as foreign financial institutions smoothly operating in Indian economy. These financial institutions includes mutual funds, broking firms, insurance companies, merchant banking firms, factoring, credit rating agencies, depositories, banking organizations, etc. Various measures were taken to protect interest of individual investors. These measures include introduction of capital adequacy norms, strict disclosure requirements, prudential regulations, world class regulatory mechanisms, etc. This further gave boost to the confidence of both domestic investors and foreign investors.

Figure 1.1 shows organization of Indian Financial System which broadly consists of Financial Intermediaries, Financial Markets and the Financial Assets.

Figure 1.1 – Organization of Indian Financial System [4]



[4] Khan M. Y; "*Indian Financial System*", Tata McGraw Hill Publishing Co. Ltd, New Delhi, Fifth Edition, 2007, p – 1.5

1.2.1) Key Players in Financial Market

1) **Household Individuals:** Household individual include wage earners, service person, salaried employees, individuals, housewives, students, retired persons, etc. They demand funds for meeting their various needs of investments. These needs may be housing, education, consumer durables, marriage and other day to day requirements. Supply of funds arises due to result of their savings. They save for retirement benefits, for meeting precautionary motives, for expenses on emergency requirements, etc. The demand for and supply of funds from these players are largely influenced by demographic factors. This comprises of their age, gender, income earnings, marital status, family background, qualification, experience, perceptions, etc.

2) **Business Enterprises:** It includes various business units and firms operating in the economy. On basis of period of investment of funds, their demand arises for two type of investments; i.e. short term requirements (working capital) and long term investments (capital expenditure). These business units meet their funding requirements either though borrowings from outside or through their own accumulated reserves and surplus out of profits earned in the past. Their demand for and supply of funds depends upon various factors like expected risk and returns, business cycle phase, investment opportunities, industrial and economic policies, government policies, etc.

3) **Government:** As a player in financial markets, Government includes Central, State and Local Government. It plays an important role of

both, borrowers as well as lenders of funds in functioning of financial markets. Their primary role is restricted to borrowing of required funds. One of the methods of Government financing includes deficit financing i.e. borrowings to bridge the deficits. Government starts lending funds as soon as surplus is generated when revenues exceeds more than expenditures. However, there are many other factors which determine the demand for and supply of funds.

4) **Financial Intermediaries:** Efficiency of financial markets depends largely on existence of active and efficient functioning of financial intermediaries in the financial system. These intermediaries include banking organizations, non banking firms, mutual funds, investment institutions, financial institutions, insurance companies, etc. All these are involved in the task of allocating assets. These intermediaries play an important role in eliminating market imperfections. These imperfections mainly arise from lack of distribution of adequate and timely information to the borrowers.

5) **External Agencies:** In addition to domestic agencies, there are certain external / outside agencies which include foreign investors, foreign companies, foreign banks and financial institutions, etc. They cause demand for & supply of funds that are called International borrowings and lending. They are determined by various factors such as economic policies, information, transactions costs, etc. Foreign exchange market is concerned with borrowings and lending of foreign currencies.

1.2.2) Contribution of Indian Financial Markets

At present, Indian financial markets are more advanced and organized as compare to many other sectors in the country. The domestic financial markets play a significant role in promoting household savings within the economy. This further helps in implementing and executing the various economic and financial policies framed from time to time. Today, these markets are properly developed and well capable of overcoming from different phases of economic cycles. There are variety of financial products / instruments operating in these markets where prices are openly determined by large number of buyers and sellers. Financial markets in India are broadly classified into following types:

- **Capital Markets:** This also includes stock markets that make available capital funds to different corporates by issuing equity shares. Subsequently, it facilitates transfer and exchange of such securities among different people.
- **Bond Markets:** This makes available capital funds by issuing debt securities like bonds and debentures. Similarly, it also facilitates exchange of debt securities among different people.
- **Commodity Markets:** facilitates trading and exchange of different types of commodities and products.
- **Money Markets:** This helps in assembling short term finance for investing for short term requirements.
- **Derivative Markets:** In this, instruments are traded in order to reduce financial risk involved.

- **Futures Market:** provides forward contracts for trading products that shall be executed at a future date.
- **Insurance Market:** involves operations of various insurance companies with main objective of reducing different types of risks involved.
- **Foreign Exchange Market:** involves transactions related to various foreign currencies and reserves.

In addition to mobilization of savings from individual & institutional investors and promoting capital formation in the economy, Indian financial markets contribute significantly by performing various important functions. Financial markets provide wider number of investments alternatives and options to the investors. These alternatives are developed in order to fulfill different needs and objectives of investors. Also financial markets facilitate easy and quick liquidity of funds. Due to advancement in internet and technology, financial markets through demat / online accounts ensure speedy conversion of assets (securities) into cash and vice versa.

For ensuring smooth and efficient working of financial markets and in order to build up confidence among investors, SEBI issues different guidelines and by-laws at regular intervals. Bringing transparency in the operations helps to minimize risk, generating better returns and thereby, helps to attract large number of potential investors. Indian financial market acts as a mediator between household and business organizations. As a barometer of domestic economy, financial markets facilitate to measure the pace of economic growth and development of the country.

1.3) Indian Capital Market

Capital Market is a place where transactions related to financial assets that have long time maturity period takes place. Capital market is a regular and ideal source of external finance required by business firms for long term investments. ***Capital market is defined as a market for borrowing and lending long term capital funds required by the business enterprises. It refers to all the facilities and the institutional arrangements for borrowing and lending both medium term and long term funds.***[5] This market comprises of borrowers on one side who demand funds and lenders on other side who supply those funds. In capital market, there is direct as well as indirect link between ultimate borrowers & ultimate lenders. It is a market mechanism organised in order to bring these two sets of people together. Capital market which is also known as *Securities Market* deals with securities such as shares, stocks, bonds, debentures, etc. It is not confined to any specific locations. It exists all over the economy wherever suppliers and users of capital come together to do business.

According to Hebert E. Dougall, *"Capital Markets are the complex of institutions and mechanisms, whereby intermediate term loans and long term loans are pooled and made available to business, government and individuals & whereby instruments already outstanding are transferred."* [6] A well build capital market is very essential for both the industrial as well as

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[5]Gurusamy. S; *"Financial Services and Markets",* Vijay Nicole Imprints Limited, Chennai, 2004, p 450

[6]Patankar Sanjay, *"Analytical Financial Management"*, Everest Publishing House, Pune, 2000, p 131

economic development of a nation. It helps in solving the problem of scarcity of funds. Thus, it increases economic welfare of the society. Capital market plays a key role in assembling large volume of savings from numerous household investors into productive investments. The hard earned savings of individuals are collected and allocated among different corporate and other business houses. Developing capital market also helps in attracting new and prospective investors who are willing to make new investments. Investing funds in financial assets / securities are more productive as compare to investing in physical assets. Capital market provides adequate opportunities to investors for investing money in financial securities. Capital market acts as an important medium through which buyers and sellers can exchange different securities among themselves. This exchange takes place at a mutually agreed and determined price. It also allows better liquidity and easy marketability of long term securities. This further helps in establishing confidence in mind of investors. In simple words, capital market is a market place where productive capital can be raised and made available for industrial and investment purpose.

In India, number of financial reforms in financial markets, particularly in capital market was taken during 1990s. Today, those reforms have ensured that Indian Capital Market is now equivalent and competitive to various other capital markets in developed countries as well as emerging economies in the world. The size and volume of Indian capital market has improved, but there is a long way ahead. Certainly, Indian capital market has grown in size and depth in post reform period. But the scale and volume of activities is still negligible as compared to those prevailing in the global market.

The term capital market is a wider term which includes both, the new issue market and the stock markets. Capital market consists of two different segments, i.e. *Primary Market and Secondary Market.*

1.3.1) Primary Market (New Issue market)

Primary Market deals with new or fresh issue of securities. Therefore, is also known as *New Issue Market*. Primary market is an important constituent of capital market. Business houses require financial resources either for setting up new undertaking or for expansion, modernization or diversifying their existing business. However, primary market facilitates transfer of financial resources from those people who have savings and are willing to invest these funds in productive purposes. Primary market deals with issue of new / fresh instruments by corporate sector. This includes equity shares, preference shares, debentures, bonds, depository receipts, etc. Primary market plays a key role in raising maximum monetary resources for capital formation in the country. Thereby, it also ensures balanced and diversified industrial and economic growth. Thus, an efficient, effective and smooth functioning of primary market is very essential for overall economic growth and development of the country.

Primary market is considered as one of the important medium through which required funds are collected by corporate sector. Major players in primary market include Promoters of company, Merchant Bankers, Stock Brokers, Underwriters, Bankers to Issue, Mutual Fund Houses, Financial Institutions, Foreign Institutional Investors, Advertising Agencies, Joint Stock Companies, Individual Investors, etc. Primary market channelizes investors' savings into productive financial investments. Thus, proceeds

collected from new issue market results in investment in real capital of the country. Companies may raise long term capital in Primary market by way of Initial Public Offering (IPO) or Right Issue or by Private Placements.

1.3.2) Secondary Market (Stock Market)

Secondary Market also called as *Stock Market or Stock Exchange* provides a place for purchase or sale of existing / old securities. Secondary Market also known as *Existing Securities Market* facilitates trading in outstanding equity shares and/or debt claims. These securities may be either issued by public companies or local authorities or Government companies. This market provides a place for investor to convert their cash into securities and also vice versa. A stock exchange acts as a barometer for measuring the health of both, individual companies as well as overall economy. It ensures free and unrestricted transferability of different securities. Stock exchanges provide ready and continuous market for willing and desired investors who comes together to transact in securities. A well organised and properly regulated stock market ensures greater safety and fair dealing to investors. This is because all transactions on stock exchanges are made under well defined rules, regulations and bye – laws. This helps to develops confidence in the minds of savers and investors. This further encourages them to save more and invest these funds in securities which have better prospects and higher returns. Secondary market helps in allocating scare and limited available resources in proper and profitable avenues.

In India, the secondary market consists of around 27 recognised Stock Exchanges. It also includes Over the Counter Exchange of India (OTCEI) and the Interconnected Stock Exchange of India Limited (ISEIL) on which

existing instruments including negotiable debts are traded and exchanged. Of these stock markets, two stock exchanges are leading i.e. Bombay Stock Exchange (BSE) and National Stock Exchange (NSE). However, the major players in secondary market include individuals, companies, banks, stock brokers and agents, financial institutions, mutual funds, etc.

1.3.3) Primary Market v/s Secondary Market

Both, primary market and secondary market are interdependent and inseparable. They cannot exist without each other. There is a symbolic relationship between primary market and secondary market. The process of new capital formation takes place in primary market; whereas, the secondary market provides a continuous market for various financial securities. These securities are purchased and sold in volume with variation in current market prices. Secondary market also provides easy liquidity and ready market to initial buyers in primary market. Thus, they can further reinvest the same funds in some other securities. An active and effective secondary market promotes growth of capital formation as well as of primary market. This is because investors in primary market are assured of a ready marketability and proper liquidity of their investments. Hence, capital market which include primary market and secondary market are considered as backbone of financial system in any economy.

1.4) Indian Money Market

The Money Market is considered as an important segment of Indian financial system. It is a market for transactions related to monetary assets of short term maturity. It is a market where short term funds are borrowed and lend. In money market, surplus funds are assembled together and made available to business firms in order to meet temporary shortages of cash and other obligations. ***According to J. S. G. Wilson, Money Market is defined as "a centre in which financial institutions congregate for the purpose of dealing impersonally in monetary assets."*** [7] Money market which is also known as *Credit Market* is a market for short term financial assets, which are near substitutes for money. Financial instruments that are transacted and exchanged in money market are highly liquid in nature. They can be easily and quickly transferred from one person to another at low transaction cost and without much loss in its value.

As such, Money Market does not deal in cash or money. But it simply provides a market for credit instruments. These instruments include Treasury Bills (T-Bills), Bill of Exchanges, Promissory Notes, Commercial Papers, etc. It represents a pool of short term investible funds to meet short term requirements of the economy. Demand for such short term funds comes from business firms, traders, manufacturers, governments, etc. However, suppliers of these funds include commercial banks, insurance companies, mutual funds, non-banking financial institutions, etc. Alike to capital market,

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[7] Tripathy Nalini Prava, *"Financial Services",* Prentice Hall of India Private Limited, New Delhi, 2007, p 2

there is no specific fixed place for conducting operations of money markets. In money market, funds which are traded usually have a maturity period of maximum one year.

In India, money market includes both components organised and un-organised. Organised money market is dominated by commercial banks and other such financial institutions operating within the control of RBI. Money market is an important segment through which the central bank influences liquidity and general level of interest rates. Over a period, there has been substantial expansion and growth in organised money market in India. But still, there is a large portion of un-organised sector prevailing in India. This un-organised sector consists of local bankers and native money lenders. In addition, there is no clear differentiation between short term finance and long term finance in this un-organised segment. However recently, role of domestic un-organised sector in providing required financial resources has diminished considerably. This is mainly because of two reasons. First, due to increased geographical coverage of organised banking sector; and second, due to rise in flow of bank finance to small and retail borrowers. Still, huge numbers of poor people are unable to meet banking sector norms and requirements. Hence, they are left at the mercy of cruel money lenders and landlords. In money market, volumes of transactions are very large and are generally settled on daily basis. This trading is usually conducted through telephone, followed by written confirmation from both borrowers and lenders. In India, Reserve Bank of India (RBI) is the leader of money market. Indian money market consists of RBI, Commercial banks, Co–operative banks and other non banking financial institutions like LIC, GIC, UTI, etc. operating within the economy.

1.5) Foreign Exchange Market in India

Foreign Exchange Markets are the largest, but highly complicated element of financial markets in the world. Foreign exchange market covers all transactions involving trading and exchange of various currency units of different countries. Every country has its own domestic currency. All economic transactions at global level involve exchange of one currency unit for another. During foreign trade, every country requires currency units of different countries other than domestic currency. Foreign exchange market provides mechanism for exchanging different monetary units for each other. Thus, it also facilitates international trade and investments. This market operates with relatively free and with very few restrictions and regulations. In addition, there are no regulations for protection of investors and transparency in foreign exchange market.

In foreign exchange market, there is no physical place or location where buyers and sellers come together to exchange currencies. Trading is usually done over the counter. Exchange takes place through huge network of international banks, foreign dealers and currency brokers. All these are widely spread throughout the leading financial centers of world. Currency transactions takes place either through interbank network worldwide or through wholesale market in which banks trade with each other. This market is screen based market which is open for transactions throughout the day. There are large numbers of buyers and sellers in this market. Investors can trade in very large volumes without moving prices. Foreign exchange rates are determined on the basis of demand for and supply of currencies. These rates are adjusted quickly depending on volume of transactions. Traders in foreign exchange market prefer to trade in currency units of high income

countries. Also they prefer to trade in currencies of those countries where Government imposes lesser restrictions on currency trade.

Majority of transactions in foreign exchange market are wholesale in nature. These transactions are either spot contract or forward contract. In case of spot contract, foreign currencies are traded for immediate delivery within two business days. In case of forward contract, contracts are made to buy and sell currencies for future delivery. Major participants in foreign exchange market includes large commercial banks, individual traders, business firms, retail investors, dealers and brokers, investment banks, speculators and central banks. In India, key players in foreign exchange market include the authorised dealers that consist mainly of commercial banks, customers and RBI.

Foreign Exchange Dealers Association of India (FEDAI) plays an important role in implementing various rules for commission, fees and other charges. The Indian foreign exchange market mainly covers commercial segment. This segment is dominated by large number of customers trading to meet their needs of foreign exchange. Interbank market is dominated by State Bank of India (SBI) and other few foreign banks. Commercial banks play an important role of financing foreign trade and help to administer the Foreign Exchange Management Act (FEMA). These commercial banks have to maintain proper relationship with abroad banks through correspondence. In addition, they also have to maintain various accounts abroad to meet public requirements of foreign exchange. All sales and purchases of foreign exchanges takes place through these accounts maintained with banks abroad. These banks quote rates at which they are willing to buy and sell foreign exchange. These rates are determined according to rules and regulations of

RBI and FEDAI. The rates quoted depend upon rates prevailing either in interbank or in international markets. It also includes margin of profit charged by the commercial banks.

1.6) Concept and Meaning of Investment

Generally, *Investment* means employment of funds with an objective of achieving either additional income or growth in its value or both. Investment is commitment of funds either in real assets or financial assets. Investment involves sacrificing certain present value for some uncertain rewards in future. It involves commitment of funds which have been saved by postponing current consumptions. People postponed their present consumption in expectation that some benefits or rewards will take place in coming future. In broader sense, investment decision is a trade – off between both risk and return. It involves arriving at number of decisions including proper amount of funds, right timing, right class or grade of investment, etc. It is very important that investment decisions must not only be continuous, but also it must be rational.

Broadly speaking, there are three concepts of investments. First concept is the Economic Investment which normally means net additions to capital stock of the society. Capital stock of society means capital goods, i.e. those goods and commodities which are used in production of other goods and services. It also includes stocks of inventories and human capital that are used by manufacturers or producers in the process of production activities. Second concept indicates Investment in a more general or wider sense. In everyday use, the term investment means a number of things. But for a common individual, it refers to commitment of money of some kind. It

means investments of funds in the form of residence, vehicles, gold, silver, jewelries, white goods, etc. These types of investments are very general in nature. Hence, investors cannot expect either financial returns or capital growth from them. The third concept is termed as Financial Investments. It involves allocation of monetary resources in different stocks, securities and other such kind of financial instruments. These investments are made with an objective of generating some positive gains or returns from them over a given period of time. This return however depends upon volume of risk element involved in it.

1.6.1) Investment v/s Speculation v/s Gambling

The term Investment is very much different from Speculation and Gambling. Investment usually means putting money into different assets for a longer period of time in order to enjoy continuous and moderate returns over the period. Before purchasing any securities for investments, a proper investigation and analysis is carried out. This analysis makes sure to generate expected returns and minimize risk element involved. Investment considers limited volume of risk and aims towards safety of principal value. On other hand, Speculation is a short term concept. It means buying of assets and securities with an expectation that profits can be earned from subsequent changes in prices of those assets and securities. Speculation is generally based on expectations that certain price changes will occur in near future. It involves higher level of risk. Hence, excepted returns are more uncertain and doubtful. A well trained and experienced speculator will either buy or sell financial assets only when chances of his/her success are higher.

Gambling is opposite of investments. It indicates higher level of risk followed by higher expectations of returns. It consists of high uncertainty for thrill, fun and excitement. It is mainly based on tips, suggestions, intuitions and rumours. Gambling is unplanned, non–scientific and without any knowledge of exact nature of risk involved in it. In gambling, a person keeps on taking higher risk without demanding for any compensation.

Both, Speculation and Gambling are different from one another. In speculation, risk is already in existence, but question is who will bear that risk. In gambling, artificial and unnecessary risks are created purposefully. In speculation, future conditions can be anticipated sensibly. But gambling is more based on unreliable intuitions and judgments in order to create pleasure and adventure. Compare to gambling, speculation usually last for a longer period of time. On the basis of holding period, one cannot separate gambling from speculation and speculation from investments. In simple words, investments are carefully planned and properly analysed speculations.

Today, finding out right, adequate and profitable investment avenues are of great importance. This is due to ever changing and dynamic global environment. Investment skills are developed over a longer period of time. These skills are largely affected by knowledge, experience, logical analysis and research activities carried out to arrive at suitable conclusions. Success or failure of every investment activity mostly depends on expertise, know–how and ability of investors to invest right amount of funds in right type of investment at right time. While choosing any specific investment, investors must clearly define their investment objectives as well as desired features of their portfolios.

In reality, overall investment activity is much difficult than just setting up the objectives. Investments in real assets are different from investments in financial assets because real assets are more tangible, but less liquid in nature. Compare to financial assets, it is also difficult to accurately measure returns on real assets. This is because there is no ready and active market available for real assets. There are varieties of financial assets available in the market for investments that offers number of benefits to individual investors. All financial investments involve certain level of risk. But degree of risk associated and expected returns differ from one another.

1.6.2) Present Scenario

As an emerging economy, one important challenge that India faces is scarcity of capital. But capital formation, on other hand takes place from productive investments of available savings. Today, Investments has become a household word. It is very much popular among people from all parts of the society. This has been possible mainly because of rise in investible funds from different sections of the country. A well developed financial system consists of adequate financial institutions, sufficient financial instruments and properly regulated financial markets. All these factors together provides necessary framework for mobilization and allocation of valuable savings. Domestic savings is one of the most important factors that influence development of capital markets in any economy. Thus, these savings are an important aspect in the overall economic growth and development. Financial sector plays a significant role in assembling these wide spread domestic savings across the country.

In India, over a period of past two decades, development of financial sector has resulted into significant increase in the domestic savings rate, particularly savings from household sector. This steady and remarkable growth in domestic savings has been possible only because of financial deepening. India is one of few countries in the world to have achieved a consistently high rate of growth in its domestic savings. Gross Domestic Savings have increased substantially higher during past two decades. Thus, this indicates growth in potential funds for capital formation in the country.

Table 1.1: Table showing sector-wise Gross and Net Domestic Savings in India from 1991–92 to 2010–11 (Base Year 2004 – 05 at Current Prices)

(` in Crores)

Year	Household Sector			Private Corporate Sector	Public Sector	Gross Domestic Savings	Net Domestic Savings
	Financial Savings	Physical Savings	Total				
1991 – 92	62,101	43,531	1,05,632	20,304	17,594	1,43,530	78,904
1992 – 93	65,367	62,576	1,27,943	19,968	16,709	1,64,621	90,483
1993 – 94	94,738	56,716	1,51,454	29,866	11,674	1,92,994	1,10,138
1994 – 95	1,20,733	66,408	1,87,142	35,260	24,266	2,46,668	1,49,919
1995 – 96	1,05,719	92,866	1,98,585	59,153	31,527	2,89,265	1,76,679
1996 – 97	1,41,661	82,993	2,24,653	62,540	31,194	3,18,387	1,88,539
1997 – 98	1,46,777	1,37,350	2,84,127	66,080	29,583	3,79,790	2,32,523
1998 – 99	1,80,346	1,71,768	3,52,114	69,191	– 3,146	4,18,159	2,54,419
1999 – 00	2,06,603	2,32,248	4,38,851	87,234	– 9,238	5,16,846	3,30,374
2000 – 01	2,15,219	2,48,530	4,63,750	81,062	– 29,266	5,15,545	3,08,653
2001 – 02	2,47,475	2,97,813	5,45,288	76,906	– 36,820	5,85,375	3,56,526
2002 – 03	2,53,255	3,10,906	5,64,161	99,217	– 7,148	6,56,229	4,10,049
2003 – 04	3,13,260	3,44,327	6,57,587	1,29,816	36,372	8,23,775	5,51,621
2004 – 05	3,27,956	4,35,729	7,63,685	2,12,519	74,499	10,50,703	7,30,812
2005 – 06	4,38,331	4,30,657	8,68,988	2,77,208	88,955	12,35,151	8,71,430
2006 – 07	4,84,256	5,10,140	9,94,396	3,38,584	1,52,929	14,85,909	10,67,180
2007 – 08	5,80,210	5,38,137	11,18,347	4,69,023	2,48,962	18,36,332	13,51,637
2008 – 09	5,71,026	7,59,846	13,30,873	4,17,467	54,280	18,02,620	12,37,422
2009 – 10	8,35,558	8,03,481	16,39,038	5,32,136	11,796	21,82,970	15,25,073
2010 – 11	7,67,691	9,81,620	17,49,311	6,02,464	1,30,155	24,81,931	17,28,458

Source: Compiled from www.indiastats.com & Handbook of Statistics on Indian Economy, RBI

The above table exhibits Gross Domestic Savings and Net Domestic Savings generated in India at current prices from different sectors from 1991 – 92 to 2010 – 11. The table highlights that aggregate Gross Domestic Savings are rising continuously every year, but since 2001 – 02, this savings started increasing at an accelerated rate. This Gross Domestic Savings in India comes from three major sectors which includes Household sector, Private sector and Public sector. Of all these three sectors, Household sector contributed a huge portion to this GDS. On an average, approximately 70 to 80% p.a. of total savings have come from these individual households. This household savings further comprised of financial savings and savings in the form of physical assets of which both moves hand in hand. It can be seen from the table that volume of physical savings comparatively increased more than volume of savings in financial assets.

Second important contributor to this gross savings came from private sector companies which also add positively to this national savings. The savings from this private sector firms dropped marginally in 2000 – 01, but it enhanced significantly over the period. Private sector savings comprised of both, private companies and from co-operative banks & societies, of which the former contributed more compare to the later. The last source of savings was public sector units, whose contribution in national savings fluctuated consistently over two decades. It can be seen from above table that rather than adding funds for productive investments, it sucked out scare financial resources from the economy. However, later on after 2003 – 04, aggregate savings from public sector turned positive, but still was very variable. Of this public sector, huge valuable funds were expended on public authorities and on Government administration. However, since beginning, departmental

as well as non – departmental enterprises added positively among the public sector. As consumption on fixed capital was rising every year, but the expenditure was proportionately lower than aggregate gross savings generated. Hence, annual net savings produced every year was very substantial. Over a period of two decades (from 1991 – 92 to 2010 – 11), the Gross Domestic Savings and Net Domestic Savings has increased at a CAGR of 15.317% and 16.689% respectively which comparatively very high and significant.

One of most significant developments in pattern of savings was continued increase in financial savings from household sector. Also it was accompanied by an accelerating rise in physical savings. It can be seen that since beginning household individual savings were even greater than Net Domestic Savings. This indicates potential of household family savings which can be invested productively in capital assets is very high. Traditional investment avenues like bank deposits, life insurance, Provident Funds, Post Office Savings, investments in government securities, etc. continued to enjoy support of these household investors.

India being a developing economy is one of the emerging markets in the world. In this process of development, one important obstacle that India faces is scarcity of financial / monetary resources required for productive investments. This huge stock of rising savings particularly from household individuals can help India to overcome this problem. Financial resources available for capital formation in India are on rise. This further indicates a high growth and prospectus of development in Indian financial markets.

1.7) Investor and Types of Investors

1.7.1) Meaning of Investor

"An Investor is a person who uses money for the purchase of some species of property from which interest or profit is expected".[8] An investor is usually willing to take modest risk with his money to earn moderate returns. An investor makes his investment with an objective of earning long term gains which will be realised over a reasonable period of time. An investor expects rational periodic returns along with capital appreciation of his / her investments in long run. An investor mainly aims at safety of principal funds rather than taking unwanted high risk. There are different classes of investors for any portfolio which are broadly classified into following categories:

1) Individual Investors

a. Individual Investors includes those investors who are in some way associated with the company. This includes existing shareholders, employees, creditors, friends, relatives of management, customers, suppliers, consultants, etc.
b. This also includes those investors who are not associated with the company which include general investing public which in turn would include investors and speculators.

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[8] Jonathan Fisher QC, *"The Law of Investor Protection",* Second Edition, Sweet and Maxwell Ltd., London, 2003, p 3

2) Institutional Investors

a. Institutional Investors includes private sector institutions and public sector institutions. Private sector institutions include companies, private mutual funds, private banks, etc.
b. Public sector institutions include UTI, LIC, GIC, nationalised banks and other public sector institutions. These private sector and public sector institutions invest on their own on the stock markets or they may invest on behalf of others.

1.7.2) Investors in Mutual Funds

According to workbook for NISM series II – Registrar & Transfer Agents (Mutual Funds) Certification, published by National Institute of Securities Markets, Navi Mumbai in August 2009 (page 145), there are two broad categories of investors in a mutual fund: ***Individual Investors and Institutional Investors.*** Investment process as well as documentation details are different for both these categories.

1.7.2.1) Individual Investors

a) Individual Person

An Investor over and above 18 years of age is classified as resident individual. All individual investors are assumed to be resident of India, unless they are specifically mentioned as non-resident. A resident is an Indian citizen who has stayed in India for at least 182 days during previous financial year. An individual investor who is residing outside India is called an NRI (Non Resident Indian). Such individuals can either be Indian citizens or a Person of Indian Origin (PIO). PIO is the one whose spouse, parent or

grandparent is an Indian citizen or an NRI. *People who are residing outside India that are neither NRIs, nor PIOs are not eligible to invest in Indian mutual funds*.

b) Hindu Undivided Family (HUF)

Hindu Undivided Family (HUF) is a traditional Indian business structure. In this, pool of money belonging to a joint family business is managed by a senior male member of family called as ‘Karta’. Transactions on behalf of HUF are done by the Karta, in his own name. He indicates that he is acting on behalf of HUF by writing "HUF" alongside his name. While investing funds in mutual funds, HUF as an investors are required to provide basic information such as name of investor (s), address for correspondence, joint holders, signature, nominee, bank details, PAN number, etc.

c) Minor investors

Minor Investors are those whose age is less than 18 years on the date of investments in mutual funds. Whenever minor make an application, they have to compulsorily mention their date of birth. Legally, minors are not authorised to enter into any contracts on their own behalf. Therefore, financial transactions of minors are conducted by their guardian on their behalf. These guardians have to provide all the necessary details required by mutual fund which also includes their PAN. This is because they themselves are investing in mutual fund. Guardians must also sign the application and payment instruments on behalf of minors.

d) NRI Investors

RBI regulates foreign currencies coming in and going out of the country. Foreign Exchange Management Act (FEMA) is the regulatory body that controls all transactions that involve foreign currencies. There is no specific permission required from RBI for NRIs while investing money in mutual funds. NRI investors have to use payment instruments that clearly show sources of their funds. Investment in mutual funds can be made by NRI investors either from Non Resident External (NRE) Account or Non Resident Ordinary (NRO) Account. If they use NRE Account, which is a foreign currency account, they will be able to send back funds to their home countries on redemption. However, if investors use NRO Account, which is a rupee account, then funds cannot be redeemed and send back abroad.

NRIs may also use a foreign currency demand draft or direct remittance from their overseas bank to invest in Indian mutual funds. In such case, they will have to provide a Foreign Inward Remittance Certificate (FIRC) from their banker. This certificate will help to prove that their source of funds was in foreign currency. Thus, payments of funds on redemption can be sent back to their home country.

e) Investing through Power of Attorney

Individual investors who are willing to invest in Mutual Fund units can also use Power of Attorney (PoA). They can authorize any person whom they trust to execute transactions on their behalf with the help of Power of Attorney. This facility is mostly used by those NRIs who are staying outside in foreign country and are not able to invest in mutual fund in India. As minors are not permitted to enter into valid contracts, hence this provision of

PoA for investing in mutual funds is not applicable for them. The guardian who is acting on behalf of a minor plays a role similar to a PoA holder. Investing through Power of Attorney involves two parties. First party is the Grantor who is primary investor and grants the rights. Second party is the Attorney (or holder of PoA) who is authorised to execute an agreed set of actions on behalf of the grantor.

Generally, PoA holders exercise all the rights of an investor in a mutual fund. They can perform general routine transactions such as purchase and redemption of units, operating bank account of investor, etc. The rights of PoA holder are clearly defined in PoA agreement. Signature of Grantor is recorded in folio for the purpose of verification. Grantor can also continue to operate his / her account even after giving a PoA. Mutual fund investors can nominate any person to receive investment proceeds in case of their death. In case if nominees are minors, then details of guardian will also have to be provided. The PoA holders are neither authorised to change details of nomination, nor they can act as nominee of original investors.

1.7.2.2) Institutional Investors

Following are various types of institutional investors who are permitted to invest in mutual fund units in India:

- **Private and Public Companies:** These companies are formed and registered under Indian Companies Act 1956. Their objectives, functions and other regulations are laid out in Memorandum of Association (MoA) and Articles of Association (AoA). These companies are governed and managed by the Board of Directors.

- **Partnership Firms:** These firms are established by individuals who are known as partners coming together under a partnership deed.
- **Association of Persons:** These are set up by individuals to undertake a common set of activities as defined by terms of their charter / deed.
- **Societies and Trusts:** These organizations pool individual contributions together and manage them according to set objectives and goals. Trusts and societies can be set up for various purposes like social, religious, and educational, etc.
- **Banks and Financial Institutions (FIs):** Banks are set up under Banking Regulation Act 1949. These are financial institutions that are either set up under an Act or as a corporation.
- **Foreign Institutional Investors (FIIs):** FIIs are foreign institutions that are allowed to invest in Indian securities markets. However, they have to first register themselves as FIIs from the SEBI.

Individual investors invest in their own capacity. On other hand, institutional investors have to follow a prescribed procedure before they can invest in mutual funds. Generally, various institutions authorise specific managers / executives to execute investment decision on their behalf. The process for investing in mutual funds for institutional investors involves following three components:

- Charter of organisation authorizing to undertake investment activity.
- Managers need approval of concern people before they start investing institutional funds in mutual funds units.
- Authorised signatories should be selected to execute various decisions on behalf of the organization.