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Cool Explanations!

TABLE OF CONTENTS

<p>WHAT IS SWEAT EQUITY? GOLDEN HANDSHAKE WHAT IS INDIAN DEPOSITORY RECEIPT (IDR)? GOLDEN SHARE TOBIN TAX WHAT IS DIVIDEND INCOME? CURRENCY FUTURES 13TH FINANCE COMMISSION'S FUNCTIONS WHAT IS A PERPETUAL BOND? COMPULSORY LICENCING BENCHMARK BOND ESSENTIAL COMMODITIES ACT ALL ABOUT RATE CORRIDOR WHAT IS LIQUIDITY? WHAT IS FINANCIAL INCLUSION? RBI'S KEY POLICY RATES WHAT IS A GDP DEFLATOR? KYC NORMS FOR MF INVESTMENTS NEW RULES TREAT GDRS/ADRS ON PAR WITH SHARES WHAT ARE REVERSE MORTGAGE LOANS? LIFESTYLE INFLATION HOUSING START-UP INDEX INDIA REFUSES 'MARKET ECONOMY' STATUS TO CHINA STOCK VALUATION WHAT IS THE ASIAN CLEARING UNION (ACU)? PROGRESS OF THE BUDGET IN PARLIAMENT AND THE CONCEPT OF CUT MOTION SLR AND NON-SLR INVESTMENTS CHEQUE TRUNCATION SYSTEM STRIPS: GET THE RIGHT VIEW INTEREST RATE SWAP CASHLESS MEDICLAIM RIDER BENEFITS IN LIFE INSURANCE POLICIES NON-TAX SOURCES OF INCOME FOR THE GOVERNMENT FORWARD PREMIUM WHAT IS THE NEGOTIATED DEALING SYSTEM? WHAT IS ASSET-LIABILITY MISMATCH? BANKING OMBUDSMAN CLASH OVER ULIPS</p>	<p>WHAT IS SYSTEMATIC TRANSFER PLAN - STP? WHAT IS OFFSHORE BANKING UNIT? BIG WORDS IN THE BUDGET SPEECH WHAT ARE EXCHANGE TRADED FUNDS (ETFs)? NON-DELIVERABLE FORWARDS WHAT DOES POWER OF ATTORNEY MEAN? WHAT IS PRIVATE BANKING? LIMITED LIABILITY PARTNERSHIP WHAT IS VIABILITY GAP FUNDING? ESTATE PLANNING: WHAT IS ARBITRAGE? WHAT IS FISCAL CONSOLIDATION WHAT IS A STRUCTURED PRODUCT? WHAT IS A DEMAT ACCOUNT? WHAT SECURITIES CAN I HOLD IN MY DEMAT ACCOUNT? LIVING BEYOND MEANS WHAT DO EQUITY ANALYSTS' RECOMMENDATIONS MEAN? WHAT IS BEGGAR THY NEIGHBOUR POLICY? REGISTRAR AND TRANSFER AGENT IN A MF WHAT ARE MORTALITY CHARGES? WHAT IS REGULATORY AUTONOMY? WHAT IS A STOCK SPLIT? WHAT IS A CURRENCY PEG? WHAT IS THE CONCEPT OF ANCHOR INVESTOR? WHEN WAS IT INTRODUCED? WHAT IS FRONT RUNNING? WHAT IS AN INITIAL PUBLIC OFFERING (IPO)? HOW DOES A BANK MEET ITS DAY-TO-DAY SHORTFALLS OF CASH? WHAT ARE CAPITAL CONTROLS? VARIOUS TYPES OF TAX WHAT IS THE TAKEOUT FINANCING SCHEME? WHAT IS A MUTUAL FUND STATEMENT?</p>
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WHAT IS SWEAT EQUITY?

Sweat equity refers to shares given to a company's employees or directors on favourable terms in recognition of their work. These shares are issued to employees or directors at a discount or for a consideration other than cash for providing know-how, making available rights in the nature of intellectual property rights or value additions.

Why is sweat equity issued?

The idea behind issuing sweat equity is to retain your best employees. There is no limit to the discount on share price that can be offered. Sweat equity makes employees part owners of the company and gives them a share of profits earned.

Is there any limit to the amount of sweat equity?

The sweat equity issued during a year should not exceed 15% of the total paid-up capital of the company or a value of Rs 5 crore, whichever is higher. The company needs to get prior approval of the central government to go beyond this level. It is also restricted from issuing sweat equity before completing one year of incorporation.

Who determines the value of sweat equity?

The price of sweat equity shall be determined by an independent valuer. If shares are issued for a consideration other than cash, the valuation of intellectual property or know-how shall be carried out by a valuer. Such valuer shall consult experts considering the nature of the industry and the value addition.

What steps do a company need to take?

The issue of sweat equity shares should be approved by shareholders by means of a special resolution at a general meeting or an extra-ordinary general meeting of a company. The explanatory statement accompanying the notice of the general meeting should include reasons and justifications for such the sweat equity issue, value of such shares, the valuation report and other details.

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GOLDEN HANDSHAKE

A golden handshake is a clause in an executive employment contract that provides the executive with a significant severance package in the case that the executive loses their job through firing, restructuring, or even scheduled retirement. This can be in the form of cash, equity, and other benefits, and is often accompanied by an accelerated vesting of stock options.

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WHAT IS INDIAN DEPOSITORY RECEIPT (IDR)?

An IDR is a receipt, declaring ownership of shares of a foreign company. These receipts can be listed in India and traded in rupees. Just like overseas investors in the US-listed American Depository Receipts (ADRs) of Infosys and Wipro get receipts against ownership of shares held by an Indian custodian, an IDR is proof of ownership of foreign company's shares. The IDRs are denominated in Indian currency and are issued by a domestic depository and the underlying equity shares are secured with a custodian. An Indian investor pays in Indian rupees for the IDR whereas a shareholder in the issuer's home country pays in home currency.

What is the security of the underlying shares? Where will the receipts be deposited?

The underlying shares for IDRs will be deposited with an overseas custodian who will hold the shares on behalf of a domestic depository. The domestic depository will accordingly issue receipts to investors in India. Investors will get an entry in their demat accounts reflecting their IDR holding.

How will IDRs be issued? Who can participate?

IDRs will be issued to Indian residents in the same way as domestic shares are issued. The issuer company will make a public offer in India, and residents can bid the same way as they do for Indian shares. Investors eligible to participate in an IDR issue are institutional investors, including FIIs — but excluding insurance companies and venture capital funds — retail investors and non-Institutional Investors. NRIs can also participate in the Issue. Commercial banks may participate subject to approval from the RBI.

What are the benefits that Indian investors can look forward to?

Indian individual investors have restrictions on holding shares in foreign companies, but IDR gives Indian residents a chance to invest in a listed foreign entity. No resident individual can hold more than \$200,000 worth of foreign securities, including shares, as per foreign exchange regulations. However, this will not be applicable for IDR. Besides, these additional key requisites such as demat account outside India to hold foreign securities, KYC with foreign broker, foreign bank account to hold funds are too cumbersome for most investors. These troubles are completely avoided in holding IDRs.

Will Indian investors get equal rights as shareholders?

Indian investors have equivalent rights as shareholders. They can vote on EGM resolutions through the overseas custodian. Whatever benefits accrue to the shares, by way of dividend, rights, splits or bonuses will be passed on to the DR holders also, to the extent permissible under Indian law.

Can IDRs be converted?

IDR holders will have to wait for an year after issue before they can demand that their IDRs be converted into the underlying shares. However this conversion is subject to certain conditions:

- a) IDR Holders can convert IDRs into underlying equity shares only with the prior approval of the RBI.
- b) Upon such exchange, individual persons resident in India are allowed to hold the underlying shares only for the purpose of sale within a period of 30 days from the date of conversion of the IDRs into underlying shares
- c) Current regulations do not provide for exchange of equity shares into IDRs after the initial issuance i.e.reverse fungibility is not allowed.



GOLDEN SHARE

Golden Share is a nominal share, held by a government organization, in a government company undergoing the process of privatization and transformation into a stock-company. This share gives the government organization the right of decisive vote, thus to veto all other shares, in a shareholders-meeting. Usually this will be implemented through clauses in a company's Articles of Association (law), and will be designed to prevent stakebuilding above a certain percentage ownership level, or to give a government veto powers over any major corporate action (such as the sale of a major asset or subsidiary or of the company as a whole).

This share is often retained only for some for some defined period of time to allow a newly privatised company to become accustomed to operating in a public environment, unless ownership of the organization concerned is deemed to be of ongoing importance to national interests (e.g. for reasons of national security).

The term arose in the 1980s when the British government retained golden shares in companies it privatised, and later in many other European countries.



TOBIN TAX

Named after Nobel-winning US economist James Tobin who proposed it in 1971, this tax on short-term cross-border currency transactions is levied to discourage such flows and help stabilise exchange rates by curbing speculation. Since speculative currency trades occur on smaller margins, Tobin Tax reduces or eliminates incentive for speculation. Mr Tobin argued that national economies and governments are not capable of adjusting to massive movements of funds across borders, without sacrificing the effectiveness of national economic policy with respect to employment, output, and inflation.

Why is Tobin tax relevant now?

The global financial crisis reopened the debate on the relevance of Tobin tax. The proponents of the tax argue that ill-effects and risks of volatility are inherent to all financial markets and measures should be in place to curb flows. Many countries such as Brazil, Thailand, Columbia, Chile and Malaysia have similar taxes in place. Economists say globally co-ordinated action will enhance the effectiveness of the policies at the national level.

Is there an optimum Tobin tax rate?

In 2001, James Tobin said the rate could be close to 0.5%. Economists have proposed financial transaction tax rates ranging between 0.05% and 1%. Even a 0.5% tax applied per transaction in the currency market could discourage trades, as the spreads in the many of these transactions are as low as 0.005%.

What are the implications of the tax?

Various studies suggest that capital account management and measures like Tobin tax dissuade short-term capital flows. In the longer term non-financial direct investment is relatively unaffected by the tax. While the long-term implications on growth is not yet assessed, the literature available doesn't suggest any serious downside risk due to capital account management.

How effective is Tobin tax?

For a speculative trade to be profitable, the margin must be greater than the proposed tax. But some argue that Tobin tax will lower liquidity and hence raise volatility. So it may prove more damaging than exchange rate instability it is trying to cure.

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WHAT IS DIVIDEND INCOME?

Dividend is the portion of profits that a company distributes among its shareholders in the form of cash. Usually it is expressed per share. In some cases it is expressed as a percentage of the share's face value. So if your company declares a 100% dividend, you will get an amount equal to the face value of the share and not equal to its market price. When dividend is expressed in percentage terms, it is the face value that is referred to. The same holds good when it comes to dividends declared by mutual funds — it is the par value of units that is considered — which usually stands at Rs 10.

What is dividend yield? The ratio of dividend amount per share to the prevailing market price of the share is a yardstick to identify attractively-valued stocks. Other things remaining equal, the higher the dividend yield, more attractive is the stock for investors. Some draw a parallel between dividend yield and the rate of interest quoted on a fixed deposit, the only difference being that on the latter, the amount invested is expected to be returned along with a pre-determined interest whereas in the case of stocks, neither future dividends nor prices are fixed. One can extend the logic of dividend yield of a stock to a stock index to determine if an index is quoting at a cheap valuation.

Are stocks with high dividend yield good investments? If you come across a stock with a high-dividend yield, don't lap it up blindly. Check if the dividends are regularly paid by the company, which should have a dividend policy in place. You should also be aware of the source of the dividend, i.e., whether it is paid out of a previous year's profits or out of profits earned from non-operating activities such as sale of assets, etc. You further need to have a good sector understanding to pick up good opportunities.

Investing on the basis of dividend yield has emerged as a popular practice in developed markets. One such popular investing practice is 'Dogs of Dow' where investors each year pick up 10 stocks which have the highest dividend yields on the Dow Jones Industrial Average index. These stocks are held till the end of the year. This has made many invest in equities with minimum efforts on research and earn healthy returns.

How will I benefit from dividend income? In India, equity dividends paid by listed companies are tax free in the hands of shareholders. The company declaring the dividend has to pay a dividend distribution tax to the government. Though dividend is one of the reasons that makes investors hold on to equities, capital appreciation is a more important reason. Dividend yield can be a good tool to identify an undervalued stock that may offer good appreciation. There are investors who recognise the importance of dividend yield investing. Mutual funds have long ago identified it as a useful strategy in the Indian capital markets. There also are dedicated schemes that invest in equity and equity-related instruments of companies focusing on dividend yields of companies. The schemes maintain a portfolio of stocks that are available at attractive dividend yields among a host of other factors. The strategy is known as a defensive investment strategy.

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CURRENCY FUTURES

What are currency futures and how are they different from other derivatives?

Theoretically, a currency futures is a contract to exchange one currency for another at a specified date in the future at a price that is fixed in advance. The system was originally designed to protect against the risk of volatile currencies, especially for businesses having receipts or outgo of foreign currency as a part of their routine operations. However, today, currency futures are most commonly used by traders to speculate on the rate of the dollar and other currencies at a future date.

Who can profit from it?

Suppose an edible oil importer wants to import edible oil worth \$100,000 and places his import order on January 15, 2010, with the delivery date being four months ahead in April. At the time when the contract is placed, one US dollar was worth, say, Rs 45.50 in the spot market. Now, suppose the rupee depreciates to Rs 45.75 per US dollar when the payment is due in April 2010, the value of the payment for the importer goes up correspondingly. If the importer locks in a particular rate for April 2010 (by buying a currency futures contract) he is not affected by this rise in rate.

The same is true for a jeweller who is exporting gold jewellery, and fears an appreciating rupee. But we repeat, currently the product is mostly being used by individual traders who make money every time their prediction on the rate of the dollar is proved right.

Why has the product become so popular with Indian traders?

In the Indian version of the product, no hard currency actually changes hands. The difference in the price a trader predicted and the market price can be met through exchange of rupees. A forward contract, another derivative instrument that can also help protect against volatility in rates, has to be bought from a bank.

Besides that, one needs to have underlying business leading to receipts or payments of a foreign currency. In futures, an individual can open an account with a broker, like a share trading account, and get access to a screen and are instantly ready for action. Futures were mainly conceived for small corporates, while forwards are mainly used by large companies dealing in mega-dollars.

What is the future of futures?

Futures contracts based on dollar-rupee pair were introduced in India in August 2008. Given the recent surge in volumes, it's only a matter of time before RBI and Sebi introduce futures based on other currency pairs. So traders will soon get to speculate on the euro, yen and pound sterling. Currency futures are currently listed on National Stock Exchange, Bombay Stock Exchange and the MCX-SX.

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13TH FINANCE COMMISSION'S FUNCTIONS

What is the role of the commission?

The Constitution provides that certain tax revenues of the Union government be shared between the Centre and the states. President constitutes the finance commission under Article 280 of the Constitution to recommend what percentage of such revenues should go to the states and also how the funds are shared among the states.

Why the resources are shared between the Centre and states?

This is necessary due to the fact that the bulk of taxation powers are with the Centre, but expenditure is in the domain of states. In fact, most federal systems need a mechanism to address the issue of vertical distribution of resources. Canada has a federal system very similar to that of India. There, too, a mechanism is in place to address the issue of vertical imbalance and horizontal equity — how the resources are shared amongst states themselves. Australia is another such federal setup.

What are the other key responsibilities?

Finance commission is also required to lay down the principles governing the grants-in-aid to states out of the consolidated fund of India. It should also suggest measures to augment the resources of states to supplement the resources of panchayats and municipalities. At times the government can also ask the finance commission to make suggestions on specific issues. The Thirteenth Finance Commission was asked to make recommendations on accounting of off budget subsidies.

Are the recommendations of finance commission binding?

The recommendations of the finance commission are not binding on the government. But, the recommendations have the force of precedent and governments generally go by the suggestions. The recommendations relating to distribution of Union taxes and duties and grants-in-aid can be implemented by a presidential order.

When was the First Finance Commission appointed? What is the timeline for recommendations?

The First Finance Commission was constituted on 22 November 1951 under the chairmanship of KC Neogy. Thirteen finance commissions have been appointed so far at five-year intervals. Recommendations are valid for a period of five years. The recommendations of the current finance commission will be for the five year period beginning April 1, 2010.

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WHAT IS A PERPETUAL BOND?

As the name suggests, these are bonds which do not have any maturity date and are hence perpetual. Since they are never redeemed, such debt instruments give the issuers the comfort that equity capital offers in their capital base. Hence treated as equity by issuers, particularly the banks. Even regulators allow them to treat such bonds as a part of a bank's tier-I capital, which traditionally comprise equity instruments. (While tier-II capital of a bank comprises debt instruments). But on the flip side, unlike equity, they have to be serviced perpetually by way of paying interest to the subscribers of such bond.

Who are the issuers of such bonds?

Globally, such bonds are issued essentially by entities in need of very long-term funds such as the government, banks and other financial intermediaries. But in India, it is an innovative instrument that the Reserve Bank of India allowed them to do a few years ago because of its equity like features, and are allowed to be treated as tier-I capital.

Why is it relevant in India?

After RBI stipulated banks to migrate to Basel-II or the new international bank supervisory practice, capital requirements of Indian banks went up. Allowing only pure equity instruments may not be adequate for banks. Hence, banks were allowed to raise perpetual bonds to meet their capital requirements. However, there is a growing debate that only pure equity and net worth should qualify as tier-I in the future.

What are the features of such bonds in India?

In India, innovative perpetual debt instruments presently qualify as tier-I capital. They can be issued as bonds or debenture in the local currency and the amount raised through such instruments is to be decided by the bank's board. They can comprise up to 15% of a bank's tier-I capital after deduction of goodwill and intangible assets, but before investments. Excess amounts raised will be eligible for tier-II capital. Such bonds can be called back by the issuer after a supervisory approval.

COMPULSORY LICENCING

Compulsory licensing is a provision that allows governments to override Patent rights.

What is compulsory licensing?

Compulsory licensing is a process through which a government allows the local industry to produce drugs under patent protection without the permission of the patent holder. While the global agreement on intellectual property, the Trade Related Intellectual Property Rights (Trips) under the WTO, says that a patent holder will have the sole right to give permission to produce its patented products on payment of a licence fee, flexibilities have been given to countries to address public health concerns by issuing compulsory licenses.

When can a government issue compulsory licences?

These could be issued to address any public health concern as considered appropriate by the issuing country. The Trips Agreement gives a country the freedom to decide when it wants to issue such licenses and it does not necessarily have to be an emergency. It is generally issued for producing life-saving medicines to ensure their availability at low prices.

Does compulsory licensing strip a patent holder off the right to collect license fees on patented products or process?

Not at all. Companies that are issued compulsory licenses to produce a patented product have to pay 'adequate remuneration' based on the 'economic value' to the patent holder, but there is no elaboration on what the value is.

Why has India not been issuing compulsory licenses? Why has it suddenly woken up to the need?

While the Indian Patents Act provides for issuing of compulsory licenses, the procedural guidelines and the policy framework for the same are not in place. India had been taking it easy so far, as it had a flexible patent regime till 2005, which granted protection only to processes and not the final product. This allowed other producers to manufacture generic versions using a different method.

However, ever since there was a switch-over to the more stringent product patent regime in 2005 (under which a patented product cannot be produced through any other process) to meet the country's commitments under Trips, the country has been facing a shortage of life-saving drugs such as anti-cancer medicines and prices of patented versions have been going up. This prompted the DIPP to float a note on compulsory licensing inviting comments on how the country should go about implementing it.

Can compulsory licenses be issued for exporting to other countries?

Compulsory licenses are generally issued for producing for the domestic market. However, during the Doha ministerial meet in 2001 the WTO recognised that there are countries which do not have manufacturing capacities and allowed such countries to import generic versions from other countries by issuing compulsory licenses.

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BENCHMARK BOND

What is a benchmark bond in the government securities market?

The benchmark bond is the most actively-traded paper in the government securities market. In case of India, the 10 year Government bond maturing on March 5, 2020, with the fixed coupon rate of 7.8%, currently trading at an yield of 7.97% is the benchmark government bond.

Why is the maturity of a benchmark bond always 10 years?

Theoretically, there is a benchmark for a bond of every tenure, which would be the most liquid in the particular category, but in practice, the 10-year bond is the most prevalent and the most liquid among the g-sec bonds. Also, the government is most comfortable with such a tenure, to finance its long-term social infrastructure development projects. Therefore, in the Indian bond market, the 10-year security serves as the bellwether security.

What determines whether a bond will be a benchmark security?

The most important factor is the liquidity of the bond. Generally, the most liquid, in other words, most traded bond is the benchmark bond. Also, the residual tenure of the bond has to be of 10 years. The benchmark has a low bid-offer spread.

How long does a security remain a benchmark?

A security remains a benchmark for six months to a year or till its outstanding amount crosses `50,000 crore, whichever occurs earlier. Beyond a year, its tenure changes.

Why does the market need a benchmark?

A benchmark bond brings efficient price discovery as prices are determined by market forces of demand and supply based on its yield, unlike the illiquid bonds. The benchmark is a reference point for the pricing of other bonds along the yield curve. For example, it aids the pricing of non-SLR bonds along the yield curve. The benchmark helps peg floating rate assets and liabilities.

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ESSENTIAL COMMODITIES ACT

The Prime Minister will soon hold a meeting of chief ministers to discuss the alarming food price situation and review the implementation of Essential Commodities Act (ECA). We look at the ECA and how it can help combat the rising prices of food articles.

What are essential commodities?

The government has powers under the Essential Commodities Act, 1955 (EC Act) to declare a commodity as an essential commodity to ensure its availability to people at fair price. The EC Act, 1955 allows the government to control the production, supply, and distribution of these commodities for maintaining or increasing supplies and securing their equitable distribution. Essentially, the act aims to ensure easy availability of important commodities to consumers and check exploitation by traders.

How many commodities are covered by the Essential Commodities Act?

There are seven broad categories of essential commodities covered by the Act. These are (1) Drugs; (2) Fertilizer, inorganic, organic or mixed; (3) Foodstuffs, including edible oilseeds and oils; (4) Hank yarn made wholly from cotton; (5) Petroleum and petroleum products; (6) Raw jute and jute textile; (7) (i) seeds of food-crops and seeds of fruits and vegetables; (ii) seeds of cattle fodder; and (iii) jute seeds. Recently cotton seed was also included in the list.

How does the Act help check price rise?

The Act is implemented by the state governments and union territories, leaving the central government to merely monitor the action taken by states in implementing the provisions of the Act. State and UT administrations use the powers of the Act to impose stock or turnover limits for various commodities and penalise those who hold them in excess of the limit. Stock limits have been imposed in several states for pulses, edible oil, edible oilseeds, rice, paddy and sugar.

How effective is the Act?

Over the three years 2006-2008 , state and union territory governments prosecuted 14,541 persons under the provisions of EC Act, 1955 and secured conviction in 2,310 cases. In 2009 as on 31 August 2533 persons had been prosecuted and 37 convicted. But, doubts have been raised about effectiveness of the Act time and again. Recently, Parliament's estimates committee asked the government to come out expeditiously with a new legislation for controlling the retail prices of essential commodities such as rice, wheat, pulses, edible oils, sugar, milk and vegetables.

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ALL ABOUT RATE CORRIDOR

In the monetary policy on Wednesday, the RBI raised the repo rate by 25 basis points to 5.75% and the reverse repo rate by 50 basis points to 4.5%. This has narrowed the rate corridor from 150 basis points to 125 basis points.

What are repo and reverse repo rates?

- * Repo rate is the rate of interest charged by the central bank when banks borrow money from it. It is the tool through which the RBI in-fuses funds into the system by lending to banks against pledging of securities.
- * The reverse repo is the rate the RBI offers to banks when they deposit funds with it. The RBI drains out liquidity from the financial system through reverse repo by releasing bonds to the banks. This is a daily operation by the central bank to manage liquidity. Over a longer time, the RBI can also manage liquidity through open market operations.

What is an interest rate corridor?

- * Interest rate corridor refers to the window between the repo rate and the reverse repo rate wherein the reverse repo rate acts as a floor and the repo as the ceiling. Ideally, rates in the overnight interbank call money market, where lending and borrowing is unsecured, should move within this corridor. However, when banks are short of funds and the overnight call money rates are high and above the repo rate, banks approach the RBI to borrow under the repo window.
- * Therefore, the repo rate becomes an effective policy tool as it would help bring down the rates in the overnight market. The reverse happens when money market rates fall below the reverse repo rate. Banks then park surplus funds with the RBI through a reverse repo transaction. As a result, when there is excess liquidity in the system, the reverse repo is more effective. When liquidity is tight and banks need short-term funds from the RBI to manage mismatches, then the repo rate emerges as the effective policy rate. But if liquidity returns to the system the reverse repo would become the operative policy rate as the RBI would be draining out funds from the system.

Why is a narrow rate corridor desirable?

A narrow rate corridor means that short-term interest rates in the call money market will move within that band. This band was earlier 150 basis points, which has now been lowered to 125 basis points. Effectively, the narrower rate corridor will mean there will be less volatility in short term rates.

Do other central banks also have rate corridors?

Many developing countries have the rate corridors but central banks in developed and deeper financial markets have a single rate. In the US, for instance, the Fed Fund rate is the key interest rate. Short term funds are available at this rate to the eligible borrowers.

WHAT IS LIQUIDITY?

Liquidity simply means the amount of money floating in the system that is available to all participants in the financial markets, which includes individuals, corporate entities and the government.

What affects liquidity?

Liquidity is influenced by demand and supply of money in the system. The central bank, the Reserve Bank of India, can increase or decrease the liquidity in the financial markets. There are three ways the liquidity gets affected. First, the borrowings of the government — the biggest borrower in India — to fund the deficit that arises when its income falls short of expenses.

Second will be the increased borrowings by the corporate sector to fund capital expenditures and short-term credit needs. A third reason could be a reduction of availability of the rupee by the central bank by buying rupee and selling a foreign currency such as the US dollar. This is primarily done to maintain the value of rupee. The central bank prefers to withdraw excess liquidity from the financial market when asset prices near a bubble situation.

What are the variables affected by liquidity?

Commodities that are not available easily tend to become costly. Money is no exception to this. If the central bank prefers to reduce liquidity from the financial system, the same is reflected by a hardening of interest rates. It is especially visible at the short end of the yield curve. Put simply, the loans become costlier. At the other end, borrowers will have to pay more to raise money.

If there is ample liquidity in the financial system, investors and speculators find it easy to leverage. This ensures that the asset prices rise. Hence periods of low interest rates, with ample liquidity in the financial system, create a good environment for price rise across asset classes, such as equities, commodities and real estate. But if the liquidity is reduced, the speculators find it difficult to hold on to their positions due to higher interest burden or non availability of money. This results in a fall in asset prices.

What should investors do?

As the central bank makes their stand clear on policy issues such as interest rates, investors should be prepared to take advantage of the same.

When the interest rates enjoy upward bias and liquidity is seen tight, it makes sense to go for short-term bond funds to enjoy good risk adjusted returns. As liquidity tightens, the short end of the yield curve finds the maximum movement and short-term bond fund managers, if they can catch the movement, reward investors well.

There are events where large-scale borrowings from the corporate sector draws money out of the system, pushing interest rates up. This is the time one can lock in returns by investing in fixed maturity plans. Traditionally, such opportunities were

seen ahead of advanced tax payments by the corporate sector, when the liquidity in the system goes down.

Investors can also find solace by investing in floating rate instruments, to catch interest rate movements arising out of a modification in liquidity in the financial system. Investors with high risk appetite can consider resorting to leverage to build big positions in assets of their choice.



WHAT IS FINANCIAL INCLUSION?

In a broader sense, financial inclusion is providing or ensuring banking services at affordable costs to the weaker sections of society or the unbanked segment which does not have access to the formal banking system. In bigger cities, every household may have more than one bank account but thousands of villages in India do not even have a bank branch. The Indian central bank — Reserve Bank of India, or RBI — is keen on achieving 100 per cent financial inclusion and has nudged banks to extend the reach to as many citizens as possible.

What is the status of financial inclusion in India?

Despite the rapid advance in technology, after five decades since independence, close to 60 per cent of the population in India do not have a bank account. This ratio is especially higher in the North-Eastern part of the country. Of the six lakh villages, only 30,000 have bank branches. A government-sponsored report says only 10 per cent of Indians have a life insurance cover, 13 per cent have debit cards and just two per cent own credit cards.

Why is RBI keen on 100 per cent financial inclusion?

In a recent speech, RBI Governor D Subbarao said financial inclusion was the key to sustaining equitable growth. Access to financial services will provide the poor opportunities to build savings, make investments and avail of credit. Also, such access helps them insure themselves against income shocks and equips them to meet emergencies such as illness, death in the family or loss of employment. Further, 'it protects the poor from the clutches of the usurious money lenders,' he was quoted as saying.



RBI'S KEY POLICY RATES

What are the key policy rates used by RBI to influence interest rates?

The key policy or 'signalling' rates include the bank rate, the repo rate, the reverse repo rate, the cash reserve ratio (CRR) and the statutory liquidity ratio (SLR). RBI increases its key policy rates when there is greater volume of money in the economy. In other words, when too much money is chasing the same or lesser quantity of goods and services. Conversely, when there is a liquidity crunch or recession, RBI would lower its key policy rates to inject more money into the economic system.

What is repo rate?

Repo rate, or repurchase rate, is the rate at which RBI lends to banks for short periods. This is done by RBI buying government bonds from banks with an agreement to sell them back at a fixed rate. If the RBI wants to make it more expensive for banks to borrow money, it increases the repo rate. Similarly, if it wants to make it cheaper for banks to borrow money, it reduces the repo rate. The current repo rate is 5.50%.

What is reverse repo rate?

Reverse repo rate is the rate of interest at which the RBI borrows funds from other banks in the short term. Like the repo, this is done by RBI selling government bonds to banks with the commitment to buy them back at a future date. The banks use the reverse repo facility to deposit their short-term excess funds with the RBI and earn interest on it. RBI can reduce liquidity in the banking system by increasing the rate at which it borrows from banks. Hiking the repo and reverse repo rate ends up reducing the liquidity and pushes up interest rates.

What is Cash Reserve ratio?

Cash reserve Ratio (CRR) is the amount of funds that banks have to park with RBI. If RBI decides to increase the cash reserve ratio, the available amount with banks would reduce. The bank increases CRR to impound surplus liquidity. CRR serves two purposes: One, it ensures that a portion of bank deposits are always available to meet withdrawal demand, and secondly, it enables that RBI control liquidity in the system, and thereby, inflation by tying their hands in lending money. The current CRR is 6%.

What is SLR? (Statutory Liquidity Ratio)

Apart from keeping a portion of deposits with RBI as cash, banks are also required to maintain a minimum percentage of deposits with them at the end of every business day, in the form of gold, cash, government bonds or other approved securities. This minimum percentage is called Statutory Liquidity Ratio. The current SLR is 25%. In times of high growth, an increase in SLR requirement reduces lendable resources of banks and pushes up interest rates.

What is the bank rate?

Unlike other policy rates, the bank rate is purely a signalling rate and most interest rates are delinked from the bank rate. Also, the bank rate is the indicative rate at which RBI lends money to other banks (or financial institutions) The bank rate signals the central bank's long-term outlook on interest rates. If the bank rate moves up, long-term interest rates also tend to move up, and vice-versa.



WHAT IS A GDP DEFLATOR?

What is a price deflator?

A deflator is used to convert data compiled over a period into prices prevailing at an earlier point in time. for example, the current price of a television can be deflated to what it would cost say three years ago. Essentially, a deflator removes the effect of inflation from data, making it comparable across periods.

What is the role of price deflator in GDP calculations?

Prices are always in a state of flux, but generally move upwards over time. Therefore, a change in prices can give the impression of an increase in the gross domestic product (GDP -- a measure of national income) even without an increase in the quantity of goods and services produced by an economy. The impact of prices has to be removed to arrive at a true measure of economic growth. A deflator is used to restate output estimates at current prices into what they would be if calculated with reference to prices in an earlier year. This will give an idea of the real growth in the economy, minus the price effect.

Why is GDP deflator considered a good measure of inflation?

The ratio between the GDP at current prices and GDP at constant prices gives an idea of the increase in prices of all goods and services with reference to the base year. In that sense it is a more comprehensive measure of inflation than price indices, which are based only on a limited basket of goods collected from select centres. However, the deflator comes with a lag, which limits its usefulness.

How is it used in India?

In India a combination of WPI and CPI is used as deflator. The usage is dependent on the particular estimate we are trying to deflate. There will be different deflators for private consumption and government consumption. There is a difference in the value of quarterly and year-end deflators. This is due to the fact that prices are not constant. At the year-end we have an overall measure of WPI/CPI, which is used appropriately. This is why year-end estimates of GDP are more reliable than quarterly estimates.



KYC NORMS FOR MF INVESTMENTS

What is KYC?

Client identification process is known as 'Know Your Customer or Client' aka- KYC. Sebi has made it mandatory for all mutual funds to know their clients. This would be in the form of verification of address and identity, providing financial status, occupation and such other demographic information to CDSL Ventures Limited (CVL), a wholly owned subsidiary of Central Depository Services India Limited. Investments equal to and more than Rs 50,000 in a mutual fund portfolio necessarily have to be accompanied by a KYC acknowledgement letter.

How to get KYC compliant?

CVL is the designated body to carry out the KYC compliance procedure for mutual fund investors. You have to approach CVL through any of the point of service (POS). The KYC application form is available on the CVL website in the downloads section. One can take a printout of the applicable form. The same is also available on mutual fund websites.

Investors need to attach self-attested photocopy of the pan card as identity proof, along with the application form. There is a need of self-attested photocopy of an address proof enlisted by CVL. Alternatively, the investors can also attach true copies attested by a notary or a gazetted officer or a manager of a scheduled commercial bank of a multinational foreign bank. Investors need not visit POS in person. The application can be routed through mutual fund distributors or a representative of investors. The original documents are verified at the counter and given back to the applicant or representatives of the applicant.

Non-resident Indians also need to undertake the same process. They additionally have to provide certified true copy of their overseas address. If the same is in foreign language other than English, the same has to be translated in English for submission. The documents can be attested by the consulate office or overseas branches of scheduled commercial banks registered in India.

POS upon verification of the documents and receipt of duly filled-in application form issues an acknowledgement letter free of cost. The letter needs to be duly stamped and signed by representatives of POS. In the case of joint holdings in a portfolio, all joint holders have to get themselves KYC-compliant. Applications where the investments are in joint names, photocopies of KYC acknowledgement letters of all applicants must be attached with the application form. In the case of investments in the name of minors, the KYC acknowledgement letter of the guardian is a must.

What should you do with KYC acknowledgement letter?

Please note that neither POS nor CVL will inform about the KYC exercise you have completed in respect of any of the mutual fund houses. It is your responsibility to do so. You can attach a photocopy of KYC acknowledgement letter, along with the application letter, at the time of fresh investments. You can simply write to the fund houses where you have an investment and request them to update your KYC status.

Such requests must be accompanied by the photocopies of the KYC acknowledgement letter. You can also attach the photocopy of KYC acknowledgement letter with your request for additional investments in your mutual fund portfolio.

A point to note that upon submission of your KYC acknowledgement letter, the mutual fund house will update your status in their books. The address mentioned in your KYC letter will prevail over the address you have mentioned in your original application. All future correspondence by the fund house will be maintained at the address mentioned in the KYC letter.

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NEW RULES TREAT GDRs/ADRS ON PAR WITH SHARES

Do Global Depository Receipts (GDRs) and American Depository Receipts (ADRs) currently have voting rights?

The GDRs and ADRs in themselves do not have voting rights, but the underlying equity shares do. These shares are held by a depository, which then issues the corresponding receipts (GDRs/ADRs) to investors looking to buy such instruments. So it is the depository that has the voting rights. Whether the holders of the GDRs/ADRs can vote or not depends on the depository agreement between the company issuing the GDRs/ADRs and the depository. During the initial years when GDRs and ADRs came into vogue, the agreement mandated depositories to vote on behalf of the management. But later, the depository agreements were changed so as to allow the GDR/ADR holders to instruct the depository to vote on their behalf.

How do ADRs/GDRs work?

ADRs/GDRs are issued by companies looking to raise funds overseas. These instruments may represent one, multiple or a fraction of the underlying shares. For instance, if an Indian company wants to issue ADRs, it will deliver the corresponding number of shares to the US depository bank. The depository will then issue receipts to investors who have subscribed to the issue. Depository receipts are transferable instruments, so they can be freely traded on the exchange on which they are listed. They are also fungible, which means the holder of ADRs can instruct the depository to convert them into underlying shares and offload them in the local market (in this case India).

What did SEBI say about GDRs/ADRs on Tuesday?

Till now, purchases made through GDRs/ADRs did not trigger an open offer by the acquirer even if the 15% threshold was crossed so long as the depository receipts had not been converted into underlying shares. But on Tuesday, the regulator amended this rule. Anyone now holding ADRs/GDRs with voting rights will have to make an open offer to minority shareholders if his holding touches the 15% limit.

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WHAT ARE REVERSE MORTGAGE LOANS ?

Reverse Mortgage Loan (RML) enables a Senior Citizen — In India, citizens above 60 years age — to avail of periodical payments from a lender against the mortgage of his/her house. Such a loan allows the borrower to continue to occupy his house as long as he lives. Unlike other loans, reverse mortgage need not be repaid by the borrower.

How are such loans structured?

In India, RMLs can be extended by banks and housing finance companies registered with the National Housing Bank. The loan amount is dependent on the value of the house property as assessed by the lender, age of the borrower(s) and prevalent interest rate.

The loan can be provided through monthly or quarterly or half-yearly or annual disbursements or a lumpsum or as a committed line of credit or as a combination of the three. The maximum period of the loan (over which the payments can be made to the reverse mortgage borrower) is 20 years. The lender on the other hand has to value the property periodically at least once in five years and the quantum of loan may be revised based on such re-valuation of property at the discretion of the lender.

How are such loans settled?

On the borrower's death or on the borrower leaving the house property permanently, the loan is repaid along with accumulated interest, through sale of the house property. The borrowers or their heirs also have the option of prepaying the loan at any time during the loan tenor or later, without any prepayment levy. The borrowers/heirs can also repay the loan with accumulated interest and have the mortgage released without resorting to sale of the property.

Are there any taxation issues?

A mortgage of property, in certain cases, is a transfer under the provisions of the Income-Tax Act. Consequently, any gain arising upon mortgage of a property may give rise to capital gains. However, in the context of a reverse mortgage, the intention is to secure a stream of cash flow against the mortgage of a residential house and not to alienate the property.

A new clause has been inserted to provide that any transfer of a capital asset in a transaction of reverse mortgage under a scheme made and notified by the Central Government shall not be regarded as a transfer. A borrower, under a reverse mortgage scheme, shall, however, be liable to income tax (in the nature of tax on capital gains) only at the point of alienation of the mortgaged property by the mortgagee for the purposes of recovering the loan.

BASIC TRAVEL QUOTA

Foreign currencies that Indians are allowed to buy for leisure and/or business travel overseas come under the basic travel quota which the Reserve Bank of India prescribes. RBI fixes a cap on the amount that can be bought for such purposes. This cap has been progressively relaxed.

Why did RBI increase forex limit recently?

The increase is a part of the central bank's move to liberalise foreign exchange transactions. Travellers can now buy foreign exchange from banks and full-fledged money changers up to \$3,000 in cash. Any cash more than this would require special RBI approvals. Earlier, this limit was \$2,000. This is a part of the government's ongoing efforts to ease restrictions around hard currency movements. RBI has also specific limits for some countries. For instance, for travel to certain countries like Iraq, Libya, Islamic Republic of Iran, Russian Federation and other Republics of Commonwealth of Independent States, the limit is even higher at \$5,000.

Can travellers carry other alternate instruments?

A traveller can of course carry more money than this, but she or he will have to do it with traveller's cheques, banker's drafts or prepaid cards issued by banks. Banks and money changers can release foreign exchange up to \$25,000 for a business trip for most countries. For a casual tourist, this limit is set at \$10,000 for medical treatment and for studies abroad, it is \$100,000.

Why does India have limits on hard cash for travellers going abroad?

The Indian rupee is fully convertible on current account, but only partially convertible on capital account. This means that while exporters and importers are allowed to buy and sell foreign currency as per their requirements without RBI's permission, any currency movement outside trade is strictly regulated. Typically, developing countries which have faced foreign exchange problems in the past use such restrictions to avoid sudden erosion of their foreign exchange reserves which are essential to maintain financial stability and that of trade balances.

What is ultimate policy destination?

With India's forex reserves increasing steadily, it has slowly and steadily removed restrictions on the movement of capital on many counts. An ideal scenario is when the rupee is fully convertible on the capital account, so that a person travelling abroad can take any amount of cash as he thinks fit, as is the case with open markets like the US.

LIFESTYLE INFLATION

Rising inflation raises the spectre of an increase in the cost of living. But for most of the Indian middle class with high aspirations, the main reason why their salaries are never enough is they acquire expensive tastes and desires as their salaries rise. Welcome to lifestyle inflation.

What is lifestyle inflation? Lifestyle inflation indicates the rise in your lifestyle expenses, which you need to consider even if the headline inflation — the data published every Thursday — is not soaring. There are two versions of lifestyle inflation. One expensive tastes and desires, which is also the function of choices available, coupled with higher purchasing power. For example, earlier you would have been watching movies in a small theatre in your neighbourhood. But now, you would have upgraded to multiplexes. That simply means a jump in your ticket costs from Rs 100 to Rs 250. This jump in lifestyle costs is lifestyle inflation. Another way to define your lifestyle inflation is the nature of your consumption. For example, if your hobby is to travel and explore the earth, then it is expensive today, considering the soaring oil prices.

Is it a new concept? Earlier, the concept of lifestyle inflation was not prevalent. The reason being, the growth in income of most individuals was usually 5% over and above the inflation. Hence, people in earlier generations saw lesser or no surplus income in the individual's hands. Now, the income grows a minimum of 10% in excess of inflation. Second, the salary structures of people working in the private sector realise higher disposable income as most companies don't deduct retirement benefits. So, the affordability is much higher which makes people succumb to aspirational and peer pressures. Third, people have to actively save and invest to live off their savings in future.

When does it affect you? The lifestyle inflation bug hits individuals who are in the range of 30-45 years. This is the age where individuals stretch themselves to buy the latest car or the LCD TV even if that siphons off their bank balance. They are ready to take higher EMIs for their Honda City and subsequently replace it with a Toyota Corolla even before completing the loan tenure. If an individual is over 40 years, they show more maturity and just look at a car more from the utility perspective than the status symbol. Also, an individual doesn't expect as sharp an increase in his income at this age as in his thirties, experts say.

How do I provide for it in my investments? Whenever you invest in an instrument, compute the future value after accounting for an inflation of 8-10% to get accurate results. Fixed deposits, PPF or NSC assure safe returns, but are not capable of beating the inflation. Real estate, gold, and equity are considered good hedges against inflation on a long-term basis. It's crucial to provide a certain mark-up at the planning phase itself. For retirement planning, every individual has to do a certain loading on the numbers today based on their lifestyle to get the required future value. Again, this loading has to vary from period to period so as to reflect true value.

HOUSING START-UP INDEX

What is a Housing Start-Up Index?

Housing start up index (HSUI) tracks construction of new houses started in a particular period. It is a measure of the level of construction activity in a given period for a region and is considered as one of the leading indicators of economic activity. New starts pick up when the business cycle picks up.

How does such an index help?

Business: Housing activity has a bearing on a number of other sectors such as steel, cement and construction labour. Moreover, investment in housing would at a later stage translate into increased purchases of other consumer goods such as furniture, furnishings and home appliances. Timely and quality data on housing starts can help these businesses plan better. The index will help the developers ascertain the risk of building in a particular area, as it will provide information about the construction activity happening across major cities. For instance, a developer will not enter a location where there excessive housing construction.

Policy-makers: The housing start index is one of the key leading indicators of the economic activity. It is a good measure of consumer confidence as only in a situation when they are confident about the future would they take on a big liability such as buying a house. Therefore, the index is one of the important input in monetary policy in the developed countries and is keenly watched. It can also help authorities detect property bubbles in their early stage.

Home buyers: Through this index, prospective buyer or seller will get a good idea of the future supply, helping them get a better fix on the likely trends in prices. The buyer/seller can compare the index price with the offer while deciding on a deal. The Index, also helps in tracking consumer behaviour as well as the investment trends geographically.

Which cities will be covered under the index?

The first phase of HSUI will cover 31 cities across the country. These will include all major cities like Delhi, Mumbai, Chennai, Bengaluru, Kolkata, among others. Eventually it will cover the rest of the country. Once operational, the data is expected to be printed on a quarterly basis.

INDIA REFUSES 'MARKET ECONOMY' STATUS TO CHINA

India has refused 'market economy' status to China. We look at what it means for china?

What is a 'market economy' status?

When a country accords market economy status to another country, it recognises that free market forces of demand and supply are operating there. It accepts that economic variables such as prices and exchange rates are not determined by the state. When a country recognises another as a market economy, it will have to accept information on prices supplied by that country while contesting anti-dumping cases.

Why is India refusing to give the status?

India believes that China's corporate governance and accounting systems are not transparent and the country is not following global best practices in its financial & banking systems and stock markets. It had recently sent a questionnaire to China seeking information on key issues such as land laws, accounting practices, minimum wages and electricity rates, which was the first step towards granting the status. China, however, dismissed the move labelling the entire issue as a political one.

Is the issue economic or political?

The issue is both economic and political. China has the maximum cases of dumping -- exporting goods at prices lower than those prevailing in its domestic market -- against it. India does not want to give the market economy status to China as it would then have to accept all information on local prices supplied by China while framing its dumping cases.

At present, India fights anti-dumping cases against China on the basis of prices prevailing in third countries exporting the same product to India. Refusing to recognise China as a market economy also suits India politically at the moment because of the renewed tension on the border. A few years back when political relations with China were better, the ministry of external affairs was trying to convince the commerce department to grant the status to the country.

Is India breaking multilateral trade rules?

Not at all. As per China's accession contract with the World Trade Organisation (WTO), members are not obligated to recognise China as a market economy till 2016. Only about 60 countries have given China the status. These countries include members of the 10-member Asean, which has a free trade agreement with China.

STOCK VALUATION

What are the various analytical approaches for valuation of stocks?

For investing, an investor can use an approach based on either fundamental analysis, technical analysis or quantitative analysis.

What is Fundamental Analysis?

It is the process of looking at a company's business from an investment point of view. The process involves analysing a company's management capabilities, its competitive advantages, its competitors and the markets it functions in.

As part of the analysis, you would look at examining key financial ratios like the net profit margins, operating margins, earnings per share and so on.

After examining the key ratios of a business, one can come at a conclusion about the financial health of a stock and determine the value of the stock. It further focuses primarily on the valuation of a company and its relationship with the current share price.

Combining all this, the analyst arrives at a valuation for a stock. Fundamental analysts believe that it is possible to estimate the true value of a company using these financial valuation methodologies.

If the share price is trading below the value arrived at by a fundamental analyst, investors should buy the stock, in anticipation of the share price rising to the true value in the future. Conversely, if the share price is higher than the estimated true value, investors should sell.

What is Technical Analysis?

This technique focuses on the past to predict the value of the future, using share prices and volumes traded in a stock. It does not look at fundamentals or financial results at all. Technical analysts believe that all information about a company is factored into the share price.

According to them, share price behaviour is repetitive in nature and hence can be used to predict future share price movements. Based on historical share price data of a company, technical analysts identify share price levels that act as support or resistance.

They try to identify support, resistance and breakout levels for stocks. Technical analysts also use various technical indicators and chart patterns to help them determine probable future share price movements.

What is quantitative analysis?

With the advent of computers, a third type, namely quantitative analysis, has come up. Quantitative analysis seeks to understand behaviour by using complex mathematical and statistical modelling, measurement and research. It is a process of determining the value of a security by examining its numerical, measurable characteristics like sales, earnings and profit margins.

Pure quantitative analysts look only at numbers with almost no regard for the underlying business. Although even fundamental analysis look at numbers from a balance sheet, their primary focus is always the underlying business, the environment in which the company is operating and so on. Quantitative analysts create mathematical algorithms, which help them arrive at buy and sell decisions.

Which is the best?

The different analytical tools have different uses. For instance, fundamental analysis could be used to identify companies with a possibility of strong earnings growth in the future.

Technical analysis could be used to decide when to buy this stock. When you combine technical and fundamental analysis it is called techno-fundamental research. Depending upon your style and time frame of investment you could choose among them.

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WHAT IS THE ASIAN CLEARING UNION (ACU)?

ACU is a system for clearing payments among the member countries on a multilateral basis. The central banks and monetary authorities of Iran, India, Bangladesh, Bhutan, Nepal, Pakistan, Sri Lanka and Myanmar (Maldives wef 1.1.2010) are the members of the ACU. It was established in 1974, with its headquarters in Tehran, Iran, at the initiative of the United Nations Economic and Social Commission for Asia and Pacific (ESCAP), as a step towards securing regional co-operation.

How are the ACU transactions to be handled?

All transactions to be cleared through the ACU are handled by authorised dealers in foreign exchange, which are essentially commercial banks with a foreign exchange treasury, in the same manner as other normal foreign exchange transactions. All authorised dealers in India have been permitted to handle ACU transactions. They may freely enter into correspondent arrangements with banks in the other countries participating in the Clearing Union. The Asian Monetary Unit is the common unit of account of ACU and is equivalent in value to one US dollar or one EURO. The Asian Monetary Unit may also be denominated as ACU dollar / ACU Euro.

What is the procedure for settlement of transactions?

Large part of transactions are settled directly through the accounts maintained by authorised dealers with banks in the other participating countries and vice-versa, only the spill-overs in either direction are required to be settled by the central banks in the countries concerned through the clearing union. Authorised dealers are permitted to settle commercial and other eligible transactions in much the same manner as other normal foreign exchange transactions. Authorised dealers can open ACU dollar accounts in the names of all banks, in all member countries, including Pakistan, without the prior approval of RBI.

What is the mechanism for settlement through ACU?

RBI undertakes to receive and pay US dollars from/to authorised dealer for the purpose of funding or for repatriating the excess liquidity in the ACU dollar accounts maintained by the authorised dealer with their correspondents in the other participating countries. Similarly, the central bank has also been receiving and delivering US dollar amounts for absorbing liquidity or for funding the ACU dollar (vostro) accounts maintained by the authorised dealers on behalf of their overseas correspondents.

What are the transactions which are eligible to be settled through ACU?

Transactions that are eligible to be made through ACU are payments from a resident in the territory of one participant to a resident in the territory of another participant. Other eligible transactions among others include the ones for current international transactions as defined by the Articles of Agreement of the International Monetary Fund.

PROGRESS OF THE BUDGET IN PARLIAMENT AND THE CONCEPT OF CUT MOTION

How is the budget debated in Parliament?

Budget discussion in the Lok Sabha is a two-stage process. In the first stage there is a general discussion on the budget as a whole, lasting 4-5 days. Only the broad contours of the budget and the principles and policies underlying it are discussed at this stage. After the general discussion on both the railway and general budgets, the House is adjourned for a period. In this interval, demands for grants of various ministries and departments including railways are considered by the concerned standing committees (Rule 331G). These committees are required to submit their reports to the House within a specified period without asking for more time. The reports of the standing committees are of persuasive nature, they cannot suggest anything in the nature of cut motions.

How are demands for grants dealt with by the Lok Sabha?

After the reports of the standing committees are available with the House, it begins discussion and voting on demands for grants of each ministry. The speaker, in consultation with the leader of the House, fixes for the time for discussion and voting on demands for grants. On the last day, the speaker puts all the outstanding demands to vote. This process is known as 'guillotine'. The Lok Sabha has the power to assent to or refuse to give assent to any demand or even to reduce the amount of grant sought by the government.

What are cut motions?

These are moved to discuss specific matters by the minister concerned or to ventilate grievances or to suggest economies. Each motion has to focus on one matter and one demand, which needs to be precisely stated. It must not relate to expenditure charged to the consolidated fund of India and not suggest any change of law. There are three types of cuts.

What are the different types of cut motions?

- * **Policy cuts:** There is a notional cut of Re 1 to express total disapproval of the policy. Token cut: Grant is sought to be reduced by Rs 100 and the purpose is to ventilate a grievance relating to the demand.
- * **Economy cuts:** There are cuts suggested by members to bring about economy in expenditure, or to reduce the demand by such amounts that may be considered necessary.

What are the implications of a cut motion getting passed? The cut motions are put to vote after discussion. Depending on the result of the vote the demands are either reduced or allowed to go through. Cut motions invariably put the government on the defensive, but if the replies are convincing and the ruling party has a good majority then it would not mean much. If the cut motion goes through, the government will have to resign.

SLR AND NON-SLR INVESTMENTS

What are SLR investments?

As part of prudential guidelines, central banks require lenders to maintain a portion of their deposits in liquid assets. These liquid assets can be cash, gold or government securities. The ratio of prescribed liquid investments to deposits is termed as statutory liquidity ratio. In India, banks invest in bonds issued by the government and notified by the Reserve Bank of India as qualifying for SLR to meet the prescribed ratio. Currently, the prescribed statutory liquidity ratio for banks is 25% of their deposits. SLR is occasionally used as monetary policy tool and the stipulation is made by authorities, keeping in mind the monetary policy objectives.

What are non-SLR investments?

Besides giving loans to businesses and individuals, RBI has also allowed banks to invest in various capital market instruments such as stocks and bonds issued by public and private sector companies and commercial papers. In addition, banks are also allowed to invest in various mutual fund schemes. Unlike SLR investments, there is no compulsion on banks to invest in these instruments. Investments are entirely guided by commercial considerations and many such investments are in accordance with the prescribed guidelines.

How are non-SLR investments and loans linked?

RBI treats both loans extended by commercial banks and the non-SLR investments as a resource flow to the commercial sector. Hence, it includes both while making credit projections it is comfortable with to achieve the targeted economic growth at the time of the monetary policy formulation during the beginning of the fiscal year.

Is there any differential treatment for the two types of investments?

Since SLR investments in bonds are issued by the government or its bodies, these enjoy a sovereign protection, and hence, are perceived to be risk-free. However, in case of non-SLR investments, the central bank attaches risk weights, depending on the industry and the state of the perceived risk on that sector as a prudential measure.

CHEQUE TRUNCATION SYSTEM

What is cheque truncation?

It is one of the major innovations in cheque clearing after the Magnetic Ink Character Recognition (MICR) cheques introduced in the 80s. Cheque truncation is a system between clearing and settlement of cheques based on electronic images. This form of clearing does not involve any physical exchange of instrument.

Bank customers would get their cheques realised faster as local cheques are cleared almost the same day as the cheque is presented to the clearing house, while intercity clearing happens the next day. Besides speedy clearing of cheques, banks also have additional advantage of reduced reconciliation and clearing frauds. It is also possible for banks to offer innovative products and services based on CTS.

Why is it needed?

Though MICR technology helped improve efficiency in cheque handling, clearing is not very speedy as cheques have to be physically transported all the way from the collecting branch of a bank to the drawee bank branch.

The CTS is more advanced and more secure. Many countries have sought to address this issue with cheque truncation, in which the movement of the physical instruments is curtailed at a point in the clearing cycle, beyond which the process is completed, purely based only on the electronic data and images of the cheques.

What has been the international experience in this regard?

Denmark and Belgium are pioneers in CTS. They adopted complete cheque truncation system more than two decades ago. Sweden is the typical example for having achieved complete truncation where all the cheques can be presented and encashed at any branch; irrespective of the bank on which they are drawn. CTS also takes care of the needs of future electronic transactions.

What has RBI and banks done?

RBI has already enabled CTS to be fully functional in New Delhi. Soon even cheque clearing in Chennai will be settled through CTS. Banks have also taken steps to introduce appropriate technology to facilitate this system.

What are the salient features of CTS?

The physical cheque is truncated within the presenting bank itself. Settlement is generated on the basis of current MICR code line data. These images will be archived electronically and be preserved for eight years. A centralised agency per clearing location will act as an image warehouse for the banks.

STRIPS: GET THE RIGHT VIEW

What is STRIPS?

It is an acronym for Separate Trading of Registered Interest and Principal of Securities. Stripping is an act of detaching the interest payment coupons from a bond and treating the coupons and the body as separate securities. Each security so created, entitles its owner to a specified cash return on a specific date. These are known as 'zero coupons' or 'zeros' because there are no periodic interest payments on each instrument. After stripping, the zero-coupon bonds trade in the market at a discount and are redeemed at a pre-determined face value.

For example, a 20-year bond with a face value of Rs 1,000 and a 10% interest rate could be stripped into its principal and its 40-semi-annual interest payments. The result would be 41 separate zero coupon instruments, each with its own maturity date. The principal would be worth Rs 1,000 upon maturity, and each interest coupon of Rs 100, or one-half the annual interest of 10% on Rs 1,000. Each of the 41 distinct securities so created would be traded separately until its maturity date at prices determined by the market.

How is it useful?

STRIPS are usually preferred by market players who have a certain cash requirement at a fixed time. Buying the zero-coupon bonds can help them fulfil that requirement without worrying about the fluctuation in prices. Since there are no periodic interest payment, a bond holder does not have to worry about the need for reinvestment of intermediate cash flows.

For the larger market too, Strips are beneficial since they will lead to the development of a market-determined zero coupon yield curve (ZCYC). In its recent release operationalising STRIPS from April 1, RBI said instruments should also appeal to retail investors, given the simplicity of such securities.

How will it be done?

Stripping is to be carried out at RBI through an automated process within the Negotiated Dealing System (NDS) — the debt-trading platform. Requests for stripping is to be generated and approved by market participants on the NDS, which will thereafter flow to a chosen Primary Dealer (PD) for authorisation, RBI release said. Initially, STRIPS are to be tradable only in the OTC market and reported on NDS.

What is the experience of STRIPS abroad?

It was in February 1985 that the US Treasury introduced STRIPS intended primarily to reduce the cost of financing the public debt "by facilitating competitive private market initiatives." Zeros have since become most popular for investments on which taxes can be deferred, such as individual retirement accounts and pension plans, or for non-taxable accounts.

INTEREST RATE SWAP

An interest rate swap is an over-the-counter (OTC) derivative instrument available in the currency market where counter parties can exchange a floating payment for a fixed payment and vice-versa related to an interest rate. Financial institutions going for foreign borrowings usually buy interest rate swaps to hedge their interest rate exposure due to fluctuating interest rates.

These were originally created to allow multinational companies to evade exchange controls. Today, they are used to hedge against or speculate on changes in interest rates.

Interest rate swaps are also used speculatively by hedge funds or other investors who expect a change in interest rates or the relationships between them. Traditionally, fixed income investors who expected rates to fall would purchase cash bonds, whose value increased as rates fell.

Today, investors with a similar view could enter a floating-for-fixed interest rate swap; as rates fall, investors would pay a lower floating rate in exchange for the same fixed rate.

How does it work?

In an interest rate swap, each counter party agrees to pay either a fixed or floating rate denominated in a particular currency to the other counter party. The fixed or floating rate is multiplied by a notional principal amount (say, \$1 million).

This notional amount is generally not exchanged between counter parties, but is used only for calculating the size of cash flows to be exchanged.

The most common interest rate swap is one where one counter party A pays a fixed rate (the swap rate) to counter party B while receiving a floating rate (usually pegged to a reference rate such as LIBOR — London Inter Bank Offered Rate).

A pays fixed rate to B (A receives floating rate)

B pays floating rate to A (B receives fixed rate).

Consider the following swap in which Party A agrees to pay Party B periodic fixed interest rate payments of 3.784%, in exchange for periodic floating interest rate payments of LIBOR + 70 bps (0.70%). There is no exchange of the principal amount and that the interest rates are on a notional principal amount.

The interest payments are settled in net. The fixed rate (3.784% in this example) is referred to as the swap rate.

What are the different types of swaps?

Being OTC instruments, interest rate swaps can come in a huge number of varieties and can be structured to meet the specific needs of the counter parties. By far the most common are fixed-for-floating, fixed-for-fixed or floating-for-floating.

The legs of the swap can be in the same currency or in different currencies. The above example is a specimen of fixed-for-floating swap. Fixed-for-fixed works the same way except that there is no change in the rate used during the date of payment, as does floating-for-floating swap.

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CASHLESS MEDICLAIM

Cashless mediclaim is not a new concept anymore. As the name suggests, you can get hospitalised, undergo surgery or both without having to pay cash at the time of bill settlement. The insurance company settles the bill directly through its third-party administrator (TPA) whose contacts are usually provided along with the policy. The hospital would require the patients ID card to check the policy details so as to deliver the cashless service. But this easy insurance works only under certain conditions.

Can you avail of cashless mediclaim in all hospitals?

Every insurer has a list of hospitals in which you can use the cashless facility. You can get this information in the insurance company's website and cross check with the TPA. The list, however, is subject to change as hospitals frequently have disagreements with insurers and drop the cashless arrangement. If the hospital of your choice is not on the list, you can still avail of treatment there. However, you will have to pay for the treatment at the first instance and later get a reimbursement from the insurer by submitting your bills. The average time taken for reimbursing bills is 20 days.

Whom should you approach if there is a problem with your cashless mediclaim?

Although the insurance policy would have been issued by some general insurance company, third party administrators play an active role in cashless mediclaim. The payment usually is made by the TPAs. Most of these TPAs provide administrative support to the insurance companies for servicing their insurance policies. As far as you are concerned, TPAs are the main contact point for settling claims. If the insurance company fails to stick to its contract, you can complain to the insurance ombudsman whose contacts are available on the Irda website.

What happens if your cashless mediclaim gets partly reimbursed?

This doesn't mean that the claim has been rejected by the insurance company. The claim has been rejected at the TPA's end. TPAs sanction the claim amount based on a clause called "customary and reasonable charges". They keep a database on

average costs of various surgeries across cities. Based on this database, the TPA sanctions the claim amount.

Usually, a surveyor visits the hospital to validate the claim. At times, the TPA approves a part of the amount and the balance has to be borne by you. In extreme cases, the TPAs reject the claim if the surveyor is suspicious of the patient or hospital's credibility. In such cases, you have to settle the hospital bill and take up the case with the TPAs/insurer later.

How can you avoid part-payment or rejection of the claim?

In case of planned surgeries, you should check the approximate bill amount with the hospital. Then, you could check with the TPA on the size of the claim amount and its likely settlement. Often, even hospitals should take an in-principle approval from the TPA to avoid last-minute hassle in the case of planned surgeries. In fact, some TPAs make it mandatory for patients/hospitals to take prior in-principle approval except in case of accident-related claims.

Can you use cashless facility abroad?

Yes, you can, provided you have an overseas students mediclaim or a travel policy. Private insurers have tie-ups with hospitals abroad. Still, it is advisable for travellers or students to take a prior in-principle approval as mentioned above.

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RIDER BENEFITS IN LIFE INSURANCE POLICIES

What are riders?

Riders refer to covers that are offered by insurance companies in addition to the basic life cover. In other words, they cover risks that are beyond the scope of the main life policy, resulting in more comprehensive protection.

What are the types of riders offered by insurers?

Rider benefits offered could vary as per the insurance company and the policy purchased by the insured. Typically, riders extended include critical illness (or dreaded diseases) cover, personal accident (or accidental death and dismemberment) and waiver of premium benefit.

How do riders help the insured?

They help customise the life cover as per the policyholder's needs. Let's say a policyholder, the sole breadwinner in the family, meets with an accident resulting in temporary disability. If it forces her to stay away from work during the period of recovery, the life cover will not make good the loss of income. This is where a personal accident rider covering temporary disability could come to the family's rescue. In such cases, the insurance company undertakes to provide monetary

compensation to the insured, subject to the terms and conditions mentioned in the insurance contract.

Similarly, for a policyholder diagnosed with a critical or terminal illness, the life insurance cover can provide little relief as it is not capable of preventing the drain on finances during the treatment. A critical illness rider could come in handy in such times. The illnesses generally covered under the include cancer, kidney failure, paralysis, bypass surgery, major organ transplant and so on. The sum assured under the rider is paid upfront as a lump-sum to the policyholder.

Therefore, even if you have a health insurance policy in place, this amount can help meet other expenses or act as succour if the insured is unable to resume work during the period.

How does one choose the rider best suited for her?

The decision could depend on a variety of factors like your age, regular mode of commuting and history of illnesses in your family, if any. For someone who has just started her career and relies on public transport or two-wheeler for daily commuting, a personal accident policy is a must. Critical illness cover, on the other hand, would be of use to policyholders across age-groups.

Does one have to incur an extra cost for availing these covers?

Yes. The insurer arrives at the additional premium chargeable to the policyholders based on factors like their age, sum assured, premium paying term and the company's underwriting norms.

What are the tax benefits available to those who opt for these riders?

The tax breaks depend on the rider chosen. For instance, while tax benefits pertaining to premium paid towards the accidental death rider can be claimed under section 80C, critical illness premium falls under section 80D.

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NON-TAX SOURCES OF INCOME FOR THE GOVERNMENT

Non-tax Revenues

Any loan given to state governments, public institutions and PSUs earn interests and this forms the most important item under this head. The government also receives dividends and profits received from PSUs. It also earns income for the various services it provides. Of this, the railways is a separate ministry, though all its receipts and expenditure are routed through the consolidated fund.

Capital Receipts

Receipts in the capital account of the consolidated fund are divided into three broad heads — public debt, recoveries of loans and advances, and miscellaneous receipts.

Public Debt

Since everything the government does is on behalf of the people, its borrowings eventually are the burden of the people. In budget parlance, the difference between borrowings (public debt receipts) and repayments (public debt disbursements) during the year is the net accretion to the public debt. Public debt can be split into two heads, internal debt (money borrowed within the country) and external debt. The internal debt comprises Treasury Bills, market stabilisation scheme, ways and means advances, and securities against small savings.

Treasury Bills (T-Bills)

These are bonds (debt securities) with maturity of less than a year. These are issued to meet short-term mismatches in receipts and expenditure. Bonds of longer maturities are called dated securities.

Market Stabilisation Scheme (MSS)

The scheme was launched in April 2004 to strengthen RBI's ability to conduct exchange rate and monetary management. These securities issued under MSS are not to meet the government's expenditure but to provide the RBI with a stock of securities with which it can intervene in the market to manage liquidity.

Ways & Means Advances (WMA)

RBI is the banker for both the central and state governments. Therefore, it provides funds to manage mismatches in the governments' receipts and payments in the form of WMAs. Now, RBI wants the government to issue short-term securities to meet temporary needs.

Securities Against Small Savings

The government meets a small part of its loan needs by appropriating small savings collection by issuing securities to the funds that manage such schemes.

FORWARD PREMIUM

What is a forward premium in the foreign exchange market?

It's the price paid for hedging by buying dollars in the forward market. Forward transactions take place at a premium or discount to the spot rate. The outright forward transactions are over-the-counter transactions undertaken by dealers. In India, it is generally the banks that transact in forward markets.

The maturity date agreed upon by the parties generally varies from months to a year or two. But maturities beyond that tend to have wider bid-ask spreads, in other words, tend to be more expensive, so are rare. The forward rate could be in premium or discount, based on the interest rate differential in case of currencies which are fully convertible and in case of partially-convertible currencies, they are determined purely on the basis of demand and supply. For example, in India, the USD/INR forward rate for six months could be in premium or at a discount over the spot rate, based on how liquid the dollar is.

What determines forward premium?

Countries that have fully-convertible currencies, the forward premium is deduced from their interest rate differentials, respectively. The premium/discount is measured in points, which represent the interest rate differential of the countries to which the currencies belong, for the period of maturity.

These points are the quantum of foreign exchange that would neutralise the interest rate differential. Points are subtracted from the spot rate, when the interest rate of the base currency is higher, since the base currency should trade at a forward discount and points are added to the spot rate, when the interest rate of the base currency is lower, since the base currency is expected to trade at a forward premium. This is, however, only applicable to non-rupee currencies, that are fully convertible.

What are currency futures?

Exchange-traded currency forward transactions are known as currency futures. Before April 2007, only banks were allowed to trade in currency forwards market through over-the-counter deals.

But it was not a structured market, in the sense that it was not traded on an RBI-recognised exchange platform. But in 2007, RBI and Sebi allowed trading of currency futures on the National Stock Exchange.

The objective of opening up trading in currency futures on the exchanges was to deepen the futures market by allowing the small retail investors to take a view and hedge their foreign exchange risks. The regulatory authorities in India are on their way to allow trading in currency options on exchanges as well, though it is already available as a product.

WHAT IS THE NEGOTIATED DEALING SYSTEM?

NDS is an RBI-operated electronic trading system, that does away with the physical exchange of forms between its trading members in facilitation of exchanges of government securities and other money market instruments. The platform also hosts the new government issues. The platform was introduced as a part of RBI's long-term plan for developing the government securities market. The system has helped in achieving paperless settlement of secondary market transactions and in the process has brought about transactional efficiency and transparency. The system was introduced in February 2002. Brokers are not eligible for membership in NDS.

The objectives of NDS include: Starting an automated electronic reporting and settlement process, facilitating electronic auctions and providing a platform for trading in government securities on a negotiated basis as well as through a quote-driven mechanism.

What type of trades are settled through NDS?

NDS provides an interface to the securities settlement system. All outright and repo transactions in Treasury Bills and government-dated securities (Central and state governments) are settled through NDS, though corporate bonds are not traded on the NDS.]

What is NDS-OM (Negotiated Dealing System-Order matching?)

The problem largely with NDS was that it was not user friendly. Thus, the working group on screen-based trading in government securities, chaired by Dr RH Patil, suggested the improvised NDS-OM system, which did away with the inherent drawbacks of NDS.

The broad features of the NDS-OM system are as follows: The use of NDS-OM trading module is voluntary and will be available in addition to the existing telephone-based trading mechanism on NDS. During the first phase, the NDS-OM started with serving the trading requirements of all banks, primary dealers and financial institutions regulated by RBI that hold current NDS membership. The system is purely order-driven with all orders being matched, based on strict price/time priority.

The system is an anonymous order matching system, wherein the identity of parties is not revealed before or at the time of trade. The Clearing Corporation of India (CCIL) is the central counterparty to each trade done on the system. The system allows straight-through processing (STP), and trades executed will flow straight to CCIL in a ready-for-settlement stage.

The system provides functionalities for order management (placing, modifying or cancellation of orders), trade-related queries, activity log, market information and analytics. The system started with supporting dealing in all Central government and state government securities for T+1 settlement. The system is set to be further upgraded later to facilitate trading in discounted instruments like Treasury Bills.

WHAT IS ASSET-LIABILITY MISMATCH?

Banks' primary source of funds is deposits, which typically have short- to medium-term maturities. They need to be paid back to the investor in 3-5 years. In contrast banks usually provide loans for a longer pe-riod to borrowers. Home loans, for instance, can have a tenure of up to 20 years. Providing such loans from much shorter maturity funds is called asset-liability mismatch. It creates risks for banks that need to be managed.

What are the consequences of asset-liability mismatch?

The most serious consequences of asset-liability mismatch are interest rate risk and liquidity risk. Because deposits are of shorter maturity they are repriced faster than loans. Every time a deposit matures and is rebooked, if the interest rates have moved up bank will have to pay a higher rate on them. But the loans cannot be repriced that easily. Because of this faster adjusting of deposits to interest rates asset-liability mismatch affects net interest margin or the spread banks earn.

Liquidity issues also arise when loans and deposits have different ma-turities. Depositors have to be repaid when their funds mature, but banks cannot recall their loans. They will have to find new deposits or roll over those maturing or else they will not be able to service their depositors. In an acute situation they may have to pay really high in-terests to raise funds.

How do banks manage asset-liability mismatches?

Most banks have elaborate institutional arrangement to manage asset-liability mismatches. The interest rate risk is usually managed by pric-ing a large percentage of loans at variable interest rates that move in tandem with market rates. Fixed rate loans are, therefore, usually priced at a huge mark up to variable rate loans to entice borrowers to opt for the latter.

This takes care of interest rate risks as loans are linked to a benchmark and repriced when the benchmark rate moves up. Sophisticated derivatives are also used to manage interest rate risk. Liquidity risk involves a more hands on management. RBI requires banks to have dedicated asset-liability management committees to manage liquidity risks. A careful matching of cash inflows and out-flows and gap funding are employed to manage liquidity risks.

BANKING OMBUDSMAN

What is the Banking Ombudsman Scheme?

The Banking Ombudsman Scheme provides an expeditious and inexpensive forum to bank customers for resolution of complaints relating to certain services rendered by banks. The Banking Ombudsman Scheme was introduced under Section 35 A of the Banking Regulation Act, 1949, by RBI in 1995. The Banking Ombudsman is a senior official appointed by RBI to redress customer complaints against deficiency in certain banking services.

Where can one lodge his/her complaint?

One may lodge his/her complaint at the office of the Banking Ombudsman, under whose jurisdiction, the bank branch complained against is situated. For complaints relating to credit cards and other types of services with centralised operations, complaints may be filed before the Banking Ombudsman within whose territorial jurisdiction, the billing address of the customer is located.

Can compensation be claimed for mental agony and harassment?

The Banking Ombudsman may award compensation not exceeding Rs 1 lakh to the complainant only in case of complaints relating to credit card operations for mental agony and harassment. The Banking Ombudsman will take into account the loss of the complainant's time, expenses incurred by the complainant, harassment and mental anguish suffered by the complainant while passing such award.

What happens after a complaint is received by the Banking Ombudsman?

The Banking Ombudsman attempts to ensure a settlement of the complaint by an agreement between the complaint and the bank named in the complaint. If the terms of settlement (offered by the bank) are acceptable to one in full and final settlement of one's complaint, the Banking Ombudsman will pass an order as per the terms of settlement which becomes binding on the bank and the complainant.

Is there any further recourse available if one rejects the Banking Ombudsman's decision?

If one is not satisfied with the decision passed by the Banking Ombudsman, one can approach the appellate authority against the Banking Ombudsmen's decision. Appellate Authority is vested with a Deputy Governor of RBI.

One can also explore any other recourse and/or remedies available to him/her as per the law. The bank also has the option to file an appeal before the appellate authority under the scheme.

CLASH OVER ULIPS

The dust is yet to settle on a very public spat between market regulator SEBI and insurance watchdog IRDA over regulation of unit-linked insurance plans, or Ulips. The RBI is opposing a joint committee under the finance minister, envisaged to settle jurisdiction disputes on hybrid products.

Dispute over ULIPs

Ulips are hybrid instruments where a part of the amount paid by sub-scribers is invested and a small portion goes towards insurance pre-mium. SEBI passed an order in April this year saying that regulation of Ulips should be its responsibility rather than IRDA's, as the funds were mostly invested in stock markets. Sebi had justified it by saying that in some of the products 90% of the money was channelised into markets and not insurance.

On April 9, it had banned 14 insurance companies from selling ULIPs without its approval, saying they needed to register with the market regulator. This was opposed by IRDA, which asked insurance compa-nies to ignore the directive. The finance ministry intervened and asked both sides to seek legal recourse to the problem.

How was the dispute settled?

The President promulgated an ordinance last month clarifying that life insurance business includes Ulips, which meant that IRDA would con-tinue to regulate Ulips. Four Acts -- RBI Act 1934, Insurance Act 1938, Sebi Act 1992 and Securities Contract Regulations Act 1956-- had to be amended for the purpose. The decision was taken just days before the Supreme Court was scheduled to hear the matter on July 8.

What is the new controversy surrounding the joint committee envisaged by the ULIP ordinance?

In a bid to ensure that similar disputes that may arise in the future are taken care of, the ordinance provided for a joint mechanism headed by the finance minister, two other government representatives and the four regulators, for settling conflicts over hybrid products.

What are the RBI's concerns?

The RBI has said that it the central bank had certain reservations and concerns relating to the ordinance. Reportedly, the central bank feels that the dispute resolution mechanism worked out can undermine the autonomy of the regulators. It is more inclined towards the current mechanism for dispute resolution, --the non-statutory High Level Co-ordination Committee on Financial Markets chaired by the RBI gover-nor. It is holding discussions with the finance ministry on the issue.

What is the way ahead?

The government has to move a bill in Parliament in the monsoon session of parliament to get the ordinance, a temporarily law, passed into a law. The government can make changes when it moves the bill or allow the ordinance to lapse by not moving the bill altogether.

What were fallouts of the dispute?

It prompted the IRDA to look within and reform ULIPs by issuing fresh guidelines. Ulips launched after September 1, 2010 will have lower charges, guaranteed returns, longer lock-in period and larger insurance cover.

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WHAT IS SYSTEMATIC TRANSFER PLAN - STP?

Mutual funds not only manage our money but also offer us various easy to use tools that are aimed at improving our investment experience.

Most of us know systematic investment plan, where we invest at regular intervals. But few are aware of **systematic transfer plan (STP)**.

Under STP, at regular intervals, an amount you opt for is transferred from one mutual fund scheme to another of your choice. Typically, a minimum of six such transfers are to be agreed on by investors.

You can get into a weekly, monthly or a quarterly transfer plan, as per your needs.

You may choose to transfer a fixed sum from one scheme to another. The mutual fund will reduce the number of units equal to the amount you have specified from the scheme you intend to transfer money. At the same time, the amount such transferred will be utilised to buy the units of the scheme you intend to transfer money into, at the applicable NAV. Some fund houses allow you to transfer only the capital appreciation to be transferred at regular intervals.

How is it useful?

STP is a useful tool to take a step by step exposure into equities or to reduce exposure over a period of time. Say you have Rs 10 lakh to invest in equity over a period of time. You could put this amount in the liquid fund of a mutual fund or a short-term bond fund. This gives an opportunity to earn a better than saving bank account rate of return. You than start an STP where every month a pre-determined amount will be invested into an equity fund. This helps in deploying funds at regular intervals in equities with minimum timing risk.

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WHAT IS OFFSHORE BANKING UNIT?

Offshore banking unit (OBU) is the branch of an Indian bank located in a special economic zone (SEZ), with a special set of rules aimed at facilitating exports from the region. As laws define it, it's a "deemed foreign branch" of the parent bank situated within India, and it undertakes international banking business involving foreign currency denominated assets and liabilities. The concept comes from the practice prevalent in several global financial centres. Here an OBU can accept foreign currency for business but not domestic deposits from local residents. This was conceived to prevent competition between local and offshore banking sectors.

What was the need for OBUs?

In addition to providing power, tax and other incentives to SEZs, policymakers felt a need to provide SEZ developers access to global money markets at international rates. So in 2002, RBI instituted OBUs, which would be virtually foreign branches of Indian banks. These would be exempt from CRR, SLR and few other regulatory requirements. RBI regulations make it mandatory for OBUs to deal in foreign exchange, source their foreign currency funds externally, follow all prudential norms applicable to overseas branches and are entitled for IT exemptions. Thus in many respects, they are free from the monetary controls of the country.

What price, freedom from regulations?

In the eight years that they have been operational, concerns have been raised that, funding by OBUs to SEZs would lead to increase in external debt of India. Also, some have suggested that OBUs as vehicles for extending dollar loans have no use as long as they are restricted to doing business only in the zones in which are they located. This would create an unnecessary regulatory arbitrage like booking business because there is some arbitrage advantage on offer. Anyways, ground realities could not be more different. Hardly a handful of banks have set up their OBUs, so the argument looks very far fetched. SEZ, itself as a concept has been struggling, given the issues that SEZ developers have faced over acquiring land from farmers.

What is the future of OBUs?

Most international financial centres still house OBUs, so saying they are not required may be incorrect. However, some analysts have said OBUs are losing relevance at a time of increasing globalisation. They say OBUs will be of no use after the economy opens up fully and the rupee is fully convertible. These experts argue for one or two OBUs, instead of having several of them spread across the country.

BIG WORDS IN THE BUDGET SPEECH

The finance minister's budget speech may be ridden with jargon, but its core is no different from that of a household budget.

ANNUAL FINANCIAL STATEMENT: This is the last word on the government's receipts and expenditure for the financial year, presented to Parliament. This is actually the annual budget, as stated in the Constitution. Divided into three parts — Consolidated Fund, Contingency Fund and Public Account — it has a statement of receipts and expenditure of each. Expenditure from the Consolidated Fund and Contingency Fund requires the nod of Parliament.

CONSOLIDATED FUND: The government's lifeline. It contains all revenues, money borrowed and receipts from loans it has given. All government expenditure is made from this fund.

CONTINGENCY FUND: As the name suggests, any urgent or unforeseen expenditure is met from this Rs 500 crore fund, which is at the disposal of the President. The amount withdrawn is returned from the Consolidated Fund.

PUBLIC ACCOUNT: When it comes to this account, the government is nothing more than a banker, as this is a collection of money belonging to others such as public provident fund.

REVENUE VS CAPITAL: The budget has to distinguish all receipts/expenditure on revenue account from other expenditure. So all receipts in, say, the consolidated fund, are split into Revenue Budget (revenue account) and Capital Budget (capital account), which include non-revenue receipts and expenditure.

REVENUE RECEIPT/EXPENDITURE: All receipts like taxes and expenditure like salaries, subsidies and interest payments that do not entail sale or creation of assets fall under the revenue account.

CAPITAL RECEIPT/EXPENDITURE: Capital account shows all receipts from liquidating (eg. selling shares in a public sector company) of assets and spending to create assets (lending to receive interest).

REVENUE/CAPITAL BUDGET: The government has to prepare a Revenue Budget (detailing revenue receipts and revenue expenditure) and a Capital Budget (capital receipts and capital expenditure).

WHAT ARE EXCHANGE TRADED FUNDS (ETFs)?

An ETF is a basket of stocks that reflects the composition of an index, like S&P CNX Nifty, BSE Sensex or the banking index. An ETF's trading value is based on the net asset value of the underlying stocks that it represents. It is similar to a mutual fund that you can buy and sell in real-time at a price that changes during the trading session. ETFs are essentially index funds that are listed and traded on exchanges like stocks. They enable investors to gain broad exposure to entire stock markets in different countries and specific sectors with relative ease, on a real-time basis and at a lower cost than many other forms of investing.

What are the type of ETFs?

The two popular ETFs in India are index ETFs and commodity ETFs. Most ETFs in India are index funds that hold securities and attempt to replicate the performance of a stock market index. Nifty Bees, Junior Bees, Gold Bees, Bank Bees and Hang Sang Bees are some of the ETFs traded in India. Among the commodity ETFs, gold ETFs are actively traded in India.

What are the advantages and disadvantages of using ETFs?

There are several benefits in investing in ETFs. They can be easily bought and sold like stocks during trading hours using your demat account with no additional paperwork. They have lower expense ratio and the minimum investment is of one unit. However, unlike mutual funds that do not need a demat account, for buying and selling ETFs you need a trading account. Also since ETFs, like stocks, are bought through a broker, every time you trade you also end up paying brokerage for your transaction. However, ETFs allow investors to take the benefit of intra-day movements in the market, which is not possible with open-ended funds.

Take the example of a gold ETF. Buying physical gold and storing it involve tedious processes. You will have to pay a mark up to the jeweller and then spend some more get a bank locker. On the other hand, buying, selling and storing gold in electronic form is more convenient and price-effective. As ETFs are listed on the exchanges, distribution and other operational expenses are significantly lower.

How are ETFs used?

Asset allocation: For individuals it could be difficult to manage asset allocation given the cost involved. ETFs provide investors with exposure to broad segments of the equity markets. They enable investors to build customised investment portfolios in line with their risk taking ability and time horizon.

Ride the market rally: Many times, investors need time to make investment decisions, like buying a particular stock, but do not want to miss out on the opportunity in the stock markets. At such times they can park their funds in ETFs. Because ETFs are liquid, investors can participate in the market rally while deciding where to invest the funds for the longer-term, thus avoiding potential opportunity costs.

Hedging Risks: ETF's can be used as hedging vehicle because they can be borrowed and sold short. The smaller denominations in which ETFs trade relative to most derivative contracts provide a more accurate risk exposure match, particularly for small investment portfolios.

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NON-DELIVERABLE FORWARDS

What are NDFs?

Non Deliverable Forwards, or NDFs as they are popularly known, are short-term forward contracts on foreign exchange. International investors use this market to bet on currencies like the rupee in the overseas markets. NDF contracts are largely on thinly-traded or non-convertible currencies and they are settled at an international financial centre, generally in US dollars. They are quoted for periods between a month and a year. These deals are off-balance sheet and are always settled in cash. In other words, if an overseas investor feels that the rupee will rise, he will place an order for rupees in the forward market. If the currency does indeed rise, he will receive the difference between the exchange rates in dollars. There is no physical settlement of two currencies at maturity.

The purpose of an NDF

Emerging markets are the fastest growing and most international investors are keen on participating in their growth. Some players are also keen in the emerging market currencies. However, emerging markets always face a convertibility risk as there is a possibility that their partially convertible currency might turn inconvertible (Mexico, 1982). Also, investors find the documentation process in these partially convertible markets very elaborate. This makes hedging emerging market currency exposure difficult and expensive. NDFs allow foreign investors to hedge their exposures against emerging market currencies risk outside the country. But NDFs are carried out in an offshore market, and the central banks have little say in these operations, as they are being carried out in foreign shores outside their jurisdiction.

How does an NDF transaction occur?

When an international company invests in India with the object of taking out its money in six months, the company enters into an NDF contract with its bank. If on the fixing date, the rupee has weakened, the investor will collect the difference. If it's stronger, the investor will pay the bank the difference — again, in dollars.

What is the Fixing date and Settlement date?

The fixing date is the date at which the difference between the prevailing market exchange rate and the agreed upon exchange rate or the reference rate is calculated. The settlement date is the date by which the payment of the difference is due to the party receiving payment.

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WHAT DOES POWER OF ATTORNEY MEAN?

A power of attorney (PoA) is an instrument in writing empowering a specified person to act for and in the name of a person executing it. In other words, a power of attorney is an authorisation to act on someone else's behalf in a legal or business matter. The person authorising the other to act is the grantor/principal of the power and the one authorised to act is the attorney/agent.

It is a unilateral document signed and executed only by the grantor or principal. A PoA may be revoked at the instance of the grantor or due to his death or incapacity. A PoA is usually construed very strictly. The PoA is frequently used in the event of a principal's illness or disability, or when the principal is out of the country and can't be present to sign necessary legal documents for financial transactions.

Why should one make a PoA? Who should one choose?

There are many reasons to make a PoA, as it ensures that someone will look after your financial affairs in case you are not available. You should choose a trusted family member, a proven friend or a honest professional with past reputation. However, one must remember that signing a power of attorney that grants broad authority to an agent is very much like signing a blank check — so make sure you choose wisely and understand the laws that apply to the document.

What are the types of PoA?

General purpose PoA: The PoA holder can perform all activities on behalf of the original holder(s)

Specific purpose PoA: The PoA holder can perform only certain operations. A power of attorney conferring on the agent the authority to act in a single transaction in the name of the principal is a Special Power of Attorney.

If the power of attorney authorises the agent to act generally or in more than one transaction in the name of a principal, it is a General Power of Attorney. A single act or transaction is meant to imply either a single act or acts so related to each other as to form one judicial transaction. For example power of attorney for sale of a particular property.

How do you execute your PoA if you are within India/outside India?

The PoA should be signed and duly executed on a non-judicial stamp paper per prescribed stamp duty, if executed within India. The power of attorney should be duly signed by the person executing the same. It may be accepted by the person in whose favour it is drawn and should be duly attested by two witnesses.

The power of attorney should be duly executed before and authenticated by a Notary Public, or any court, Judge, Magistrate, Indian Consul or Vice Consul or representative of the Central government. In case it is executed outside India, it should be on a plain paper without any stamp. The same is required to be stamped within three months after it is received in India by the Collector of Stamps.

WHAT ARE REGIONAL RURAL BANKS?

In the early 70s, there was a realisation that the even after nationalisation there were cultural issues which made it difficult for commercial banks, even under government ownership, to lend to farmers. To address this issue, the government set up a working group to suggest alternatives for institutional finances to the rural sector. Accepting the recommendations of the committee, the government promulgated the Regional Rural Banks Ordinance on September 1975, which was replaced by the Regional Rural Banks Act 1976. The Act allowed the government to set up banks from time to time at places where it considers necessary. Each bank carries on banking business within local limits specified by the government notification. The regional rural banks (RRBs) were owned by the central government, the state government and the sponsor bank who held shares in the ratio of 50,15 and 35%.

Why are they in the news?

The Reserve Bank of India in its discussion paper on grant of bank licences to corporate houses said that if corporates were keen on improving financial inclusions, they could look at taking over some of the weaker RRBs and strengthen them through capital and technology infusion.

Is this likely to happen?

There are several impediments. Firstly, the RRB Act will need to be amended. Secondly, there will be resistance from employee unions and state governments. Thirdly, corporates themselves may not be inclined to get into rural banking where the payback may take many more years.

What is the status of RRBs now?

The worst appears to be behind the RRBs, a large number of which were in the red for most of the previous decades. The process of consolidation through amalgamation of RRBs is now almost complete, resulting in a decline in the total number of RRBs to 84 as on August 31, 2009 (which includes a new RRB set up in the Union Territory of Puducherry). The process of recapitalisation of RRBs with negative net worth as on March 31, 2007, is also almost complete, with 27 RRBs fully recapitalised with an amount of Rs 1,796 crore as on July 31, 2009. The assets in the consolidated balance sheets of RRBs have increased by 16.5% in March 2009 to Rs 1.46 lakh crore.

They now open no-frills accounts and issue general credit cards. An RBI working group on technology in RRBs has observed that RRBs could not remain isolated from the technological developments sweeping the banking sector. The group has set a target date of September 2011 for all RRBs to move to a core banking solution platform.

WHAT IS PRIVATE BANKING?

Private banking is a personalised financial and banking service offered to a bank's high net worth individuals (HNIs). In India, it is offered by foreign banks and few private sector banks. A dedicated relationship manager is assigned to the customer who takes care of all his banking needs and investments. So be it a simple thing like wanting cash delivered at your doorstep, or planning for your retirement, drafting a will, investing surplus money, or buying a complex structured product, it's just a call away for these customers.

How does a bank define a private banking customer?

In India, the landscape of retail banking is divided into mass market banking, priority banking which targets customers with an investible surplus of Rs 1 lakh to 1.5 crore. Then comes private banking which targets the top end of retail banking customers with investible surplus of Rs 1.5 crore to Rs 13 crore. The creamiest layer includes ultra high net worth individuals with AUM of Rs 100 crore and above. The range of services improves as you climb up the ladder. The rationale is that clients with such high levels of wealth can participate in alternative investments such as private equity, hedge funds and real estate. Secondly, this level of wealth prevents liquidity problems.

What does the private banker do?

The private banker helps you in all your banking and wealth management needs. The starting point of the relationship is understanding the customer. So a private banker has initial meetings with the client to understand his risk profile, his cash flows, his needs and wants. Based on that, he develops an asset allocation model for the client. Using this model he allocates the client wealth into various assets that he feels opportune such as equities, debt or real estate. Within each category, he offers various products. Once a portfolio is restructured and built, it is monitored on a monthly or a quarterly basis. The private banker comes up with appropriate strategies to enhance returns from the portfolio. A private banker's role is to anticipate and understand client needs and to help achieve his immediate and long-term wealth goals. So whether you run a business, or are employed or a professional, a private banker should be able to help you.

Do you have to invest the entire money at one go? Most customers tend to bank with 2-3 bankers. You can take time with your bankers to find out your comfort and compatibility with your personal bankers and invest money over a time period of 1-2 years. The bank typically upgrades your relationship as you increase the bank balance.

How to select a private banker? Customers will have to see wait for a market swing to judge the competency of the private banker. For instance, just before the financial crisis in 2009, many top notch banks in India didn't recommend their clients to exit the market. Also, many of these banks sold structured products which affected the financial health of customers. Hence, spread your wealth around to minimise risks. Also, don't trust your banker blindly. Monitor your investments regularly.

LIMITED LIABILITY PARTNERSHIP

The government plans to encourage Limited Liability Partnerships - a flexible way of organising businesses - by allowing 49% foreign direct investment. LLPs do not carry restrictions on the number of partners or the combination of services that an LLP can provide. Here's a ready-reckoner on LLPs for the uninitiated.

What are the advantages enjoyed by LLPs?

Unlike an unlimited partnership firm, no partner in a LLP is liable for independent or unauthorised acts of other partners. It gives individual partners a shield against joint liability created by another partner's negligence or misconduct. The basic difference between an LLP and a joint stock company lies in its flexibility to formulate its internal governance structure. The management-ownership divide inherent in a company is not there in an LLP. The compliance norms are much easier compared with companies.

Does it make sense to convert private companies into LLPs?

The LLP format gives private companies the flexibility of expanding its members beyond 50 without converting itself into a public limited company. Converting a private company into an LLP is much easier than to form a public limited company. Such conversion provides the firm the benefits of minimal government intervention and less compliance requirements. Even a partnership can avail the benefits of expanding its business by converting itself into a LLP. The conversion of a private company or unlisted public company into an LLP will be exempt from tax, if the total sales or turnover or gross receipts of the company does not exceed Rs 60 lakh in any of the three preceding years, as proposed by the Union Budget 2010.

Will a partner be able to carry out commercial transactions with LLPs?

A partner may lend money to and transact other businesses with the LLP and shall have the same rights and obligations with respect to the loan or other transactions as a person who is not a partner.

Can LLPs carry out activities related to financing such as accepting deposits?

Currently there is no regulation prohibiting LLP from carrying out activities related to NBFCs, but as a matter of precaution before initiating any such activity, it is advisable to contact Reserve Bank of India.

Can foreigners incorporate LLPs?

Yes, the LLP Act 2008 allows foreign nationals, including foreign companies & LLPs, to incorporate an LLP in India provided at least one designated partner is a resident of India. Such an LLP and its partners will have to comply with all relevant foreign exchange laws and rules therein.

WHAT IS VIABILITY GAP FUNDING?

There are many projects with high economic returns, but the financial returns may not be adequate for a profit-seeking investor. For instance, a rural road connecting several villages to the nearby town. This would yield huge economic benefits by integrating these villages with the market economy, but because of low incomes it may not be possible to charge user fee. In such a situation, the project is unlikely to get private investment. In such cases, the government can pitch in and meet a portion of the cost, making the project viable. This method is known as viability gap funding.

How does the scheme work?

VGF is typically provided in competitively bid projects. Under VGF, the central government meets up to 20% of capital cost of a project being implemented in public private partnership (PPP) mode by a central ministry, state government, statutory entity or a local body. The state government, sponsoring ministry or the project authority can pitch in with another 20% of the project cost to make the projects even more attractive for the investors. Potential investors bid for these projects on the basis of VGF needed. Those needing the least VGF support will be awarded the project. The scheme is administered by the ministry of finance.

Which are the eligible sectors?

Projects in a number of sectors such as roads, ports, airports, railways, inland waterways, urban transport, power, water supply, other physical infrastructure in urban areas, infrastructure projects in special economic zones, tourism infrastructure projects are generally eligible for viability gap funding. The government now proposes to add social sectors such as education and health to the list.

How does the government benefit?

The government has limited resources. It can use those funds to build everything on its own, but such public funding will take years to create the infrastructure that is needed to achieve higher growth. Through viability gap funding, the same amount of funds can be used to execute many more projects through private participation. VGF is in that sense a force multiplier, enabling government to leverage its resources more effectively.

What has been the success rate?

The government has so far approved 199 VGF-supported projects involving investment of Rs 170,651 crore by the end of December 2009.

ESTATE PLANNING:

Everyone talks about the importance of succession planning. What comes to your mind when you have to assign beneficiaries for your hard earned savings? It's a Will. But what if the Will is challenged once it comes into being. It will be difficult to clarify the soundness of the Will as the testator (one who makes the Will) would have passed away. Is there a better alternative to ensure a hassle-free process to bequeath wealth? The answer is Estate Planning.

What is Estate Planning?

Estate Planning is a process of accumulating and disposing of your wealth, be it cash, shares or property in a systematic and pre-determined manner to a certain beneficiary/beneficiaries of your choice. This process is carried out through the Trust route. The testator sets up a Trust, which is manned by trustees appointed by him/her. The idea is to appoint third party trustees, so that the asset transfer process is carried out in a neutral manner. This also helps in maintaining the confidentiality of the Will.

How estate planning scores over a will?

The first step to estate planning is making a will. You have the option of transferring your assets to your legal heirs either through will or estate planning. Estate planning will gain ground in India because even today a large percentage of Wills get challenged. When Wills are challenged, it leaves individual beneficiaries and families in disarray.

If an individual carries out succession planning through Trusts, in one's life time, then the possibility of loopholes is minimal. Moreover, an individual is perishable not the entire trust. There are evidences of deceit by individual lawyers at the time of the execution of Will. So setting up of a Trust will help especially those individuals who have a high net worth

Who offer these services?

There are some independent firms that specialise in such services. Recently, banks have started offering Estate Planning services for their HNI and ultra-HNI clients. They mainly include individuals, who have bank balances of a few crores of rupees. Banks and firms help in a range services. Apart from helping the customers write a Will, they help you register and safe keep the Will.

Banks preserve the Will in physical form as well as in e-form. Banks also help in setting up of the Trust, its registration, documentation management and execution. Over and above, such banks take care of legal and regulatory requirements. Further, they also help in filing tax returns and settling liabilities of the Trust. Usually, these banks work in conjunction with lawyers to ensure a smooth process of Estate Planning.

How much does it cost?

You can walk into your bank to seek its help in appointing the trustees or the bank can just handhold you till you set up a Trust. If you have to just make a Will, it might cost you anything between Rs 6,000 and Rs 10,000. Making of a Will, registration, other processes like safe-keeping and execution will work out to about Rs 25,000.

If you are taking your bank's help in setting up of a Trust, its management and execution, the bank will charge you 0.5-3% of total assets under management (AUM) as the estate planning fee. If you seek an independent professional the charges vary depending upon the service. The setting up of a trust, will work to a one time cost of Rs 2-3 lakh.



WHAT IS ARBITRAGE?

Arbitrage is an investment strategy aimed at capturing the price differential between two or more markets to earn a risk-free profit. To execute an arbitrage deal, one has to simultaneously enter into deals in two markets where the price differential exists.

For example, one can buy shares of Company ABC in cash market at Rs 100 a piece and at the same time sell a future contract of an equal number of shares at Rs 105. This helps to catch the price differential of Rs 5 per share. By the end of the expiry of the contract, prices in cash and futures market converge, offering a risk-free profit.

Conversely, one may sell in cash market and buy in futures, if the price in the cash market is higher than the futures market, provided there is an efficient security lending arrangement.

Can money be made in this manner? There are many who identify arbitrage opportunities across asset classes and markets. These are called arbitrageurs. Continuous tracking of markets and availability of good amount of cash are must to carry out the role of an arbitrageur to make a decent size of money.

Narrow spreads also limit the rate of return. This makes life difficult for an individual with limited resources.

How do retail investors participate? Mutual funds come to the rescue of those who intend to take the arbitrage route but lack the expertise. The schemes here aim to make risk-free profits, by capturing the price differentials across markets arising out of the inefficiencies of the markets. You can invest in such funds with a minimum of Rs 5,000. The ideal time horizon of an investment ranges between one and two years. The expected rate of return can be slightly above that of one offered by bank fixed deposits of a similar tenure.



WHAT IS FISCAL CONSOLIDATION

A conscious policy effort is needed by the government to live within its means and thereby bring down the fiscal deficit and public debt. It includes, among other things, efforts to raise revenues and bring down wasteful expenditure such as subsidies . As a larger mandate, it also involves the participation by state governments in the process. But the whole initiative is planned as a long-term exercise by the government through a road map for fiscal reform rather than through a single Budget announcement. This is particularly true for a country like India where the government's expenditure is way beyond its revenues, forcing it to borrow.

Why do rating agencies often express their concern about it?

Just as a borrower's creditworthiness depends on her indebtedness, a country's rating is often linked to its fiscal deficit. Fiscal consolidation efforts are looked at positively by sovereign-rating agencies. This is because it gives them an indication of a country's financial strength and hence, its ability and capacity to service the debt it raises. Many a time, even though an economy has grown well or its other indicators, such as external sector strength, are buoyant, it does not get a good rating only on the ground of poor efforts at fiscal consolidation.

How is India placed on fiscal consolidation ranking?

For many years, India ranked low on fiscal consolidation. However, from 2003 onwards , the government made conscious efforts to bring down its fiscal deficit and public debt after it passed the Fiscal Responsibility and Budget Management (FRBM) Act. This enabled the government to pursue fiscal reforms aimed at committing to a pre-decided level of deficit.

Though its efforts went off well in the initial years, government finances slipped in the last two years as it was forced to provide fiscal sops initially to tackle high inflation and then to contain the impact of the global financial crisis of 2008-09 that hit the real economy hard. As a result, through its fiscal stimulus package, it had to announce several fiscal concessions and also increase expenditure on account of some sops. This ended in a further worsening of the country's finances.

What is India going to do about it?

Although the government does not borrow overseas, it cannot ignore the fisc as it is now a part of the global economy. The cost of borrowing for private corporates which raise money overseas, depends a lot on its home country's sovereign ratings . It is expected that finance minister Pranab Mukherjee will roll out a road map for fiscal consolidation during the Union Budget, which includes unwinding of the fiscal stimulus.

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WHAT IS A STRUCTURED PRODUCT?

A structured product, also known as a market-linked product, is a pre-packaged investment strategy based on derivatives such as a single security, an index, debt issuances or even foreign currencies. Most structured products that are sold in India, have 'principal protection' function as the key, which means that the investor is assured that he will not lose anything from what he has invested. Structured products are designed to facilitate highly-customised risk-return objectives.

How does a structured product work?

Let us take the example of a simple Nifty-linked capital protection structure. Say, you invest Rs 100 in a product with a tenure of 40 months. Of this, Rs 80 is invested in debt securities, yielding a return of 6-7% per annum. Thus over a period of 40 months, you could get Rs 20 as interest on these debt securities.

Hence, this ensures that your capital of Rs 100 is protected. The balance of Rs 20 available is invested in the Nifty. If the Nifty doubles in 40 months, Rs 20 will become Rs 40. Thus the value of your Rs 100 will be Rs 140 at the end of the period giving you an absolute return of 40%.

On the other hand, if the Nifty were to fall by say 50%, then Rs 20 invested would become Rs 10, thereby giving you Rs 110 back. This strategy ensures that at any given time, your capital is protected and you will get Rs 100 back at the end of 40 months.

While this is a simple structure, more complex structures using quantitative strategies could be deployed, depending on the risk profile of the investor to generate higher returns.

Who uses structured products?

Structured products are privately placed and typically offered to high net worth individuals. Structured products are issued in the form of NCDs (Non convertible debentures), whose returns are linked to an underlying stock index such as the Nifty or a basket of stocks. For retail investors, sophisticated structured products, depending upon the market conditions, can be specially created for a set of clients and privately placed.

The ticket size generally is Rs 10 lakh upwards. Typically, they are made by the likes of BoA Merrill Lynch, Citicorp, Edelweiss and Kotak. They are distributed by wealth management firms, typically foreign and private sector banks to their high net worth clients.

One product could differ from the other based on its tenure, participation rate and trigger conditions. With their popularity increasing, they are also available in the form of mutual fund products, mostly as debt schemes in the form of fixed maturity plans (FMPs).

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WHAT IS A DEMAT ACCOUNT?

WHAT SECURITIES CAN I HOLD IN MY DEMAT ACCOUNT?

Today, to buy and sell securities, brokers insist on having a demat account. Just as you open a bank account to hold money and make payments, similarly you need to open a demat account now to buy and sell securities in the financial markets. Today, all trades are settled in dematerialised form i.e. in the form of electronic records rather than certificates. Physical securities carry the risk of being stolen, forged or faked, and hence, it is necessary for investors to trade in demat form. A demat account can be used not only to hold shares, but also mutual funds, debentures and exchange-traded funds (ETFs). Hence, it is essential to have a demat account.

How does one convert physical shares into demat form?

If you are holding shares in physical form, it is advisable to convert them into dematerialised form. To get your shares dematerialised, you have to open a demat account and get into an agreement with a depository participant (DP). You need to surrender your physical share certificates to the company which issued them, informing them and giving details of your agreement with your depository participant. On the basis of this, the company would cancel your certificates and register your shareholdings in the name of your depository participant as the registered owner of those shares and intimate this registration through a notice to your depository participant. On receipt of the aforesaid notice from the company, the depository participant would register you as the beneficial owner of those shares. As a registered owner, your depository participant has no rights of benefits from those shares. All rights would lie with you as the beneficial owner.

With whom can you open a demat account?

You can open a demat account with any depository participant which could be a bank or even a stock broker having the licence to do so depending on your convenience. A broker is separate from a DP. A broker is a member of the stock exchange who buys and sells shares on his behalf and on behalf of his clients, though he could also hold a licence to provide depository services. A DP will just give you an account to hold those shares. It is not necessary for you to open a DP account with your broker. Your account can be different from that of the broker. Many brokers also offer you three-in-one trading accounts which link your broking, demat and bank accounts online, thus making it easier for you to trade. To view a complete list of registered depository participants, you can visit the websites of NSDL and CDSL.

What are the charges incurred in a demat account?

Various entities could levy various charges while operating a demat account. Broadly, there are three kinds of charges which a depository participant can levy. The first is an account opening charge, which also covers the cost of the agreement with the depository participant. The second is the annual maintenance charge to maintain your account and send you statements on a regular basis. The third charge is the transaction charge which is charged every time you sell a security, and request the DP to move it from your account to the broker's account.

LIVING BEYOND MEANS

Going through govt borrowing and how it affects the economy in more ways than one.

FISCAL DEFICIT

The government is taking a lot of flak these days for the 16-year high fiscal deficit in the current fiscal year. Here's how it is: The government's 'non-borrowed receipts' — revenue receipts plus loan repayments received by the government plus miscellaneous capital receipts, primarily divestment proceeds — fall short of its expenditure. The excess of total expenditure over total non-borrowed receipts is called 'fiscal deficit'. The government then has to borrow money from the people to meet the shortfall.

REVENUE DEFICIT

Revenue deficit is an important control indicator. All expenditure on revenue account should ideally be met from receipts on revenue account. Ideally revenue deficit should be zero, else the government will be in debt.

PRIMARY DEFICIT

This is a key indicator. When it shrinks, it indicates we are not doing too badly on fiscal health. The primary deficit is fiscal deficit minus interest payments the government makes on its earlier borrowings.

DEFICIT AND THE GDP

It's important to see where all this fit in the larger economic picture. The Budget document mentions deficit as a percentage of GDP. In absolute terms, the fiscal deficit may be large, but if it is small compared to the size of the economy, then it's not such a bad thing. Prudent fiscal management requires that the government does not borrow to consume in the normal course.

FRBM ACT

Enacted in 2003, the Fiscal Responsibility and Budget Management Act sought the elimination of revenue deficit by 2008-09. This means that from 2008-09, the government was to meet all its revenue expenditure from its revenue receipts. Any borrowing was to be done to meet capital expenditure — that is, repayment of loans, lending and fresh investment. The Act also mandates a 3% limit on fiscal deficit after 2008-09. The financial crisis and the subsequent slowdown forced the government to abandon the path of fiscal consolidation.

WHAT DO EQUITY ANALYSTS' RECOMMENDATIONS MEAN?

- * You often come across stock and industry reports made by analysts with various terminologies such as buy, accumulate, overweight, underweight. Let us try and understand what these various terminologies indicate.
- * **Buy/ Accumulate or Sell/ Book Profits:** These recommendations tell you whether the analyst expects the stock price to rise, fall or trade in a range from its current price or on the day the report is published. If an analyst expects a company's performance in the near future to be good, he puts a buy / accumulate recommendation. On the other hand, if he expects the future financials to dive, he recommends you to sell the stock.
- * Many a time a sell recommendation could also indicate that he expects the share price to drop sharply, and hence, is advising you to sell. Similarly, in the case of a buy recommendation it could indicate he expects the share price to move up sharply. A lot of time analysts suggest 'book profits' in the place of a sell, if he has recommended buying at a lower price and the stock has run up subsequently, leaving you with profits.
- * **Hold:** On the face, a hold recommendation calls for maintaining a status quo. But this recommendation is far more useful when seen in conjunction with the analyst's earlier recommendation. If the analyst earlier had a buy, the subsequent hold means that he has downgraded the stock. However, if the stock was a 'sell' earlier, the new recommendation would mean that the company's prospects have improved.
- * **Overweight / Outperformer:** It is a rating system used by an analyst to indicate the attractiveness of the stock being tracked. It conveys that the analyst is positive about the company. So, if an overweight rating is assigned to a stock, it indicates that an investor should hold proportionately more than the benchmark weight of a certain asset.
- * So, if an analyst gives an overweight rating to say Infosys, it means in his opinion the stock offers more value for money than others in the sector. If the weight of Company X in Nifty is 8.55%, and the analyst is overweight it means you should hold more than 8.55% of Company X in your portfolio. However, as an investor, do not think that if a stock has been given an overweight rating you cannot lose money as the rating in no way conveys absolute return. If the Sensex slides by 20% over a month, a stock that is down by only 15% would be an 'outperformer'... but you would not have made any money on it.
- * **Underweight / Underperformer:** Underweight indicates that an investor should hold proportionately lower than the benchmark weight of a certain asset. So if your advisor tells you to be underweight on Company A, he means your portfolio should hold less of 'A' than its weight in the index. If your advisor is underweight on A and its value in the Nifty is 11%, you should hold less than 11% of A in your portfolio.
- * **Equal Weight / Neutral :** This indicates that the analyst is not very optimistic about a company's future, but neither does he have a negative view. He has no firm view on the company and feels that the company may perform in tune with the market and hence it is worthwhile holding it. Another way of looking at a neutral rating is to check the previous rating on the stock. It is a negative sign if the view on the stock has turned from a 'buy' to a neutral and a positive one if the view has turned from 'sell' to 'neutral'.

WHAT IS BEGGAR THY NEIGHBOUR POLICY?

The beggar thy neighbour policy refers to a policy that aims at addressing one's own domestic problems at the expense of others — trading partners in particular.

What are the instances of such a policy?

The most popular forms of a beggar thy neighbour policy are in the areas of foreign trade and currency management. Conventionally, countries often impose tariff barriers and restrict imports to protect their domestic industries. However, with globalisation, such practices are not popular.

But to achieve its domestic policy objective, for instance, encouraging exports, central banks devalue or encourage the depreciation of their own currencies compared to its trading partners to retain their respective competitive edge. Sometimes economies compete in encouraging appreciation of their currencies to tame inflation at the expense of hurting income in the exporting countries.

Is China adopting a beggar thy neighbour policy?

Many economists, especially in the US, say China has deliberately kept the value of its currency low to forge ahead in exports. But in this case, more than the competitors, the importing country, US, is complaining because more than anything else, cheap Chinese imports are hurting its domestic economy.

How do current economies policies compare?

Currently, the raging concern among most emerging market economies in Aisa is spiralling inflation on account of rising global commodity prices. Central banks in most economies, including India's, are (though not necessarily planned) encouraging appreciation of their respective currencies.

This is helping them curtail inflation arising out of imported goods as imposing tariff barriers is perceived to be against the principles of free trade. Such a practice hurts export earnings of the countries from where such imports are sourced. But the impact also depends on how crucial such exports are for each economy.

What are the limitations of such a practice?

In certain cases, such a policy may prove counter productive. If, for instance, even the competing country counters one policy move, of say, depreciation (to protect exports) then such a practice may not have desirable results, especially the country's imports are not price elastic (the imports are essential and not dependent on prices) and instead could end up hurting the trade balance through higher import price and resulting in inflation in such economies.

REGISTRAR AND TRANSFER AGENT IN A MF

What is an R&T agent?

Mutual fund investors do a number of transactions on any given day. They may buy, sell or switch units. They could request for a bank address change or an address change. Each such request is a transaction by itself. Mutual fund houses have to maintain records of each such transaction. A mutual fund may not want to invest in these processes nor would have the skilled expertise to handle these huge transactions on a professional basis.

Hence, they would want to outsource this work to an agency which can handle these requests from investors on a regular basis. Registrar and Transfer agents (R&T agents) help them in this. An R&T agent maintains these records on behalf of the fund house, through its offices across the country. Computer Age Management Services (CAMS), Karvy and Deutsche Investor Services are the three main transfer agents that maintain these records.

How does an R&T agent function?

An R&T agent typically acts as a third-party on behalf of a fund house. The R&T agent has a wide network of branches across the country to service investors and help them execute their transactions. This huge network of branches across the country helps investors get forms of fund houses, complete their transactions and even obtain their account statements. It acts as single-window system for investors.

An R&T agent also helps investors with information and detail on new fund offers, dividend distributions or even maturity dates in case of FMPs (fixed maturity plans). While such information is also available at fund houses, an R&T agent is a one-stop shop for all the information. Investors can get information about various investments in different schemes of different fund houses at a single place.

Why is an R&T agent needed?

From a mutual funds perspective, R&T agents help in saving costs. An R&T agent brings in reach for the mutual fund. Since the R&T agent has offices across the country, they also double as branches for the mutual funds that they service and help them in their sales process.

An R&T agent helps mutual fund investors to fill their forms and submit the same. Typically, investors hold a diversified portfolio and want to invest in different schemes of different fund houses. As per Securities and Exchange Board of India's (Sebi) rules, there is a cut-off time by when the investment has to be made for that day. So, if an investor has to make multiple investments, he will have to approach multiple fund houses. Instead, he can use an R&T agent's services to conduct his transactions.

How is an R&T agent compensated?

The mutual fund pays money for the services offered by the R&T agent. The charges would depend on the volume of transactions done for the mutual fund. The mutual fund, in turn, charges such expenses to the expense ratio of the fund. As an investor, while doing any transaction at the R&T agents office, you do not have to pay any charges.



WHAT ARE MORTALITY CHARGES?

Mortality charges are that part of life insurance premium that go towards providing a death benefit cover. In other words, these are the actual cost of insurance in a life policy. In most policies, the bulk of the premium goes towards investing in a savings fund which is returned to the policyholder when the policy matures or the policyholder dies.

How are they calculated?

Most companies use a table of charges prepared by the Life Insurance Corporation (LIC) since this is the only company which has five decades of experience and consequently has historical data on life expectancy. Since private insurers have been around for a decade, some have made alterations to the rates based on their own experience. Work is on progress on a new mortality table with data from all companies and prices are expected to fall as life expectancy has gone up.

Will the policyholder benefit from buying a policy at a young age?

Yes. For instance, the life expectancy of a 25-year-old will be higher than that of a 55-year-old, and hence, the former will stand to benefit in terms of lower charges while buying insurance.

How will the updated mortality table impact pension policies?

Since the life expectancy of the average Indian has gone up, it is likely that you will have to incur a higher cost when it comes to buying whole-life annuities. Those who invest in pension plans will have to use at least two-thirds of the accumulated sum to buy annuities — a product where the investor gets regular income for a specified period in return for a lumpsum payment. The savings under a pension plan have to be invested in annuities to avoid them being taxed. One-third of the pension fund value at maturity is made available to the insured for tax free. The balance has to be used for purchase of annuities from any insurer.



WHAT IS REGULATORY AUTONOMY?

Financial market regulators like the Reserve Bank of India, the Securities Exchange Board of India (Sebi) and the Insurance Regulatory Development Authority (IRDA) have their jurisdiction over different segments of the market. Their activities are overseen by the government, though they are supposed to be autonomous - meaning the government will not interfere in their daily functioning or in the rules and guidelines they formulate for market participants. But there is a regular interface between the government and the regulators over several issues.

How does this interface work?

In case of RBI, its most essential function is that of public debt management on behalf of the government. RBI performs an important function of regulating the volume and the value of money in circulation in the system, both locally as well as globally. So whether and how should the money created by RBI be used for government expenditure becomes an issue of conjecture.

In which areas do regulators interact with the govt?

There are three areas where autonomy of the regulator interacts with the powers of the legislature - matters of appointment, matters of monetary policy making and matters of finance of public debt, as a whole, maintenance of financial stability of the economy. In matters of appointments, we refer to the extent of the government's involvement in appointment, dismissal and terms of procedures of central bank top officials and the governing body. Autonomy in financial matters, refers to RBI's power to manage the limit of its credit to be used for servicing government's expenditure. Finally autonomy in terms of policy making refers to the autonomy of RBI to formulate and regulate the monetary policy.

Have there been instances of clashes between RBI and the govt in the past?

The differences were summarised by former governor YV Reddy in his speech earlier this year. RBI came to be nationalised in 1948. Back then there were minimal areas of conflict as price inflation was modest. But differences have always been there. For example, during the five-year plans in the 1950s, RBI did not approve of financial planning being substituted with "Physical planning", but it had little autonomy to oppose it. The differences between the RBI and the government led to resignation by Governor Rama Rau. In the '60s Governor Iyenger identified four areas of conflict between the RBI and the Government - interest rate policy, deficit financing, co-operative credit policy and management of sub-standard banks. But in the post-liberalisation period, the relationship between the two took a new turn. In 1994, RBI and the legislature mutually disabled the ad-hoc treasury bills, the move moderated the magnetisation of government deficits.

WHAT IS A STOCK SPLIT?

A Stock split is an increase in the number of outstanding shares in such a way that the proportionate equity of each shareholder remains the same. So if a firm has a capital of Rs 10 crore, with 1 crore shares, each with a face value of Rs 10, and when this firm opts to split its shares into a face value of Rs 5, then it would issue 2 shares, against 1 share held by each shareholder. The firm will now have two crore shares, with a face value of Rs 5, and its equity capital would be the same at Rs 10 crore.

What happens to the price?

Once a company decides to split its shares, it calls for a book closure. Post the book closure, the stock price falls to the same extent as the split. So if the stock was trading at Rs 200, before the split, post the split, it would trade at Rs 100 per share. However, the market value, or market capitalisation, which is the number of shares multiplied by the market value of the stock, would not change and remain the same.

Why does a company split its stock and what approvals are needed?

One reason as to why stock splits are done is that a company's share price has moved so high that it is difficult or expensive for people to buy in round lots. So for example, if ABC company's shares were worth Rs 1,000 each, an investor would need Rs 1 lakh to invest in 100 shares. If, however, the company splits its share in the ratio of 10:1 and the price was Rs 100, you would need a mere Rs 10,000 to buy 100 of these shares.

Recently, HDFC has opted to split its shares in the ratio of 1:5. Also, Tata Tea has decided to split its shares into face value of Re 1 from the earlier face value of Rs 10. Any stock split can be done only with the approval from the board of directors and shareholders. Once the approval is obtained, the company can call for a book closure and split its shares.

What is a reverse stock split?

A reverse stock split, or reverse split, is the opposite of a stock split, i.e. a stock merge — a reduction in the number of shares and an accompanying increase in the share price. There are many institutional investors and mutual funds, who have rules that forbid them from purchasing stocks which quote below Rs 10, as they feel the stock may be manipulated or belongs to the penny category. Every professional company management likes to have a broad-based shareholding.

Hence to attract such investors, a company could go for a reverse stock split, where the ratio is reversed namely 1-for-2, 1-for-5 and so on. However, some firms also use a reverse stock split as a tactic to reduce the number of shareholders or avoid getting delisted. However, this is not as commonly used as stock splits. Earlier this year in March, LG Balakrishnan and Bros went in for a reverse split to consolidate the share's face value from Re1 to Rs10.

WHAT IS MONETARY POLICY TRANSMISSION?

It refers to various channels through which the monetary policy of a central bank alters prices or output in the real economy.

What are the various transmission channels of monetary policy?

The central bank can achieve its objective through a host of measures. These could include altering the money supply, credit availability, asset prices, influencing exchange rates and finally by managing expectations. The more popular channel of transmission these days is either by changing the bank rate, which is a way of managing expectations. In the last quarter, the central bank used the money supply channel by increasing the cash reserve ratio and thereby reducing the availability of cheap credit. The central bank also influences prices and output by increasing its lending and borrowing rates (repo and reverse repo, respectively).

How efficient is monetary policy transmission in India?

The monetary policy transmission is reasonably efficient to the money and bond markets, though, slower to the credit market because of structural rigidities. In recent communications, RBI governor D Subbarao has acknowledged that the transmission of monetary policy is weak on account of which policy rates signals do not get effectively communicated to the market participants. To an extent, the purpose of these signals get diluted. In an attempt to address this, it has asked banks to rework their loan pricing mechanism and adopt what is called the Base Rate system which it feels will help improve monetary policy transmission.

How does the base rate system work?

Hitherto, banks were free to decide their prime lending rates which served as the benchmarks for most of bank lending. In future, RBI will have much lesser leeway in determining the benchmark rate. The proposed Base Rate, which will replace the PLR, will be based on a formula linked to the cost of deposits for every bank. From the middle of this fiscal, banks will have to replace PLR with the base rate. RBI believes that the base rate will transmit changes in the monetary policy more effectively as any drop in the cost of borrowing for banks will result in lower lending rates.

WHAT IS A CURRENCY PEG?

There are various ways in which the price of one currency against another is arrived at. In a pegged exchange rate, the value of the currency is fixed with respect to another currency, usually the US dollar. In other words, it is the rate the country or the central bank of the country maintains as the official exchange rate. Chinese currency, for example, is pegged at 6.83 yuan to the dollar.

How is the currency peg maintained?

Currency pegs work only when the central bank has the muscle to intervene in the market to check the currency from going beyond a permissible band. It should be able to supply the market with enough dollars in the event of a huge demand at the pegged rate and in the event of too much supply be ready to buy dollars from the market. It implies that the central bank must have large foreign exchange reserves. China has foreign currency reserves of nearly \$2.5 trillion.

How does a currency peg help ?

Countries go for a pegged exchange rate to have stability in the foreign exchange market. China had also effectively gone to a dollar peg in July 2008 keeping its currency steady at 6.83 yuan to a dollar as it fought the global economic crisis. The stable currency creates a conducive environment for investments as investors do not fear losses on account of currency fluctuations. Exports benefit as appreciation is kept in check. However, there are numerous instances of currency pegs causing financial crises. Pegged values are difficult to maintain if the central bank is not in position to intervene and defend the peg.

Why is the US so bothered about the currency peg?

The US believes that China accumulates its huge current account surplus (to the tune of 8% of GDP) and the US, its current account deficit (to the tune of 2.9% of GDP) because its currency is undervalued, making its exports to the US cheap and its imports from the US expensive. The US blames the pegged yuan for the resultant global imbalance, and want the yuan to appreciate.

A bit of history

From 1997 to mid-July 2005, Chinese currency was pegged to the US dollar. On 21 July 2005, China ended the peg to the US dollar and switched to a crawling peg linked to a basket of currencies. The renminbi gradually appreciated over 20% over the next three years. In July 2008, China went back to the dollar peg, bringing the Yuan appreciation to an end. Yuan is now valued a 6.83 to a dollar with a plus/minus 0.5% fluctuation.

WHAT IS THE CONCEPT OF ANCHOR INVESTOR? WHEN WAS IT INTRODUCED?

An anchor investor in a public issue refers to a qualified institutional buyer making an application for a value of Rs 10 crore or more through the book-building process. Securities and Exchange Board of India (Sebi) introduced the concept of “anchor investor” in public issues in July 2009 with a view to create a significant impact on pricing of initial public offers. Since equity markets are volatile, it is believed that companies going for initial public offering (IPO) would benefit from anchor investors.

What is the significance of an anchor investor?

An anchor investor can attract investors to public offers before they hit the market to infuse confidence. The volume and value of anchor subscriptions will serve as an indicator of the company’s reputation and soundness of the offer. Finally, the anchor investor sets a benchmark and gives a guideline for issue pricing and interest among Qualified Institutional Buyers (QIBs).

What are the conditions stipulated for an anchor investor?

Up to 30% of the portion available for allocation to qualified institutional buyers (QIBs) is required to be made available to anchor investor(s) for allocation. An anchor investor is required to make an application for a minimum value of Rs 10 crore in a public issue. Allocation of shares to anchor investors is made on a discretionary basis and subject to a minimum number of two such investors for allocation of up to Rs 250 crore and five such investors for allocation of more than Rs 250 crore. Company has a right to reject the anchor investor’s bid. An anchor investor is required to pay a margin of at least 25% on application with the balance to be paid within two days of the date of closure of the issue. If the price fixed as a result of book building is higher than the price at which the allocation is made to anchor investor, he is required to bring in the additional amount.

However, if the price fixed as a result of book building is lower than the price at which the allocation is made to such investors, the excess amount is not refunded. The number of shares allocated to anchor investors, and the price at which the allocation is made, is made available in public domain by the merchant banker before opening of the issue. There is a lock-in of 30 days on the shares allotted from the date of allotment in the public issue. Neither the merchant bankers nor any person related to the promoter/promoter group/merchant bankers in the concerned public issue can apply under anchor investor category. The parameters for selection of anchor investor are required to be clearly identified by the merchant banker and are made available as part of records of the merchant banker for inspection by the board.

How is an anchor investor different from a private equity or a venture capital investor?

A private equity investor is a person with deep pockets and capacity to play the role of a venture capitalist. The anchor investor, on the other hand, is a bridge between the company and the public in the run up to an initial public offer. Getting an anchor investor would ensure greater certainty and better price discovery in the issue process. If some investor is ready to come in with prior commitment, it enhances the issuer company's ability to sell the issue and generate more confidence in the minds of other investors.

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WHAT IS FRONT RUNNING?

Front running is an illegal practice whereby a trader or a dealer buys or sells shares in a company before his organisation buys or sells the same shares. It is called front running because the employee literally runs his deals ahead of his employer's bulk transactions to take the advantage of the subsequent price movement.

Some people also term it as forward trading. For example, if a dealer/trader is aware that his firm wants to buy 1 lakh shares of XYZ. Before placing the order for his firm, the trader passes on the information to his known source or buys 10,000 shares on his own account at, say, Rs 100 per share.

When he goes to buy 1 lakh shares of XYZ for his company, the price may jump to Rs 103 per share because of the size of the order. The dealer then sells his shares at Rs 102 per share, making a neat profit of Rs 2 per share in a short period, many a time in the same day itself.

His organisation is hurt to the extent that it is forced to pay Rs 20,000 more to buy 1 lakh shares, caused due to front running. By front running, the trader acts in an unethical manner, putting his own interest above that of his organisation, thereby causing a fraud. Front running causes a loss and leads to loss of trust amongst the organisation's investors.

What kind of stocks does front running happen in?

Front running could happen in all types of stocks be it large-cap, mid-cap or small-cap stocks. However, mid-cap and small-cap stocks are more susceptible to front running due to their lower float and liquidity.

Also, if there is a large order, a small-cap or a mid-cap stock could fluctuate far more than a large-cap stock. Hence the extent of profit a trader could make by front running in case of a small-cap stock could be far higher than if he were to take a position in a large cap stock.

Action by the regulator

The regulator can take strict action to protect the interest of the common investor. In a recent case, Sebi banned a dealer of a mutual fund and directed the fund and dealer to jointly deposit the estimated losses identified due to front running. It also directed the trustees of the fund to submit within one month, a plan to overhaul the internal control systems and the internal preventive measures to avoid such instances happening again in the future.

How do organisations deal with it?

Big brokerage houses and asset management companies have strict compliance process for their key personnel. Analysts/ fund managers need to take permission or clearance from their compliance department before buying stocks in their personal account.

Those associated with dealing/ fund management, are asked to switch off their mobile phones in the dealing room during trading hours. All phone calls in the dealing room are made from landlines, which are recorded. Such records are stored for periods as long as 7-10 years.

The compliance department, proactively watches for any irregularity in trades. If an employee is found to indulge in such activity organisations have the right to take strict action against them which could include termination.

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WHAT IS AN INITIAL PUBLIC OFFERING (IPO)?

A maiden public issue of shares by a company is termed as an Initial Public Offering (IPO). It is often treated as a milestone in a company's lifecycle and usually marks the transition from a small closely-held company to a listed entity. Most IPOs are done by smaller, younger companies which need capital to expand their business. However, often they are also done by large privately-owned companies looking to become publicly-traded. The new investors who come in the company by way of owning shares, through the IPO become members of the family of existing shareholders.

Why do companies go for an IPO? What are its benefits?

Companies float an IPO to raise capital. Listed companies get access to cheaper capital. Since they are more compliant and transparent, and are subjected to scrutiny by various authorities, they can get access to lower interest rates when they issue debt. A listed company can issue more stock and raise fresh capital faster than an unlisted company. They can also offer their own stock to buy out a company. Hence, mergers and acquisitions are easier for listed companies since they can issue stock as part of the deal. A listed company can offer ESOPs to employees, which is an attractive retention tool. There is also a considerable amount of prestige that follows a successful listing.

How can an IPO be structured?

An IPO can be done either through a fresh issue of shares or through an offer for sale of existing shares to investors. If fresh shares are issued, the company's fresh capital is injected into the business and its equity base increases. The stake of existing investors in the company decreases, to that extent. When existing shareholders of the company sell equity shares that they own, then it is called an offer for sale. In this case, there is no infusion of money in the company. The existing shareholders sell their stake usually for a profit.

How long does it take for a company to list post-IPO? In a recent directive, Sebi has ordered companies to get their issue listed within 12 days, from the date of closure of the IPO. Earlier, it took companies 22 days to list the IPO.

How is an IPO priced?

IPOs are priced by companies in conjunction with merchant bankers. Essentially, there are two ways of pricing an IPO — the fixed-price route and the book-building option. In a fixed-price mechanism, the price at which the shares are issued to the public is disclosed, before the issue opens for subscription. In the book-building process, the company announces a price band within which investors have to bid for the shares. The lower end of the price range is called the floor and the upper end is called the cap. After the bidding process is complete, the cut-off price is arrived at based on the demand of securities. Retail investors have the option of bidding at a cut-off price.

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HOW DOES A BANK MEET ITS DAY-TO-DAY SHORTFALLS OF CASH?

A bank treasury official's key task is to match the assets of a bank (loans which mostly are long term) with its liabilities (that are mainly short term.) Put simply, a bank's liabilities with other banks are its inter-bank liabilities (IBL). These mainly consist of its borrowings in the overnight call money market and money raised by selling certificate of deposits of other banks. Even interbank CBLO and repurchase (repo) transactions where a bank borrowing overnight funds from another bank is an IBL for the lending bank. Well, deposits raised from retail investors are part of a bank's total liabilities.

How is CBLO and repo different from call money?

A bank goes to the Collateralised Borrowing and Lending Obligations(CBLO) market if he has government securities and wants to get cash. The repo facility is used if a bank wants to increase his SLR, since a bank can get government securities in lieu of the cash deposited. Both are run by the Clearing Corporation of India and transactions take place on the screen. However, call money market does not involve exchange of securities. Here cash is borrowed and lent, through telephone calls between banks.

CBLO is becoming popular with market participants in recent years because its much more efficient and a secured market (government securities are used as collateral.) In recent months, volumes in CBLO have been in the range of Rs 50,000-75,000 crore daily, while that in market repo and call money are around Rs 20,000 crore and Rs 10,000 crore everyday.

To what extent can a bank have such liabilities on their books?

In March 2007, RBI limited a bank's IBL to twice its net worth. A higher IBL limit up to 300% of the net worth was allowed for banks whose CRAR was at least 25% more than the minimum CRAR (9%) i.e., 11.25%.

Why is the regulator concerned?

According to RBI, the liability-side management has its own merits from the point of view of financial stability. Controlling the concentration risk on the liability side of banks is therefore as important as controlling the concentration risk on the asset side. More particularly, uncontrolled IBL may have systemic implications, even if, the individual counterparty banks are within the allocated exposure. Further, uncontrolled liability of a larger bank may also have a domino effect.

WHAT ARE CAPITAL CONTROLS?

Foreign capital inflows in the form of loans and equity that are allowed in a restricted form are said to be controlled. Many countries which had closed economies had imposed severe restrictions on foreign capital. However, as these economies started opening up in the 80s, capital controls were eased, facilitating free flow of capital and ensuring integration with global financial markets.

What are capital inflows?

From the perspective of balance of payments — a country's external sector balance sheet — foreign currency inflows are broadly divided into current account and capital account flows. While current account flows arise out of transactions in goods and services and are permanent in nature, capital account flows are essential in various kinds of loans and equity investments, which can be reversed. That is why policy makers have to keep a close eye on capital flows.

What are the kind of capital inflows in India?

These would include inflows through foreign borrowings by Indian corporates and businesses, NRI deposits and portfolio flows from institutional investors into the stock markets. Loans to government and short-term trade credit are also included.

What has been the extent of dismantling of capital controls in India?

India had controls on both capital account transactions as well as on the current account with the local currency fixed by the central bank. However, since 1991, when structural changes to the Indian economy were carried out, the rupee was first made convertible on the current account. Subsequently, capital controls were eased. In 1994, a big shift took place with the government allowing foreign portfolio investments. Over a period of time, foreign direct investment norms and overseas borrowing norms were eased.

Why are policy makers thinking of reimposing controls?

Though allowing foreign capital allows firms in a capital scarce economy to access cheaper resources to finance their growth plans, the flip side is that it presents risks to value of the country's currency as well as managing local liquidity arising out of such inflows (as the central bank buys the foreign currency and pumps in local currency).

Dependence on foreign capital could leave a country vulnerable to risks, arising out of a abrupt reversal of flows. With many emerging economies remaining relatively unscathed after the global financial crisis, there has been a surge in such inflows, leading to an appreciation in their currencies, including in India. But inflows beyond the absorptive capacity of an economy pose other challenges such as high demand side inflation.

WHAT IS IFRS?

IFRS is a set of accounting standards developed by the International Accounting Standards Board (IASB)--an independent group of 15 experts-- that is steadily becoming the global standard for the preparation of financial statements of public companies.

How many countries follow IFRS?

Approximately 120 nations require IFRS for domestic listed companies. Of these, about 90 countries have made it mandatory for their domestic companies to follow IFRS, while in the rest it is optional for companies to either follow IFRS or the domestic accounting norms. India, at the moment, does not require companies to follow the IFRS. However, as per its commitment in the G20 summit last year, India will converge its domestic accounting standards with IFRS in a phased manner starting April 1, 2011.

While BSE and NSE listed entities, apart from companies with net-worth over Rs 500 crore, are required to converge with IFRS from April 2011, for banks and insurance companies the date of convergence has been extended to April 1, 2013 and April 1, 2012 respectively.

How relevant is a shift to IFRS now?

By making a shift to IFRS, a business can present its financial statements on the same lines as its foreign competitors, making comparisons easier. This will lead to increased trust and reliance placed by investors, analysts and other stakeholders in a company's financial statement. Companies also need to convert to IFRS if they are a subsidiary of a foreign company that is mandated to use IFRS, or if they have a foreign investor that is mandated to use IFRS. Companies may also benefit by using IFRS if they wish to raise capital abroad.

How difficult is it for Indian companies to converge their accounts as per IFRS?

The costs would be determined largely by the size and nature of the respective company. While the initial cost to identify and quantify the differences between Indian accounting standard and IFRS, staff training and implementing IT support could be significant, the conversion could result in an ultimate reduction of costs for capital and financial reporting. Initial challenge lies in making changes to a company's internal infrastructure related to data storage and availability.

What are the regulatory impediments that come in way of IFRS convergence in India?

For a smooth convergence to take place, India needs to amend key provisions in the Companies Act, SEBI Act, Insurance Act as also RBI regulations. While the changes to the Companies Act have been provided for in the proposed new Companies Bill, sectoral regulators like Reserve Bank of India and Insurance Regulatory and Development Authority of India will have to bring in certain changes in their norms.

CHINA'S YUAN MOVE

What is the issue with yuan?

China and the US have been trading charges over the exchange rate of the yuan. The US has accused the country of keeping the yuan undervalued, which, it argues, is the primary reason for the high trade deficit it runs with the country. The undervalued yuan, many experts have said, is also the reason for global imbalances — deficits in the developed world and surplus in China.

What exactly has China decided?

China's central bank, the People's Bank of China (PBC) said on Saturday, "In view of the recent economic situation and financial market developments at home and abroad, and the balance of payments (BOP) situation in China, the People's Bank of China has decided to proceed further with reform of the RMB exchange rate regime and to enhance the RMB exchange rate flexibility." "It is desirable to proceed further with reform of the RMB exchange rate regime and increase the RMB exchange rate flexibility," the PBC added.

The PBC also indicated that the peg to the dollar could be abandoned and instead the renminbi will be benchmarked to a basket of currencies.

What are the implications of China's move?

China's announcement is being seen as intent to allow a gradual appreciation of the yuan, largely against the dollar. Though the PBC retained the existing trading band for the currency at +/-0.5% per day, it is expected that the renminbi, another name for China's currency, will appreciate against the dollar over a period. Essentially, the tight trading band will ensure that there is no volatile adjustment in the value of the renminbi to the perceived market price of the currency.

How will the move impact the global economy?

Conceptually, a stronger yuan should erode competitiveness of China's exports, making it easier for other countries to compete. This should help address the global trade imbalances — China's surplus against deficits of others. However, to the extent the appreciation is expected to be very gradual because of the tight trading bands, there is unlikely to be a sudden change in comparative trade equation or capital flows.

In fact, the People's Bank of China effectively ruled out large scale appreciation. It said, "With the BOP account moving closer to equilibrium, the basis for large-scale appreciation of the renminbi exchange rate does not exist."

However, the move will help reduce the tension between the US and China. More importantly, it sends a strong signal about the state of the Chinese economy and the sustainability of the global recovery.

VARIOUS TYPES OF TAX

DIRECT TAX : This is the tax that you, I (and India Inc) directly pay to the government for our income and wealth. So income tax, wealth tax, and STT are all direct taxes.

INDIRECT TAX : This one's a double whammy: It's essentially a tax on our expenditure, and includes customs, excise and service tax. It's not just you who thinks this isn't fair - governments too consider this tax 'regressive', as it doesn't check whether you're rich or poor. You spend, you pay. That's precisely why most governments aim to raise more through direct taxes.

MAKING YOU PAY : The various taxes that the government levies

CORPORATION (CORPORATE) TAX : It's the tax that India Inc pays on its profits.

TAXES ON INCOME OTHER THAN CORPORATION TAX : It's income-tax paid by 'non-corporate assesseees' — people like us.

FRINGE BENEFIT TAX (FBT) : No free lunches here. If you want the jam with the bread and butter, you'd better pay for it. In the 2005-06 Budget, the government decided to tax all perks — what is calls the 'fringe benefit' — given to employees. No longer could companies get away with saying 'ordinary business expenses' and escape tax when they actually gave out club memberships to their employees. Employers have to now pay a tax (FBT) on a percentage of the expense incurred on such perquisites.

SECURITIES TRANSACTION TAX (STT) : If you're dealing in shares or mutual funds , you have to loosen those purse strings a wee bit too. STT is a small tax you need to pay on the total amount you pay or receive in a share deal. In the 2004-05 Budget, the government did away with the tax on profits earned on the sale of shares held for over a year (known as long-term capital gains tax) and replaced it with STT.

CUSTOMS: Anything you bring home from across the seas comes with a price. By levying a tax on imports, the government's firing on two fronts: it's filling its coffers and protecting Indian industry.

UNION EXCISE DUTY: Made in India? Either way, there's no escape. In other words, this is a duty imposed on goods manufactured in the country.

SERVICE TAX :If you text your friend a hundred times a day, or can't do with-out the coiffeured look at the neighbourhood salon, your monthly bill will show up a little charge for the services you use. It is a tax on services rendered.

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WHAT IS THE TAKEOUT FINANCING SCHEME?

The takeout financing scheme is aimed at encouraging commercial banks to lend more to the infrastructure sector. Under the scheme, banks lend to infrastructure projects but sell a part of that loan to a third party after a certain period of time. This is called takeout financing.

Why is takeout financing important for infrastructure projects?

Core sector projects have long gestation periods and therefore require long-term funds, which banks are unable to provide because of the risks of asset-liability mismatch. Deposits, the key source of funds for banks, are generally of less than 5-year maturity. When banks lend for longer period they are taking the risk of using short-term funds for providing long-term loans. By selling a part of the loan to an institution that has long term funds banks are able to reduce lending that involves some asset-liability mismatch. This allows banks to lend more to infrastructure projects as their exposure is limited.

How will takeout financing work in India?

India Infrastructure Finance Company (IIFCL), a stateowned company, will soon start to provide take out finance scheme. Under the proposed scheme, IIFCL will take over up to 75% of an individual bank's loan or 50% of the residual project cost on to its own books. The loan can be repaid over a 15-year time period. Projects that have a residual debt tenor of at least six years or those which are yet to achieve financial closure will be eligible for the scheme. The project developer, IIFCL and the lender will enter into a tripartite agreement, which would include the rate of interest on the take out amount. IIFCL can take over the loan after four year's from the commencement of the project.

Will the scheme be able to successfully address core sector financing?

Internationally, the concept has a mixed response. But industry players say that if banks have the comfort that their loan can be taken over by IIFCL at a later date, they will provide funds more readily. Banks have, however, not responded as enthusiastically. This is because under the scheme IIFCL will charge an annual transaction fee of 50 basis points on the take out amount. Banks have complained that loans will become more expensive and there will be few takers. The actual litmus test will begin this year when a large number of projects will be bid out.

WHAT IS QUANTITATIVE EASING?

It is an extreme form of monetary policy management where the central bank makes availability of a huge amount of money to lenders to facilitate a growth in investment and consumption. In practice, it is similar to the easy money or accommodative monetary policy undertaken to promote growth, the difference is in the scale of liquidity released.

When do central banks go for quantitative easing?

Such drastic increases in fund availability are usually done in reaction to stave off a recession, following a shock to the economy. The central bank can do this as it has the mandate to manage the money and finance availability and supply which is consistent with the overall growth objective of the economy.

How does a central bank go about it?

The central bank can ease liquidity in a number of ways. It can for instance release liquidity by easing the cash reserve requirement (CRR). Banks are required to maintain a portion of their deposits with RBI under the CRR norms. Secondly, the bank can make increased funds available by directly lending to banks through its refinance window. The central bank can also offer to buy back bonds from banks, thereby, making available more funds for onlending. In countries like India, there is another tool available — Statutory liquidity ratio (SLR). Banks are mandated to park a portion of deposits raised in government bonds under the SLR norms. Quantitative easing can also be achieved by stipulating lower SLR.

What is the current stance of central banks?

Most central banks have gone for quantitative easing since late 2008, particularly since the global financial crisis deepened following the collapse of the American investment bank Lehman brothers.

How has this policy worked so far?

The response has been varied across countries. How have these policies responded in achieving its objective is going to be a deciding factor for any further decision on continuing quantitative easing. The downside of quantitative easing is that it cannot be used for long as this would eventually lead to too much money chasing too few goods and lead to inflation.

WHAT IS A MUTUAL FUND STATEMENT?

Whenever you invest in a mutual fund scheme, the fund house has to send you a statement providing details of your holding in the scheme. You can opt for a physical copy of the statement, or a soft copy, which can be e-mailed to you and you can access it online. This statement provides information about the transactions conducted by you within a defined period.

This statement is sent to you within a period of three working days once the transaction is done. This document indicates the changes in the account whenever there is a redemption, additional investment or dividend declaration. This makes the account statement important for tracking your investments.

Should you preserve your mutual fund statement?

No. There is no compulsion to preserve the physical statement. Your ownership has already been recorded by the AMC in its records. If you do not like dealing with paper, you can opt for e-statements. To redeem your units, you only need to fill the necessary form.

What are the details to look out for in a mutual fund statement?

It is in your interest to ensure that the mutual fund statement sent to you by the asset management company is error-free. The statement provides details of your investment which include your name, address, bank details, folio and account number, current cost and value and PAN details.

a) Investors' personal details and bank details:

Your name, address, e-mail ID and contact numbers of the investor or joint investors, if any, are mentioned in this section. Ensure that the details mentioned in the account statement are correct.

The name of your bank and account number should be correctly mentioned, or else you might face unnecessary problems at the time of redeeming your mutual fund units. In case you need to change your bank mandate, fill in the slip provided at the bottom of the account statement and submit it to the fund house.

b) Folio and account numbers:

Each time you invest in a mutual fund, the fund house gives you an account number. You could also invest in a number of schemes such as a debt fund, an equity fund or a tax plan, with the same fund house. In this case, it would be wise to mention your account number so that the fund house can consolidate all accounts under a single folio. This makes it easier to track all the investments with a particular fund house.

c) Current cost and value:

The current value is the latest market value of the investments on the date the statement is generated while the current cost indicates the amount invested in the

scheme. The number of units allotted is calculated using the amount invested divided by the NAV of the scheme as on the date of allotment. In case there is an exit load, the same would be deducted from the NAV and the proceeds paid out to the investor.

d) Advisor's name and PAN details:

If you have invested through an agent, his name and code will appear on the statement. However, if you have invested directly, these parts should be blank in your account statement. It is mandatory for you to provide your PAN, irrespective of the amount that you have invested. Check that the PAN mentioned in the account statement is correct.

e) Transaction summary:

This section mentions the types of transactions that you have opted for, which might include purchase, the systematic investment plan (SIP) or the systematic withdrawal plan (SWP). Besides, other transactions are also mentioned, along with the percentage or rupees per unit at which the dividend is reinvested or paid out.

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