



## DEPARTMENT OF MASTER OF BUSINESS ADMINISTRATION

### 1.1. FINANCIAL MANAGEMENT

#### 1.1.1. Meaning and Definition of Finance and Finance Functions

The term 'Finance' has been defined in various ways by different schools of thought. Basically, the term finance revolves around the management of money or financial resources of a business enterprise. The discipline of finance is concerned with the sources, allocation, application and usage of money by a business entity for maximising its returns and stakeholder's satisfaction.

**According to F.W. Paish**, "Finance may be defined as the position of money at the time it is wanted".

**According to John J. Hampton**, "The term finance can be defined as the management of the flows of money through an organisation, whether it will be a corporation, school, bank or government agency".

The practices and activities directed to manage business finances are known as **finance functions**. These functions are aimed to obtain and manage financial resources and use them for generating profit. These functions optimize the financial resources and information, which in turn increases the productivity of other business functions, planning, and decision-making activities.

#### 1.1.2. Aims of Finance Function

Finance function is performed for the following aims:

- 1) **To Evaluate the Financial Requirement:** Financial function is performed to evaluate the current requirement of funds as well as estimate the future requirement, which may be long-term in nature. It is performed to ensure that business operates smoothly and does not face scarcity of funds.
- 2) **To Ensure Proper Utilisation of Funds:** Evaluating the current financial requirement is not the only objective of the finance function rather it also aims to ensure that the funds are organised in the most feasible manner considering cost-effectiveness and optimal utilisation. It also helps in evaluating the available opportunities and selecting the most profitable opportunity.
- 3) **To Increase Profit:** It also aims to increase the profit by optimising business operations. Basically, it helps in simultaneously avoiding the possibility of the scarcity of funds and excess funds lying idle with the business.
- 4) **To Maximise the Value of Firm:** It aims to maximise the value of firm and eventually the profitability of the business.

#### 1.1.3. Meaning and Definition of Financial Management <sup>2021</sup> (3)

The term 'Financial Management' consists of two words – 'Financial' and 'Management'. In order to fully grasp the meaning of this term, one needs to understand the meaning of both words separately. "Financial" denotes the process of identifying, obtaining and allocating sources of money. "Management" is the process of planning, organising, coordinating and controlling various resources for the accomplishment of organisational goal.

Therefore, Financial Management is that branch of business management process, which deals with management of financial resources of an enterprise. Financial management is the skilful and proper management of financial resources.

**According to Solomon**, "Financial management is concerned with the efficient use of an important economic resource, namely, Capital Funds".

**According to J.F. Bradley**, "Financial management is the area of business management devoted to the judicious use of capital and careful selection of sources of capital in order to enable a spending unit to move in the direction of reaching its goals".

**According to Howard and Upton**, "Financial management is the application of the planning and control functions of the finance functions".

**According to Weston and Brigham**, "Financial management is an area of financial decision making, harmonising, individual motives and enterprise goals".

#### 1.1.4. Nature of Financial Management

Few salient features of the financial management are mentioned below:

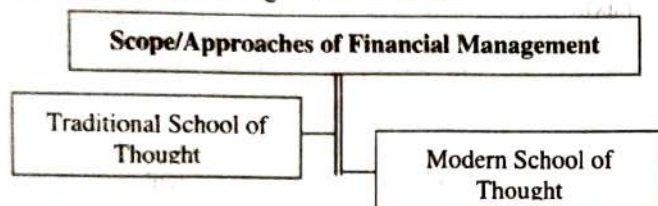
- 1) Financial management is mostly integrated and centralised in every business organisation, as it brings forth cost advantages to the company.
- 2) Irrespective of size, nature, legal status, every organisation has a financial management, as it puts across certain amount of control on other activities and functions of the organisation.
- 3) Financial management and its related activities play a very significant role in the long-term growth and survival of the organisation.



- 4) It refers to managerial decision-making, through analysis and interpretation of financial data.
- 5) Financial management is interrelated to other primary functions of business as well, such as marketing, production planning, human resources, etc. These functions are very much dependent on financial management and get affected by external factors of environment.
- 6) Basically, "Valuation of a Firm" is one of the important aspects of the financial management.

### 1.1.5. Scope/Approaches of Financial Management

The scope of financial management has grown over the years. In this respect, different schools of thought/approaches have given their views:



- 1) **Traditional School of Thought/Approach:** Under this school of thought, the scope of financial management was restricted to obtaining of funds. The finance manager was supposed to provide funds as and when required by the organisation. Finance function excluded the utilisation of funds. The decision regarding the application of funds was left to others.

Under this school of thought, the scope of financial management was limited to the following functions:

- i) Assessment of fund requirements.
- ii) Procurement of required funds from financial institutions.
- iii) Acquiring funds through the issuance of financial products like shares, bonds, debentures and raising loans.
- iv) Managing accounting and legal framework of such transactions.

- 2) **Modern School of Thought/Approach:** Modern school of thought takes a wider view of scope of financial management. According to this school of thought, financial management conceptualises and analyses the process of financial decision-making. The finance function deals not only with the attainment of funds, but it also deals with the utilisation of funds. Therefore, the modern school of thought is more comprehensive than the traditional school of thought. Financial management deals with solving three main finance-related problems faced by a firm. These three problems relate to investment, financing and dividend. According to the modern definition, following are the main functions performed by modern financial management:

- i) Investment decision,
- ii) Financing decision,
- iii) Dividend policy decision, and
- iv) Liquidity decision.

### 1.1.6. Importance of Financial Management

Financial management function is important in following ways:

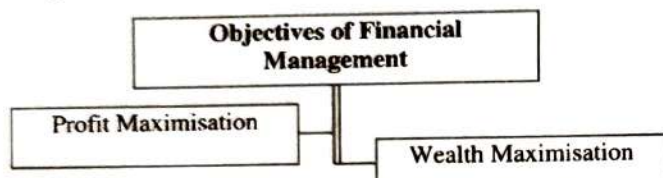
- 1) **Finance is the Controlling Function:** For all the business operations, finance is the base. Every business activity, such as production, purchase, sales and marketing, manpower planning, etc. involves the flow of funds and thus is controlled and monitored by the finance function. So, planning and implementation of all the business functions are governed by the function of finance.
- 2) **Aid to Managerial Decision Areas:** Financial management plays a vital role in policy and managerial decision-making in a firm. Major business decisions and choices relating to production, marketing, labour, research and development are based on finance decisions.
- 3) **Wealth Maximisation:** Financial management has two basic objectives – profit maximisation and shareholders' wealth maximisation. Finance function aims to achieve maximum profitability through sourcing of funds or capital at a lower cost and utilisation of those funds in profitable projects or assets, to maximise returns on investment. For sourcing and application of funds, finance function has certain techniques such as ratio analysis, budgetary control, cost-volume profitability analysis, cash-flow, fund-flow management, etc. Thus, financial management techniques help in improving the profitability of the business.
- 4) **Financial Management is an Analytical Tool:** Financial management employs a variety of scientific, mathematical and analytical tools and methods for interpretation of data and managerial decision-making.
- 5) **Administrative in Nature:** Unlike before, now-a-day financial management has evolved to be more controlling and supervising in nature. Financial management is not only concerned with fund acquisitions, but its functions are also extended to capital allocation, sourcing of funds, project appraisal, etc.
- 6) **Finance Function is Centralised:** Finance is one such business activity, which is controlled and administered centrally. Other business functions such as sales and marketing, production, purchase, etc. are mostly scattered and distributed across various verticals and parameters. Finance function is very carefully monitored and coordinated in a centralised manner.
- 7) **Base for Managerial Functions:** Proper management of finance is very important for all other functions and processes of a business concern. Thus, all other management functions such as planning, coordination, and directing can be implemented and achieved, if there is proper financial planning and control.
- 8) **Performance Measure:** Financial management often deals with those factors, which directly affect the profitability and risk factors of a business concern. So, financial management usually acts as a measure for determining the performance levels of other functions to stabilise and control profitability and risk factors.



## 1.2. OBJECTIVES OF FINANCIAL MANAGEMENT

Financial management is a business function concerned with sourcing and acquisitions of funds and the proper utilisation of those financial resources for achieving maximum returns for a firm. Allocation of capital or funds is a very crucial task, as it involves deciding on the best alternative investment proposal out of many investment alternatives available, by using various scientific and analytical appraisal techniques.

For optimum utilisation of financial resources, a firm has to decide on those projects or investment proposals, which are commercially viable. Thus, for selecting the best investment proposal, a firm should analyse the project from the criteria of low cost of capital and maximum return to be generated from the investment. Hence, the two main goals of financial management are as follows:



## 1.3. PROFIT MAXIMISATION

### 1.3.1. Concept of Profit Maximisation

Profit maximisation is the traditional and narrow approach. As per traditional theories, maximisation of profit is considered to be the sole objective of a business organisation. This theory is also called as **cashing per share maximisation**. As per the requirement of a firm, the product price and output are placed under competition to maximise profit. Profit maximisation is said to be the maximisation of returns by a firm in terms of monetary resources and increasing the earnings per share of the shareholders.

Firms often select investment proposals, which suit their profit maximisation criterion. A firm selects only those investment projects which provide excess profit and reject projects which provide comparatively less profit. Maximising profit by a firm is often influenced by the input-output relationship, where firms tend to lower their cost of capital and try to achieve maximum profit and shareholders' wealth maximisation. Thus, with the right selection of project, the firm can maximise its productivity and efficiency in the operational activities.

### 1.3.2. Features of Profit Maximisation

Profit is one of the most significant measures for assessing the efficiency of any business or economic activity. Survival and growth of a business concern also depends on its profit earning capacity. According to the traditional theories, profit maximisation is the sole objective of a business concern. Some of the salient features of profit maximisation objective are as follows:

- 1) Profit maximisation is related to the maximisation of earnings per share of a firm.
- 2) Increase in profitability is one of the foremost concerns of every business organisation and thus involves various procedures and methods to maximise profits.
- 3) Profit is one of the benchmarks of operational efficiency, survival and well-being of a business organisation, as it reflects its business decisions and policies.
- 4) The objective of profit maximisation minimises the risk and uncertainty factors in business decisions and operations.

### 1.3.3. Arguments in Favour of Profit Maximisation

Some of the arguments in favour of the objective of profit maximisation are as follows:

- 1) **Measure of Financial Stability:** Profitability of a firm is an important indicator of its financial stability as well as economic well-being.
- 2) **Optimum Utilisation of Funds:** Profit maximisation in a firm, leads to proper and efficient channelisation and utilisation of surplus funds for productive business operations and other economic activities.
- 3) **Promotes Socio-Economic Welfare:** Increased profit, promotes socio-economic welfare of various stakeholders associated with the firm. It aids in shareholders' wealth maximisation, increased incentives and benefits to employees, better and improved products to customers, employment generation, etc.
- 4) **Retained Earnings:** Retained profit acts as a major source of long-term finance for a company. Retained earnings with a low cost of capital, can be utilised for the acquisition of fixed assets, expansion and modernisation projects of a firm. Thus, outside funding is not required.
- 5) **Increases Competitiveness:** Maximisation of profit by a firm helps it to sustain competition from its competitors. With increased profits, a firm is more capable to sustain its growth and development amongst severe competition through product development, market development and gaining market share.
- 6) **Decision-Making:** Increased profitability strengthens the foundation of sound managerial decision-making and also helps to solve agency issues in an organisation, through optimum utilisation of funds for business expansion as well as increased returns to shareholders.
- 7) **Desire for Controls:** When the company earns huge profit, the entry of the shareholders is restricted, subject to internal use of funds for expansion and modernisation. And this, in turn, leads to full control of the company to the existing shareholders.

### 1.3.4. Limitations of Profit Maximisation

However, the objective of profit maximisation has been questioned and criticised on several grounds. Some of the limitations that are associated with the objective of profit maximisation are as follows:



- 1) **Ambiguity:** The complexity with profit maximisation criterion for financial decision-making is that the term profit is an ambiguous and confusing concept. It has no specific implication. It is open to different understanding by different individuals. **For example,** profit may be short-term or long-term; it may be total profit or rate of profit margin; profit after tax or profit before tax; return on capital employed or assets or return on equity. Thus, as an objective of profit maximisation, the issue arises as to which variant of profit a business concern should try to maximise.
- 2) **Timing of Benefits:** A more significant limitation to the objective of profit maximisation is that it ignores the differences in timings of the benefits received over the working life of the asset, irrespective of the fact as to when they were received. The profit maximisation criterion does not consider the time value of money.
- 3) **Quality of Benefits:** Perhaps, the most critical limitation of profit maximisation, as an objective, is that it ignores the quality aspect of benefits and returns associated with a financial activity. An uncertain and fluctuating return implies risk to the investors. The problem of uncertainty renders profit maximisation unsuitable as an operational criterion for financial decision-making, as it values only the amount of benefits generated and gives no value to the extent of uncertainty of the future returns.
- 4) **Impact on Social Welfare:** Increased profits may often lead to the organisation producing such products or services which may not be beneficial and useful to the society at large. Thus, such objective may sometimes fail to optimise social welfare.
- 5) **Ignores Financing and Dividend Aspects:** Another limitation of the profit maximisation objective is that the effects of financing and dividend decision areas on market price of shares are often ignored, while pursuing the objective of profit maximisation.
- 6) **Change in Organisation Structure:** Earlier, an owner used to manage the business alone because at that time the competition was too less. The organisation structure that has single owner is referred to as sole proprietorship. The whole profit and liability belongs to the owner. But now, all the businesses are transforming their structure to compete.

## 1.4. WEALTH MAXIMISATION

### 1.4.1. Concept of Wealth or Value Maximisation

Wealth maximisation is also known as **Value Maximisation** or **Net Present Worth Maximisation**. Wealth maximisation has all the features of certainty, quality benefits and timing benefits. The goal of wealth maximisation is the widely accepted goal of the business, as it reconciles the varied, often conflicting, interest of the stakeholders. Also, it is free from the limitations that other objectives are faced with.

**According to Ezra Solomon,** wealth maximisation goal is "The gross present worth of a course of action is equal to the capitalised value of the flow of future expected benefits, discounted (or capitalised) at a rate which reflects the uncertainty or certainty. Wealth or net present worth is the difference between gross present worth and the amount of capital investment required to achieve the benefits."

Shareholders, being the true owners of a firm, are entitled to the residual profit only. After meeting the commitment to all other stakeholders, they get the remaining. Shareholders' claim cannot precede that of any other stakeholders. Thus, by maximisation of residual as the objective of the firm, it can safely be stated that all preceding commitments have been adequately satisfied. Pursuit of these all-encompassing goals by a firm ensures that the interest of all the different stakeholders is taken care of in the process, as this wealth maximisation as a goal is in congruence with the objectives of the varied stakeholders.

No firm can bring about sustained increase in the wealth of its owners, without taking care of the interest of its other stakeholders. **For example,** deteriorating liquidity position of a firm makes the lenders, current and prospective, worried about its creditworthiness, which eventually gets reflected in its share prices and consequently the wealth of the shareholders. Similarly, a firm that cannot retain its existing customers will witness a decline in its sales and consequently the market price of shares. The wealth maximisation approach can be more explicitly defined in the following ways:

$$W = \frac{A_1}{(1+K)^1} + \frac{A_2}{(1+K)^2} + \frac{A_3}{(1+K)^3} + \dots + \frac{A_n}{(1+K)^n} - C$$

$$= \sum_{t=1}^n \frac{A_t}{(1+K)^t} - C$$

where,

W = Net present worth

$A_1, A_2, \dots, A_n$  = Streams of benefits expected/Future cashflows

C = Cash outlay or cost of action/Cost of project

K = Discount rate/Capitalisation rate

### 1.4.2. Features of Wealth Maximisation

Wealth maximisation criterion has a far and wide range of acceptance, because of its following salient features:

- 1) The idea and notion of wealth is distinct and simple to understand.
- 2) It serves as an important aid to investment decisions.
- 3) It refers to the time adjusted present value of benefits, thereby reducing the cost of investment.
- 4) Maximising economic well-being of its shareholder is one of the parameters of wealth maximisation.
- 5) Wealth maximisation takes into concern both the quantity and quality standards of benefits.
- 6) It also integrates the time value of money, risk and uncertainty factors.
- 7) It considers that the shareholders' wealth is maximised only when the market price per share is maximised.



- 8) It also avoids agency issues in an organisation, as it encompasses the personal goals of executives, such as recognition, power, status, personal wealth, etc.
- 9) It eliminates the associated limitations of the profit maximisation objective of financial management.

### 1.4.3. Arguments in Favour of Wealth Maximisation

The following arguments can be given in favour of wealth maximisation as one of the objectives of business:

- 1) Wealth maximisation is advanced and can be better compared to the objective of profit maximisation, since the sole endeavour of the business firm is to enhance the value or wealth of the shareholders.
- 2) Wealth maximisation involves the comparison of the value to cost associated with the company.
- 3) Wealth maximisation takes into concern both time value and risk factors of the firm.
- 4) Wealth maximisation promotes and improves optimum and efficient utilisation of resources.
- 5) It aims to achieve and fulfil economic obligations of the society.

### 1.4.4. Limitations of Wealth Maximisation

Issues involved in implementing the goal of maximisation of shareholder's wealth:

- 1) **Incorrect Assumptions:** The maximisation of shareholder's wealth wrongly presumes that there is an efficient capital market. In reality, the share price in the market is subject to extensive fluctuations.
- 2) **Speculation:** Speculative business activities lead to variations in price of shares. Since, an investor is more concerned about the safety and security of the investment, whereas a speculator is interested in appreciation of the capital and profit.
- 3) **Varied Objectives:** In every organisation, there are three basic stakeholders namely shareholders, professional managers and creditors. Thus, agency problem may arise, i.e., managers may place personal goals ahead of corporate goals.
- 4) **Justice to All Social Groups:** It is widely reasoned that a business organisation is not concerned with shareholders only. Employees, customers, creditors and local societies at large are also associated with the company. A business firm has to function in the social context responsibly. Obligations of the company towards different social groups should be honoured.

### 1.4.5. Profit Maximisation *v.s.* Wealth Maximisation

Basis of Difference	Profit Maximisation	Wealth Maximisation
1) Definition or Nature	The term profit maximisation, in simple words, means that a company either produces maximum output for a given	The wealth maximisation for shareholders means that a company either maximising the wealth of shareholders by way

	input, or uses minimum inputs to produce a given output. Thus, it is optimisation of the input-output relationship.	of dividends and value-creation of a course of action, in such a manner that the value of future inflows is maximised.
2) Purpose or Concept	The underlying concept of profit maximisation is to maximise the profitability of a company through the core business activity, the company is engaged in.	The underlying concept of wealth maximization is to increase the market value of the shares, which in turn would result in the wealth maximization for the company's shareholders.
3) Formulae	The concept of profit maximisation is based on the determination of maximisation of profits as reflected in the following formula:  Profit = Total Revenue Receipts - Total Costs	The wealth maximisation of shareholders of a company depends on the share price and number of shares held by a shareholder, as reflected in the following formula: Wealth = No. of Shares Owned × Current Share Price per Share
4) Rationale	The rationale behind this concept is the need for maximum level of accumulated profits for growth/expansion/ diversification and protection against unforeseen situations like economic recession, natural disaster, unexpected losses in future, cut-throat competition, etc.	The rationale behind this concept is enhancing shareholders' wealth as a courtesy for their investment in the company's equity and their continued relationship and loyalty with the company.
5) Time Span	This concept pertains to a comparatively shorter period, i.e., a financial year. Thus, a short-term vision.	This concept pertains to a comparatively long-term value creation and augmentation of individual shareholder's wealth. Thus, a long-term vision.
6) Time Value of Money	This concept does not consider the time value of money and its implications. It only determines the profits for the financial year and ignores the discounting factor of earnings.	This concept considers the time value of money and its implications. It projects the future earnings and their value by applying Net Present Value (NPV) approach and discounting factor of such earnings.
7) Immediate Beneficiaries - Management	Management of a company is the immediate beneficiary of this concept.	The immediate beneficiaries are the shareholders. Management of the



<b>versus Owners</b>	Shareholders are the secondary beneficiaries, especially when the management is separate from ownership.	company is the secondary beneficiary. This may be a cause of potential conflict of interest, especially in the case where management is separate from ownership.
----------------------	--	--

## 1.5. FINANCE MANAGER

### 1.5.1. Meaning of Finance Manager

The post of a 'finance manager' in a company is a key position. He/she is the person solely responsible for carrying out the finance functions of a company. He/she is part of the 'Top Management' team and his/her role needs to be extremely efficient in solving complicated fund management issues and also acting as the financial advisor to the top management.

### 1.5.2. Role and Functions of Finance Managers

Financial Manager's role has been undergoing a lot of changes and in the present day scenario, he/she is responsible and empowered to carry out the following functions:



- 1) **Raising Funds of Company Finance:** The prime responsibility of a financial manager is to estimate his/her company's short-term and long-term requirements, explore the possibilities of raising funds from various sources and exercising the best available option (the most reasonable one with acceptable terms and conditions). He/she is responsible and also empowered to frame the company's appropriate capital structure.
- 2) **Taking Maximum Benefits from Leverage:** The Financial Manager has powers to utilise leverages, both 'Financial' and 'Operating', to the maximum advantage of the company.
- 3) **International Financial Decision:** The financial manager of a company is expected to keep him/her abreast of latest developments taking place in the international market. The opportunities available in the form of various derivatives or financial instruments like 'Credit Default Swap', 'Interest Rate Swap', 'Currency Swap', etc., need to be trapped by him/her with the aim to make profit for his/her company.

4) **Investment Decisions:** The financial manager plays an important role in 'Capital Budgeting' exercise by applying various available tools and techniques. Net Present Value (NPV) is one of such techniques, which is very popular amongst the Financial Managers. This technique includes calculation of NPV of each proposal of a given project and comparison thereof. A proposal with highest NPV is considered to be the best one. Financial Managers have an expertise in the calculation of NPV and it is their responsibility to finalise the best proposal for a project to be implemented.

5) **Risk Management:** Risk is the part and parcel of a project or venture undertaken by a company, although at times it is clearly visible and sometimes it is hidden. Avoidance of risks altogether during the conduct of a business is next to impossible. What is required is identification and efficient management (mitigation and control) of risk, which is the responsibility of financial managers. They are free to delegate responsibilities, in this regard, down the line, but they are the one answerable to the top management in the areas of risk management. They are also responsible, in this connection, for the coordination with the institutions like insurance companies and rating agencies, who have specialised knowledge in the field of risk management.

### 1.5.3. Responsibilities of Finance Manager

The area of finance is highly specialized function of a business entity, especially in the organized corporate bodies, where such areas are centralized and handled by professionals. The policy decisions with regard to the financial matters are generally taken at the highest level of hierarchy, i.e. at the Board of Directors level. Once the broader policies are framed, powers are appropriately delegated to (and exercised by) the various levels, e.g. the executive committee consisting of the Chief Financial Officer (CFO), Managing Director (MD) and one or two directors. The officers of the lower rank are delegated with the financial powers of the routine nature. The post of financial executive of an organisation is considered to be a very crucial position. He is a strategic part of the management team, who keeps a direct link with the Chief Executive Officer (CEO) of the organisation.

The finance manager of an organisation is responsible for the following functions:

- 1) **Determining Financial Needs:** The financial requirements of an organisation are expected to be managed by its Finance Executive. The foremost responsibility in this regard is to assess the level of finance required by the organisation, which may relate to the fixed and working capital requirements or for meeting the advertising expenses. The amount of funds required for fixed assets depends upon the industry, the organisation is associated with. The fund requirement for investment in fixed asset by a trading entity would be much less when compared with that of a manufacturing entity, which needs to invest in light to heavy machineries and equipment for running



its business. Similarly, the working capital requirements are directly proportional to the level of the operations an organisation is engaged with higher the level of operations, higher would be the working capital requirements.

Assessment of the financial needs of an organisation is of paramount importance, in as much as any misjudgement in this regard may pose a question of survival for the organisation. The job of a Finance Executive is, therefore, considered to be extremely demanding as well as challenging.

- 2) **Choosing the Sources of Funds:** Once the financial requirements of an organisation have been assessed properly, the next responsibility of a Finance Executive is to raise the requisite funds. There are various options available to raise the funds, which may be broadly classified as equity route and debt route. After taking a decision in this regard, the organisation may prefer either of the above routes. In some cases, a suitable mix of the routes, viz. equity and debt may be resorted. For the long-term requirements of an organisation, its Finance Executive may approach financial institutions which are willing to offer long-term finance. As far as the working capital requirements are concerned, commercial banks may be requested to extend cash credit facilities. They may also be pursued to accommodate further by giving overdraft facilities. While tapping various sources of finance, a Finance Executive needs to be attentive and careful, so that the funds are raised without any hurdle.
- 3) **Financial Analysis and Interpretation:** Another important responsibility of a Finance Executive is to analyse the data available through the financial statements of the organisation and interpretation thereof. He should know the profitability, liquidity position, short-term and long-term financial position of the organisation. He needs to keep a close track of the short-term and long-term liabilities of the organisation, and an appropriate plan for their timely discharge. Through the computation of different ratios from the basic data and their interpretations, can arrive at certain conclusions, and initiate suitable steps in the right direction, wherever needed. Financial analysis and interpretation has gained a lot of significance as a useful tool in the field of financial management.
- 4) **Capital Budgeting:** Capital Budgeting is a technique, which facilitates the decision-making process with regard to the expenditures of capital nature. Such expenditures are required to be incurred for the improvement in the efficiency of the existing fixed assets and acquisition of new fixed assets, both of which are advantageous in the long run, as the benefits of such improvement in efficiency or new assets may be reaped over a long period of time. As the capital budgeting is based upon logical and scientific approach, the decisions taken on its strength rarely go wrong. Various methods, e.g. payback period, rate of return, net present value, internal rate of return, and profitability index, are available for undertaking the capital budgeting, and a method most suitable for an organisation may be used by it.

- 5) **Working Capital Management:** Funds required for financing of the current assets or short-term assets, like cash, inventories, receivable, etc. are termed as working capital. Working capital management entails maintaining its suitable level, neither in excess nor in shortage. It is a job of extreme responsibility, which the Finance Executive has to shoulder. Any shortage or excess of working capital may result either in slowing down / stoppage of activities or decline in profitability.
- 6) **Dividend Policy:** The shareholders are rewarded by a company, for having invested in its shares, or in dividend. Dividends are paid out of the profit earned by a company during a particular year. Decision with regard to the amount of dividend (in terms of percentage) to be distributed amongst the shareholders is taken. To decide in respect of such a trade-off of conflicting interests is an important as well as tough job. Framing of dividend policy, therefore, needs to be carried out very carefully.

### 1.5.4. Changing/Emerging Role of Financial Manager <sup>2019</sup> (7)

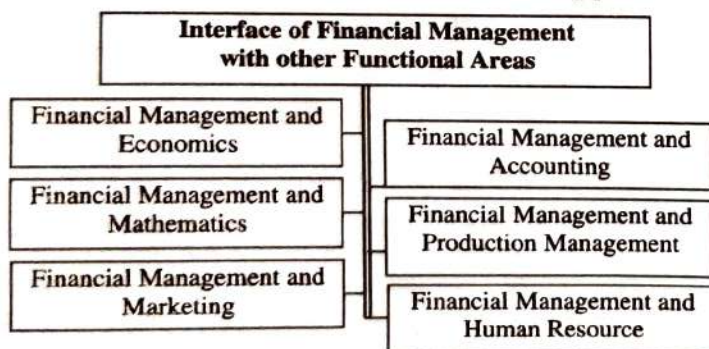
- 1) The modern age finance manager is no longer just another employee of a company, looking after the 'accounting aspects' of a business organisation. In view of the importance of the role played by him/her, nowadays he/she is considered a part of the Top Management of a company. As such he/she is fully involved in the process of policy formulation and implementation thereof, as well as in other crucial decision-making processes.
- 2) In modern times, the finance manager is a person, whose knowledge and skills are critical for the company's viability and growth. His/her role has undergone enormous changes during the last few years and is quite different from the traditional one, which was restricted to procurement of funds from various available sources. This metamorphosis has been necessitated in order to keep pace with the recent economic developments and opening up of the financial sector. Financial Manager now occupies a crucial position in a company.
- 3) This is an age of competition and the survival of a business organisation depends upon its ability to foresee and keep itself ready for the changes, which may occur in the near future. Such changes may be policy related, technological, economic or political and the Financial Manager is required to face it head-on, in a proactive manner.
- 4) In this era of fast changing world, finance managers are always in the lookout for the ways to enhance the value of their companies through innovative financial activities. The image of traditional financial managers has been replaced by the modern financial managers, who are expected to think 'Out of the Box' and come out with innovative ideas in respect of analytical methods and comprehensive measures, which are critical forces behind the financial decisions.



- 5) Finance managers are expected to keep themselves updated with regard to the contemporary technologies, so that their company's financial operations are carried out in the most efficient manner. Keeping in view the competitive atmosphere prevailing in the market, the 'mantra' for survival is to always remain on toes for impending changes. This 'mantra' is very crucial for the financial manager of a company.
- 6) The evolution in the area of financial management and related planning and control tools and techniques has taken place during the last twenty years. These changes have occurred in such a manner that the financial manager has been able to change and evolve himself/herself with almost the same pace. This has placed him/her in a better position in comparison with other personnel of the same organisation.
- 7) The scope of financial management has shown a tendency of widening during the last many years. As of now, it has direct concern with other functional departments (like Production and Marketing), of an organisation. The finance manager is concerned not only with the procurement of funds, but also its application, viz., investment decisions. Efficient allocation of funds is the prime responsibility of finance managers.

## 1.6. INTERFACE OF FINANCIAL MANAGEMENT WITH OTHER FUNCTIONAL AREAS

Out of the various branches of management, the financial management is considered to be the most important one. Financial management is directly linked to different functional areas, viz. Purchase, Marketing, Production, Personnel, etc. The relationship between financial management on one side and other fields of management on the other are discussed in detail in the following points:



- 1) **Financial Management and Economics:** Financial management and certain economic concepts, viz. micro-economics and macro-economics are closely related, as these concepts are applied with the financial management approaches. Important economic equations, like Money Value Discount Factor, Economic Order Quantity etc., are frequently used in financial management. One of the upcoming branches of economics is financial economics, which has tremendous potential to provide opportunities in the fields of economics as well as finance.

- 2) **Financial Management and Accounting:** The relationship between the accounting and financial management is a closed one, as most of the management records pertain to the financial accounting records. Both the faculties, i.e. financial management and accounting were considered as one (single) discipline during the bygone era, which subsequently evolved as management accounting. Knowledge of management accountancy facilitated in taking important decisions.

However, under the modern approach, financial management and accounting are considered two separate and distinct disciplines, although they happen to be closely related to each other.

- 3) **Financial Management and Mathematics:** A number of mathematical and statistical tools and techniques (referred to as Econometrics) are applied in the field of financial management under the modern approach. Some of the econometrics frequently used in the field of financial management are economic order quantity, discount factor, time value of money, present value of money, cost of capital, capital structure theories, dividend theories, ratio analysis and working capital analysis.

- 4) **Financial Management and Production Management:** The operational part of a manufacturing unit is the production management, which is the most vital area of business as it facilitates multiplication of money into profit. The creation of profit for a business organisation begins with the production of item(s), in which the company deals with. The function of production requires finance for the purchase of machineries, tools, raw materials, etc.

Funds are also required for the payment of wages and operating expenses. The assessment of all the production related expenditures and allocation of funds are made by the finance department.

The personnel posted in finance department need to be competent enough to understand the processes involved in production cycle and make an accurate assessment of funds required at each stage of production, so that timely and appropriate allocation of funds may be made to the production department and production cycle is not hampered in any way.

- 5) **Financial Management and Marketing:** Marketing of the goods produced is as important as the production of the goods itself. It involves application of innovative ideas and modern approach in tune with the changing times and the strategies adopted by the competitors.

For all these, the marketing department needs funds, which again is assessed and allocated by the finance department. Therefore, the marketing department and finance department are closely related with each other and need to have mutual understanding so that they may function in tandem.



# Chapter 2

## Indian Financial System

### 2.1. INDIAN FINANCIAL SYSTEM

#### 2.1.1. Meaning and Definition of Financial System

For economic transformation of a country, the financial system is the key for the institutional and functional vehicle. Finance assists in reducing the gap between the present and the future, and covers every aspect like channelisation and effective usage of savings and making an efficient investment. It formulates the base, the sets and the tone for the accomplishment of wider national objectives.

**According to Christy**, the objective of the financial system is to "Supply funds to various sectors and activities of the economy in ways that promote the fullest possible utilisation of resources without the destabilising consequence of price level changes or unnecessary interference with individual desires".

**According to Robinson**, the primary function of the financial system is "To provide a link between savings and investment for the creation of new wealth and to permit portfolio adjustment in the composition of the existing wealth".

A financial system acts as an intermediary where there is surplus and deficiency of funds. It bridges the gap between the two segments. It comprises of various institutions, markets, regulations, laws, money managers, experts and many others. The flow of funds in Indian financial system is explained by figure 2.1 given below:

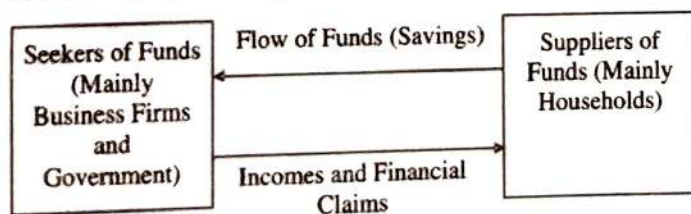


Figure 2.1: Flow of Funds

In the context of "financial system" the term system means a sequence of complex and closely attached variables like institutions, agents, practices, markets, transactions, claims and liabilities in an economy. The main function of a financial system is to take care of the money, credit and finance. However, these three terms may appear to be same but still there is some difference among each term. The Indian financial system comprises of the **financial market, financial instruments, financial intermediary and also the financial services.**

#### 2.1.2. Features of Financial System

Following are the features of the Indian financial system:

- 1) Financial system establishes a link between the one having surplus funds with those who are in need of such funds. Both the investment and the savings aspects are encouraged.
- 2) Financial system contributes towards the expansion and the development of financial markets.
- 3) Financial system facilitates the efficient allocation of financial resources for the benefit of the society and the public at large.
- 4) Financial system boosts the economic quality and accelerates economic development.
- 5) Financial system lays the foundation for an ideal economy.
- 6) Financial system builds an efficient portfolio for the fund seeker.
- 7) Financial system reduces the transaction costs.
- 8) Financial system ensures availability of all the price-related information.

#### 2.1.3. Functions of Financial System

Following are the functions of the Indian financial system:

- 1) **To Connect the Investors with the Savers:** The key function of a financial system is to bridge the gap between the one who saves money and the one who needs the funds. Thereby, the financial system helps in channelising the savings in an effective manner to reap the best possible outcome. The resources are allocated in such a manner that there is a regular advancement in technology and sustained growth can be achieved.
- 2) **Assistance in Selection of a Project:** A good financial system helps in selection of an optimum project for investment purpose. Alongside, it also constantly monitors the outcome of the project. It facilitates in the payment process for goods and services and the movement of the products to different industries and geographical areas.
- 3) **Risk Allocation:** A good financial system assists in the optimum distribution of the risk component. It restricts and controls the investment in the form of savings in a particular risky venture. The basic idea is to set a tolerance limit and to ensure that investments are made only within the prescribed limits.
- 4) **Availability of Information:** It further ensures that the information associated with the price is available all the time which helps in taking economic and financial decisions.



- 5) **Reducing the Cases of Asymmetric Information:** An ideal financial system aims in avoiding the occurrence of cases when the information available is found to be asymmetric. Such situations are highly adverse in nature and affect the motivation among the operators and also to a person who possesses information which the other person does not have. Besides this, it provides other services like insurance pension and adjustment of portfolio, etc.
- 6) **Reduction in the Borrowing and the Transaction Cost:** A sound financial system creates an ideal financial scenario that reduces the cost of the transactions. By reducing the cost, the returns for the investors are likely to rise. The borrowing cost is similarly reduced. So, this builds the habit of saving among the society.
- 7) **Liquidity Promotion:** In a financial system, the key function is to have adequate resources of money for the manufacturing of goods and services. In case of a production firm, the money should not fall short. Here, the term "money" and "monetary resources" signify liquidity. Liquidity in liberal sense is that form of the asset that can be readily converted into cash. In a financial system, all the activities are thus related with money and focus is on having a better liquidity position to ensure that the activities carry on in a smooth and effective manner.
- 8) **Financial Broadening and Deepening:** An ideal financial system encourages the process of financial deepening and broadening. **Financial deepening** refers to an increase of financial assets as a percentage of the Gross Domestic Product (GDP). **Financial broadening** refers to building an increasing number and a variety of intermediary and instruments.

#### 2.1.4. Importance of Financial System

Following are the importance of Indian financial system:

- 1) **Increment in the Output and Production of the Economy:** The surplus savings are channelised in such a manner that adequate resources are available for the production sector. This eventually results in the increase in output of the economy. The market, institutions and instruments are the basic market transformers who get adequate funds which leads to economic development. The financial system directs towards savings and contributing more value added areas which lead to national development.
- 2) **Accelerating the Quantum and Pace of Savings:** Apart from channelising of savings, a financial system also drives the rate of savings by diversifying the financial instruments, thus making number of options available for the investors to invest in. This creates competition among the intermediary; hence the investor gets the maximum return.
- 3) **Facilitates Innovation:** Healthy competition is promoted in the financial system. This leads to innovation of new products and investment

opportunities. The overall cost is reduced which enhances profitability. Countries having a well-diversified financial system maintain national competitiveness and their products are regularly updated.

- 4) **Evaluation of Assets, Increasing the Liquidity, Production and Spreading of Information:** Apart from having an effect on the rate of return, it also influences economic development. A good financial system evaluates the assets, increases the liquidity and transmits the required information.
- 5) **Provide Risk Management Services:** A financial system is a need-based system. It changes with the change in requirement for funds. During the current scenario, the world has observed an increase in demand for better risk management services. This was fulfilled by increasing the trading volume and by introducing risk management products. So, the economic growth and the financial system work hand in hand.
- 6) **To Ensure Stability and Resilience:** Financial market is a part of the main branch of the financial system. There will be more stability and resilience as the system gets deeper. The Central Bank of the country can make effective policies if it is supported by well organised money and capital market instruments. The onus is on the financial markets to create a well-balanced and efficient financial system which comprises of both the financial market and the financial institutions. If there is any imbalance, similar problems will arise as experienced in South-East Asia.
- 7) **Introduction of Discipline in Management Companies and Guiding them:** The financial system also ensures that management companies work under the discipline and constantly guides for the same. When the domestic and the foreign financial system are linked together, the flow of the capital is increased. This combination reduces the risk by diversifying the portfolio and boosts the growth.
- 8) **Accelerating the Rate of Economic Growth:** There exists a bilateral and mutual relation between the financial system and the economic growth. A well developed and balanced financial system boosts the rate of the economic growth.

#### 2.1.5. Limitations of Financial System

Indian financial system faces the following limitations/weaknesses:

- 1) **Missing Coordination among the Financial Institutions:** Significant number of financial institutions exists and the government controls and operates the most important ones. Alongside controlling the FIs, government also exercises control over the regulatory of the financial institutions. Such situation leads to lack of coordination. With the presence of number of institutions in the financial system, there always exists lack of coordination in their operations.
- 2) **Monopolistic Market Structure:** In India, some of the financial institutions capture the major portion of



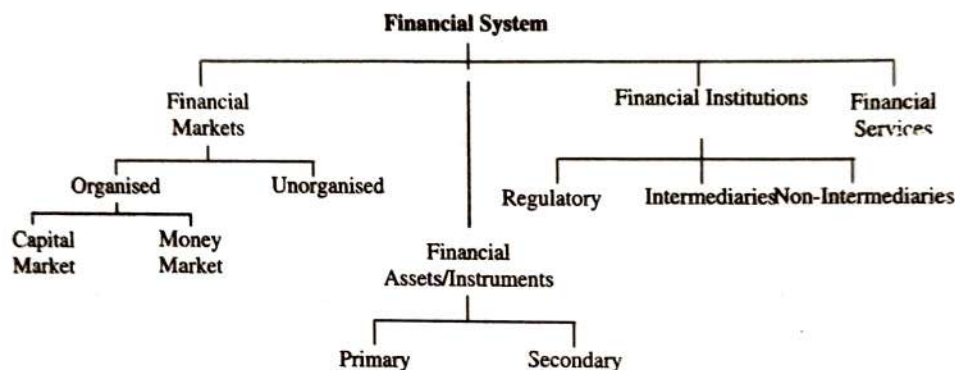
the market share and thus it leads to a monopolistic structure in the financial system. For example, LIC holds majority stake of the life insurance business in India. So the presence of these large corporations may disrupt the entire financial system of the nation.

- 3) **Major Hold of Development Banks in the Industrial Financing:** Development banks are considered as the most indispensable part of the financial system and hold a significant role in the capital market. In India, majority of the industrial financing is routed through the financial institutions which are created by the government at the national as well as the regional level. However, new methods of raising finance from the public have been introduced in the recent past like issuing bonds or debentures.

- 4) **Inactive and Erratic Capital Market:** At present, due to regular frauds and scams taking place, the public at large is losing confidence in the market and thus is not an attractive and dependable segment for the investors. This causes a serious area of concern in the capital market.
- 5) **Imprudent Financial Practice:** The development banks hold majority of the market share among the corporate clients and has lead to the development of imprudent market practices. Majority of the funds are provided by them in form of term loans giving rise to the debt content in the capital structure. Thus, there exists an unfavourable balance between owners' contribution and the debt portion. In the past, to curb this practice, actions have been taken to promote capital market. Different FIs are also being integrated.

## 2.2. STRUCTURE/TYPES OF INDIAN FINANCIAL SYSTEM

There are four segments or components of the Indian financial system. These are financial institutions, financial markets, financial instruments and financial services. The structure of financial system in an economy is shown in the figure below:



## 2.3. FINANCIAL MARKETS

### 2.3.1. Meaning of Financial Market

**Finance** is considered to be one of the most important ingredients of the contemporary business. **Financial markets** comprise of the entire institutional set-up in place, which primarily deals with various financial instruments, including credits extended in the form of cash, cheques, bank deposits, bills, etc. A financial market offers a platform for individuals, various entities, and institutions to enter into trading activities in respect of different financial instruments (such as equities, debentures, bonds, etc.), commodities (such as gold, silver, and other precious metals, or agricultural produces) and other items/goods of fungible nature. Such offer is made available at a reasonable transaction cost, which represents an efficient-market hypothesis.

Financial market is a meeting ground for the market players, viz. the buyers and the sellers interested in trading in various financial instruments and commodities are gathered together. Markets may be classified into two categories, (i) general market, where different kinds of instruments and commodities are traded and (ii) specialised market, which is meant for trading in specific instrument/commodity.

### 2.3.2. Types of Financial Markets

This market is further classified in four types of market:

- 1) **Capital Market:** It is a market where the securities are usually held for long-term basis, i.e., more than one year.
  - i) **Equity Market:** It comprises of the equity shares of the company. Equity shares are further classified in two categories:
    - a) **Primary Market:** Where the shares are being sold for the very first time, i.e. Initial Public Offer (IPO) and Right Issues.
    - b) **Secondary Market:** Where the existing shares are bought or sold, after they were originally issued to the public. These shares are listed on stock exchange through which they can be traded.
  - ii) **Debt Market:** It is the financial market in which debt securities are bought and sold by the investors. These securities are in the nature of bonds or debentures and carry a fixed rate of return.
- 2) **Money Market:** The money market is an important segment of the financial market, wherein funds are either lend or borrowed for a short-term tenure, usually for a period not exceeding one year. It is done through the financial instruments of rather a short-term maturity.



2020

## (7) Difference between Money Market and Capital Market

Basis of Difference	Money Market	Capital Market
i) <b>Time-period of Investment</b>	Money market deals with the short-term investment.	Capital market deals with the long-term investment.
ii) <b>Use of Finance</b>	The finance is used for working capital in the company.	The finance is used for both fixed and working capital.
iii) <b>Functions</b>	The basic functions of money market are lending and borrowing for helping the adjustment of liquidity position.	The basic functions of capital market are to mobilise funds and have effective use of resources by lending.
iv) <b>Components</b>	The basic components of money market are call loan market, collateral loan market, bill market and acceptance houses.	The basic components of capital market are primary market and secondary market.
v) <b>Link</b>	The money market acts as the link between depositor and borrowers.	The capital market acts as the link between investors and entrepreneur.
vi) <b>Underwriting</b>	The underwriting acts as the secondary function of money market.	The primary function of capital market is underwriting.
vii) <b>Capital Raising</b>	It raises capital from the short-term surplus funds.	It raises capital from the public and invests in selected securities for getting high possible return with low risk.
viii) <b>Customers</b>	The customer of money market is Government as they purchase treasury bill of the government.	The customers of capital market are Central and State Government, public and local bodies.

- 3) **Derivative Market:** The derivative market refers to the financial market dealing in financial instruments derivatives such as futures or options. The market can be segregated into, exchange-traded derivatives and for over-the-counter derivatives. On the basis of their trading motives, participants in the derivatives markets can be segregated into hedgers, speculators, margin traders and arbitrageurs. Trading in the derivatives market is almost similar to that in the cash segment of the stock market.
- 4) **Foreign Exchange Market:** A place where buying and selling of goods or specified commodities are

performed are referred to as market. Usually, all international business activity requires transfer of money from one country to another country. Thus, foreign exchange market is a place where one form of money is changed in another form of money. For example, conversion of US dollar into Euro.

## 2.4. FINANCIAL INSTRUMENTS

### 2.4.1. Meaning of Financial Instruments

A financial instrument is an acknowledgement for a person entitling him against the claim that is receivable from another person or institution, while the person is in regular receipt of interest or dividend.

These financial instruments assist the market in routing the funds from the lender to the borrower in consideration of interest. There are number of products that are available and they vary in terms of return, liquidity, marketability, reversibility, types of assets, risk and the transaction cost.

### 2.4.2. Types of Financial Instruments

Following are the three major forms of the Indian financial instruments and assets:

- 1) **Money Market Instruments:** It is a component of the financial market for assets involved in short-term borrowing, lending, buying and selling with original maturities of one year or less. Some of the types of money market instruments are as follows:
  - i) **Call and Notice Money Market:** Call money market is a place where borrowings and lending take place for a very short period, ranging between overnight and fortnight
  - ii) **Commercial Paper:** It is a short duration instrument. They can be purchased directly from the market or through the intermediary and the amount is repayable on a certain future date.
  - iii) **Treasury Bills:** They are short-term (till 91 days) money market instrument, issued by the Government to meet its short-term deficiency of funds.
  - iv) **Bill of Exchange:** Bill of exchange is also a money market instrument, which is in the form of an order in writing by the drawer of the bill to the drawee for the payment of money to the payee.
  - v) **Certificates of Deposits (CDs):** They are unsecured, negotiable and short-term in nature, which are payable to the bearer.
  - vi) **Money Market Mutual Funds (MMMFs):** They constitute a category of open-ended mutual funds, which specializes in channelizing investors' funds to the short-term money market instruments.



2) **Capital Market Instruments:** Capital market instruments are long-term financial instruments in the form of debt or equity that are traded either on a securities exchange or directly between investors and borrowers. Some of the instruments of capital market are as follows:

- i) **Equity Shares:** They represent the ownership of the company. They have the voting rights and part of decision-making process on major issues relating to the affairs of the company.
  - ii) **Preference Shares:** Preference shareholders enjoy a fixed rate of dividend even though the company does not make profit in a year.
  - iii) **Debentures:** They are the kinds of bonds that are issued by companies carrying a fixed coupon rate which is normally payable half-yearly on pre-determined dates and the principal amount is repayable at the time of redemption.
  - iv) **Bond:** It is a certificate of the indebtedness of the firm and normally does not carry any security. Usually they are issued by a company, municipality or government agency.
  - v) **Rights Issue or Rights Shares:** They are issued to the existing shareholders in a pre-determined ratio of their holding.
  - vi) **Bonus Shares:** These are issued by companies for free to their shareholders by capitalising the reserves. They are declared out of the profits of the previous years.
  - vii) **Government Securities:** They are also termed as G-Secs. They are sovereign (risk-free credit) interest bearing instruments issued by RBI on behalf of the Government to comply with the Central Government's market borrowing programme.
- 3) **Derivative Instruments:** A derivative instrument is a financial instrument which derives its value from the underlying asset. Following are the types of derivatives:
- i) **Forwards:** This type of contract is a tailor-made contract, catering the need of the two parties. Under this, the contract is settled at a certain future date at a predetermined price.
  - ii) **Futures:** This is an arrangement between two parties, where they agree to purchase or sell a particular asset on a predetermined time in future on a specific price. They are just like the forward contracts, the only difference being that the forwards contracts are standardised and dealt on the stock exchange.
  - iii) **Options:** An option buyer acquires the right to buy or sell a specified amount of currency for another currency at a specific rate.
  - iv) **Swaps:** They are private contracts among two persons for exchange of cashflows at a future date on pre-decided terms. They may also be termed as the portfolios of forward contracts.

## 2.5. FINANCIAL INSTITUTIONS/ INTERMEDIARIES

### 2.5.1. Meaning of Financial Institutions

Financial Institutions (FIs) are the institutions engaged in the business of undertaking various financial transactions, such as deposits, loans, investments, currency exchange, etc. They include a wide range of entities like banks, trust companies, insurance companies, term lending institutions, NBFCs, brokerage firms, investment dealers, mutual funds, merchant banks, etc. They operate as intermediaries and facilitators of various financial transactions on behalf of their clients, both - individuals as well as corporates. Financial Institutions may be in the organised sector or in the unorganized sector. Financial intermediary is an entity, including an individual, who is engaged in the business of financial intermediation. In addition to the mobilizing the funds through the savers, such intermediaries also raise funds from capital market.

### 2.5.2. Types of Financial Institutions

They are further classified in three different categories:

- 1) **Regulatory:** Regulatory are the ones who provides rules and guidelines for a particular market. It comprises of RBI, SEBI, IRDA, AMC, etc. Primarily, an investor would want the funds to be under the control and to be safe to invest. This assurance is rendered by the regulatory authority that is regulating the particular market. **For example**, money market instruments are regulated by the RBI whereas the capital market instruments are regulated by SEBI.
- 2) **Intermediaries:** Intermediaries are the ones who fulfill the short-term requirement of funds of corporate as well as the individual clients. They comprise of banking as well as non-banking intermediaries. **For example**, banks like SBI, PNB, etc. whereas examples of non-banking intermediaries comprise of GIC, UTI, LIC, etc.

Other important services like credit rating, leasing, merchant banking, hire-purchase are also provided by these financial intermediaries. These services are required while creating a new firm, during expansion and the economic growth. These are of the following four types:

- i) **Commercial Banks:** These banks hold deposits on behalf of the customers and thus ensure the safety of the funds. The primary purpose was thus to hold the same for the customers who do not wish to hold the same on their own. As a result, the need for the customers to keep funds in the form of cash has reduced and he can thus use the services of credit cards, cheques, net banking for entering into any financial transaction. These banks also provide loans to individuals and businesses for long-term purposes and also for financing the working capital requirements.



## 2.6. FINANCIAL SERVICES

### 2.6.1. Meaning of Financial Services

**Financial services** are the services which are offered by the financial companies. The financial companies comprise of both **Asset Management Companies** and **Liability Management Companies**. In **Asset Management Companies**, there are leasing companies, mutual funds, merchant bankers and issue/portfolio managers while **Liability Management Companies** has the bill discounting and acceptance houses.

In other words, the financial service is referred to as the products and services which are offered by the banks as they provide various kinds of facilities of financial transactions and other financial activities like loans, insurance, credit cards, investment opportunities and money management and also give information on the stock market and other issues like market ups and down.

### 2.6.2. Types of Financial Services 2019 (3)

The financial services are classified further in two categories:

i) **Asset and Fund-Based Financial Services:** Asset based finance is termed as funding against a range of corporate assets including accounts receivable, inventory, plant and machinery, real estate and sometimes even intellectual property and brands. It is the method of making a loan secured by an asset. It includes the following:

i) **Lease Financing:** It is a financial contractual arrangement where one party having ownership of an asset lends the same to another for usage for certain duration *in lieu* of regular and periodic payments known as rent. At the expiry of the lease period the assets comes back to the original owner known as the lessor from the lessee. However, the parties may further renew the agreement.

ii) **Hire Purchase:** It refers to hiring of an asset for a certain period and after the expiry of the period acquiring the same asset. The concept of time sharing is followed in this case. The person who hires the asset eventually ends up purchasing it. It is used as a tool in financing capital goods like industrial finance, consumer goods.

iii) **Factoring:** The term '**factoring**' is originated from Latin word 'Factor' which means 'doer'. The **Webster's New Collegiate Dictionary** has defined a factor as 'one that lends money to producers and dealers on the security of accounts receivables'.

iv) **Forfaiting:** Forfaiting is a form of financing of receivables arising in the course of overseas trade. It refers to the purchasing of trade bills or promissory notes issued by the banks or the financial institutions without recourse to seller. Finance is carried out by discounting the instruments and taking over the entire risk involved in case of default payment.

ii) **Non-Banking Financing Institutions (NBFI):** A Non-Banking Financing Institution (NBFI)/Non-Banking Financing Intermediary has alternate roles in different parts of the world:

- It is an institution which is not just a bank but is engaged in the function of finance;
- Financial institutions who do not accept demand deposits;
- Financial institutions who do not accept any deposit.

iii) **Investment Companies:** They may be called a trust or a corporation which facilitates an individual to invest in different diversified and professionally managed securities by arranging pool of funds from other investors. The individual need not invest in single company stocks but can rather purchase units directly from the investing company which are well diversified. **For example, UTI and Mutual Fund.**

iv) **Insurance Companies:** They create a risk pool by way of collection of premium from the people at large who wishes to buy a protection either for a person or for a property. It helps to mitigate the loss and preserve the wealth and meet out the uncertainties. By insuring large groups, risk is spread over the entire insured and even in the event of paying claims, they end-up with sufficient amount of profits unless there is a natural calamity or disaster.

#### Structure of Insurance Sector in India

The various insurance companies in India are as follows:

i) **Life Insurance Company in Public Sector:** The main life insurance company in the public sector is known as **Life Insurance Corporation of India (LIC)**.

ii) **General Insurance Companies in Public Sector:** There is only one public sector general insurance company known as **General Insurance Corporation of India (GIC)**. It is divided into the following subsidiaries.

- National Insurance Company Limited,
- New India Assurance Company Limited,
- Oriental Insurance Company Limited, and
- United India Insurance Company Limited.

Other than that there are 33 private general or non-life insurance companies.

3) **Non-Intermediaries:** They are engaged in providing funds on long-term basis to individuals as well as corporate clients. They comprise of institutions who are lending on term basis. **For example,** financial corporations and investment institutions like IDBI, NABARD, IFCI, etc.



- v) **Mutual Fund:** Under this the investment made by the investors are pooled together and the same is invested in securities like stock, bonds and money market instrument and other allied assets.
  - vi) **Exchange Traded Fund:** It is just like other investment funds that are traded on the stock exchange. Assets like stock, commodities, bonds, etc., are traded close to their NAV during the daily trading. Majority of these funds track an index like stock or the bond index.
  - vii) **Consumer Credit or Consumer Finance:** It is the phenomenon of providing credit to the consumers for the purchase of consumer durable goods for everyday use. There are other names for the same concept like deferred payments, credit merchandising, instalment buying, pay as you earn scheme, pay out of income scheme, hire purchase, easy payment, instalment credit plan, credit buying, etc.
  - viii) **Bill Discounting:** It denotes a short-term money market instrument and assists in financing credit trade related transactions. Normally, bills are discounted with the bank in the ordinary course of the trading activity.
  - ix) **Housing Finance:** It is a set of financial arrangements which are rendered by the Housing Finance Companies to finance the need of funds for the construction and the purchase of house.
  - x) **Venture Capital:** It consists of two words that are, 'venture' and 'capital'. The first term venture means a course or a proceeding where the result is uncertain but the risk of loss arising exists. While the other term capital means the funds required to initiate the venture.
- 2) **Fee-Based Financial Services:** Fee-based financial services do not create funds on the outset, rather, they ensure that the funds are created via their services for which a fee is charged by them. It comprises of:
- i) **Merchant Banking:** It may be an institution or an individual who may be an agent for the corporation and the municipalities issuing securities. Further, broker or dealer operations are also maintained by them alongside and they also trade in existing issued securities. They also offer advice related to the investments to the investors in general.
  - ii) **Credit Rating:** It is the process of allocating symbols having unique reference to the different instruments being rated, that indicate the opinion of the issuer to issue debt-related instruments on the ability to pay off the debt in timely manner is known as credit rating.
  - iii) **Stock Broking:** The mechanism under which the buyer and the seller of the securities come to a particular place like stock exchange for transaction dealing is termed as stock broking.
  - iv) **Debt Securitisation:** It is the process by which assets like auto loan receivables, cash credit receivables, mortgage loans are converted into tradable investment.

- v) **Letters of Credit:** It is commonly referred as LC. It is a written document which is issued by the buyers bank to the sellers bank to reimburse the cost of goods and services that are supplied by the seller to the buyer when the documents are submitted within the particular timeframe at a specified time and specified place, upto a certain amount and to a particular bank on the condition that the documents are submitted in accordance with terms and the conditions implied.
- vi) **Bank Guarantees:** It is the contract between the client and the issuing bank where the bank assumes the responsibility to settle the claims of the client for the customer for which the guarantee was given.

## 2.7. NON BANKING FINANCIAL COMPANIES (NBFCs)

### 2.7.1. Meaning and Definition of NBFCs

**Non-Banking Financial Institution** refers to those financial institutions which provides various banking services but does not have any banking license. These are registered under the Companies Act, 1956. These are controlled by the Reserve Bank of India.

**According to the Reserve Bank (Amendment Act) 1997,** "A Non-banking Finance Company (NBFC) means:

- 1) A financial institution which is a company;
- 2) A non-banking institution which is a company and which has as its principal business the receiving of deposits under any scheme or arrangement or in any other manner or lending in any manner;
- 3) Such other non-banking institution or class of such institutions, as the Bank may with the previous approval of the Central Government specify.

The definition given by Reserve Bank (Amendment Act), 1997 does not include the financial institutions which does agricultural operations as their main business.

The NBFC includes those companies which does the work as stated in the above definition and also the foreign companies which comes under Section 591 of the Companies Act. The company which does the following activities is not an NBFC:

- 1) Agricultural activity
- 2) Industrial operation
- 3) The purchase or sale of any goods except securities or also providing any kind of services.
- 4) The purchase, construction or sale of immovable property and also no part of income of the institution is taken from the financing of purchase, construction or sale of immovable property by other persons.

The company for working as NBFC needs to register with RBI.

### 2.7.2. Features of NBFCs

The various features of NBFCs are as follows:

- 1) The non-banking financial companies need to registered with the Reserve Bank of India. The companies which are not registered cannot do the financial activities.



- 2) The NBFCs has constant communication and direct relation with the customers.
- 3) The NBFCs has the better understanding of the need and demand of the customers.
- 4) The NBFCs has various branches in the country so they are present everywhere.
- 5) The NBFCs involves very low cost operations.

### 2.7.3. Types of NBFCs

The principal business/types of NBFCs are as follows:

- 1) **Equipment Leasing Company (ELC):** As by the name the companies which are involved in the leasing of the equipment or financing of such activity is known as equipment leasing company.
- 2) **Hire-Purchase Finance Company (HPFC):** The company which are involved in the hire-purchase business or in the financing of hire-purchase is known as hire-purchase finance company.
- 3) **Housing Finance Company (HFC):** The company whose principal business is to provide finance for the acquisition or construction of house which includes the acquisition or development of plots of lands is known as housing finance company.
- 4) **Investment Company (IC):** The company which are involved in acquisition of securities is known as investment company
- 5) **Loan Company (LC):** Loan company is the company whose principal business is to provide loan and advances. The equipment leasing company or a hire-purchase finance company or a housing finance company are not the part of loan company.
- 6) **Miscellaneous Non-Banking Company (MNBC):** The MNBC includes the following types of business:
  - i) The company involved in handling, doing or controlling as a promoter, foreman or agent of any type of transaction or arrangement by the help of the company enters into an agreement with specific number of subscribers in which all of them should subscribe same number of instalments in the specific period. These subscribers will estimated by lot or by auction or by tender or in the way to be given in the agreement which is eligible for prize amount.
  - ii) The company which is doing different type of chit or kuri which not the same from the business which is given above. Undertaking or doing the other kind of business which is same to the business given above.
- 7) **Nidhis or Mutual Benefit Finance Company (MBFC):** MBFC are the company which is reported by the Central Government under Section 620A of the Companies Act, 1956. These have ₹1 as the nominal shares. It gets deposits from its member and give loan only to the members in mortgage of some tangible securities. The loans are provided for personal expenses like marriages, repair of houses, etc. These types of loans are not given by commercial banks.

It is one of the oldest type of non-financial companies. The main objective of Nidhis to take deposit from their members and to get loans at a favourable rate of interest. It helps in increasing the saving habit among the people. These are generally well-managed and work on the principle of complete mutuality of interest. As these promote the saving habits in the middle and lower class of society so the government also provides deduction under Section 620A of the Companies Act.

- 8) **Residuary Non-Banking Company (RNBC):** RNBC is the company which gets deposits according to various schemes or arrangement in one lumpsum or in instalments by the help of contribution or subscriptions or by sale of units or certificates or other instruments or in any other form as stated in the definition of non-banking financial companies (Reserve Bank) Directions, 1977 or as the case may be, the Miscellaneous non-banking companies (Reserve Bank) Directions, 1977 is not an insurance company.
- 9) **Non-Banking Non-Financial Company (NBNFC):** NBNFC is the industrial concern which is defined in Industrial Development Bank of India Act, 1964 or the company whose main work is the agricultural operation or trading in goods and services or construction/sale of real estate and which is not classified as financial or miscellaneous or residuary non-banking company.

### 2.7.4. Services Rendered by NBFCs

There are different kinds of financial services provided to the clients. The different types of services which are under on-banking financial services are as follows:

- 1) **Mobilisation of Savings:** The NBFCs has the positive impact on certain deposits segments. These companies help in increasing the savings among the public. They provide different methods for catering the needs of different customers by providing different interest rate. The 98% of deposits is given at the interest rate above 13%.
- 2) **Provision of Easy, Simple, and Adequate Credit:** The NBFCs provide the credit on the time of requirement. It is available for everyone. The procedure and formalities are easy in it. They give loans for personal expense like marriage religious activities, etc.
- 3) **Acting as Financial Supermarket:** NBFCs gives different types of services which makes it a financial supermarket for the customers. They provide services with diversification of the activity which reduces the risk of NBFCs. The different services provided by NBFCs are mutual funds, specialist forex operations, counselling, merchant banking, etc., which are different from the traditional services.
- 4) **Channelising Funds for Productive Purposes:** NBFCs helps in mobilising the small savings of the public and help in increasing the production. The industrialists can do production with less capital as the machinery and equipment given by leasing companies.



- 5) **Increasing Saving in Public:** NBFCs help in increasing saving in the public by receiving deposits from the public in different ways. They help in mobilising saving by the issue of debentures, unit certificates, saving certificates, chits, subscriptions, etc.
- 6) **Providing Housing Finance:** NBFCs provides different types of housing loans to the public on simple terms and conditions. The housing facility is very important for the public to survive.
- 7) **Increasing the Standard of Living:** NBFCs helps in increasing the standard of living by providing loan to public for purchasing consumer durable goods on instalment basis. The efficient transport facilities helps in the movement of goods from one place to another and also increase the availability of different goods which has increase the standard of living of the people.
- 8) **Promoting Economic Development:** NBFCs helps in increasing the economic development by increasing the growth of the financial market and providing different choices to the investors. These NBFCs by the help of diversification provides good return on savings while reducing risk. They keep the capital market active and busy which help in enhancing the stability of business in the economy and also increase the growth of an enterprises. They are interested in price stability rather than speculative activities. Hence, it has the positive effect on the stock market which also lead to the economic development of the country.
- 9) **Rendering Investment Advice:** NBFCs also provides advices for doing and controlling the investments. They also provide protection to the small investors by giving diversified investment opportunity. They provide service to the investors by giving options of various securities which provide maximum return.

### 2.7.5. Importance of NBFCs

The importance's of NBFCs are as follows:

- 1) **Greater Reach:** NBFCs are present in every part of the country. These institutions are present in the remote area of the country which expand their reach

in the country. These are able to reach the financial requirement of large number of customers which does not get the services of the banking institutions.

- 2) **Flexibility in Tapping Resources:** The NBFCs are present everywhere which let them use the new and different types of resources of the economy. The different type of financial sources keep on changing.
- 3) **Retail Services to Small and Medium Business:** The NBFCs provides loans and funds to the small and medium units on easy terms and conditions which is not possible in other banking institutions.
- 4) **Important Component of Financial Market:** NBFCs help in providing financial services to the people present in the distant and remote areas of the countries. It is very important part of financial market.

## 2.8. EXERCISE

### 2.8.1. Very Short Answer Type Questions

- 1) What is a financial system?
- 2) Name the constituents of financial system.
- 3) What is financial market?
- 4) What is financial institution?
- 5) What are Financial Services?
- 6) What do you mean by NBFCs?

### 2.8.2. Short Answer Type Questions

- 1) Explain in brief the overview of Indian Financial System.
- 2) Discuss the features of Indian Financial System.
- 3) What are the functions of financial system?
- 4) Explain the role of financial system on the economic development of the country.
- 5) Differentiate Capital market and Money market.

### 2.8.3. Long Answer Type Questions

- 1) Discuss financial system importance and limitations.
- 2) Illustrate the constituents of financial system.
- 3) Write in brief on NBFCs types and its render services.



# Chapter 3

## Emerging Areas in Financial Management

### 3.1. EMERGING AREAS IN FINANCIAL MANAGEMENT

- 1) Risk Management
- 2) Behavioural Finance
- 3) Financial Engineering
- 4) Derivatives

### 3.2. RISK MANAGEMENT

#### 3.2.1. Meaning and Definition of Risk Management

**Risk** refers to the situation where there is a chance that the results would be different from the required outcome in a negative manner. The main reason behind the risk is the existence of uncertainty. The risk arises when there are minimum two possibilities. If the occurrence of loss is certain then there is no risk and there should be at least one possibility which is undesirable in its nature. Every business organisation needs to manage the risks faced by it. This is essential for the purpose of robust decision making.

The risk management is required to help the organisation in making prudent decisions by following set procedures. The main aim of risk management is to help the process of decision making.

**Risk management** refers to the process of identifying, assessing and prioritising risks by following judicious use of resources for the purpose of minimising, monitoring and controlling the likelihood of and the impact of negative events. Risk arises due to uncertainty in different areas such as legal, projects, financial markets, natural causes and credit risks.

Risk management is the approach used for defining risk that a firm may be willing to undertake. The risk level is adjusted by undertaking the financial instruments. Thus, the choice of such financial instruments forms a major part of risk management. The term risk management may be used to describe the application of certain principles and approaches for the purpose of identification and proper assessment of risk measures. This process also involves determination and then application of various tools for the purpose of managing risk.

**Thus, risk management is the process of identifying, assessing, analyzing and evaluating the risk with the view of controlling its impact.**

#### 3.2.2. Features of Risk Management

Following are the main features of risk management:

- 5) **Risk Pervades the Organisation:** The risk management practices have become fundamental to an organisation. Such policies are required at every level of the organisation. It not only helps in minimising the risk probability but also in increasing the goodwill and efficiency of the business.
- 6) **Dangers Lurk in Non-Traditional Risks:** It is important to look beyond traditional areas of risk such as finance, credit etc. Many companies do not pay attention in risk fields such as IT, regulatory and human capital as these are the areas where are several underlying dangers.
- 7) **Drivers to Strengthen the Function:** There are different factors which impact the overall effect of risk management practices. Most important internal factors are the board of director while external factors are investors and regulatory authorities.
- 8) **Awareness of Risk is the Key:** It is essential that the importance of risk management is understood at every level of an organization. It is also important to recognize the risk potential of the firm and set up clear policies to ensure that such limits are not breached.
- 9) **Companies Create a Fore frontier for Risk:** The companies generally appoint a person such as Chief Risk Officer to ensure that the responsibility for the risk management is proper taken care of. This approach is prevalent in financial services industry where nearly two thirds of the firms have created the position of Chief Risk Officer.
- 10) **Increase in Investment is Predicted:** It is expected that risk management function will gain importance in the future. In the coming times, organisations of all sizes and in all fields are expected to offer more focus on this function.

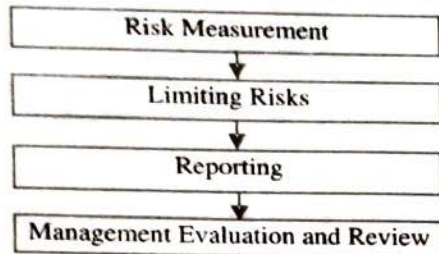
#### 3.2.3. Process/Steps for Risk Management

The main ingredients of a robust risk management strategy are a comprehensive risk measurement approach, an exhaustive framework of limits, guidelines and other parameters to be used for the purpose of governing risk and a strong management information system. These parts are essential for both non-derivative and derivative securities. It should also be noted that fundamental risks inherent in such situations are not new. Although in



modern times, the tools for measuring and managing these risks have become more sophisticated. Some of these risks are credit risk, market risk, operations risks and legal risks.

The risk management process should be integral to any organisation. It should be in close harmonisation with other activities of the organisation. This type of framework allows the organisation to work in a more efficient manner. The organisation should ensure its financial stability and that there is adequate capital available at different point of times:



- 1) **Risk Measurement:** The organisation should try to differentiate between trading and non-trading risk. This should be done at the institutional level. Also the type of risk management strategy should commensurate with the level of risk faced by an organisation. It is important that such policies are clear to the people who have to carry out these tasks. There should be a uniform framework for this purpose and people at different levels should be aware of such policies. This is especially important if the organisation has exposure to foreign exchange. In such cases, it is important that proper monitoring instruments are there in place.

Further, it is also important that various stress situations are properly analysed. Such risk measurement practices help in enumerating various situations which may have unfavorable impact on the organisation. Once such situations are identified, proper measures to address them may be undertaken. Such analysis should extend to different facets and should not be limited to merely determining the probability of such events happening. It should also consider the highest possibility of loss. The qualitative analysis should also encompass proper procedures and communication.

- 2) **Limiting Risks:** A robust system of risk management is an important part of the entire risk management process. Such process should clearly delineate the risk-taking abilities of the organisation. It should also ensure that the outliers are promptly brought into concerned person's attention.

The organisations should set global limits for each type of risk likely to be faced by the organisation. The limits should be set in such a manner that it fits with the overall objective of the business. Further, the system should also allow the setting of limits at more micro level. As and when the set limits are breached, the incidence should be brought to the notice of senior management. It should also be ensured that such misbehavior was approved by appropriate authorities. An institution which sets tighter limits is expected to face more breaches than the ones with more lax limits.

- 3) **Reporting:** The process of risk management is also deeply related to the reporting aspect. It should be designed in such a manner that appropriate authorities are informed about deviations promptly. Dealer operations, exposures and net results should be sent to managers on daily basis. Similarly, macro reports should also be sent on periodic basis. The organisations should set up the reporting frequencies for different levels of management and should ensure that such frequencies are properly adhered to. The reports pertaining to risk exposures should also be sent to top management on regular basis. For this purpose, the organisation should have appropriate framework in place.

- 4) **Management Evaluation and Review:** The environment faced by a business is constantly changing, therefore, it is important that the organisational policies are constantly reviewed and modified accordingly. The review process should be comprehensive and should analyse the extent of change in circumstances. It should also compare the limits set earlier with the actual exposure of the firm. The review should look into whether the set policies are still relevant or not in the current environment. The frequency and the depth of such reviews differ from organisation to organisation and is dependent on several factors such as risk exposure, quantum of derivatives used and the nature of market conditions. However, any organisation should undertake such review at least on the annual basis. Apart from such internal reviews, there should also be such reviews carried out by qualified outside parties such as auditors and consultants.

### 3.2.4. Methods of Risk Management

Risk is the possibility of a loss, people, organizations, and society; usually try to avoid risk, or, if not avoidable, then to manage it somehow. There are four major methods of handling risk as follows:

- 1) **Avoidance:** It is the elimination of risk. Investor can avoid the risk of a loss in the stock market by not buying or shorting stocks; the risk of a venereal disease can be avoided by not having sex, or the risk of divorce, by not marrying; the risk of having car trouble by not having a car. Many manufacturers avoid legal risk by not manufacturing particular products. Of course, not all risks can be avoided. Notable in this category is the risk of death. But even where it can be avoided, it is often not desirable. By avoiding risk, investor may be avoiding many pleasures of life, or the potential profits that result from taking risks. Those who minimize risks by avoiding activities are usually bored with their life, and do not make much money. Virtually, any activity involves some risk. Where avoidance is not possible or desirable, loss control is the next best thing.
- 2) **Loss Control:** It works by either loss prevention, which involves reducing the probability of risk, or loss reduction, which minimizes the loss. Loss prevention requires identifying the factors that increase the likelihood of a loss, then either eliminating the factor or minimizing



its effect. **For example**, speed and driving drunk greatly increase auto accidents. Not driving after drinking alcohol is a method of loss prevention that reduces the probability of an accident. Driving slower is an example of both loss prevention and loss reduction, since it reduces both the probability of an accident and, if an accident does occur, it reduces the magnitude of the losses, since accidents at slower speeds generally cause less damage. Most businesses actively control losses because it is a cost-effective way to prevent losses from accidents, and damage to property; and generally becomes more effective, the longer the business has been operating.

- 3) **Risk Retention:** It is also known as "active retention" and "risk assumption", is handling the unavoidable or unavowed risk internally, either because insurance cannot be purchased for the risk, because it costs too much, or because it is much more cost-effective. An insurance deductible is a common **example** of risk retention to save money, since a deductible is a limited risk that can save money on insurance premiums for larger risks. Risk retention is retaining risk because the risk is unknown or because the risk taker either does not know the risk or considers it a lesser risk than it actually is. **For example**, smoking cigarettes can be considered a form of passive risk retention, since many people smoke without knowing the many risks of disease; and of the risks they do know, they do not think it will happen to them.

- 4) **Non-Insurance Transfers:** Risk can also be managed by non-insurance transfers of risk. The three major forms of non-insurance risk transfer are as follows:

- i) **Contract:** A common way to transfer risk by contract is by purchasing the warranty extension that many retailers sell for the items that they sell. The warranty itself transfers the risk of manufacturing defects from the buyer to the manufacturer. Transfers of risk through contract is often accomplished or prevented by a hold-harmless clause, which may limit liability for the party to which the clause applies.
- ii) **Hedging:** It is a method of reducing portfolio risk or some business risks involving future transactions. Thus, the possible decline of a stock price can be hedged by buying a put for the stock. A business can hedge a foreign exchange transaction by purchasing a forward contract that guarantees the exchange rate for a future date.
- iii) **For Business Risks by Incorporating:** Investors can reduce their liability risk in a business by forming a corporation or a limited liability company. This prevents the extension of the company's liabilities to its investors.

### 3.2.5. Advantages of Risk Management

Following are the main advantages of practicing sound risk management procedures in an organisation:

- 1) A risk management policy forces an organisation to take comprehensive view of the threats faced by it.

- 2) It allows the organisation to prepare itself for such contingencies, thus saving it from any unpleasant surprises.
- 3) It helps the organisation in properly scheduling its investment pattern and make the process more formal.
- 4) It helps in better utilisation of resources by avoiding any sort of duplication.
- 5) Risk management also makes the system more efficient by allowing integration.

### 3.2.6. Disadvantages of Risk Management

Following are the main shortcomings of risk management practices:

- 1) If risks are not properly identified then it is likely that the organisation may waste its resources in monitoring the risks which are highly unlikely to happen.
- 2) Even if such risks do happen, the risk attached to them may not justify the costs incurred for monitoring them.
- 3) Qualitative analysis is by nature subjective and is not consistent across the board.
- 4) If the risk management practices are prioritised, then the organisation may become too conservative to operate properly. It is important that the broader business mission is kept in view while designing risk management practices.

## 3.3. BEHAVIOURAL FINANCE

### 3.3.1. Meaning and Definition of Behavioural Finance (BF) 2019 (3)

As by the name we understand that behavioural finance is the part of finance which inquire about the application of psychological decision process in the organized financial market like stock market and property market. It uses the knowledge of cognitive psychology, social sciences and anthropology for explaining the illogical behaviour of investors. This type of behaviour of the investors are not detected by the traditional rational based models. It also recognizes the problems faced by the stock market and property market and analysis the behavioural literature of both the market. The behavioural finance explain the effect of sentiment and mentality of the investors on the investment decisions and also analysis the effect of psychology on the investors and the market.

**According to Lintner**, Behavioural finance as "the study of how humans interpret and act on information to make informed investment decisions".

**According to De Bondt**, Behavioural finance as "a theory which explores financial issues with the help of ideas borrowed from cognitive psychology".

**According to Weber**, "Behavioural finance closely combines individual behaviour and market phenomenon and uses the knowledge taken from both the psychological field and financial theory".



**According to Shleifer**, Behavioural finance termed as "a study of human fallibility in competitive markets". This human fallibility often tends to base decisions on non-rational motivations. It can thus be seen that BF interferes with rational beliefs and decisions".

### 3.3.2. Scope/ Application of Behavioural Finance

The scope and application of behavioural finance has the wide area of operation. The various scope and application are as follows:

- 1) **Inflation and Stock Market:** The behavioural finance is used in inflation and stock market. The behavioural finance check various factors like the worth of equity of the firm. **For example**, the nominal income expense is shown in the income statement. The change in nominal liabilities because of inflation is not shown in income statement due to which investors does not consider it and they undervalue the equities when inflation is high. The stocks will become more risky as the stock may decrease more than the increase in inflation and they should increase more than the inflation increase. In the full inflation cycle the two effects is made equal which makes the stocks less risky in long run than in short run.
- 2) **Underpricing of Initial Public Offerings:** The scope of behavioural finance is related to the underpricing of IPOs. The behavioural finance checks the behaviour of the entrepreneur and also monitor their selection at the time of uncertainty. **For example**, if there are pre-issue stockholders and the IPO is underpriced than the wealth of the shareholder is reduced. If the shareholder gets the good news than the wealth of the entrepreneur will increase as the price of the IPO is more than expected price of IPO and also the entrepreneur does not indulge themselves in bargaining for high offer price. It is because the person combine the good news of increasing the wealth and bad news of too much dilution. The individual is at better position on net. The underwriter takes benefit of the mental accounting and also lower down the price of these deal. In these IPO, the price will increase more which will leave more money on table if the market price also increased.
- 3) **Investors:** There are various researches which has shown the issues related to the individual investor trading and portfolio allocations. The way the investors improve their financial decisions is seen in behavioural finance. The issues are due to cognitive abilities, experience and learning of the investors while other problem is due to the types of decision made by employee doing investment decisions. **For example**, re-framing of pension choice helps employees to make better selection.
- 4) **Corporations:** The past studies about the finance explain that arbitrageurs will always trade away investor mistakes which will not affect the market price. The limitation of arbitrage give rise to distrust on the capability of arbitrageurs to correct mispricing. Thus, arbitrage argument will be even less assurance in a corporate setting. The decisions in companies are framed by one or a few managers including lots of

money. Hence the belief will directly affect the corporate behaviour which will not be capable to arbitrage corrections. So, the behavioural finance is more important to corporate finance than it is to investments and markets. **Shefrin** explains that "Like agency costs, behavioural phenomena also cause managers to take actions that are detrimental to the interests of shareholders". The efficient manager can solve these issues by financing, capital budgeting, dividend policy, corporate governance, initial public offerings and mergers and acquisitions decisions which will increase the value of the firm.

- 5) **Markets:** The behavioural finance focuses on the effect of cognitive errors of the market participants on the market. The market is the important method of distributing finance in a capitalistic society and these financing affects the health of economy like the biases of the people which are working in the derivative market. The behavioural finance has suggestions for the trust between participants and markets. The trust plays an important role in the functioning of market.
- 6) **Regulations:** The behavioural finance also affects the regulation policy in various ways. The behavioural finance have same impact on the investors and managers to that on the politicians who make law and policy. The new regulation is more reactive to financial events. The well-designed policy will help people to overcome the biases for making better selection.
- 7) **Education:** The cognitive decisions of employees, investors, institutions, managers, politicians and others has adverse effect on the financial strength of individuals and society. The behavioural finance is not taught in various management school as it is new field but knowledge and understanding of behavioural finance give the chance to increase the substantial value to any undergraduate and graduate business programme.

### 3.3.3. Objectives of Behavioural Finance

The various objectives of behavioural finance are:

- 1) **Accurate Decision-Making:** The decision-making process is very important for all the company. Every company has the objective of increasing the worth of the firm and also framing decision to do so. The behavioural finance focuses on the market which helps in accurate decision-making. It also checks the irrational behaviour of the investors. Therefore, the stock prices differ both from the long-term equity value and from the irrational behaviour of the investors. Hence, the managers should make decisions which will increase the value of the firm and also use the stock price for making such decisions as they can be changed easily. The decisions should also affect the investors.
- 2) **Helps the investors to take Investment Decisions:** Behavioural finance provides knowledge about the market and helps them to know about the problems of various investment strategy which lets the investors take accurate decisions about investment.



- 3) **Examining the Investors Behaviour:** Behavioural finance checks the regular decisions making of the investors about their investment. The behavioural finance has the direct or indirect impact on the investment. Hence by studying behavioural finance investor's behavior can be analyzed.
  - 4) **Identifies Emotions and Mental Errors:** The behavioural finance tells about the behaviour of the market and also the effect on the pattern of stocks and bonds according to the investors' mood. The mood of the investors also determines the conditions of investment. It also checks the various repeated mistakes of the investors. The behavioural finance is growing its presence as it shows the effect of psychology on the investment decisions of the investors. It combines the classical economics and finance with psychology and decision making.
  - 5) **Maintaining a Consistent Approach:** The efficient advisors use a regular method for wealth management service and also by adding the various merits of behavioural finance to these regularly used method they will not require large scale changes when used by the advisor. It will add to the professionalism and will also help in building relationship as the advisors can use this process to get the knowledge about the introduction of any actual investment. It will be supported by the clients and will help in making the relationship more efficient.
  - 6) **Delivering According to the Client:** Behavioural finance is very important for advisory relationship. The advisor can build successful relationship with the client by delivering the product according to the needs of the client. Behavioural finance helps in explaining the factor affecting the clients. Once the advisor knows the expectations of the client than it can help the client in more effective way.
  - 7) **Ensuring Mutual Benefits:** The satisfied client will help in improving the practice and work-life of the advisor. By the help of behavioural finance there will be effective advisory relationship with the clients. It is known that the individual investor advisory business is not the only reason due to which client require a new advisor but also as the clients thinks that the advisors cannot understand or attempt to understand the financial objectives of the clients. The behavioural finance helps in establishing the relationship between the client and advisors. The advisor after knowing the requirement of the clients to makes the client understand the reason for the designing the kind of portfolio and the efficient portfolio for the client irrespective to the working of the markets.
- 2) **Signifies that Investors are Emotional:** Behavioural finance helps in concluding that the investors are emotional creatures as they are overconfident, fearful, confused and committing mistakes.
  - 3) **Defines Investor's Biases:** Behavioural finance also checks the biases of the investors and also helps in providing the accurate solution to solve it. It also helps the investors in making less mistakes.
  - 4) **Helpful for Financial Advisors and Fund Managers:** Behavioural finance helps in better understanding of the investors' requirement which is required by the financial advisors and it help the fund managers to make and deliver the accurate investment solution for increasing the profit of the firm and investors.
  - 5) **Manages Behavioural Biases:** Behavioural finance explain the biases of the investors. These types of behavioural biases are called as systematic errors in judgement and these can be divided into two types:
    - i) **Cognitive Biases:** It is associated to incorrect reasoning and these can be corrected by better information and instructive advice.
    - ii) **Emotional Biases:** It is associated with the impulsive feeling like lack of self-control or overconfidence.

It can be managed by making adjustments in portfolio and regulating the investors.
  - 6) **Helps in Investment Decisions:** Behavioural finance helps in analyzing the investment decisions of the investors and also the strength and weakness of human nature. The investment decisions refer to the decision making process according to the information, risk and uncertainty.

### 3.3.5. Disadvantages of Behavioural Finance

The various disadvantages of behavioural finance are as follows:

### 3.3.4. Advantages of Behavioural Finance

The various advantages of behavioural finance are as follows:

- 1) **Establishing Goals of Investors:** The establishment of the investor's goals involves the understanding of investors and their response towards uncertainty, volatility and current global news. The investors may have some amount of money for the required time period which helps in attaining the goal of the firm.

- 1) **Lacking in Discipline:** Behavioural finance does not have the unified theoretical knowledge of neoclassical finance. For example, it does not contain the characteristics of prospect theory, SP/A theory, regret theory, self-control theory and affect theory. Also, the various studies show that the drawbacks of prospect theory for understanding the behaviour of real world investors. There are various behavioural explanation for momentum which are not regular. Due to which various behavioural asset pricing model is eclectic and ad hoc. There are various methods which are based on the principle that the prices are fixed by a representative behavioural interest although the aggregation theory explains that such assumptions are not right.
- 2) **Analogy:** The various study of the economic functions of payments and settlements does not give much detail about the practical organization of the payment. Similarly, the undivided focus on the psychological method will not help in accurate interpretation of economic and financial events.



- 3) **Remains Unintelligible:** Behavioural finance should focus more on micro-level study of difficult mistakes and if not possible the behaviour will remain unintelligible.
- 4) **Less Converge:** There is no connection between the importance of behavioural research and the human weakness. The reality is that the various people around the world leads a happy life.

## 3.4. FINANCIAL ENGINEERING

### 3.4.1. Meaning and Definition of Financial Engineering

The financial services sector has undergone vast change in the recent past. It has given way to a new discipline which includes corporate finance, bank finance and investment finance called financial engineering. It is the process which uses current financial instruments for creating new type of products. It may simply combine two products or several products.

Financial reinsurance is one such example of financial engineering. Companies offering re-insurance options are used for the proper conservation of the resources in the events of constantly changing premium value. In this case, the financial engineering helps in stabilizing the environment.

According to John Finnerty, "Financial engineering involves the design, the development, and the implementation of innovative financial instruments and processes, and the formulation of creative solutions to problems in finance".

According to the International Association of Financial Engineers (IAFE) describes the term 'financial engineering' as, "the development and creative application of financial technology to solve financial problems and exploit financial opportunities".

According to Galitz, financial engineering, "is the use of financial instruments to re-structure an existing financial profile into one having more desirable properties".

### 3.4.2. Types of Financial Engineering

Following are the four main types of financial engineering:

- 1) **Financial System Engineering:** This is mainly engaged with the design of organizational structure. It also helps in creating new types of financial intermediaries. For example, designing group mechanism.
- 2) **Financial Institution Engineering:** This branch deals with form, structure and legal form of the organization. This kind of engineering mainly helps MFIs in providing new type of products.
- 3) **Process Engineering:** This deals with introducing new types of business practices for achieving better results. It is related with technological progress. For example, automation of the processes comes under the scope of process engineering.

- 4) **Product Engineering:** The new types of financial services such as insurance, leases, credit services and saving accounts come under this category. Product engineering helps in introducing new products for better serving the needs of the customers.

### 3.4.3. Advantages of Financial Engineering

Financial engineering has made specific contribution to examine and influence the sustainable competitive benefit. The main advantages of financial engineering are as follows:

- 1) Identification of opportunities for sustainable competitive advantage which can influence the decision making of the firm.
- 2) Financial engineering also involves the use of derivatives for the minimization of various expenses such as taxes and default risks. It also helps in decreasing the cost of capital.
- 3) It helps in improving the investor preference. It also helps in reducing the cost of capital. For example, it introduced asset-backed bonds and convertible bonds.
- 4) Financial engineering helps in the evaluation of risk management policies. It also helps in asset portfolio diversification and hedging.

### 3.4.4. Disadvantages in Financial Engineering

- 1) Financial engineering may lead to problems related to liquidity.
- 2) Financial engineering has not been able to solve the problem of valuation.

Various risk management tools forwarded by financial engineering are flawed. For example, VAR calculates the risk of holding as the maximum variation in the value which may occur in 99% of the cases. It assumes normal distribution for price movements.

## 3.5. DERIVATIVES

### 3.5.1. Meaning of Derivatives <sup>2019</sup> (3)

This type of security derives its value from the underlying asset. The value of the backing asset determines the value of the derivative security. A derivative security is mainly used for the purpose of risk management. The risks arising out of price fluctuation may be managed with the help of derivative securities. These securities help in breaking down the risk in several components including risk arising out of interest rate, credit rate and exchange rate risk etc. There are several types of derivative securities available in India. For example, forex market uses a type of derivatives called forwards. In the Indian context the Securities Contracts (Regulation) Act, 1956 defines "derivative" to include:

- 1) A security derived from a debt instrument, share, loan whether secured or unsecured, risk instrument or contract for differences or any other form of security.
- 2) A contract which derives its value from the prices or index of prices, of underlying securities.



### 3.5.2. Features of Derivatives

Following are the main features of derivatives:

- 1) The transactions in **derivatives are separate** from the transactions in the underlying securities.
- 2) The financial derivative is **priced according to the value of the underlying asset**.
- 3) Financial derivatives are used **for a wide variety of reasons** such as hedging, risk management and in many cases for speculation.
- 4) The settlement of derivatives generally takes place **through net payment** of cash. It is also generally done before the maturity date.
- 5) Financial derivatives allow for **geared returns**, which are generally higher than the returns made by investing in the underlying. However, it also increases the risk. **For example**, paying the premium is all that is required to invest in options. The potential returns can be substantial.
- 6) The risk involved with derivative trading may be mitigated through trading or through the contract. The **offset ability** of the derivatives can be achieved through the use of options or other hedging activities.

### 3.5.3. Types of Derivatives 2021 (3)

Following are the main types of derivatives:

- 1) **Forwards:** A forward contract is a simple customised contract between the two parties to buy or sell an asset on a certain date in future for a certain price. Unlike future contracts, they are not traded on an exchange, rather traded in the over-the-counter market, usually between two financial institutions or between a financial institution and one of its components (subsidiary companies).

In other words, it is a privately negotiated contract which is not traded in an **organised** marketplace or exchange. Both parties to a forward contract are required to follow the terms and conditions mentioned in the contract. The terms and conditions of the contract specify the quantity, quality and delivery periods. Both parties are expecting to make or receive delivery of the commodity on agreed date. It is difficult to get out of a forward contract, unless both the parties are mutually agreed.

- 2) **Futures:** A futures contract is an agreement between two parties to buy or sell an asset on a certain date with specified quantity, quality, and price in the future. Futures contracts are different from forward contracts in various aspects as the former are traded in standardised exchange and latter are traded in over telephone or telex (OTC). Unlike forward contracts, the counterparty to a futures contract is the clearing corporation on an appropriate exchange. Futures are often settled in cash or cash equivalents, rather it is not required to have physical delivery of the underlying asset. Parties to a Futures contract may enjoy exercising their option either to buy or write options on futures.

- 3) **Options:** Options is the derivative contract that give the right but not the obligation to either buy or sell a specific underlying security for a specified price (called as strike/exercise price) on or before a specific date. The option contracts are created for any type of underlying security.

Equity (stock) is the most common underlying asset, but there are several other categories of non-equity options on the basis of underlying asset, such as, bonds, foreign currency, indices, or commodities, like gold or oil.

The person who buys underlying asset through an option contract is normally known as the buyer or holder. Conversely, the seller is known as the seller or writer.

- 4) **Swaps:** Swap is a derivative contract which is formed to exchange the underlying asset of contract in future for a specified date. Where one asset is exchanged for another or one liability is exchanged for another or more specifically one stream of cash flows is exchanged for another.

A swap is a private contract between two parties in which both parties are obligated to exchange some specified cash flows at periodic intervals for a fixed period of time. Unlike, a forward or a future contract, a swap contract generally involves multiple future points of exchange.

### 3.5.4. Advantages of Derivatives

Following are the main advantages of derivatives:

- 1) **Reflect Perception of Market Participants:** In a developed and organized market, the price of the derivatives will show the view of market participants about the future course of action for the market. It will also guide the price of the underlying. Towards the expiration date, the price of the derivatives and the price of the underlying tend to converge. Hence, derivatives help in price discovery.
- 2) **Helps to Transfer Risks:** The derivatives also help in transfer of risk from one party to another.
- 3) **Higher Trading Volume:** The derivatives are directly linked to their underlying cash market. With the help of derivatives, cash market experiences higher volumes, which helps in improving the liquidity in the market.
- 4) **Controlled Environment:** Derivative market allows for speculative trade in a more controlled manner. In the absence of this market, speculation will take place in legal markets, making them more risky and harmful to the health of the markets and the economy.
- 5) **Attract Entrepreneurial:** Derivative market also helps in generating new entrepreneurial activities. This type of trading generally attracts qualified and ambitious people and thus helps in creating new products and markets.



### 3.5.5. Disadvantages of Derivatives

Following are the main disadvantages associated with the use of derivatives:

- 1) **Speculative and Gambling Motives:** As derivatives offer leveraged positions, it allows participants with even low capital indulge in high volume trading. While it magnifies the gains, it also leads to higher losses, if the trade goes the wrong way. Speculation has become one of the biggest motives behind the growth of derivatives market.
- 2) **Increased Bankruptcies:** The leverage in the derivatives may cause people to take more risk than they can handle. In derivative market, one default may trigger a chain, causing high amount of loss.
- 3) **Increase in Risk:** The derivatives were initially designed to manage risk in the market. However, since then, the tools are mainly used for the purpose of speculation. This is especially true in Over the Counter (OTC) markets. Many of the derivatives fail to provide the risk cover they are designed for. In such situations, the leveraged positions may cause severe damage.
- 4) **Instability of Financial System:** It is claimed that the use of derivatives has led to overall increase in risk for the financial markets. The slow growth of derivatives has made the markets more liable for fluctuation threatening the stability of the market and its participants.
- 5) **Price Instability:** Derivatives were designed for price discovery and stability. However, the use of these tools for the purpose of speculation now causes the markets to have unstable pricing. The use of derivatives has also increased the range of fluctuations. The derivatives may cause the price stability if these are used in a controlled manner.

## 3.6. EXERCISE

### 3.6.1. Very Short Answer Type Questions

- 1) What is risk management?
- 2) What is Behavioural Finance?
- 3) State the two types of financial engineering.
- 4) What are Derivatives?

### 3.6.2. Short Answer Type Questions

- 1) Discuss the objectives of risk management.
- 2) Explain the methods of risk management.
- 3) Briefly explain the steps for risk management.
- 4) What are the advantages of behavioural finance?
- 5) Explain the various types of financial engineering.
- 6) What are the advantages of derivatives?

### 3.6.3. Long Answer Type Questions

- 1) Illustrate the advantages and disadvantages of risk management.
- 2) Discuss the various concepts of behavioural finance.
- 3) What is financial engineering? Explain the advantages and disadvantages of financial engineering.
- 4) Define the term derivative. What are the features and types of derivatives?