Financial Institutions- Fund Based

Topics

- Mutual Funds
- Insurance Companies
- Pension Funds
- Provident Funds
- Banking and NBFCs

Mutual Funds

- Mutual fund is a mechanism in which money is pooled in from various investors, who either lack expertise or interest in directly trading in equity and debt markets.
- Then the money that is pooled is invested in various stocks and debt instruments by a fund manager on behalf of the investors.
- Investors who purchased mutual funds will be allocated units.
- The value of the units is called as Net asset value (NAV) because the fund manager invests the funds in diversified holdings either of same sector or multiple sectors

Classification of Mutual Funds

- The investment need of the investors vary from person to person.
- So based upon the needs and operational issues mutual funds can be classified broadly based on the following criteria
- 1. Maturity Period
- 2. Investment Objective
- 3. Investment Strategies

Mutual Funds based on Maturity Period

- Based on period of maturity mutual funds can be put into two categories. They are
- Open Ended Fund
- Close Ended Fund
- **Open Ended Fund**
- In an open ended mutual fund there is no limit on the number of outstanding units.
- Anyone can subscribe or redeem the subscribed units at any point of time as per the Net asset value of the unit prevailing on the date of the transaction.
- The important feature of open ended mutual funds is high liquidity. Generally the sale and purchase transactions of the units are done directly with the fund management company.
- There is no involvement of the exchange in these transactions.

Mutual Funds based on Maturity Period

- **Close Ended Fund**
- Closed ended mutual funds generally liquid in nature but don’t offer the liquidity that is offered by the open ended mutual fund. In this type of fund, no fresh units can be offered to the subscribers beyond the limit as the corpus amount to manage the fund is fixed. Buying and selling of the closed ended mutual funds happen on a stock exchange as they are supposed to be listed there. Generally there are two values exist for a closed ended mutual fund.
- Net asset value of all the investments made
- The ongoing trading price in the stock exchange where it has been listed

Mutual Funds based on Investment Objective

The investment needs change from investor to investor. Based on these needs mutual funds can be classified into the following categories.

- Income Fund
- Offshore Fund
- Growth Fund
- Tax saving Fund
- Hybrid Fund
- Special Fund
- High Growth Fund
- Real Estate Fund
- Capital Protection Fund
- Infrastructure Debt Fund
- Exchange Traded Fund
- Hedge Fund
- New Direction Fund
- Leverage Fund
- Money Market Fund
- Fund of Funds

Mutual Funds based on Investment Strategies

Based on the investment strategy adopted mutual funds can be classified as

- Balanced Funds
- Money Market Funds
- Income Funds
- Sector Funds
- Equity Funds
- Top Down Investing
- Bottom Up Investing

Advantages of Investing in Mutual Funds

Though investments in mutual funds are subjected to market risks they carry the following advantages for the investors

- Investors can get access to the professional services and experience of the fund managers as the fund managers not only posses rich understanding of the markets but also backed by strong investment research teams who continuously track the changes that are happening in the market
- Since the investments are made across various sectors and different companies the mutual funds doesn't carry much risk
- If the investor needs to manage his portfolio of investments it not comes with not only lot time and attention but also lot of transaction costs. So mutual funds make the investment in stocks a convenient and cost effective process
- If invested for a long term mutual funds delivered higher returns when compared to available investment alternatives. So the chances of earning high returns on mutual funds are high
- Since the mutual funds are tightly monitored and controlled by SEBI, the investor can expect transparency in management of the funds.
- In case of open ended mutual funds the investor can liquidate his investments as and when he wants at the prevailing Net Asset value of the Mutual Fund Unit.

Insurance Companies

- Insurance sector in India is one of the important contributors to the capital markets.
- Individuals and entities view as a safeguard measure to address any untoward incidents like death, accidents, calamities etc.
- On account of it insurance companies receives huge amount of money in the form of premiums, which facilitates them to be capital providers to corporate mostly in the form of equity and thereby contribute to the economic wellbeing of the nation.
- The insurance business in India largely operates under two segments i.e. Life and Non-life.
- As on date there are 24 companies operating in life insurance business with Life Insurance Corporation of India being the largest entity in this segment.
- When it comes to non-life insurance segment, there are 33 companies that are in operational state as on date.

Key players of Insurance Business in India

Apart from the insurers there are other players who support the functioning of this industry. They are

1. Insurance Agents (Corporate entities as well Individuals)
2. Insurance Brokers
3. Surveyors (For Property Valuation)
4. Third Party Administrators (TPAs), who process Health Insurance Claims

ECGC Limited

- The ECGC Limited (Formerly Export Credit Guarantee Corporation of India Ltd) is a company wholly owned by the Government of India based in Mumbai, Maharashtra.
- It provides export credit insurance support to Indian exporters and is controlled by the Ministry of Commerce

Functions of ECGC

- Provides a range of credit risk insurance covers to exporters against loss in export of goods and services as well.
- Offers guarantees to banks and financial institutions to enable exporters to obtain better facilities from them.
- Provides Overseas Investment Insurance to Indian companies investing in joint ventures abroad in the form of equity or loan and advances...

Facilities provided by ECGC

- Offers insurance protection to exporters against payment risks
- Provides guidance in export-related activities
- Makes available information on different countries with its own credit ratings
- Makes it easy to obtain export finance from banks/financial institutions
- Assists exporters in recovering bad debt
- Provides information on credit-worthiness of overseas buyers

Pension Funds

Investments in pension funds have become a necessity for every individual considering the growing inflation levels, standard of living and life expectancy rate. So post retirement the income from salary stops and the entitlement to pension is no longer available.

The individual has to spend an average duration of 10-15 years post retirement without salary. Coupled with expenses on medical treatment the living expenses on account of inflation necessitate a stable income post retirement. This is where the role of Pension Funds started evolving in India to provide stable pension income to the individuals.

The working mechanism of pension funds happens in two phases.

- Accumulation Phase
- Vesting Phase

In accumulation phase the investor contributes and builds the corpus. Once the pension plan is matured the vesting phase starts where he starts receiving the payment either at one go or in the form of stable monthly income.

Investment in Pension Plans

The investments in the pension plans are dependent on the risk appetite of the individual. Pension plans in India come with investments in

1. Government Debt
2. Private Debt
3. Combination of Debt and Equity

The investments can be made by the investor based on his expected rate of returns and the amount he wishes to contribute.

- If the investor is very conservative he can choose only those pension fund which invests in government debt
- If the investor is moderately conservative and needs slightly better returns his choice of pension funds can be the ones investing in private debt.
- If the investor is willing to take risk he can consider a combination of both equity and debt.

Types of Pension Plans

Depending on the needs of the investors pension plans are classified into the following categories

1. National Pension System/Scheme
2. Deferred Annuity
3. Immediate Annuity
4. Annuity Certain
5. With Cover Pension Plan
6. Life Annuity
7. Pension Funds
8. Guaranteed Period Annuity Plan

Advantages of investing in Pension Funds

a. Option in Investment

b. Long-term savings

c. Choose how you want to get paid

d. Works as a life insurance cover

e. Negates the effect of Inflation

f. Access a lump sum amount during an emergency

Limitations of pension funds in India

- Contribution to the corpus of these pension funds are non taxable only to the tune of INR 1.5 Lakh under Section 80C of the income tax act. An additional INR 50,000 can be contributed to National Pension system (NPS) and can claim tax rebate.
- Except withdrawals of NPS on maturity, pension paid or proceedings received on maturity of pension funds is subject to tax
- If the corpus accumulated is high at the time of maturity of the pension fund, the investor can get high amount as pension. So if the investor starts at an early age he can get high pension but if he starts late, either he should contribute in large amounts to the corpus or end up with low pension payments after the plan matures
- The amount of pension received is dependent on the investments made by the pension plan and the returns it receives. If the investors expect high returns then he should choose those pension funds which park the investments in high risk instruments like equity shares.

Provident Funds

Provident fund is a retirement scheme in India managed by the government. An equal contribution from employee and employer from an employee’s salary is deposited in the provident fund account of the employee.

Simple annual interest is paid on the corpus every year, which is directly deposited into the provident fund account of the subscriber. If a person is not employed with any establishment he can still contribute to provident fund but they are offered in the form of Public Provident fund.

Since provident fund gives a huge corpus at the time of retirement or maturity at low risk with an option of tax savings, it is one of the sought after investment for employees as well individuals.

There are various types of provident funds that are in operational state in India. They are

- Public Provident Fund
- Recognized Provident Fund
- Unrecognized Provident Fund
- Statutory Provident Fund

Banking and NBFCs

Banking forms an important segment of the Indian financial system. It plays a key role in handling both cash and credit finances in the economy.

The primary role of banks is to collect deposits from the fund givers and channelize them in the form of credit to fund seekers thus fuelling the economic activity in the country.

Considering their importance in financing the growth of the economy, banking activities are strictly monitored by the government.

Reserve Bank of India, which is the central bank of India, supervises and regulates the banking operations with strict rules and regulations.

Classification of banks

Based on the nature of operations Banks can be classified as follows

- Commercial Banks
  - Public Sector Banks
  - Private Sector Banks
  - Foreign Banks
  - Regional Rural Banks
- Development Banks
- Cooperative Banks
  - Urban Co-operative Banks
  - State Co-operative Banks
  - District Co-operative Banks

Commercial Banks

Commercial banks collect deposits from the investors and issue loans to the borrowers.

As the name itself says commercial banks model of business involves profit making.

The functions of the commercial banks are listed below

- Collection of Deposits
- Advancing of Loans
- Creation of Credit
- Payments through Cheque

Regional Rural banks

Regional Rural Banks are also public sector banks which were started in 1975. The primary aim of these banks is to facilitate credit and finance for agriculture and allied activities in rural areas. Even other product activities that are taken up in rural areas are financed by these banks. The capital structure of these is provided as follows

- 15% by the concerned state government
- 35% by sponsoring public sector bank
- 50% by Central Government

Development banks

A development bank is a financial institution which is involved in the sectoral development and promotion in India.

Unlike commercial bank, a development bank doesn’t accept deposits from the general public.

The important features of a development bank are highlighted below

- Besides the existing financial institutions who has wide focus on economic activities, these banks exclusively focus on a sector and fills the financing gaps that are missed addressing by the other financial entities
- The financial assistance given by the development banks is applicable to both private as well public sectors
- The financing offered by these banks is generally medium to long term in nature.
- The role of these banks just doesn’t end by providing financial assistance to the borrowers but helps them in their business promotion from strategic level to operational level.
- They play a key role in the fuelling the growth rate of sectors they are dealing with

Cooperative banks

Cooperative Banks differ from commercial banks in terms of the business model.

Cooperative banks operate on no profit no loss business model which are operated by and elected committee.

Depending on their presence they plan and manage their activities. If they are operating in urban areas, their focus shall be on financing the needs of

- Self-Employment
- Entrepreneurs
- Small businesses and Industries

If they are operating in rural areas, their focus shall be on financing agriculture and allied activities like farming, livestock management, fisheries etc.

NBFCs

A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 1956 engaged in the business of loans and advances, acquisition of shares/stocks/bonds/debentures/securities issued by Government or local authority or other marketable securities of a like nature, leasing, hire-purchase, insurance business, chit business but does not include any institution whose principal business is that of agriculture activity, industrial activity, purchase or sale of any goods (other than securities) or providing any services and sale/purchase/construction of immovable property.

A non-banking institution which is a company and has principal business of receiving deposits under any scheme or arrangement in one lump sum or in installments by way of contributions or in any other manner, is also a non-banking financial company (Residuary non-banking company).

Banks Vs NBFCs

Though the activities of NBFCs are very much similar to banks i.e. making investments and lending loans to the fund seekers, they differ from banks on account of the following reasons.

- Banks can give access to deposit insurance facility to its depositors whereas depositors of NBFCs don’t have this option. The deposit insurance facility referred is of Deposit Insurance and Credit Guarantee Corporation.
- Demand deposits cannot be accepted by NBFCs.
- As far as payment and settlement system is concerned NBFCs are not a party to it and hence they are restricted from issuing cheques drawn on them

Categorization of NBFCs

NBFCs are categorized

- in terms of the type of liabilities into Deposit and Non-Deposit accepting NBFCs,
- non deposit taking NBFCs by their size into systemically important and other non-deposit holding companies (NBFC-NDSI and NBFC-ND) and
- by the kind of activity they conduct.

Categorization of NBFCs

Based on the above categorization, the following classification can be made with respect to NBFCs in India.

1. Asset Finance Company (AFC) :
2. Investment Company (IC) :
3. Loan Company (LC):
4. Infrastructure Finance Company (IFC):
5. Systemically Important Core Investment Company (CIC-ND-SI):
6. Infrastructure Debt Fund:
7. Non-Banking Financial Company - Micro Finance Institution (NBFC-MFI):
8. Non-Banking Financial Company – Factors (NBFC-Factors):
9. Mortgage Guarantee Companies (MGC) –
10. NBFC- Non-Operative Financial Holding Company (NOFHC)

Precautions while placing deposits with NBFCs

A depositor wanting to place deposit with an NBFC must take the following precautions before placing deposits:

1. That the NBFC is registered with RBI and specifically authorized by the RBI to accept deposits.
2. NBFCs have to prominently display the Certificate of Registration (CoR) issued by the Reserve Bank on its site.
3. The maximum interest rate that an NBFC can pay to a depositor should not exceed 12.5%.
4. The depositor must insist on a proper receipt for every amount of deposit placed with the company.
5. In the case of brokers/agents etc collecting public deposits on behalf of NBFCs, the depositors should satisfy themselves that the brokers/agents are duly authorized by the NBFC.

Thank You