

₹ 200

ISSN - 2249-555X

Volume : 1

Issue : 7

April 2012



Journal for All Subjects

www.ijar.in

Listed in International ISSN Directory, Paris.



ISSN - 2249-555X

Indian Journal of Applied Research

Journal for All Subjects

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Role of Investment Banks and Institutions in Economic Development

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ABSTRACT

The basic object of investment banks and institutions are to diversity by the small outlays of its shareholders or unit-holders, by operating the collective fund so accumulated through the medium of a large portfolio. Given its ability to safe investment using its professional managers, such a company is able to reduce risk exposure of its shareholders.

Keywords : Role of Investment Banks and Institutions in Economic Development

Banks play an important role in the process of economic development. Banking development is a prerequisite for the economic development of developing countries. It helps in strengthening and sound development of an economy by mobilizing funds in all sectors of the economy. Lack of banking activities is a hurdle in the way of development. Thus banking system is the heart of economic system which helps in smooth flow of finance in the economy. The development of industries, agriculture, trade-business, transport etc. all depends on banking development.

Meaning of Investment Banks and Institutions

Investment companies and investment trusts, as they are often known, are financial institutions which obtain funds from a large number of investors through the selling of shares or units. These funds are then placed in a pool under professional management, and securities are purchased for the benefit of all the shareholders. While investment in the fund may be made by either large or small savers, the investment institution exists primarily to offer the small saver a means to diversify securities in a manner to attain maximum return.

- (i) According to the Section 372 (10) of the Indian Companies Act, "an investment company is a company whose principal business is the acquisition of shares, Stocks, debentures or other securities."
- (ii) According to Reserve Bank of India (for the purpose, directions to non-banking institutions), "an investment company is any company not being a banking company carrying on as its principal business acquisition of securities but does not include any company which is an industrial concern or which carries on mainly the business of purchases and sale of any goods or commodities other than securities and which also acquires in the course of its business any securities as aforesaid."
- (iii) The essential task of investment institution, however in any economy, is to attract savings from the community and to invest these savings in industrial securities. For the successful working of such companies, it is necessary that they have expert, professional and independent management over a large number of securities reducing their risks of poor returns on and depreciation of capital.
- (iv) The Banking Commission in its study in (1968-69) defined an investment company, "as a public limited company, the main object of which is holding of investments

in securities and which derives at least 75% of its total income from such investments."

Investment companies provide investors with the best overall results. The picture of the individual as a direct owner of securities has been romanticized almost beyond recognition. In many ways investment companies resemble corporations which invest in land, machinery, building etc., only they invest in bonds, preferred stock and common stock of such other corporations. They are simply business corporations dealing in the securities of other corporations. Their assets are the securities owned and their liabilities are the same as in the company itself, sold to the investors. Their earning assets are the securities owned, which give income in the form of dividends and interest and capital gains. Each investment company tries to satisfy in the largest possible measure the special needs of a particular class of investors.

Role of Investment Banks and Institutions in Economic Development

Investment banks play a very vital role in the economic development of a country. Banks are essential for all types of economic systems whether they are developed or developing. No, developing country can make progress without setting up investment institutions in the country. The small savers have been vastly benefited by the operations of investment banks. The importance of investment institutions for developing countries may be depicted as follows :

- (i) **Promotion of Saving:** The basic function of investment bank is to mobilize the saving of the community and to utilize it in productive purposes. By Investment accepting deposits under different schemes they promote the habit of thrift and saving in the society. People collect their small saving and invest it in the investment banks to earn profitable returns. These small savings later result in capital formation in the country.
- (ii) **Capital Formation:** Through encouragement of savings among the people, the investment banks promote capital formation which is the basis of economic development of the country. These savings are used to provide loans to industries and business. The amount invested in the securities of industries used as capital to the industries. Thus, by collecting small savings investment banks help in capital formation and ultimately in the economic development of the country.

- (iii) Financing for Trade and Industries: The investment bank also encourages industrial development and business expansion through providing funds to entrepreneurs. Modern industries required a huge amount of capital. They cannot without sufficient capital. Investment banks finance small and large industries through purchasing their securities. Investment banks collect scattered small saving in the society and utilize this amount by giving loans to industries, business and Govt. They also help in increasing productivity of capital by providing funds to the entrepreneurs.
- (iv) Representative and Advisor: Investment banking activities are very useful for industries and traders. They provide a variety of services at low cost as an agent of the business units and save labour and time.
- (v) Employment Generation: Investment banks help in development and expansion of industrial and business activities. They have opened the vista of development in the country. With the growth of industrial, business and banking activities employment opportunities in the country have increased to a considerable extent.
- (vi) Finance for Priority Sectors: In an underdeveloped economy, commercial banks hesitate in extending financial accommodation to the priority sectors such as agriculture, small scale industries, on account of the risks involved therein. They mostly extend credits to trade and commerce where the risk involved is far less. But, for the development of these countries it is essential that banks take risks in extending credit facilities to the priority sectors. Nationalized investment institutions are doing this job successfully through providing loans to State Govt. for the development of social overheads.
- (vii) Innovations: Innovations are an essential prerequisite for economic development. These innovations required sufficient finance. In developed countries, investment institutions extend credit for innovations. But the entrepreneurs in developing countries cannot bring about these innovations for lack of adequate funds. The investment institutions should, therefore, pay special attention to the financing of business innovations in developing countries by extending cheap credit to the entrepreneurs.

Growth of Investment Institutions in India

Investment companies appeared on the Indian scene much later than in United States of America. Several factors were responsible for this among which mention may be made of delayed industrial investment, low volume of savings available for investment and the absence of adequate outlets for investment owing to the slow growth of joint stock companies.

The effective development of investment trust companies commenced only in the 30's following the report of the Indian Central Banking Enquiry Committee. The committee had suggested that the Government should encourage the development of investment trusts in India.

In 1933, the Industrial Investment Trust Ltd. was started by a Mumbai Brokerage Firm named Premchand Roychand & Sons. A number of investment trusts went into liquidation following the stock market crash in 1937. During the Second World War, interest in starting investment companies was revived. Many of the investment trusts in India were set up by business houses to promote their own interest. In the early stages of industrialization, the initial finance required for the promotion and development of industrial ventures was provided by business houses through investment holding companies controlled by them. Thus, the major objective of larger investment companies in India was to control, manage and assist the companies within their particular group.

In India, the investment trusts or the companies are of the management type and are formed under the Companies Act. Like joint stock companies engaged in commercial or industrial business, investment companies raise their capital by issue of shares and debentures to the public. They invest the funds thus raised in securities of various companies and also gilt-edged securities keeping in mind that "all eggs should not be put in the same basket." The profits of such companies comprise the dividends and interest received on the various securities purchased out of the raised capital. Like other companies they create reserves and distribute dividends out of the current profits.

The public sector financial institutions were set up in India with nationalization of Reserve Bank of India in 1948; in 1956 State Bank of India was setup by nationalization of the Imperial Bank. In 1956, the Life Insurance Corporation was set up by amalgamating 245 existing Life Insurance Companies. In 1964, Unit Trust of India of India came into existence under the Unit Trust of India Act, 1963. 14 and 6 big commercial banks were nationalized in 1969 and 1980 respectively. The General Insurance Corporation was setup in 1972 by reconstructing already General insurance Companies. Thus, Govt. of India has established new financial institutions in this era. Mutual funds were established by various public sector institutions such as LIC, GIC, UTI and different commercial banks as investment institutions.

At present, there are various investment institutions working in India. The main institutions among these are UTI, the Life Insurance Corporation of India, the General Insurance Corporation of India, various mutual funds etc.



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