

## **Preface**

1. SEBI has been receiving several representations from investors regarding the high cost of operating in a demat environment. There is also a perception in certain quarters that small investors are being overcharged and that the charges are beyond the capacity of certain class of investors. In order to examine these issues in the light of various research reports, press articles and representations made to SEBI, SEBI had set up an internal group.
2. The report of the group is placed below for public comments.
3. The comments, if any, on this report may please be forwarded to Shri V.S. Sundaresan, Deputy General Manager, SEBI or may be emailed to Ms. Sangeeta Uchil at [sangeetau@sebi.gov.in](mailto:sangeetau@sebi.gov.in) on or before February 20, 2004.

# **Report of the Group on Reduction of Demat Charges**

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## **Abbreviation**

|         |  |
|---------|--|
| BSE     | The Stock Exchange, Mumbai                     |
| CDSL    | Central Depository Services Limited            |
| DoT     | Department of Telecommunications               |
| DPs     | Depository Participants                        |
| DTCC    | Depository Trust and Clearing Corporation      |
| FFS     | Flat Fee Structure                             |
| ISIN    | International Securities Identification Number |
| MCS Ltd | MCS Limited                                    |
| MFs     | Mutual Funds                                   |
| NSDL    | National Securities Depository Limited         |
| ROI     | Return on Investment                           |
| RTA     | Registrar and Transfer Agent                   |
| SEBI    | Securities and Exchange Board of India         |
| SHCIL   | Stock Holding Corporation of India Limited     |
| UK      | United Kingdom                                 |
| USA     | United State of America                        |
| WAN     | Wide Area Network                              |

## **Background and Terms of Reference**

Ever since Depositories changed the method of charging depository participants on transactions, from the earlier method of ad valorem to flat fee structure (FFS), there has been a perception in certain quarters that small investors are overcharged. Further, it has been felt that the charges are beyond the bearable capacity sometimes for certain class of investors and thus it was reported that small investors have been driven away from the Indian equity market. In the light of various research reports, press articles and representations made to SEBI, it has been decided to examine the issue.

### **I. Issues Identified for the Study**

The group identified the following major issues for discussion and recommendations

- a) Whether small investor is over charged on account of shift in method of charging? Is the present method and procedure of charges justified? Is there any better alternative?
- b) What were the charges under paper based share certificate environment? Who bore the burden and who benefited?
- c) How demat charges were levied and collected in the early stages of demat?
- d) Need for shifting to the present system (FFS).
- e) Explore who benefited (savings) on account of changes in post-trade activities.
- f) How to reduce the burden on small investor? and
- g) Any other matter.

### **II. Pre-demat era (under paper based share certificate environment)**

The investors can be broadly classified into two groups on the basis of process of acquiring equity shares, viz. investors who get allotment of shares in the primary market and investors who purchase shares from the recognised stock exchanges (secondary market). Some of the risks involved in dealing with physical shares through public issue allotment and secondary market transactions can be identified as follows:

- Share certificates are sometimes lost in transit. In that scenario, the investors have to give an indemnity bond to Company, which involves a cost to the investor, besides depriving him of the opportunity to sell the shares at the opportune time.
- Time taken to receive the shares is also quite long compared to the present dematerialised environment.

- Secondary market operations were fraught with bad paper due to signature differences, forged and fake certificates, stolen certificates and delayed transfer resulting in low confidence in the market place.

In public issues, Companies were / are incurring several costs in distributing the share certificates to the investors. They are as follows:

- Printing of share certificates (@ about Rs 1.00 per certificate), RTA handling charges (@ about Rs 5.50 per folio), actual cost of dispatching by registered post and other expenses.

In case of investors purchasing the shares from the secondary market, there are certain costs incurred by the companies. After the shares are transferred into the investor's name, the expenses on corporate benefits distribution will be same for all shareholders owning the shares in physical form. These issues are discussed in the following paras.

### **III. Structure and Collection method of charges under paper based share safe-keeping and transfer mechanism.**

Under this method companies used to incur all expenses pertinent to share transfer in the name of the buyer. These could be classified into two broad categories on the basis their nature:

#### **(a) Variable expenses**

- (i) Share Transfer
- (ii) Maintenance of folio records.
- (iii) Custody of physical shares, etc.,
- (iv) Dividend and other corporate actions

#### **(b) Event Specific Expenses**

- (i) Issue of duplicate certificates
- (ii) Adhoc reports, etc.

Individual investor/Institutional investor was required to pay 0.5 percent of purchase value of share as stamp duty under physical environment which has been totally removed under demat conditions. Further, issues pertaining to bad paper like, signature difference, fake or forged certificate, etc. besides delay in transfer, are eliminated and thus investor is a direct beneficiary. The price risk faced by the investor has also been eliminated. As per some unofficial estimates, the cost related to the bad paper was to the extent of about 20 per cent of the market value of shares. Currently this figure is estimated to be almost nil.

#### **IV. Post-trade activities**

The post trade activities of the stock exchanges are handled by their respective Clearing house/corporation. In the physical environment, the Clearing house/corporation incurred several expenses on various heads as follows:

- Physical space required to collect share certificates
- Sorting them with respect to receiving member.
- Safekeeping of share certificates delivered at the Clearing house/corporation.
- Insurance costs.
- Huge human costs incurred for executing pay-in and pay-out activities.
- Transportation costs incurred in movement of physical share certificates from one metro to other metro for pay-in and pay-out.

On the basis of informal discussion, it can be stated that there is drastic reduction in cost of pay-in and pay-out facility. A part of it might have been passed on to brokers/ dealers of the stock exchanges. Further, as it has been observed in the study of M.T. Raju (2000), the brokerage fell significantly during this period for high networth investors. For small investor, the fall in the brokerage is not proportional even though there is a decline in the brokerage.

#### **V. Early period of demat**

The regulator, SEBI, had played a significant role in nurturing the promotion and growth of dematerialization for the benefit of all investors and for the cause of developing efficient securities market in India.

During the initial period, the depositories used to collect transaction charges as well as custodial charges on 'ad valorem' basis. This is directly related to the value of securities bought or sold and held in custody. Higher values attracted higher fees and vice-versa. There was a feeling under this system that the payment by the high networth investors and institutions was disproportionate to services received by them. In the demat environment, to a large extent, services rendered are invariant to value of transaction. In many other markets, the charges are levied on the basis of number of transactions which is also known as flat fee structure. In India, depositories subsequently switched over to flat fee structure of charges on transactions. .

However, notwithstanding this, in India the share ownership pattern is quite different from what it is, in the developed markets, as well as in some of the emerging markets. Considering the role of small investors in Indian capital market, we need to have a cost effective system which will address many of the issues concerning small investors. The dematerialization success story could be partly attributed to individual investor for his full support to the regulatory direction

of compulsory trading in demat environment for selected stocks in phases. As it was mentioned in the study of M.T. Raju and Prabhakar Patil (2001), Indian stock markets had taken significantly less time to complete the herculean task of dematerialization as compared to some of the developed markets like USA, UK, etc.

### **Depository Participants**

Depository participants (DPs) impose various charges on the institutional as well as on individual clients under various heads for providing services. The services available in dematerialised environment that are extended to the clients are as follows:

- Dematerialisation
- Rematerialisation
- Custodial services
- Debit or Credit facility
- Hypothecation
- Speed-e along with smart card
- Corporate benefits like bonus, stock split, dividend payment, etc.

This is an illustrative list of services available. The system of charging a fee for the services extended to an investor is in two-layers. The Depository charges the DPs and DPs in turn collect fee/charges from the investor. Each DP uses different norms to classify charges depending on the extent of services rendered. NSDL has a provision for collecting a one-time fee of 0.05 percent of market capitalization of the company, as custody fees for life. For these companies, no custody charge is supposed to be charged from the investors for life. The list of 55 companies that had paid this one time fee is enclosed in Annexure I. However, it is not clear whether DPs are passing this benefit to investors or not for these 55 companies.

### **VI. Charges under the present method FFS**

The depositories started charging DPs on FFS basis since May, 2002 and DPs in turn started charging on FFS basis to investors. This system is tilted in favour of high networth and institutional investors who trade in large quantities. The long term small investor who trade less frequently feel the unwanted burden of heavy outgo on account of FFS.

Custody charges are levied on the basis of ISIN numbers, irrespective of the value of shares in custody. As a result, there is a piquant situation, wherein on one side, the value of shares may be getting eroded while on the other hand the investors are required to pay custody charges that some times exceed the value of shares held in custody. This has been a very sour point. As the value of the



holding is small, the charges paid as percentage of value of their holding works out to be very high.

The DPs are generally required to pay the following as one time charges to NSDL, under the following heads:

- Non-refundable entry fee - Rs 25,000
- Minimum fee per year - Rs 1,50,000, irrespective of business volume
- Interest free refundable fee of Rs 10,00,000

Further, the DP will be incurring fixed and variable costs on account of establishment, staff, computers, WAN connectivity, stationary, postal or courier expenses and telephone. These costs will vary according to the size of operations, place of operations etc.

The companies have an opportunity to make one time payment of custody fee of 0.05 percent or five basis points on the market value of the shares computed on previous 26 weeks average of market price of the equity. In these cases investors are not required to pay any custodial charges. This seems to be a viable alternate/solution since the custodial charges will then be 'nil' for the investors, for ever.

## **VII. Analysis and Discussion**

Table 1 A shows some of the basic costs involved in physical and demat environment for different sizes of share folios. The costs taken into consideration are from a leading RTA and the size is hypothetical for computational purposes. It is clearly evident from the table that as the number of folios increases, the benefits, in the form of reduction in Company's costs, also increase. Thus, the size and costs are inversely related and benefits positively related. Therefore, a company having a large shareholder base derives maximum benefit out of the depository environment.

**Table 1 A: Costs Involved in Alternative Scenarios (in Rupees)**

|   | <b>50,000 Folios</b> | <b>One Lakh Folios</b> | <b>Two Lakh Folios</b> | <b>Five Lakh Folios</b> | <b>Ten Lakh Folios</b> |
|---|----------------------|------------------------|------------------------|-------------------------|------------------------|
| <b>Under Physical Environment</b>                   |                      |                        |                        |                         |                        |
| R&T Service Charges(PA)                             | 2,75,000             | 5,50,000               | 11,00,000              | 27,50,000               | 55,00,000              |
| Charges for Transfer of Shares or Bonds             | 75,000               | 1,50,000               | 3,00,000               | 7,50,000                | 15,00,000              |
| Charges for issue of Duplicate or split certificate | 25,000               | 50,000                 | 1,00,000               | 2,50,000                | 5,00,000               |
| Certificate   | 75,000               | 1,50,000               | 3,00,000               | 7,50,000                | 15,00,000              |

|  |          |          |           |           |           |
|--|----------|----------|-----------|-----------|-----------|
| Printing with all safety features            |          |          |           |           |           |
| Total Minimum Cost                           | 4,50,000 | 9,00,000 | 18,00,000 | 45,00,000 | 90,00,000 |
| <b>Under Demat Environment</b>               |          |          |           |           |           |
| R&T Service Charges, Lump sum per annum      | 50,000   | 50,000   | 50,000    | 50,000    | 50,000    |
| Connectivity Charges for NSDL&CDSL per annum | 40,000   | 40,000   | 40,000    | 40,000    | 40,000    |
| One time charge of dematerialization         | 1,75,000 | 3,50,000 | 7,00,000  | 17,50,000 | 35,00,000 |
| Total Minimum Cost                           | 2,65,000 | 4,40,000 | 7,90,000  | 18,40,000 | 35,90,000 |
| Savings                                      | 1,85,000 | 4,60,000 | 10,10,000 | 26,60,000 | 54,10,000 |
| Savings (%)                                  | 41.11    | 51.11    | 56.11     | 59.11     | 60.11     |

**Table 1 B: Cost of One Time (life time) Custodial Payment by a Company (in Rs)**

|  |                 |                 |                  |                  |                  |
|--|-----------------|-----------------|------------------|------------------|------------------|
| Savings from Table 1A                        | 1,85,000        | 4,60,000        | 10,10,000        | 26,60,000        | 54,10,000        |
| <b>Market Capitalization (Rs)</b>            | <b>10 Crore</b> | <b>50 Crore</b> | <b>100 Crore</b> | <b>250 Crore</b> | <b>500 Crore</b> |
| 0.05% to be paid by cos. (Lifetime)          | 50,000          | 2,50,000        | 5,00,000         | 12,50,000        | 25,00,000        |
| Savings under 0.05%                          | 1,35,000        | 2,50,000        | 5,00,000         | 12,50,000        | 25,00,000        |
| 0.10% proposed to be paid by cos. (Lifetime) | 1,00,000        | 5,00,000        | 10,00,000        | 25,00,000        | 50,00,000        |
| Savings under 0.10%                          | 85,000          | -40,000         | 10,000           | 1,60,000         | 4,10,000         |

NSDL accepts one-time payment of 5 basis points (0.05 percent) from a company on its market capitalization and thereafter completely exempts custody charges to its DPs on securities of such companies. Based on an hypothetical size of market capitalization of Rs 10 crore to Rs 500 crore, the one-time custodial cost for the company will range in Rs 50,000 to Rs 25 lakh. A look at the table 1B clearly shows that after paying one time existing custodial charges, the companies would still make a lot of savings on annual basis whereas the amount paid to depository is a onetime one. On the basis of proposed 10 basis points payment also companies make substantial savings.

Table 2 shows a broad picture of charges levied by DPs and this information is downloaded from NSDL website. For the present study, the costs shown in the table pertain to highest charged by a DP and may not necessarily be by each

DP. The account opening fee ranges from nil to Rs 500 and the actual cost incurred by DPs for opening account are on the account of stamp paper, stationary, human labour, office space and computer time. Some of the DPs are not charging any fee on this account for active traders or institutional investors. Thus, it shows a skewed pattern of charges.

**Summary Observations on DP Charges are as under:**

- Dematerialisation charges of NSDL are nil however, the DPs charge goes as high as Rs 23 per certificate plus courier charges of Rs 30..
- The remat charges of DPs is ten times more than the depositories' charge.
- The account maintenance fee of Rs 1200 per annum charged by DPs is not charged by Depository at all.
- Custodial charges are three times of the amount charged by the depository.
- Buy or Sell transaction instruction for demat shares is costing a minimum of Rs 20 per transaction which was not there in physical environment.

**Table 2: Summary of selected charges levied by DPs to Clients**

| S.No. | Activity            | Cost  | Remarks  |
|-------|---------------------|---|--|
| 1.    | Account Opening Fee | Rs 500  | Includes cost of stamp paper   |
| 2.    | Demat Charges       | Rs 53 (per certificate, minimum)              | Includes courier charges. However, NSDL will not charge any fee  |
| 3.    | Remat Charges       | Rs 100 (per certificate)                      | Vary between Rs 10 to Rs 100, NSDL charges are Rs 10 per certificate only.   |
| 4.    | Account Maintenance | Rs 1200 per annum                             | Some DPs are not charging, if there is a deposit   |
| 5.    | Custody charges     | Rs 1.50 per ISIN per month                    | NSDL charges Rs 0.50 per ISIN Per month  |
| 6.    | Buy Transaction     | 0.05% of value or Rs 20 (whichever is higher) | NSDL charges Rs 1.00 per instruction in respect of securities received from the Clearing Corporation into the Receipt-in account of each Clearing member.. |
| 7.    | Sell Transaction    | 0.06% of value or Rs 20 (whichever is higher) | NSDL charges Rs 10.00 per debit instruction in a Client's account shall be charged to the participant of the Client..                                      |
| 8     | Account Closing     | Rs 250 or Rs 25 per ISIN                      | Besides NSDL charges for off-market transaction charges at the time of closing account.  |

Table 3 presents the historical change in the costs of custody and transaction services.

**Table 3: Changes in Demat Custody and Transaction Charges**

| <b>Reduction in Custody Charges by NSDL</b>     |                         |                                  |                           |
|---|-------------------------|----------------------------------|---------------------------|
| <b>Date of Circular</b>                         | <b>With effect from</b> | <b>Old Charges</b>               | <b>New Charges</b>        |
| 21-Jul-97                                       | 1-Aug-97                | 7 basis pts                      | 3.5 basis pts             |
| 25-Aug-98                                       | 1-Oct-98                | 3.5 basis pts                    | 2 basis pts               |
| 2-Feb-99  | 1-Apr-99                | 2 basis pts                      | 1 basis pts               |
| <b>Reduction in Transaction Charges by NSDL</b> |                         |                                  |                           |
| 2-Feb-99  | 1-Apr-99                | 5 basis pts                      | 4 basis pts               |
| 19-Jul-99                                       | 1-Aug-99                | 4 basis pts                      | 2 basis pts               |
| 20-Jul-00                                       | 1-Sep-00                | 2 basis pts on both buy and sell | 2 basis pts only for sell |
| 26-Feb-02                                       | 1-May-02                | 2 basis pts only for sell        | Flat Rs 10 per debit (**) |

(\*\*) **Due to the benefit derived out of increased volumes to the market, NSDL revised the fee structure w.e.f. 01/01/04 for debit instruction from Rs.10/- to Rs.8/- , i.e. reduction of 20%. DPs were also advised to pass on the said reduction to the beneficial owners.**

The table 4 presents qualitative characteristics of physical and demat environment. Under the demat environment every constituent of the market got benefited.

**Table 4: Status of Constituent in Physical and Demat Environment**

| <b>Constituent</b>          | <b>Physical Era</b> |  | <b>Demat Era</b> |  |
|-----------------------------|---------------------|--|------------------|--|
|                             | <b>Costs</b>        | <b>Remarks</b>   | <b>Costs</b>     | <b>Remarks</b>                                   |
| Company                     | V. high             | Investor complaints, bad reputation                                    | Marginal         | No investor complaints, reduced cost of capital. |
| Clearing House/ Corporation | V. high             | Large work force maintained  | Marginal         | Increased volumes leading to higher profits      |
| Stock Exchanges             | V. high             | Handling of large volumes(difficult), increased cost of infrastructure | Marginal         | Increased volumes leading to higher profits      |
| Brokers/dealers             | V. high             | Bad delivery, theft, postal delay in receiving /                       | Marginal         | No such evils, no postal loss, increased volumes |

|                  |         |   |          |  |
|------------------|---------|---|----------|--|
|                  |         | delivering shares from/to clients                             |          | leading to higher profits                          |
| Investors        |         |   |          |  |
| Institutional    | V. high | Bad delivery, theft, delivery in market lots, custodial costs | Low      | Good delivery, low custodial costs, nil stamp duty |
| Retail Investors | V. high | Bad delivery, theft   | Moderate | Good delivery, nil stamp duty                      |

### **VIII. Recommendations**

On the basis of data collected, analyzed and discussions held, the group has made the following recommendations:

#### **Transaction Charges**

a) This small investor<sup>1</sup> should be charged on the basis of ad valerom only.

#### **Custody Charges**

b) Since companies have derived largest part of the benefits accrued on account of dematerialization, it is proposed that the companies may be advised to pay one time fee to the depository concerned at the rate of 0.1 per cent of market cap of that particular company on the existing lines or on the basis of number of post issue shares. In case of new companies it may be worked out on the basis of the post-issue paid up capital or the number of post issue shares, as mentioned in the prospectus. The same may be implemented in a phased and time bound manner.<sup>2</sup>

c) Further, charges like account maintenance and demat charges should not be levied on small investors at all, by DPs.

#### **Account Closure Charges**

d) As long as the investor is under demat environment and desires to shift his account from one DP to another DP (owing to some perceived advantages) the investor may be permitted to close his account with the existing depository participant without any transaction charges or other incidental charges, as are being levied currently<sup>3</sup>. The account closure charges may be collected if he / she / it is going out of the demat environment.

<sup>1</sup> An investor who buys or sells securities worth Rs. 50,000 or less on any business day. The other alternative of defining small investor could be based on the maximum number of transactions carried out in a financial year e.g. 60 transactions in a year.

<sup>2</sup> In order to implement this recommendation of levying fees from the companies, SEBI may have to amend listing agreement of the stock exchanges and other relevant legal provisions.

<sup>3</sup> The rationale is that the investor is still in the demat environment.

- e) Alternately, Depositories may consider giving one time exemption from account closing fee for switch over from one entity to other.

#### **Standardisation and Uniformity**

- f) DPs charge under various heads and there is no uniformity across the DPs. Some times, it appears there are excessive charges on certain heads. Therefore, there is a need to rationalize this structure as much as possible.

### **IX. Assumptions**

Like any other study in Financial Economics, this study and its recommendations are also based on certain assumptions. The following are some of the assumptions:

- 1) Securities market as a whole has benefited by the dematerialization;
- 2) The small investors have been charged highly;
- 3) Companies, as a constituent, derived maximum pecuniary benefit;
- 4) Companies are expected to pay one time charges;
- 5) Folio-size and cost calculating;
- 6) Folio-size and market capitalization do not always have direct relationship.

**List of Companies that had made One Time Payment to NSDL**

NSDL accepts a one-time payment of 5 basis points (0.05%) from a company on its market capitalisation and thereafter completely exempts custody charges to its DPs on securities of such companies. The following companies have so far opted for this scheme:

**List of Companies**

1. Apple Finance Ltd.
2. Aurobindo Pharma Ltd.
3. Bank of India
4. Blow Plast Ltd.
5. BPL Engineering Ltd.
6. BPL Ltd.
7. BPL Refrigeration Ltd (Now B. S. Refrigeration Ltd.)
8. BPL Sanyo Utilities & Appliances Ltd. (Now B.S. Appliances Ltd.)
9. BSES Ltd
10. Carborundum Universal Ltd.
11. Cholamandalam Investment & Finance Co. Ltd.
12. Crompton Greaves Ltd.
13. Cybertech Systems and Software Ltd.
14. DGP Windsor Ltd.
15. EID Parry Ltd.
16. Finolex Industries Limited
17. Geometric Software Solutions Limited
18. Global Trust Bank Limited
19. HCL Infosystems Ltd.
20. Himatsingka Seide Ltd.
21. Housing and Urban Development Corporation Limited (Only for ISINs INE031A09010, INE031A09028, INE031A09036,

INE031A09044)

22. IDBI Limited
23. IndusInd Bank Limited
24. Infosys Technologies Limited
25. Integrated Enterprises (I) Ltd
26. Isibars Ltd.
27. JBF Industries Ltd.
28. K.G. Denim Ltd.
29. Krishna Filaments Limited
30. LIC Housing Finance Ltd.
31. LKP Merchant Financing Ltd
32. Max India Ltd
33. Modern Home Credit & Capital Ltd. (Now Modern Shares & Stockbrokers Ltd.)
34. Mukand Ltd
35. Navneet Publications (India) Ltd.
36. Onward Technologies Limited
37. Parrys Confectionery Ltd.
38. Pidilite Industries Ltd.
39. Polaris Software Lab Ltd.
40. Prism Cement Limited
41. Rolta India Limited
42. Sabero Organics Gujarat Ltd.
43. Sonata Software Limited
44. SQL Star Int'l
45. Supreme Industries Ltd
46. TFCI Ltd.



47. The Dhampur Sugar Mills Limited
48. The United Western Bank Limited
49. Tube Investments of India Ltd.
50. Usha (India) Ltd.
51. UTI Bank Ltd.
52. VIP Industries Ltd.
53. Wartsila NSD India Ltd
54. Weizmann Ltd.
55. Wipro Limited

**Details of Reports and Information referred to**

The Group has referred the following published documents:

- Report of the Committee constituted by SEBI on reduction in the Cost for the Investors relating to demat operations Chaired by C.B. Bhave
- L.C. Gupta, Navin Jain and Utpal Choudhury, “Why Ordinary Investors Remain Disenchanted”
- Sucheta Dalal story on “The Disenchanted Ordinary Investor”, Indian Express
- M.T. Raju, “Transaction Cost for Equity Shares in India (Revised), November 2000, SEBI working paper, 2000.
- M.T. Raju and Prabhakar Patil, “Dematerialisation: A Silent Revolution in the Indian Capital market” March 2001, SEBI working paper.
- Mr. Narasimhan, CEO, MCS had provided lot of statistics on various charges