MP-502

Vardhaman Mahaveer Open University, Kota

Financial Services

Course Development Committee

Chairman
Prof. (Dr.)Vinay Kumar Pathak
Vice-Chancellor
Vardhaman Mahaveer Open University, Kota

Subject Convener and Coordinator
Prof. (Dr.) P.K. Sharma
Director (School of Commerce and Management),
Vardhman Mahaveer Open University, Kota

Editing and Course Writing

Editor
Dr. Anurodh Godha
Assistant Professor, Commerce
School of Commerce and Management,
Vardhman Mahaveer Open University, Kota

Unit Writers	Unit No.
1. **Dr. Naveen Kumar Sharma** Assistant Professor (Management Studies), Govt. Engineering College, Bikaner	**(1, 5)**
2. **Dr. Kamlesh Pritwani** Governent College, Nasirabad	**(2)**
3. **Dr. D.D. Bedia** Associate Professor, Faculty of Management Studies, Vikram University, Ujjain	**(3, 10)**
4. **Ms Geeti Sharma** IIIM, Jaipur	**(4, 7, 9)**
5. **Dr. Ishi Mohan** Asst. Professor (Commerce) Banaras Hindu University, Varanasi	**(6, 14, 16)**
6. **Dr. Meenu Maheshwari** Asst. Professor (Commerce & Management) University of Kota, Kota	**(8, 17)**
7. **Dr. Ira Bapna** Professor MRS Institute of Management, Indore	**(11)**
8. **Dr. Ashok Gupta** Government Commerce College, Kota	**(12)**
9. **Prof. Raj Kumar** Banaras Hindu University, Varanasi	**(15)**

Academic and Administrative Management

Prof. Vinay Kumar Pathak	**Prof. L.R.Gurjar**	**Prof. Karan Singh**
Vice-Chancellor	Director (Academic)	Director (MPD)
Vardhaman Mahaveer Open University, Kota	Vardhaman Mahaveer Open University, Kota	Vardhaman Mahaveer Open University, Kota

Production November, 2014 ISBN-

MP-502

Vardhaman Mahaveer Open University, Kota

CONTENTS

Financial Services

Unit - 1 : Financial System in India

Structure of Unit:

1.0 Objectives

After completing this unit, you would be able to:

- Understand the meaning of financial system;
- Know the objectives and significance of financial system;
- Know various functions of financial system;
- Understand the key elements of a well functioning financial system;
- Discuss the various components of Indian financial system;
- Classify the Indian financial markets, financial services, financial assets and financial institutions;
- Know how regulatory body regulates the Indian financial system;
- Point out role of financial system in economic development;
- Describe the major weakness of Indian financial system.

1.1 Introduction

The financial system plays an important role in promoting economic growth not only by channeling savings into investments but also by improving allocate efficiency of resources. An efficient financial system is now regarded as a necessary pre-condition for growth for any country. In finance, the financial system is the system that allows the transfer of money between savers and borrowers. It comprises a set of complex and closely interconnected financial institutions, markets, instruments, services, practices, and transactions. Financial systems are crucial to the allocation of resources in a modern economy. They channel household savings to the corporate sector and allocate investment funds among firms; they allow inter-temporal smoothing of consumption by households and expenditures by firms; and they enable households and firms to share risks. These functions are common to the financial systems of most developed economies. Yet the form of these financial systems varies widely.

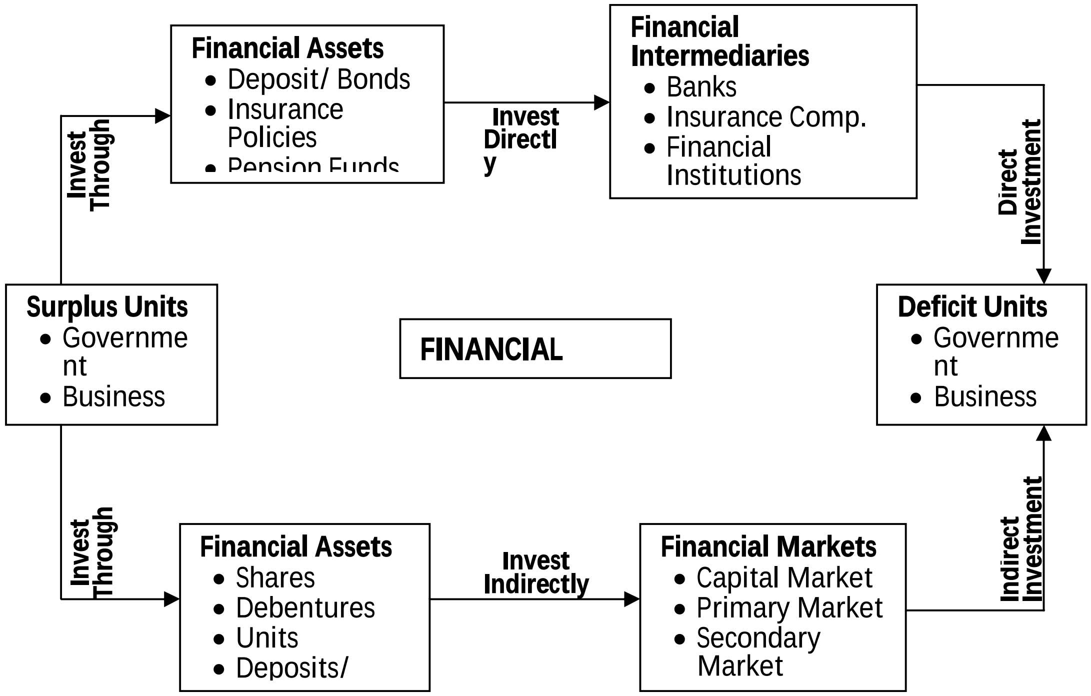


Figure: 1.1 – Working of Financial System

1.2 Objectives of Financial System

The objectives of the financial system are:

- To accelerate the growth of economic development
- To encourage rapid industrialization
- To act as a medium to various economic factors such as industry, agriculture sector, Government, etc.
- To provide necessary financial support to industry
- To finance housing and small scale industries
- To accelerate development of backward and rural areas, infrastructure, and livelihood
- To control the interest rate
- To safeguard the financial environment

1.3 Significance of Financial System

Financial system ensures that transactions are effected, smoothly and quickly on an ongoing basis. It enables agents to accelerate the financial growth and economic prosperity of the unit. The uses of the financial system are as follows:

- It provides an ideal link between depositors/savers and investors
- It encourage savings and investment in the economy
- It facilitates expansion of financial markets over a period of time
- It promotes banking sector as well as financial institutions
- It involves an efficient operation of the payment mechanism
- It enhance liquidity of financial claims through securities trading

- It assist in the diversification and reduction of financial risk
- It promotes allocation of financial resources
- It assists in generating new financial instruments over a period of time
- It influences the pace of economic development

1.4 Functions of Financial System

Financial systems are of crucial significance to capital formation. That adequate capital formation is indispensable to a seedy economic development is universally recognized in academic literature. The main function of financial system is the collection of savings and their distribution for industrial investment, thereby stimulating the capital formation and, to that extent, accelerating the process of economic growth. The process of capital formation involves three distinct, although inter-related activities:

i. **Savings:** The ability by which claims to resources are set aside and become available for other purpose.
ii. **Finance:** The activity by which claims to resources are either assembled from those released by domestic savings, obtained from abroad or specially created usually as bank deposits or notes and then place in the hands of the investors.
iii. **Investments:** The activity by which resources are actually committed to production.

The volume of capital formation depends upon the intensity and efficiency with which these activities are carried on. The effective mobilization of savings, the efficiency of the financial organization/ system and the channelization of these savings into the most desirable and productive forms of investment are all inter-connected and have a great bearing on the contribution of capital formation to economic development.

As we know, financial system is very important for the economic and all round development of any country, its major functions can be explained as following:

(i) **Promotion of Liquidity:** The major function of the financial system is the provision of money and monetary assets for the production of goods and services. There should not be any shortage of money for productive ventures. In financial language, the money and monetary assets are referred to as liquidity. In other words, the liquidity refers to cash or money and other assets which can be converted into cash readily without loss. Hence, all activities in a financial system are related to liquidity – either provision of liquidity or trading in liquidity.

(ii) **Mobilizations of Savings:** Another important activity of the financial system is to mobilize savings and channelize them into productive activities. The financial system should offer appropriate incentives to attract savings and make them available for more productive ventures. Thus, the financial system facilitates the transformation of savings into investment and consumption. The financial intermediaries have to play a dominant role in this activity.

(iii) **Provides a Payment Mechanism:** It provides a payment mechanism for the exchange of goods and services and transfers economic resources through time and across geographic regions and industries. Payment and settlement systems play an important role to ensure that funds move safely, quickly, and in a timely manner. An efficient payment and settlement system contributes to the operating and allocation efficiencies of the financial system and thus, overall economic growth. Payment and settlement systems serve an important role in the economy as the main arteries of the financial sector. Banks provide this mechanism by offering a means of payment facility based upon cheques, promissory notes, credit and debit cards. This payment mechanism is now increasingly through electronic means. The clearing and settlements mechanism of the stock markets is done through depositories and clearing corporations.

(iv) **Optimum Allocation of Risk Bearing**: One of the most important functions of a financial system is to achieve optimum allocation of risk bearing. It limits, pools, and trades the risks involved in mobilizing savings and allocating credit. An efficient financial system aims at containing risk within acceptable limits. It reduces risk by laying down rules governing the operation of the system. Risk reduction is achieved by holding diversified portfolios and screening of borrowers. Market participants gain protection from unexpected losses by buying financial insurance services. Risk is traded in the financial markets through financial instruments such as derivatives. Derivatives are risk shifting devices, they shift risk from those who have it but may not want it to those who are willing to take it.

(v) **Offers Portfolio Adjustment Facilities**: A financial system also offers portfolio adjustment facilities. These are provided by financial markets and financial intermediaries such as banks and mutual funds. Portfolio adjustment facilities include services of providing a quick, cheap and reliable way of buying and selling a wide variety of financial assets.

(vi) **Helps in Promoting the Process of Financial Deepening and Broadening:** A well-functioning financial system helps in promoting 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 depth is an important measure of financial system development as it measures the size of the financial intermediary sector. Depth equals the liquid liabilities of the financial system (currency plus demand and interest-bearing liabilities of banks and non-bank financial intermediaries divided by the GDP). Financial broadening refers to building an increasing number and variety of participants and instruments.

1.5 Key Elements of Financial System

The basic elements of a well-functioning financial system are (i) a strong legal and regulatory environment, (ii) stable money, (iii) sound public finances and public debt management, (iv) a central bank, (v) a sound banking system, (vi) an information system, and (vii) a well-functioning securities market.

- **(i) A Strong Legal and Regulatory Environment:** Since finance is based on contracts, strong legal and regulatory systems that produce and strictly enforce laws alone can protect the rights and interests of investors. Hence, a strong legal system is the most fundamental element of a sound financial system.
- **(ii) Stable Money:** Stable money is an important constituent as it serves as a medium of exchange, a store of value (a reserve of future purchasing power), and a standard of value (unit of account) for all the goods and services we might wish to trade in. Large fluctuations and depreciation in the value of money lead to financial crises and impede the growth of the economy.
- **(iii) Sound Public Finances and Public Debt Management:** Sound public finance includes setting and controlling public expenditure priorities and raising revenues adequate to fund them efficiently. Historically, these financing needs of the governments over world led to the creation of financial systems. Developed countries have sound public finances and public debt management practices, which result in the development of a good financial system.
- **(iv) A Central Bank:** A central bank supervises and regulates the operations of the banking system. It acts as a banker to the banks, banker to the government, manager of public debt and foreign exchange, and lender of the last resort. The monetary policy of the central bank influences the pace of economic growth. An autonomous central bank paves the way for the development of a sound financial system.
- **(v) A Sound Banking System:** A good financial system must also have a variety of banks both with domestic and international operations together with an ability to withstand adverse shocks without failing. Banks are the core financial intermediaries in all countries. They perform diverse key functions such as operating the clearing and payments system, and the foreign exchange market. The banking system is the main fulcrum for transmitting the monetary policy actions. Banks also undertake credit risk analysis, assessing the expected risk and return on the projects. The financial soundness of the banking system depends on how effectively banks perform these diverse functions.
- **(vi) An Information System:** Another foundational element is information. All the participants in a financial system require information. A sound financial system can develop only when proper disclosure practices and networking of information systems are adopted.

(vii) A Well Functioned Security Market: Securities markets facilitate the issue and trading of securities, both equity and debt. Efficient securities markets promote economic growth by mobilizing and deploying funds into productive uses, lowering the cost of capital for firms, enhancing liquidity, and attracting foreign investment. An efficient securities market strengthens market discipline by exerting corporate control through the threat of hostile takeovers for underperforming firms.

1.6 Classification of the Indian Financial System

The Indian financial system can also be broadly classified into the formal (organized) financial system and the informal (unorganized) financial system. The formal financial system comes under the purview of the Ministry of Finance (MoF), the Reserve Bank of India (RBI), the Securities and Exchange Board of India (SEBI), and other regulatory bodies. The informal financial system consists of:

- Individual moneylenders such as neighbors, relatives, landlords, traders, and storeowners.
- Groups of persons operating as 'funds' or 'associations.' These groups function under a system of their own rules and use names such as 'fixed fund,' 'association,' and 'saving club.'
- Partnership firms consisting of local brokers, pawnbrokers, and non-bank financial intermediaries such as finance, investment, and chit-fund companies.

In India, the spread of banking in rural areas has helped in enlarging the scope of the formal financial system.

1.7 Components of the Indian Financial System

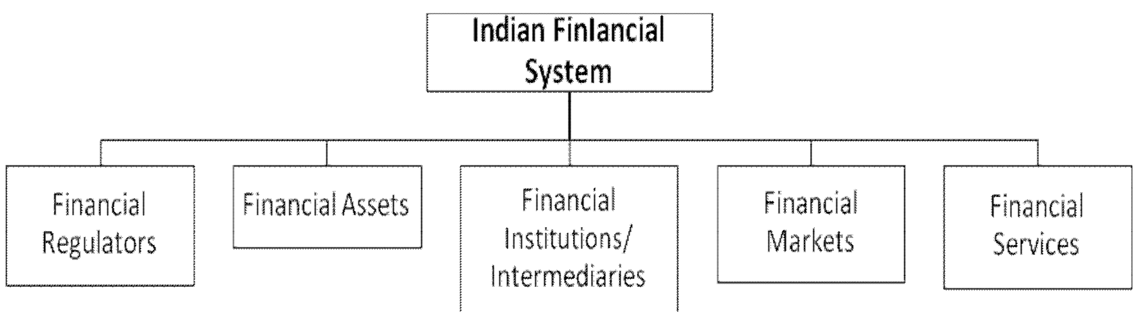


Figure: 1.2 – Classification of Indian Financial System

1.7.1 Financial Regulators

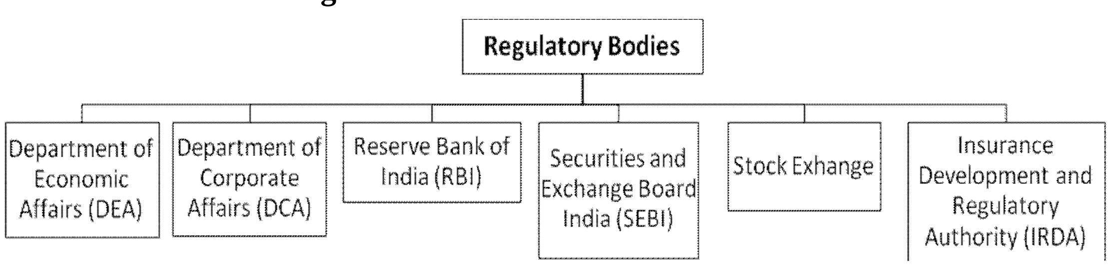


Figure: 1.3 – Regulators of Indian Financial System

The financial system in India is regulated by independent regulators in the banking, insurance, and capital market. Apart from that, the Central Government plays the role of a regulator in a number of sectors. The regulators ensure that market participants behave in a desired manner so that the securities market continues to be a major source of finance for corporate and the Government and the interests of investors are protected. Policy formulation and the regulation of the Indian financial market are made under the guidance of the Ministry of Finance (MoF) and the Reserve Bank of India (RBI).

The Securities and Exchange Board of India (SEBI) regulates and supervise the securities market; and the Insurance Development and Regulatory Authority (IRDA) regulates the insurance market. The SEBI is the apex regulatory body of the securities market. The RBI- as the country's central bank- plays its role in the banking supervision by an enactment in 1949. The RBI, on the other hand, is responsible for the regulation of a certain well defined well-defined segment of the securities market. As the manager of public debt, the RBI is responsible for primary issues of Government securities. The RBI Mandate also includes: (i) the regulation of all contracts in Government securities; (ii) gold related securities; and (iii) Money market securities. The RBI Exercise a tight regime of exchange control, particularly under the Foreign Exchange Management Act (FEMA) in June 2000, which replaced the earlier Foreign Exchange Regulation Act (FERA) 1973. Currently, the responsibility- of regulating the security market- primarily rests with the SEBI, but is shared by the Department of Economic Affairs; The Department of Company Affairs; and the RBI. The capital market division- of the Department of Economic Affairs, under the Ministry of Finance- is entrusted with the responsibility of formulating suitable policies for the development of the capital market in consultation with SEBI, RBI, and other agencies. It is, therefore, evident that the responsibility-for regulating the financial system- is discharged by the following bodies:

- Department of Economic Affairs (DCA)
- Department of Company Affairs (DCA)
- Reserve Bank of India (RBI)
- Securities and Exchange Board of India (SEBI)
- Stock Exchanges
- Insurance Development and Regulatory Authority (IRDA)

1.7.2 Financial Assets

In any financial transaction, there should be a creation or transfer of financial assets. Hence, the basic product of any financial system is the financial asset. A financial asset is one which is used for production or consumption of for further creation of asset.

Example*: Mr. Jangid buys 100 equity shares @ Rs. 15 per shares. These shares are financial assets, since they earn income (dividend) in future*

In this context, one must know the distinction between financial assets and physical assets. Unlike financial assets, physical assets are not useful for further production of goods or for earning income. Many physical assets are useful for consumption only.

It is interesting to note that the objective of investment decides the nature of the asst. For instance if a building is bought for residence purpose, it becomes a physical asset. If the same is bought is for hiring, it becomes a financial asset. Financial assets can be classified differently under different circumstances. One such classification is:

i. **Marketable Assets:** Marketable assets are those which can be easily transferred from one person to another without much hindrance.

   Example: Shares of listed companies, Government securities, Bonds of public sector undertakings etc.

ii. **Non-Marketable Assets:** On the other side, if the assets cannot be transferred easily, they came under this category.

   Cash Asset: In India, All coins and currency notes are issued by the RBI and the Ministry of Finance, Government of India. Besides, Commercial bank can also create money mean of creating credit. When loans are sanctioned, liquid cash is not granted. Instead an account is opened in the borrower's name and a deposit is created. It is also a kind of money or cash asset.

   a. **Debt Asset:** Debt asset is issued by a variety of organization for the purpose of raising their debt capital. Debt capital entails a fixed repayment schedule with regard to interest and principal. There are different ways of raising debt capital. Examples are issue of debentures, raising term loans etc.

   b. **Stock Assets:** Stock is issued by business organizations for the purpose of raising their fixed capital. There are two types of stock namely equity share capital and preference share capital.

1.7.3 Financial Institutions/Intermediaries

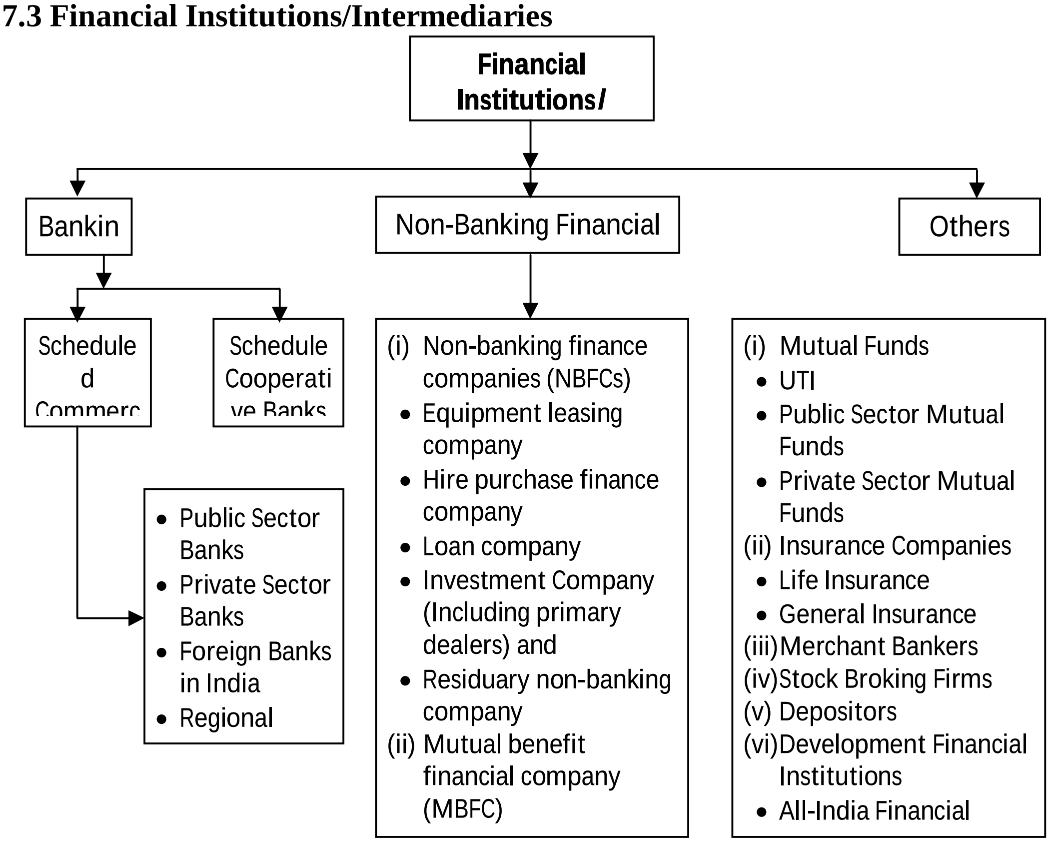


Figure: 1.4 – Financial Institutions/Intermediaries in Indian Financial System

Financial Institutions/Intermediaries in India comprise banking institutions; non banking financial institutions; and other financial institutions. These are briefly discussed as under:

I. **Banking Financial Institutions:** 14 major private banks were nationalized to meet the requirements of the planning and economic policy. This was an important milestone in the history of Indian banking in 1969. Subsequently, in 1980, another 6 private banks were also nationalized by the Government of India. Scheduled banks in India comprise: (i) Scheduled Commercial Banks (SCBs), and (ii) Scheduled Co-operative banks. SCBs form foundation of the financial system in India. SCBs-with more than 80,500 branches-are functioning across the country. So far as structure of commercial banking is concerned, SCBs are of 4 types: (i) public sectors banks; (ii) private sectors banks; (iii) foreign banks in India, and (iv) regional rural banks (RRBs).

II. **Non-Banking Financial Entities:** Non-banking financial entities-particularly, or wholly, regulated by RBI- comprise; (i) Non- Banking Financial Companies (NBFCs) consisting of equipment leasing companies, hire purchase finance companies, loan companies and investment companies (including primary dealers and residuary non-banking (RNBC) companies; (ii) Mutual Benefit Financial Company (MBFC); (iii) Mutual Benefit Company (MBF), and (iv) Miscellaneous Non-Banking Company (MNBC).

   i. ***Non-Banking Financial Companies (NBFCs):*** In terms of Section 45-1(f) read with Section 45-i(c) of the RBI Act 1934,as amended in 1997, the principal business of non-banking financial companies is that receiving deposits or of financial institutions such as: (i) lending; (ii) investing in securities; (iii) hire purchase finance or equipment leasing. Therefore, NBFCs include;

   - Equipment leasing companies
   - Hire purchase
   - Loan Company
   - Investment Company (including primary dealers)
   - Residuary non-banking company

   ii. ***Mutual Benefit Financial Company (MBFC):*** An MBFC is any company which is notifies by the Central Government as a Nidhi Company under section 620A of the Companies Act 1956.

   iii. ***Mutual Benefit Company (MBC):*** An MBC is a company which works on the line of Nidhi company but is not declared be the Central Government

   iv. ***Miscellaneous Non-Banking Company (MNBC) :*** MNBC is a chit fund company which is engaged in managing, conducting or supervision-as promoter, foreman or agent- any transaction or arrangement. MNBC enters into an agreement with a specified number of subscribers. Each one of them shall subscribe a certain sum, in installments, over a definite period and shall-in turn, as determined by tender or in such manner as may be provided for in the arrangement-be entitled to the prize amount.

III. **Other Financial Institutions:** There are other financial intermediaries including the banking and non-banking financial institutions. These are as follows:

- Mutual fund
  - UTI
  - Public Sector Mutual Funds
  - Private Sector Mutual Funds
- Insurance Companies
  - Life Insurance
  - General Insurance
- Merchant Bankers
- Stock Broking Firms
- Depositories
- Development Financial Institutions

These development financial institutions can be categorized into 3 broad heads. These are" (i) All Indian Financial Institutions (AIFIs); (ii) State Level Institutions, and (iii) Other institutions. Of these, the AIFIs are the most important in terms of assets and range of operations. The AIFIs comprise; (i) All0India Development Banks; (ii) Specialized Financial Institutions; and (iii) Investment Institutions. The Major AIFIs are as follows:

- The Industrial Development Bank of India (IDBI)
- IFCI Ltd.
- ICICI Ltd.
- Industrial Investment Bank of India Ltd. (IIBI)
- Small Industrial Development Bank of India (SIDBI)
- National Housing Bank (NHB)
- National Bank of Agriculture and Rural Development (NABARD)
- Export Import Bank of India (EXIM Bank)
- Tourism Financial Corporation of India Ltd. (TFCI)
- Unit Trust of India (UTI)
- Life Insurance Corporation of India (LIC)
- General Insurance Corporation of India (GIC) and Its subsidiaries
- Infrastructure Development Finance Company of Indian Ltd. (IDFC

These institutions perform all over India. Other institutions comprise; the Export Credit and Guarantee Corporation (ECGC); and the Deposit Insurance and Credit Guarantee Corporation (DICGC).

State level institutions consist of; State Financial Corporation (SFCs); and State Industrial Development Corporation (SIDCs). The SFC was established under the SFCs Act 1951. The exception is that of the Tamil Nadu Industrial and Investment Corporation Ltd., established in 1949 under the Companies Act.

There are at present 18 SFCs in the country. Likewise, the SIDCs were established-under the Companies Act-as wholly owned undertakings of state government for the promotion and development of medium-and large-scale industries in their respective states. There are 28 SIDCs in the Country.

1.7.4 Financial Markets

The classification of financial market in India is shown in Figure 1.5

1.7.4.1 Unorganized Markets

In these markets, there are a number of money lenders, indigenous bankers, traders etc. who lend money to the public. Indigenous bankers also collect deposits from the public. There are also private finance companies, chit funds etc., whose activities are not controlled by the RBI. Recently the RBI has taken steps to bring private finance companies and chit funds under its strict control by issuing non-banking financial companies (Reserve Bank) Directions, 1998. The RBI has already taken some steps to bring the unorganized sector under the organized fold. They have not been successful. The regulations concerning their financial dealings are still inadequate and their financial instruments have not been standardized.

1.7.4.2 Organized Markets

In the organized markets, there are standardized rules and regulations governing their financial dealings. There is also a high degree of institutionalization and instrumentalization. These markets are subject to strict supervision and control by the RBI, SEBI or other regulatory bodies.

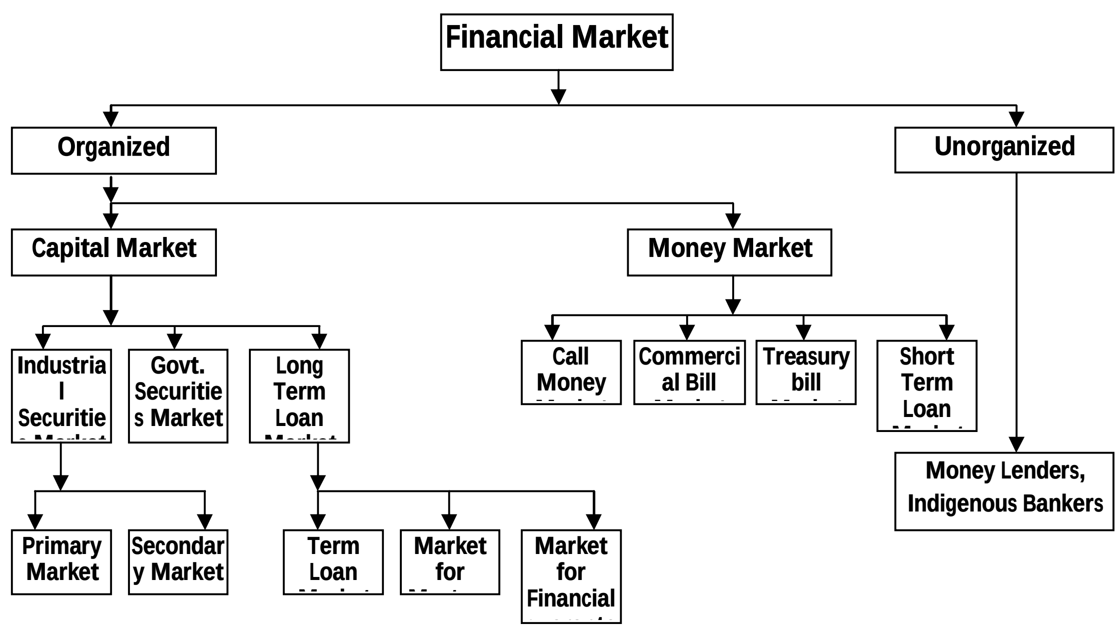


Figure1.5: Classification of Indian Financial Market

These organized markets can be further classified into two. They are:

I. Capital Market

The Capital market is a market for financial assets which have a long or indefinite maturity period of above one year. Capital market may be further classified intro three namely

A. **Industrial Security Market:** As the name indicates, this market deals with industrial securities namely: (i) Equity shares or ordinary shares, (ii) Preference shares, and (iii) Debentures or bonds. It is market where industrial concerns raise their capital or debt by issuing appropriate instruments. It can be further subdivided into two. They are:

    a) Primary Market or New Issue Market

    b) Secondary Market or Stock Exchange

    a) ***Primary Market:*** Primary market is a market for new issues or financial claims. Hence it is also called New Issue Market. The primary market deals with those securities which are issued to the public for the first time. In the primary market, borrowers exchange new financial securities for long term funds. Thus, primary market facilitates capital formation.

    There are three ways by which a company may raise capital in a primary market. They are:

    (i) ***Public Issues:*** The most common method of raising capital by new companies is through sale of securities to the public. It is called public issue.

    (ii) ***Right Issues:*** When an existing company wants to raise additional capital, securities are first offered to the existing shareholders on a pre-emptive basis it is called right issue.

    (iii) ***Private Placement:*** Private placement is a way of selling securities privately to a small group of investors.

    b) ***Secondary Market:*** Secondary market is a market of sale of securities. In other words, securities which have already passed through the new issue market are traded in this market. Generally, such securities are quoted in stock exchange and it provides a continuous and regular market for buying and selling of securities. This market consists of all stock exchanges recognized by the Government of India and SEBI. The stock exchanges are India is regulated under the securities Contracts (regulation) act, 1956. The Bombay Stock Exchange and National stock exchange are the principal stock exchange in India which sets the tone of the other stock markets.

B. **Government Securities Market:** It is also called Gilt-Edged market securities market. It is a market where Government securities are traded. In India there are many kinds of Government Securities – short term and long term. Long term securities are traded in this market which short term securities are traded in the money market. Securities issued by the Central Government, State Governments, Semi Government authorities like City Corporations, Port Trusts etc. Improvement Trusts, State Electricity Boards, All India and State level financial institutions and public sector enterprises are dealt in this market.

C. **Long Term Loan Market:** Development banks and commercial banks play a significant role in this market by supplying long term loan to corporate customer. Long- term loans market may further be classified into: (i) Term Loan Market, (ii) Mortgage Market, and (iii) Financial Guarantees Market.

II. Money Markets

The money market is a component of the financial markets for assets involved in short-term borrowing and lending with original maturities of one year or shorter time frames. Trading in the money markets involves Treasury bills, commercial paper, bankers' acceptances, certificates of deposit, federal funds, and short-lived mortgage- and asset-backed securities. It provides liquidity funding for the global financial system.

A. Participants in Money Market

- **a.** ***Reserve Bank of India:*** Reserve Bank of India is the regulator over the money market in India. As the Central Bank, it injects liquidity in the banking system, when it is deficient and contracts the same in opposite situation.
- **b.** ***Commercial and Cooperative Banks:*** Commercial Banks and the Co-operative Banks are the major participants in the Indian money market. They mobilize the savings of the people through acceptance of deposits and lend it to business houses for their short-term working capital requirements. While a portion of these deposits is invested in medium and long-term Government securities and corporate shares and bonds, they provide short-term funds to the Government by investing in the Treasury Bills. They employ the short-term surpluses in various money market instruments.
- **c.** ***Discount and Finance House of India Ltd. (DFHI):*** DFHI deals both ways in the money market instruments. Hence, it has helped in the growth of secondary market, as well as those of the money market instruments.
- **d.** ***Financial and Investment Institutions:*** These institutions (eg. LIC, UTI, GIC, Development Banks, etc) have been allowed to participate in the call money market as lenders only.
- **e.** ***Corporates:*** Companies create demand for funds from the banking system. They raise short-term funds directly from the money market by issuing commercial paper. Moreover, they accept public deposits and also indulge in inter corporate deposits and investments.
- **f.** ***Mutual Funds:*** Mutual funds also invest their surplus funds in various money market instruments for short periods. They are also permitted to participate in the Call Money Market. Money Market Mutual Funds have

been set up specifically for the purpose of mobilization of short-term funds for investment in money market instruments.

B. Types of Money Market Instruments in India

Money market instruments provide for borrowers' short-term needs and gives needed liquidity to lenders. The types of money market instruments are treasury bills, repurchase agreements, commercial papers, certificate of deposit, and bankers' acceptance.

a) ***Call Money Market:*** The call money market is a market for extremely short period loans say one day to fourteen days. So, it is highly liquid. The loans are repayable on demand at the option of either the lender or the borrower. In India, Call money markets are associated with the presence of stock exchanges and hence, they are located in major industrial towns like Mumbai, Kolkata, Chennai, Delhi, Ahmedabad etc. the special feture of this market is that the interest rate varies from day to day and even from hour to hour and centre to centre. It is very sensitive to changes in demand and supply of loans.

b) ***Treasury Bills (T-Bills):*** Treasury bills began being issued by the Indian government in 1917. They are short-term instruments issued by the Reserve Bank of India. They are one of the safest money market instruments because they are risk free, but the returns from this instrument are not very large. The primary as well as the secondary markets circulates this instrument. They have 3-month, 6-month and 1-year maturity periods. T-bills are issued with a separate price from their face value. The face value is achieved upon maturity, as is the interest earned on the buy value. The buy value is set by a bidding process in auctions.

c) ***Repurchase Agreements:*** Repurchase agreements are also known as repos. They are short-term loans that buyers and sellers agree to sell and repurchase. As of 1992, repo transactions are allowed only between RBI-approved securities such as state and central government securities, T-bills, PSU bonds, FI bonds and corporate bonds. Repurchase agreements are sold by sellers with a promise of purchasing them back at a given price and on a given date in the future. The buyer will also purchase the securities and other instruments in the repurchase agreement with a promise of selling them back to the seller.

d) ***Commercial Papers:*** Commercial papers are promissory notes that are unsecured and issued by companies and financial institutions. They are issued at a discounted rate of their face value. They have a fixed maturity of 1 to 270 days. They are issued for financing of inventories, accounts receivables, and settling short-term liabilities or loans. Commercial papers yield higher returns than T-bills. They are usually issued by companies with strong credit ratings, as these instruments are not backed by collateral. They are usually issued by corporations to raise working capital and are actively traded in the secondary market. Commercial papers were first issued in the Indian money market in 1990.

e) ***Certificate of Deposit:*** A certificate or deposit is a short-term borrowing note, like a promissory note, in the form of a certificate. It enables the bearer to receive interest. It has a maturity date, a fixed rate of interest and a fixed value. It usually has a term between 3 months and 5 years. The funds cannot be withdrawn on demand, but it can be liquidated on payment of a penalty. The returns are higher than T-bills as the risk is higher. Returns are based on an annual percentage yield (APY) or annual percentage rate (APR). In APY, interest is gained by compounded interest calculation, whereas in APR simple interest calculation is done to calculate the return. The certificate of deposit was first introduced to the money market of India in 1989.

f) ***Bankers Acceptance:*** A banker's acceptance is a short-term investment plan created by a company or firm with a guarantee from a bank. It is a guarantee from the bank that a buyer will pay the seller at a future date. A good credit rating is required by the company or firm drawing the bill. The terms for these instruments are usually 90 days, but this period can vary between 30 and 180 days. Companies use the acceptance as a time draft for financing imports, exports and other trade

1.7.5 Financial Services

There are different types of financial services in the financial markets. In fact, there is no uniform or standard scheme of the classification of financial services. The financial services industry can be classified into 3 broad categories: (i) fee-based services (ii) fund based services, and (iii) insurance services.

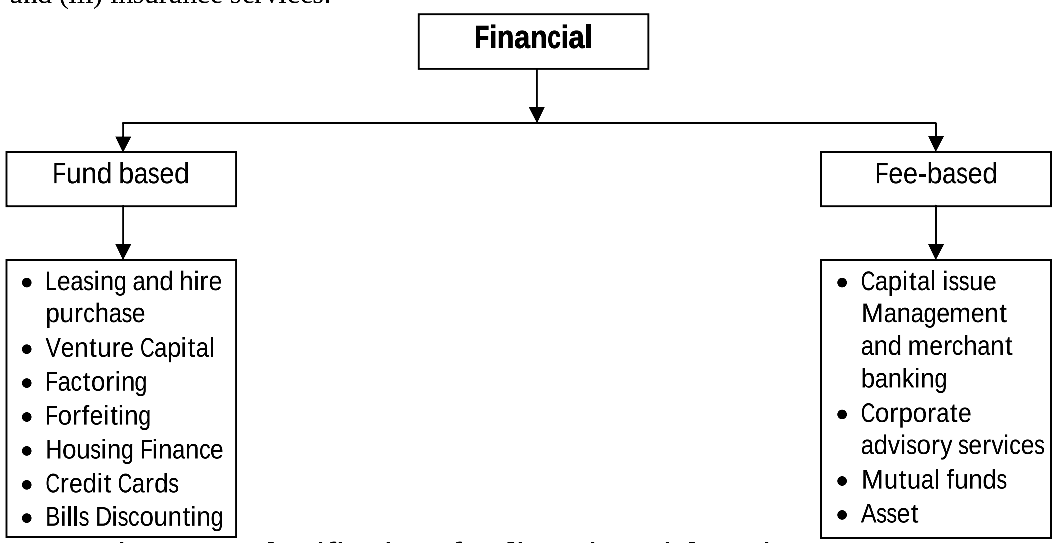


Figure1.6: Classification of Indian Financial Services

I. **Fee-based services :** Fee-based financial service are provided by financial institutions/ non-banking financial companies and banking organizations, in specialized fields, to earn a substantial income – by way of a fee; dividend; commission; discount; and brokerage – on operations. They basically render services to stakeholders in the economy. The major fee-based financial services are: (i) issue management and merchant banking, (ii) corporate advisory services, (iii) mutual funds, (iv) asset securitization, and (v) credit rating.

II. **Fund based services :** In fund-based services, the financial services firm raises funds – through equity, debt and deposits – and invests the same in securities or lends out to those who are in need of capital. We will be discussing some of these fund-based services such as: (i) leasing and hire purchase, (ii) venture capital, (iii) factoring, (iv) forfeiting (v) housing finance, (vi) credit cards, and (vii) bill discounting.

1.8 Financial System and Economic Development

Economical development of any country can be viewed on the basis of growth in the national and per capita income. An increase in the national income indicates the economic growth of a country. The national income can be calculated in three ways:

- **i.** The domestic product/ output of goods and services produced by enterprises within the country (value added approach to GDP)
- **ii.** The total income of residents of the country derived from the current production of goods and services (income approach to GDP)
- **iii.** The total domestic expenditure – by residents of the country- on consumption and investment foods (expenditure approach to GDP)

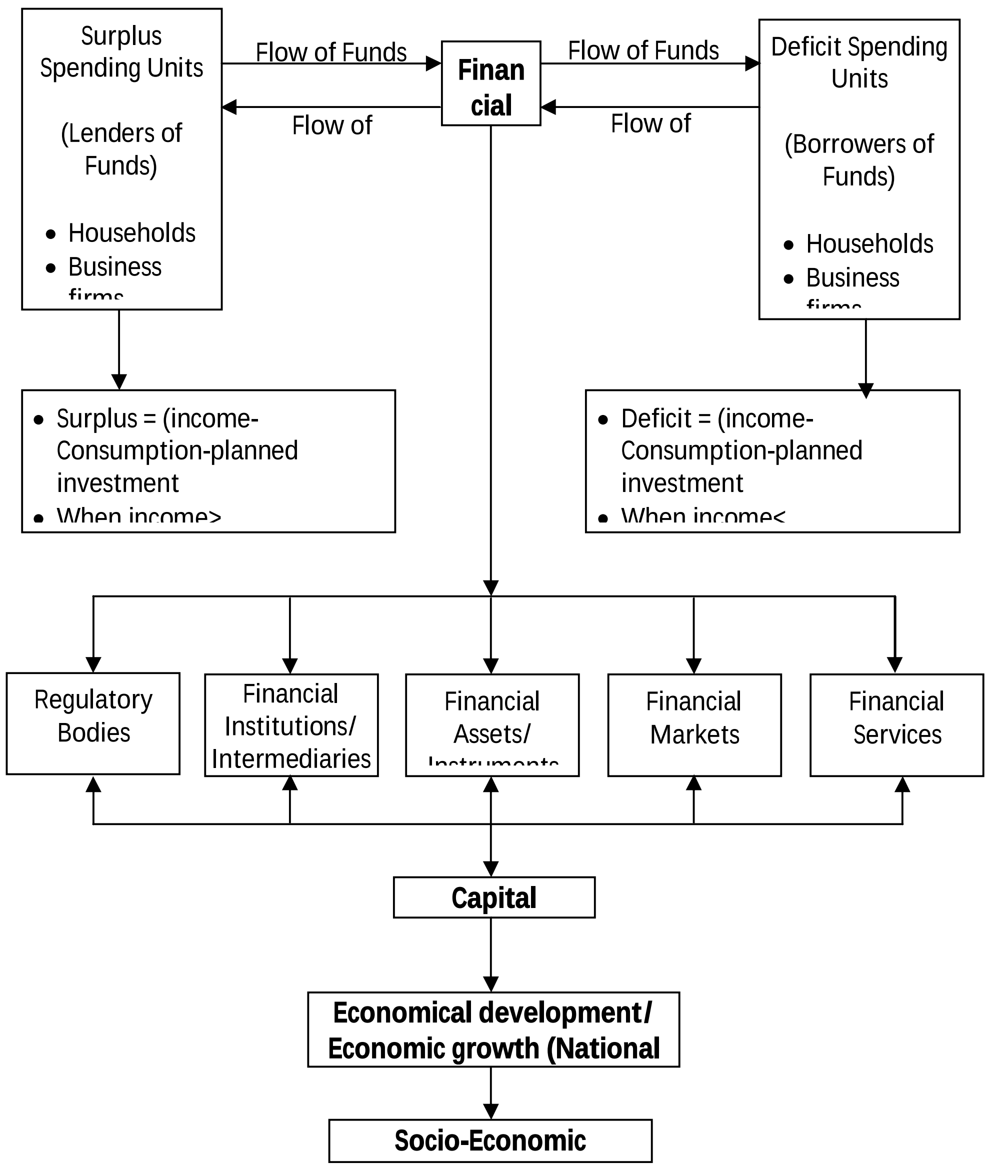


Figure1.7: Financial System and Economic Development

Whichever approach is used to calculate the national income, generally the same result arrived at. The sum total of gross value added at factor cost for all the sectors (i.e. agriculture and allied activities, industry and services sectors- represents the Gross Domestic Product (GDP) at factor cost. The Gross National Product (GNP) is obtained by adding net property (factor) income from abroad to the GDP at factor cost. The Net National Product (NNP) is calculated – by deducting depreciation of the capital stock from GNP- at factor cost. This Net National Product is known as National Income. It is needless to mention that the National Income in measured on the basis of the Gross Domestic Product (GDP) of a country. Therefore, GDP is the yardstick of measuring the growth performance of an economy. However, the impact of economy reforms, which is reflected in the GDP, ultimately indicates the economic growth and development of a country. On the other hand, the growth of the GDP, in any economy, depends on the increase on the proportion of savings and investment to the GDP of a nation.

The financial system comprises a set of sub system of: Financial institutions; financial markets, financial instruments, financial services, and regulatory bodies. The financial system plays a vital role in the economic growth process. The level and growth of savings, investment, and capital formation in an economy are essential to economic growth. Economic growth also depends upon a sound financial system which helps in the formation of capital. Thus, a financial system helps to transform savings into investments.

The financial system allocates resources in the economy and accelerates economic development. The role of the financial system-on economic development in India – is portrayed in figure no.1.7. In figure 1.7 it is found that borrowers of funds include household and others. Particularly, though households meet their requirements of finance from lenders, they cannot – unlike other users - issue any direct securities. They actually get loans through the mortgage of assets.

The role of financial system depends upon the extent to which it can extend its function to a large population. The financial system minimized transaction costs and increase resources allocation efficiently. This improves capital formation as well as the productivity.

1.9 Weaknesses of Indian Financial System

After the introduction of planning, rapid industrialization has taken place. It has in turn led to the growth of the corporate sector and the Government sector. In order to meet the growing requirements of the Government and the industries, many innovative financial instruments have been introduced. Besides, there has been a mushroom growth of financial intermediaries to meet the ever growing financial requirements of different types of customers. Hence, the Indian financial system is more developed and integrated today than what it was 50 years ago. Yet, it suffers from some weaknesses as listed below:

I. **Lack of Co-ordination between different Financial Institutions:** There are a large number of financial intermediaries. Most of the vital financial institutions are owned by the Government. At the same time, the Government is also the controlling authority of these institutions. In these circumstances, the problem of coordination arises. As there is multiplicity of institutions in the Indian financial system, there is lack of co-ordination in the working of these institutions.

II. **Monopolistic Market Structures:** In India some financial institutions are so large that they have created a monopolistic market structures in the financial system. For instance the entire life insurance business is in the hands of LIC. The UTI has more or less monopolized the mutual fund industry. The weakness of this large structure is that it could lead to inefficiency in their working or mismanagement or lack of effort in mobilizing savings of the public and so on. Ultimately it would retard the development of the financial system of the country itself.

III. **Dominance of Development Banks in Industrial Financing:** The development banks constitute the backbone of the Indian financial system occupying an important place in the capital market. The industrial financing today in India is largely through the financial institutions created by the Government both at the national and regional levels. These development banks act as distributive agencies only, since, they derive most of their funds, from their sponsors. As such, they fail to mobilize the savings of the public. This would be a serious bottleneck which stands in the way of the growth of an efficient financial system in the country. For industries abroad, institutional finance has been a result of institutionalization of personal savings through media like banks, LIC, pension and provident funds, unit trusts and soon. But they play a less significant role in Indian financial system, as far as industrial financing is concerned. However, in recent times attempts are being made to raise funds from the public through the issue of bonds, units, debentures and soon. It will go a long way in forging a link between the normal channels of savings and the distributing mechanism.

IV. **Inactive and Erratic Capital Market:** The important function of any capital market is to promote economic development through mobilization of savings and their distribution to productive ventures. As far as industrial finance in India is concerned, corporate customers are able to raise their financial resources through development banks. So, they need not go to the capital market. Moreover, they don't resort to capital market since it is very erratic and inactive. Investors too prefer investments in physical assets to investments in financial assets. The weakness of the capital market is a serious problem in our financial system.

V. **Imprudent Financial Practice:** The dominance of development banks has developed imprudent financial practice among corporate customers. The development banks provide most of the funds in the form of term loans. So there is a preponderance of debt in the financial structure of corporate enterprises. This predominance of debt capital has made the capital structure of the borrowing concerns uneven and lopsided. To make matters worse, when corporate enterprises face any financial crises, these financial institutions permit a greater use of debt than a warranted. It is against the traditional concept of a sound capital structure.

However, in recent times all efforts have been taken to activate the capital market. Integration is also taking place between different financial institutions. For instance, the Unit Linked Insurance Schemes of the UTI are being offered to the public in collaboration with the LIC. Similarly, the refinance and rediscounting facilities provided by the IDBI aim at integration, thus, the Indian financial system has become a developed one.

1.10 Summary

A system that aim at establishing and providing a regular smooth, efficient and cost effective linkage between depositors and investors in known as financial system. A financial system companies of financial institutions, financial services, financial markets and financial instruments. These constituents are closely related and work in conjunction with each others. A financial asset is one which is used for production or consumption or for further creation of assets. Financial intermediaries include all kinds of financial institutions and investing institutions which facilitate financial transaction in financial markets. Financial markets facilitate buying and selling of financial claims, assets, services and securities. Financial market is classified into organized and unorganized markets. Financial claims such as financial assets and securities dealt in a financial market are referred to as financial instruments. Financial instruments can be classified into primary and secondary securities. With the adoption of the theory of mixed economy, the development of the financial system took a different turn as to fulfill the socio-economic and political objectives. The Government has started creating new financial institutions and it also progressively started nationalizing some financial institutions so that the flow of the finance might be in the right direction. Indian financial system is more developed and integrated today than it was 50 years ago, but it suffers from some weaknesses.

1.11 Keywords

- **Financial System:** A set of complex and closely connected instructions, agents, practices, markets transactions, claims and liabilities relating to financial aspects of an economy is referred as financial system.
- **Financial Asset:** Financial assets refer to claim of periodical payments of certain sum of money by way of payment of principal, interest or dividend.
- **Primary Market:** It is a market for new issue of shares, debentures and bonds.
- **Secondary Market:** The market where existing securities are traded is referred to as secondary market.
- **Money Market:** It is a market for short-term money and financial assets that are near substitutes for money.
- **Capital Market:** It is a market for financial assets which have a long or indefinite maturity.
- **Financial Instruments:** Financial instruments refer to those documents which represent financial claims on assets.

1.12 Self Assessment Questions

1. Discuss the objectives and Significance of a financial system.
2. Explain the Indian Financial System in detail.
3. What are the major weaknesses of Indian Financial System
4. Classify financial assets and bring out their features
5. Show the classification of Indian financial markets in the form of a chart and explain the features f each market.
6. Discuss the role of financial system in the economic development of a country.

1.13 Reference Books

- Bhole, L.M., Financial Institutions and Markets, Tata McGraw Hill, New Delhi.
- Chandra, P., Financial Management, Tata McGraw Hill, New Delhi.
- Gordon, E. and Natrajan, K. (2010) Financial Markets and Services, Himalaya Publishing House, Mumbai
- Jain, T.R. and Khanna, O.P. (2011) Indian Financial System, V.K. Global Publications Ltd., New Delhi
- Khan, M.Y. (2007) Indian Financial System, The McGraw-Hill Companies, New Delhi
- Pathak Bharti V (2011) The Indian Financial System Markets, Institutions and Services, Pearson Publications, New Delhi
- Shah, A., Susan, T. and Gorham, M. (2008) India's Financial Markets, Elsevier Publication, USA

Unit - 2 : Money Market and Capital Market

Structure of Unit:

2.0 Objectives

After completing this unit, you would be able to:

- Understand the meaning and types of financial markets
- Conceptual base of money market
- Clarify the objectives, negotiations and problems and structure of money markets
- Understand the meaning of capital market
- Clarifying the objectives, role, functions, features, growth & limitations
- Distinctions between money and capital market

2.1 Introduction

A financial market in which long-term debt obligations and equity securities are bought and sold, and all financial transactions are excuted between users of funds and suppliers of funds. The capital market includes the stock market, the bond market, and the primary market.

Securities trading on organized capital markets are monitored by the government; new issues are approved by authorities of financial supervision and monitored by participating banks.

2.2 What is Financial Market?

2.2.1 Meaning

The term 'Market' is a place where people exchange goods and services. Financial Market facilitates the exchange of financial assets among the dealers. It is a place, where financial assets are sold and purchased. Financial assets are also referred as financial instruments. These are claims against the money and enable their holders disposing the claims during a particulars period of time. Financial Markets may be classified as negotiated loan markets and open markets.

Capital markets around the globe have become more internationally integrated, by the lowering of cross-country barriers, availability of information, lower transaction costs and the standardization of regulation. As markets get more integrated, they also become more susceptible to interest rate movements abroad.

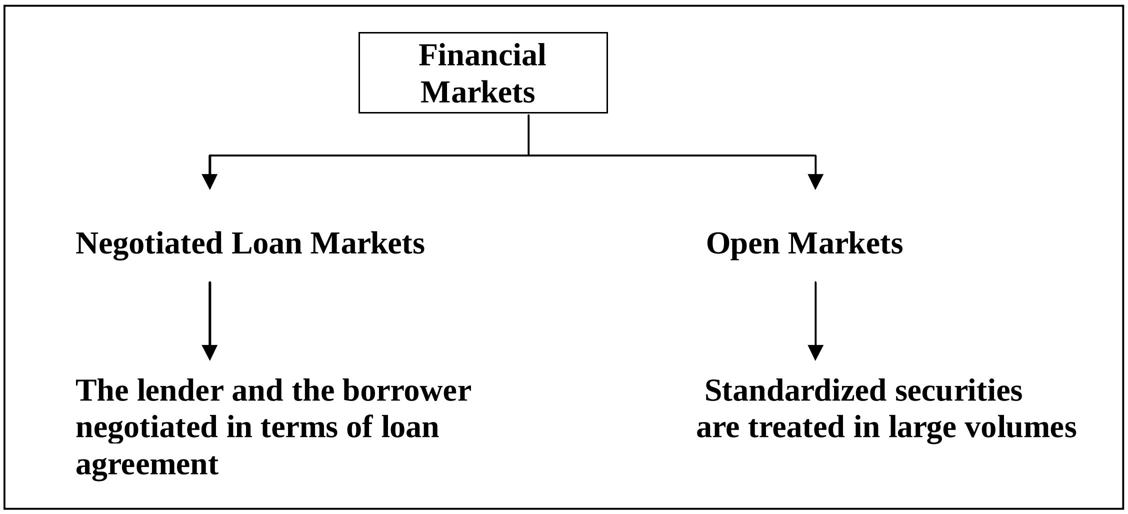


Figure 2.1: Financial Markets

2.2.2 Functions of Financial Markets

The major functions of the financial markets are:-

1. To facilitates creation and allocation of credit and liquidity
2. To serve as intermediaries for mobilization of savings
3. To assist the process of balanced economic growth
4. To provide financial convenience, and
5. To cater to the various credits needs of the business houses

2.2.3 Types of Financial Markets Financial Markets are divided into two types as per basis of credit need for short term and long term purposes:-

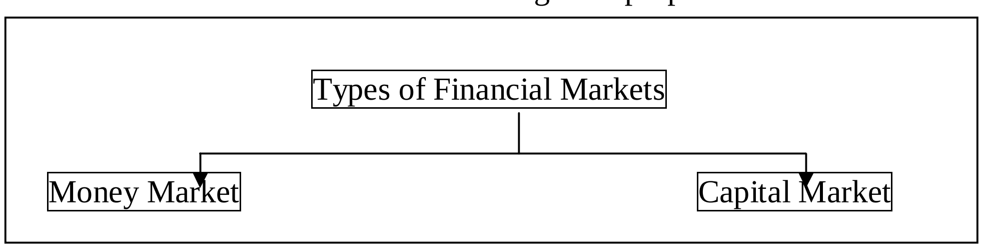


Figure 2.2: Types of Financial Markets

2.3. Money Market

The money market is a sector of the capital market where short-term obligations such as Treasury bills, commercial paper and bankers' acceptances are bought and sold. Money market trades in short term financial instrument commonly called "paper". This contrasts with the capital market for longer-term funding, which is supplied by bonds and equity. Money is defined as any asset that is acceptable as a medium of exchange in payment for goods and services.

It is the place where short term instruments that is traded in a year or earlier. It facilitates borrowing and lending of short term funds. Money market brings together lenders and borrowers. It deals in different type of financial instruments- like bills of exchange, banker's acceptances, bonds etc.

2.3.1 Definition

(i) In words of CROWTHER: "The money market is the collective name given to the various firms and institutions that deal in the various grades of near money"

(ii) The Reserve Bank of India: "The centre for dealings, mainly of a short term character, in monetary assets, it meets the short term requirements of borrowers and provides liquidity or cash to the lenders."

(iii) Nadler and Shipman: "A money market is a mechanical device through which short term funds are loaned and borrowed through which a large part of the financial transactions of a particular country or world are degraded. A money market is distinct from but supplementary to the commercial banking system."

2.3.2 Objectives Important objectives of money markets are as follows:-

(i) It provides an equilibrating mechanism for short term surpluses and deficits.

(ii) It provides a focal point for reserve bank's interventions for influencing liquidity in the economy.

(iii) It provides reasonable access to users of short term money to meet their requirements at a realistic price.

(iv) It plays a vital role in the flow of funds to the most important uses.

2.3.3 Borrowers in Money Market includes

- Merchants
- Traders
- Manufacturers
- Business Concerns
- Brokers
- Government Institutions

2.3.4 Lenders in Money Market includes

- The Central Banks
- Insurance companies
- Financial Concerns

2.3.5 Negotiations between Borrowers & Lenders Negotiations between Borrowers & lenders may be carried through:-

- Personal Contacts
- Telephone
- Telegraph
- Mails

2.3.6 Problems of Indian money Market Recently, Indian money market is facing numerous challenges. Some of the problems arising in path of 'Indian Money Market' are illustrated here:-

1. **Absence of National Money Market** Broadly to state, that India has no proper national money market. Although, India has local money markets like-Mumbai and Kolkata.
2. **Fierce Competition** Indigenous banks have no fair cooperation and co-ordination among their working process. There is fierce competition between co- operative banks and commercial banks. Indigenous banks have no proper connection with the Reserve Bank of India.
3. **Lack of Integration** Indian money market is divided into two sectors-organized and unorganized. These two sectors are completely separate from each other in view of financial operations.
4. **Lack of Rational Interest Rate Structure** There are different rates of interest for different segments. These includes-
    - Borrowing rate of the government
    - The deposit and lending rate of co-operative and commercial banks
    - The lending rate of the financial institution etc.

    The lending rates and their bill finance rates also differ from the hundi rates of State bank and Commercial banks in comparison to co-operative and indigenous banks in Indian context.
5. **Lack of Funds** The Indian money market mostly suffers from lacking of proper funds. The following reasons may be identified-
    1. Insufficient banking facilities
    2. Improper banking habits among customers
    3. Absence of diversified investment opportunities
    4. Wasteful competition
    5. Emergence of parallel economy.

6. **Lack of an organised bill market** There is organized proper bill market in India, only a limited bill market that has been created in India by the Reserve Bank of India under schemes of 1952 and 1970.

7. **Insufficient Banking Facilities** Indian money market faces numerous challenges. Some weakness of this market may be highlighted in this manner-

1. Lack of integration
2. Disparity in interest rates
3. Limited access of bill market
4. Shortage access of funds
5. Fluctuation in Interest rates

6. Limited numbers of market players
7. Restricted secondary market
8. Disparity in interest rates
9. Inadequate elasticity and stability

2.3.7 Structure of Indian Money Market Indian money market can be divided into following two categories:-

Indian Money Market

Organized Money Market | **Unorganized Money Market**

Organized Money Market	Unorganized Money Market
1. Reserve Bank of India	1. Indigenous Bankers
2. State Bank of India	2. Unregulated Non-Banking Financial Intermediaries.
3. Commercial Banks	3. Money Lenders
4. Developmental Banks (LIC, UTI, Mutual fund, Banks, IDBI, ICICI, IFCI Etc)	

Figure 2.3: Structure of Indian Money Market

2.4 Capital Market

2.4.1 Introduction & Definition

The capital market (securities market) is the market for securities, where companies and the government can raise long-term funds. The capital market includes the stock market and the bond market. Financial regulators, such as the U.S. Securities and Exchange Commission, oversee the capital markets in their respective countries to ensure that investors are protected against fraud. The capital markets consist of the primary market, where new issues are distributed to investors, and the secondary market, where existing securities are traded. Markets that facilitate the flow of long-term funds are called capital markets. The main participants in these markets are households, businesses including those that are in finance, and governments. There are regulatory bodies that also play a major role in shaping these markets. Capital market securities, are expected to generate a higher annualized return to investors as against money market securities that have a higher degree of liquidity (i.e. can be liquidated easily without loss of value).

Capital markets are a part of the larger financial market wherein, financial assets may be purchased or sold. One party transfers funds by purchasing financial assets previously held by another. Participants that provide funds are called surplus units while participants that obtain funds are called deficit units. The main providers of funds are households. The capital market serves as an important source for productive use of an economy's savings. It provides incentive to savings and facilitates capital formation by offering suitable rates of interest as the price of capital. It provides an avenue for investors, particularly the household sector, to invest in financial assets that are more productive rather than in physical assets. It facilitates increase in production and particularly in the economy, and thus enhances the economic welfare of society. It is an important link between, those who save, and those who aspire to invest. Capital market is defined as follows--

1. The 'Capital Market' refers to the institutional arrangement for facilitating the borrowing and lending of long term funds. It consists of a series of transaction through which public savings are made available for industrial and commercial development.
2. It may be defined as an organized mechanism for effective transfer of financial resources from investors to entrepreneurs.
3. Capital market is concerned with the investment of funds in long term securities.

2.4.2 Objectives

An ideal capital market is one, where finance is used as a handmade to serve the needs of industry. Finance is available at a reasonable rate of return which offers a prospective yield to make borrowing worthwhile. A capital market strives for-

1. The mobilization of national savings for economic development
2. The mobilization of foreign capital and investment to augment the deficit in the required financial resources to maintain the expected rate of economic growth

2.4.3 Role

The role of capital market is to link the funding needs of firms and households with the needs of investors, and thus realize efficient fund allocation. Interest rates, which are the price of funds, are determined by supply and demand in the market. As a market expands, various participants enter and the market and prices are formed more efficiently, resulting in more efficient fund allocation. One another role for the capital markets is to provide a variety of risk-hedge methods against such diversified risks as price volatility pertaining to interest rates, foreign exchange rates, stock prices and property prices. Banks play a financial intermediary function between fund-raisers and depositors by accepting deposits and extending loans.

2.4.4 Functions

The major functions performed by a capital market are-

1. The mobilization of financial resources at national level
2. Encouraging the foreign capital and know-how
3. Contributing in the economic growth of nation
4. Promoting projects of highest yield to moving towards balanced economic development

2.4.5 Features of Capital Market in India

1. **Mobilisation of savings and acceleration of capital formation:** Various types of securities help to mobilize saving from public features of reasonable return and liquidity in stock market.
2. **Promotion of industrial growth:** Stock exchange funds are transferred to the industrial sector of nation. It stimulates industrial growth and economic development of nation.
3. **Ready and continuous market**: It provides a place for buyers and sectors to purchase and sale securities. The feature of easy marketability makes investment in securities more liquid in comparison to other assets.
4. **Raising long term capital**: The existence of a stock exchange enables companies to raise permanent capital. The stock exchange offers an opportunity to buy or sell investors securities by without affecting company's permanent capital.
5. **Proper channelization of funds** : An efficient capital market creates liquidity through its pricing mechanism and allocates resources to most efficient industries.
6. **Provision of different services:** The capital market provides a variety of services:-
   - (i) Providing long term and medium term loans to entrepreneurs
   - (ii) Assistance in the promotion of companies
   - (iii) Participation in equity capital

2.4.6 Growth of Capital Market in India The following factors are responsible for the growth of capital market in India--

1. Growth of multinationals
2. Growth of financial institutions
3. Massive publicity of financial institutions
4. Merchant banking services
5. General awareness
6. Development plants of the government
7. Performance of private sector
8. Growing population
9. Legislative measures
10. Growth of underwriting business
11. Growing public confidence

2.4.7 Limitations of Indian Capital Market

The important deficiencies in the Indian Capital Market is as below:-

1. Inadequate regulation and control
2. Lack of market awareness
3. Malpractices by brokers
4. Dominance of small scale sectors
5. Poor Industrial relations

2.4.8 Primary and Secondary Capital Market

The primary market facilitates the issuance of new securities while secondary market facilitates the trading of existing securities. Primary market provides funds to the initial issuer of securities. The secondary market creates liquidity for investors. Some securities are more active and can therefore be traded more readily. This is an important feature of the secondary market.

Primary market operations include new issues by new and existing companies and governments. The issues may be of shares, right issue, public offers or debenture bonds. There is no element of trading and investor can apply directly to the issuer. The means of finance is sought, when debt is costly and raising money from the capital market is relatively cheap. Investors subscribe to benefit from dividend and capital appreciation.

Intermediaries associated with the primary capital markets are merchant bankers, registrars, underwriters, brokers, advisors and advertising agencies. Primary markets are guided by regulators. Regulators generally prescribe guidelines and mandatory requirements for disclosure, investor protection and education. Secondary market activities take place at stock exchanges and over the counter exchanges, through the members at the exchanges. The portfolio managers, investments advisers and transfer agents.

The cost of capital plays an important role in primary market activity. As the cost of capital increases, issuers should be inclined to issue less capital. Intuitively, equity issuance activity should be closely related to the market price of equity, which is one measure of cost. Higher prices should promote more issuances; lower prices would hinder issuance.

2.4.9. Distinctions between Capital Market and Money Market

The main points of Distinctions between capital market and money market are below:-

Distinctions

Capital Market	**Money Market**
1. Provides Finance for long term Investments	1.Provide money for short term investments
2. Finance may be used for fixed and working capital	2. Finance may be used for working capital
3. Main functions are- (i)Mobilization of resources (ii) Effective utilization of resources	3. Main functions are (i) Lending and borrowing to facilitates adjustment of liquidity position.

4. Stock exchange acts as an investment buyers and sellers of securities.	4. It does not provide such market for facility.The main components are call market, collateral loan market, bill market and acceptance houses.
5. It acts as a middle man between investor and the entrepreneur	5. It acts as a link between the depositor and the borrower.
6. Underwriting is one its primary activities.	6.Underwriting is a secondary function
7. It raises capital from public and maintains securities to get higher return.	7.It provides outlets to commercial corporations, banks, non bank financial concerns and others for their short term surplus funds.
8. It provides long term funds to central and state government, public and local bodies for development purposes.	8. It provides short term funds to government by purchasing treasury bills and other by discounting bills of exchange.

Figure 2.4: Distinctions between Capital Market and Money Market

2.5 Role of Stock Exchanges

A securities market is any place where buyers and sellers come together to trade in securities. A person who buys bonds issued by the government through RBI is part of the securities market. The securities market is actually divided into two broad classes; the original securities exchange market, and over the counter market (OTC). The organized securities market is further divided into national, regional and local exchanges. The national stock form part of the national stock exchanges. The over-the-counter market is the informal market and handles securities transactions in the office of brokers and dealers registered to engage in securities business.

Stock exchanges facilitate the trading of existing stocks in the secondary markets. Brokerage firms serve as intermediaries between the buyers and sellers in the secondary markets. Brokers receive orders from customers and pass the orders on to the exchange, through a telecommunication network. Orders are frequently executed a few months later. Full service brokers offer advice to customers, on stock to buy or sell; discount brokers only execute the transactions desired by customers. Stock exchanges provide a secondary market, allowing investors, flexibility in spending which would not be possible if they were to hold on to them, can nevertheless meet unforeseen cash requirements by selling securities to other investors. There is however, a price for this flexibility, which are uncertain. The variances of prices means that agents associated with secondary markets have to be very nimble to avoid risking their capital.

The role of secondary market is to provide liquidity in a cost effective way. To an extent, it enhances the value of the securities immediate, strengthens the primary market and lowers the cost of finance for companies and governments. It performs this job by matching buyers and sellers and establishing a price at which equilibrium occurs. It offers a forum in which investors and traders interact and exchange securities according to their requirements and beliefs about the true value of the security.

The functions of national exchanges have grown over the years; they now include far more than furnishing an area for trading and providing information about price and sales. National exchanges also assure the investor of basic financial information and protection For example, they require a company to provide its share holders with a statement of earnings and a balance sheet that summarizes its assets and liabilities.

The stock exchange provides a continuous market for individual securities issues. This is perhaps its most important function. A continuous market is predicted on a large volume of sales and a narrow price range between the bid and the ask price and between the previous sale and the sale taking place at the moment. It also depends upon the rapid execution of orders. These conditions are fostered by the trading rules of the exchange. There are also a sufficient number of buyers and sellers of shares a stock of each company traded and a sufficient number of brokers and other members of exchange, transacting orders to assure a broad and active market. The effect of such a market is to improve the liquidity and marketability of securities is traded.

The price of a share of stock is established in an auction market. It is not set by the traders on the floor of the exchange, or by the exchange, or by negotiations off the floor; it is established, by a bidding process and therefore, the price at any one time tends to reflect the fair market appraisal of the stock. Since the market for a security is continuous and since the price is established by supply and demand, securities have good collateral value for loans. Obviously, the ability of an exchange to provide a fair market price is limited, because current events can have a tremendous effect upon stock prices. A specific price may not be fair when long-range investment values are considered. All that can be expected from a market is a price established freely by competitive forces. The broad auction market tends to improve marketability, and thus securities better collateral for loans.

A continuous market for shares competitively priced provides a favorable climate for raising capital. Even if, the securities are sold by investment bankers, off the exchange, the securities traded on the exchange establish a price pattern that serves as a standard of value. Such a comparison should aid in corporate financing. Since there will be a continuous market available after the securities have been sold, the new offering is more readily saleable to investors. Most large corporations depend upon retained earnings or internally generated funds for financing. Their infrequent trips to the stock market however are aided by the formal organized stock exchange.

Companies listed on the regional and local exchanges are usually small, but they may have their stock traded on a national exchange in addition to one or more local exchanges. The price of shares traded on local exchange is usually low, the volume of trading is small, membership fees are expensive and there are few members of each exchange.

Primary market operations include new issues by new and existing companies and governments. The issues may be of shares, rights issue, public offers or debenture bonds. There is no element of trading and an investor can apply directly to the issuer. This means of finance is sought, when debt is costly and raising money from the capital market is relatively cheap. Investors subscribe to benefit from dividend and capital appreciation.
Secondary market activities take place at stock exchanges and over the counter (OTC) exchanges, through their members. The intermediaries to the activities are members at the exchanges, portfolio managers, investment advisers and transfer agents.

2.6 Recent Developments

Besides the securities discussed in the forgoing sections of this unit, there are derivative securities are also traded in capital markets. Derivative securities are financial contracts, whose values are derived from underlying assets. Most derivative securities have two main characteristics. First, is they allow an investor to speculate on movements in the underlying assets without having to purchase those assets. This allows the investor to take on large investment positions without large initial outlays and therefore provides a high degree of financial leverage. Therefore, the returns from investing in derivatives securities are even higher than investments in the underlying assets themselves. Investors who speculate in derivative contracts can achieve higher returns, but they are also exposed to higher risk than if they had speculated in the underlying assets. Second, is that derivative securities can be used to generate gains, if the value of the underlying assets declines. Consequently, financial institutions and other companies can use derivative securities as a means of hedging their existing investments in securities.

Capital markets around the globe have become more internationally integrated, by the lowering of cross-country barriers, availability of information, lower transactions costs and the standardization of regulation. As market gets more integrated, they also become more susceptible to interest rate movements abroad.

Most stock exchanges have suspended or are in the process of phasing out the outcry system of trading in stocks and have replaced it with the screen-based trading system. The trend is towards a floorless exchange. With the easing of regulation, prompted by competition for foreign direct investment with other developing countries, international issues of both debt and equity have taken off in recent years, in conjunction with the development of the domestic market for debt and equity.
Internet brokers accept orders online; provide real time quotes and information of firms. Trades are executed by automated systems. All new issues are to be in dematerialized (demat) form. The demat form ensures that there are no fake or forged shares, no bad deliveries and facilitates transfer of securities.

2.7 Summary

Financial markets facilitate the flow of funds from surplus units to deficit units. The markets that facilitate the flow of short-term funds9maturities of less than one year), are known as money markets while those that facilitate the flow of long-term funds are known as capital markets. The primary market facilitates the issuance of new securities while secondary market facilitates the trading of existing securities. Primary markets provide funds to the initial issuer of securities. The secondary market creates liquidity for investors. Secondary market activities take place at stock exchanges and over the counter (OTC) exchanges, through their members. Stock exchanges facilitate the trading of existing stocks in the secondary markets. Capital markets around the globe have become more internationally integrated, by the lowering of cross-country barriers, availability of information, lower transaction costs and the standardization of regulation. As markets get more integrated, they also become more susceptible to interest rate movements abroad.

2.8 Self Assessment Questions

1 What purpose do capital markets serve?
2 What are the factors that would go into deciding whether a company should resort to debt or equity for financing its requirement of long-term funds?
3 Why is a stock exchange an important institution of the capital markets?
4 Discuss the structure of Indian financial system?
5 Discuss the various functions of money market?
6 Discuss the features of Indian money market?
7 Define capital market and explain its functions?
8 Discuss the role of capital market in economic growth of India?
9 Discuss objectives of capital market?
10 Write down the difference between capital market and money market?

2.9 References

- Agarwal Raju, Jain Sonal & Rathi Manish (2011). 'Finance for Strategic Decisions', RBD Professional Publications, Jaipur.
- Agarwal Sanjiv (1997) 'Manual of Indian Capital Market', Bharat Law House, New Delhi
- Amling, Frederick. (1970). 'Investments: An Introduction to Analysis and Management', Prentice -Hall Inc., New Jersey.
- Avadhani V. A., (2003). 'Investment and Securities Markets inI ndia', Himalaya Publishing House, Mumbai
- Aylward Anthony & Glen Jack D., (1999) 'Primary Securities Markets: Cross Country Findings.IFC Working Paper 39.
- Bhalla, V.K. (2004), 'Investment management; Security Analysis and Portfolio Management', S. Chand, New Delhi.
- Chandra Prasanna., (1984) 'Financial Management: Theory & Practice',Tata Mc Graw –Hill Publishing Company Ltd., New Delhi.
- Cherunllam, Francis (2002), 'Business Environment', Himalaya Publishing House, Nagpur, Banglore, Hyderabad.

Unit-3 : Banking and Non Banking Financial Intermediaries

Structure of Unit:

3.0 Objectives

After completing this unit, you will be able to:

- Delineate Indian financial system concept & composition.
- Describe financial intermediaries.
- Differentiates banking and non banking intermediaries.
- Identify different benefits & problems for financial intermediaries in India.
- Describe classification of financial intermediaries.
- Recognize the roles of financial intermediaries.
- Know about the guidelines for non banking intermediaries in India.

3.1 Introduction

The financial system facilitates transfer of funds, through financial institutions, financial markets, financial instruments and services. Financial institutions act as mobilises and depositories of savings, and as purveyors of credit or finance. They also provide various financial services to the community. They act as intermediaries between savers and investors. All banks and many non-banking institutions also act as intermediaries, and are called as non-banking financial intermediaries (NBFI).

Financial institutions are divided into the banking and non-banking ones. The distinction between the two has been highlighted by characterizing the former as “creators” of credit, and the latter as mere “purveyors” of credit. The banking system in India comprises the commercial banks and co-operative banks. The examples of non-banking financial institutions are Life Insurance Corporation (LIC), Unit Trust of India (UTI), and Industrial Development Bank of India (IDBI).

Financial markets provide facilities for buying and selling of financial claims and services. The participants on the demand and supply sides of these markets are financial institutions, agents, brokers, dealers, borrowers, lenders, savers, and others who are inter-linked by the laws, contracts, covenants, and communication networks of the land. Financial markets are sometimes classified as primary (direct) and secondary (indirect) markets. The primary markets deal in new financial claims or new securities and, therefore, they are also known as New Issue Markets. On the other hand, secondary markets deal in securities already issued or existing or outstanding. The primary markets mobilize savings and they supply fresh or additional capital to business units. The secondary markets do not contribute directly to the supply of additional capital; they do so indirectly by rendering securities issued on the primary markets liquid.

Stock markets have both the primary and secondary market segments. More often financial markets are classified as money markets and capital markets. While the money market deals in the short-term claims (with a period of maturity of one year or less), the capital market does so in the long-term (maturity period above 1 year) claims.

Commercial banks, for example, belong to both. While Treasury Bills Market, Call Money Market, and Commercial Bills Market are examples of the money market, Stock Market and Government Bonds Market are examples of the capital market. Financial asset represent a claim to the payment of a sum of money sometime in future (repayment of principal) and /or a periodic (regular or not so regular) payment in the form of interest or dividend.

The detailed list of Indian Financial system consisting of Financial Institutions, Financial Markets, Financial Instruments and Financial Services is as under:

Financial Institutions (Intermediaries and Special Development)

i) Banking**:** Reserve Bank of India (RBI), Commercial Banks, Co-operative Credit Societies, Co-operative Banks, Post-office Saving Banks.

ii)***Non-Banking***: Provident and Pension Funds, Small Savings Organizations, Life Insurance Corporation (LIC), General Insurance Corporation (GIC), Unit Trust of India(UTI), Mutual Funds, Investment Trusts, Investment Companies, Finance Corporations, Nidhis, Chit Funds, Hire-Purchase Finance Companies, Lease Finance Companies, National Housing Bank (NHB), Housing and Urban Development Corporation (HUDCO), Housing Development Finance Corporation (HDFC), and other housing finance companies, Manufacturing companies accepting public deposits, Venture Capital Funds and National Cooperative Bank of India(NCBI).

Industrial Finance Corporation of India (IFCI or IFC), Industrial Credit and Investment Corporation of India (ICICI), Industrial Development Bank of India (IDBI), Industrial Reconstruction Bank of India(IRBI),Export and Import Bank of India(EXIM Bank), National Bank for Agricultural and Rural Development(NABARD), Shipping Credit and Investment Company of India (SCICI),Tourism Finance Corporation of India (TFCI),Risk Capital and Technology Finance Corporation (RCTFC),Agricultural Finance Consultancy Ltd. (AFC), National Cooperative Development Corporation (NCDC), Central Warehousing Corporation(CWC),State Warehousing Corporations (SWCs), Rural Electrification

Corporation(REC),National Industrial Development , Corporation (NIDC), National Small Industries Corporation (NSIC) and Small Industries.

iii**)** ***Regulatory***: Reserve Bank of India, Securities and Exchange Board of India (SEBI), Board for Industrial and Financial, Reconstruction (BIFR), Board for Financial Supervision, Insurance Regulatory Authority.

iv) ***Others:*** Deposit Insurance and Credit Guarantee Corporation (DICGC),Export Credit and Guarantee Corporation (ECGC), Technical Consultancy Organizations (TCOs),Stock Holding Corporation of India(SHCI),Credit Rating Information , Services of India (CRISIL),Discount and Finance House of India(DFHI),Infra-structure Leasing and Financial Services ,Ltd.(ISLFS), Technology Development and Information Company of India(TDICI),Merchant Banks, Factoring Companies, Money Lenders, Indigenous Bankers, Securities Trading Corporation of India(STCI),Primary Dealers, Investment Information and Credit Rating Agency (ICRA),Depositories and Custodians.

3.2 Evolution of Indian Financial System

The Indian Financial System was transpired from the traditional Barter system to the money lenders, the Nidhis and Chit Funds. In the later stages the concept of cooperatives was started and the same was introduced in India during 1904 by way of "Cooperative Society Act" and it paves the way in introduction of cooperative banking institutions in India.

The commercial banks were started and they occupied the prime role in Indian financial system. In India Commercial Banks are broadly categorized into Scheduled Commercial Banks and Unscheduled Commercial Banks. The Scheduled Commercial Banks have been listed under the Second Schedule of the Reserve Bank of India Act, 1934. The selection measure for listing a bank under the Second Schedule was provided in section 42 (60 of the Reserve Bank of India Act, 1934). The modern Commercial Banks in India cater to the financial needs of different sectors.

The main functions of the commercial banks comprise, transfer of funds, acceptance of deposits, offering those deposits as loans for the establishment of industries, purchase of houses, equipments, capital investment purposes etc. The banks are allowed to act as trustees. On account of the knowledge of the financial market of India the financial companies are attracted towards them to act as trustees to take the responsibility of the security for the financial instrument like a debenture. During 1969 and 1980 some banks were nationalized on public interest and during later stages the Indian Banking industry has been opened to all and it led to universal banking practices in the Indian financial system.

The concept of nidhis and chit funds are played key role in Indian financial system and it worked as bridge between the age old financial practices and the modern banking system. It is also stated that even today the chit fund industry is playing major role in reaching the public and it has become a major substitute to the banks where ever the Bank is not able to reach and cater their needs, such places the chit fund companies and nidhis are in handy to them.

3.3 Financial Markets Instruments & Financial Services

i). ***Instruments:*** Equity (ordinary) shares, Preference shares, Industrial debentures or bonds, Capital gains bonds, Government (gilt-edged) securities or bonds, Relief bonds, National development bonds, Indira Vikas Patra, Kisan Vikas Patra, National Savings Scheme, National Savings Certificates, Deposits with banking institutions, Deposits with companies, Insurance Plans, Units, Participation Certificates, Pass-through certificates, Certificates of deposits(CDs), Commercial Papers(CPs), Treasury Bills, Commercial Bills, Call and Notice Money, Hundis, Mortgages, National Savings Annuity Certificates, Social Security Certificates, Trade Credit, Chits, Inter-corporate deposits, Repos & Reverse Repos, Stock invest, Global Depository Receipts(GDRs),,Foreign Bonds, Foreign Currency Convertible Bonds (FCCBs), Eurobonds & Euro notes, Floating Rate Notes(FRNs), Futures, Options, Swaps and other financial derivatives, Zero coupon bonds, Non-voting shares and Indexed bonds.

ii). ***Markets:*** Call Money Market, Treasury Bills Market, Commercial Bills Market, Government Securities Market, Industrial Securities Market (Stock Market), Foreign Exchange Market, Over-the-Counter Exchange (OTCE), Discount Market, Market for Commercial Paper and Certificates of deposits, Mortgage Market, Market for Guarantees, National Stock Exchange(NSE), Derivatives Markets, Bonds Market and Equities Market.

Table 3.1 : Ownership patterns of financial institution

Institution	Ownership	percentage
EXIM Bank	Government of India	100
NABARD	Government of India	99.3
	Reserve Bank of India	0.7
National Housing Bank (NHB)	Reserve Bank of India	100
SIDBI	Public Sector Banks	62.5
	Insurance companies	21.9
	Financial institutions	5.3
	Others	10.3

Financial Services:-

The basic services offered by the financial intermediaries are the following;

- financial consultancy, offered to the investors regarding the possibilities of investing or the management of the owned portfolio;
- the supervision of the real and financial markets;
- classical transactions, regarding the purchase and sale of financial assets on the market and also other transactions regarding the national and international payments and settlements;
- financing the economic activity, the national and international investments and that of the foreign commerce;
- managerial expertise, as in offering consultancy in business management;
- underwriting financial operations, by offering banking collaterals for the international payments, collateralizing the issue of financial securities;
- the insurance against financial risks.

Financial Services consists of Hire-purchase and instalment credit, Deposit insurance and other insurance, Financial and performance guarantees, Acceptances, Merchant banking, Factoring, Credit rating, Credit information, Technical and economic consultancy, Stock holding, Discounting and Rediscounting, Refinancing, Underwriting, Leasing, Technology development, Funds transfer, Credit cards, Safe deposit vaults, Brokerage, Portfolio management, Deposit acceptance, Giving credit, Loan syndicating, Managing capital issues, Market making, Custodial services and Depository services. Financial system helps to increase output by moving the economic system towards the existing production frontier. This is done by transforming a given total amount of wealth into more productive forms. It induces people to hold fewer saving in the form of precious metals, real-estate land, consumer durables, and currency and to replace these assets by bonds, shares, units, etc. It also directly helps to increase the volume and rate of saving by supplying diversified portfolio of such financial instruments, and by offering an array of inducements and choices to woo the prospective saver. The growth of “banking habit” helps to activate saving and undertake fresh saving. The saving is said to be “institution-elastic” i.e., easy access, nearness, better return, and other favourable features offered by a well-developed financial system lead to increased saving.

A financial system helps increase the volume of investment also. It becomes possible for the deficit spending units to undertake more investment, because it would enable them to command more capital. Without the transfer of purchasing power to an entrepreneur, he cannot become the entrepreneur. Further, it encourages investment activity by reducing the cost of finance and risk. This is done by providing insurance services and hedging opportunities, and by making financial services such as remittance, discounting, acceptance and guarantees available. Finally, it not only encourages greater investment but also raises the level of resource allocation efficiency among different investment channels. It helps to sort out and rank investment projects by sponsoring, encouraging, and selectively supporting business units or borrowers through more systematic and expert project appraisal, feasibility studies, monitoring, and by generally keeping a watch over the executing and management of projects.

In a developing economy persons require an increasing number of alternative ways of holding wealth. Similarly, individuals and business, private or public, require funds to finance their activities. These activities may be again consumptive or productive activities. The activities may require every day working capital for a small firm or the capital needs of a sophisticated steel project involving an outlay of hundreds of crores of rupees. Institutionalization of savings and investment process is a logical and rational step in the economic expansion, development and capital formation process of a highly industrialized society. Financial intermediation is the process through which the differing needs of ultimate savers, investors and consumers are reconciled.

Financial system is linked to a reservoir. When the current consumption of householders and the economic agents are short of their income, the resulting savings flow into the reservoir. Business whose current expenditure exceeds their income borrows for meeting their excess expenditure. Without these financial intermediaries the economy's savings and investing transactions would be fragmented. New forms of credit and new types of financial institutions may increase the volume of capital of firms by facilitating the mobilization of funds. Financial intermediaries are expected to play a very important role in the development of large-scale industries in India.

The financial intermediaries perform the function of transferring funds from persons with excess money to persons who require extra funds to fulfil their expenditure or investment plans. They are responsible for channelling savings to investment and consumption purposes and without them many of the funds in the economy would remain idle. Economic growth is thus closely associated with the expansion and increased sophistication of financial activity. Financial intermediaries such as the commercial banks and public financial institutions including Life Insurance Corporation have been transmitting funds from the investors to the industries. But the Non-Banking financial intermediaries in the private sector have created major impact for innovation during the last two decades in the post independence era.

3.4 Financial Intermediaries

A financial intermediary is a financial institution such as bank, building society, insurance company, and investment bank or pension fund. A financial intermediary offers a service to help an individual/ firm to save or borrow money. A financial intermediary helps to facilitate the different needs of lenders and borrowers.

For example, if you need to borrow $1,000 – you could try to find an individual who wants to lend $1,000. But, this would be very time consuming and you would find it difficult to know how reliable the lender was.

Therefore, rather than look for individuals to borrow a sum, it is more efficient to go to a bank (a financial intermediary) to borrow money. The bank raises funds from people looking to deposit money, and so can afford to lend out to those individuals who need it.

- Financial intermediation is the process of accepting funds from one entity and lending these funds to another entity.
- Financial intermediaries intermediate between the net savers and net borrowers of funds in an economy.

3.4.1 Examples of Financial Intermediaries

Insurance Companies

You have a risky investment. You might wish to insure, against the risk of default. Rather than trying to find a particular individual to insure you, it is easier to go to an insurance company who can offer insurance and help spread the risk of default.

Financial Advisers

A financial adviser doesn't directly lend or borrow for you. They can offer specialist advice on your behalf. It saves you understanding all the intricacies of the financial markets and spending time looking for best investment**.**

Credit Union

Credit unions are informal types of banks which provide facilities for lending and depositing within a particular community.

Mutual funds/ Investment trusts

These are mutual investment schemes. These pool the small savings of individual investors and enable a bigger investment fund. Therefore, small investors can benefit from being part of a larger investment trust. This enables small investors to benefit from smaller commission rates available to big purchases.

3.4.2 Service offered by Financial Intermediaries

The basic services offered by the financial intermediaries are the following;

- financial consultancy, offered to the investors regarding the possibilities of investing or the management of the owned portfolio;
- the supervision of the real and financial markets;
- classical transactions, regarding the purchase and sale of financial assets on the market and also other transactions regarding the national and international payments and settlements;
- financing the economic activity, the national and international investments and that of the foreign commerce;
- managerial expertise, as in offering consultancy in business management;
- underwriting financial operations, by offering banking collaterals for the international payments, collateralizing the issue of financial securities;
- the insurance against financial risks. Financial intermediation has a series of advantages and disadvantages.

3.4.3 Benefits of Financial Intermediaries

The main advantages which evolve from intermediation on the national and international financial markets are determined by informing and counseling the users and also by the direct involvement, as a guarantee of the financial intermediations' quality. Some of these advantages are:

1. financial consultancy, offered to the investors and capital users;
2. the possibility of better gathering and valuing the existing information on the market;

3. Additional facilities offered to the users and capital owners, a part of these being taken over by intermediation institutions.
4. Lower search costs. You don't have to find the right lenders; you leave that to a specialist.
5. Spreading risk. Rather than lending to just one individual, you can deposit money with a financial intermediary who lends to a variety of borrowers – if one fails; you won't lose all your funds.
6. Economies of scale. A bank can become efficient in collecting deposits, and lending. This enables economies of scale – lower average costs. If you had to sought out your own saving, you might have to spend a lot of time and effort to investigate best ways to save and borrow.
7. Convenience of Amounts. If you want to borrow $10,000 – it would be difficult to find someone who wanted to lend exactly $10,000. But, a bank may have 1,000 people depositing $10 each. Therefore, the bank can lend you the aggregate deposits from the bank and save you finding someone with the exact right sum

3.4.4 Potential Problems of Financial Intermediaries

- There is no guarantee they will spread the risk. Due to poor management, they may risk depositors' money on ill-judged investment schemes.
- Poor information. A financial intermediary may become complacent about spreading the risk and invest in schemes which lose their depositors money (for example, banks buying US mortgage debt bundles, which proved to be nearly worthless – precipitating the global credit crunch.)
- They rely on liquidity and confidence. To be profitable, they may only keep reserves of 1% of their total deposits. If people lose confidence in the banking system, there may be a run on the bank as depositors ask for their money bank. But the bank won't have sufficient liquidity because they can't recall all their long-term loans. (This can be overcome to some extent by a lender of last resort, such as the Central Bank and / or government.
- big transaction costs, due to collection of taxes, fees and commissions;
- the loss of direct contact with the international financial market, therefore some investors aren't sensitive anymore to the markets' signs;
- the existence of a routine in the relationship with the financial intermediary, many markets being led according to the solutions offered over the time by important intermediary firms.

The presence of the financial intermediaries - that make the link between the economics agents, with the needs of resources and the one with surplus of resources - determinates the evolution of the banking system and the structure modification of these. What is the difference between a bank and a financial intermediary? The banks distinguish itself from the financial intermediary through its capacity of taking inside the costs and its informatics efficiency, and so the incomes are growing.

The Indian financial sector is currently facing a number of challenges such as frequent changes in technology required for modern banking, increasing competition, rising customer expectations, etc. Hence, the efficiency and productivity issues have become a major area of concern for the banks' management.

In fact, productivity is an important criterion to measure the performance of banks in addition to profitability, financial, and operational efficiency. An efficient management of banking operations aimed at increasing the efficiency and productivity of the financial sector requires up to date knowledge.

There are two main approaches that exist in banking theory literature to define the banking function: the production and intermediation approaches [Sealey & Lindley (1977)]. Under the production approach, which was pioneered by Benston (1965), a financial institution is defined as a producer of services for account holders.

That is, they perform transactions on deposit accounts and process documents such as loans. The intermediation approach on the other hand, assumes that financial firms act as an intermediary between savers and borrowers, hypothesizing total loans and securities as outputs; whereas deposits with labour and physical capital are defined as inputs. For the purpose of this study, a variation of the intermediation approach or asset approach originally developed by Sealey and Lindley (1977) will be adopted in the definition of inputs and outputs used.

3.4.5 Types of Intermediaries

Financial system can be broadly divided into the banking system and non-bank financial intermediaries.

The banking system is the largest component, accounting for approximately 70 percent of the financial system's total assets.

The *banking system can be further divided into three main groups*, namely the commercial banks, financial companies, and merchant banks.

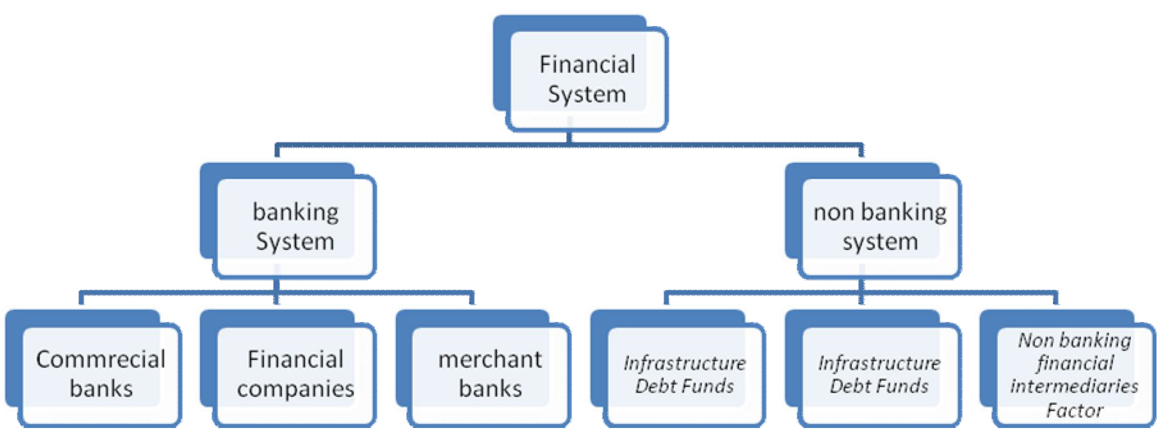


Figure 3.1 : Financial System

The commercial banks are the main players in the banking system. They are the largest and most significant providers of funds in the banking system, enjoying the widest scope of permissible activities, those of which are able to engage in a full range of banking services.

Financial companies formed the second largest group of deposit taking institutions in India. Traditionally, financial companies specialize in consumption credit, comprising mainly of hire purchase financing, leasing, housing loans, block discounting, and secured personal loans. They play a role in the short-term money market and capital raising activities such as financing, syndicating, corporate financing, and management advisory services that arrange for the issue and listing of shares, as well as managing portfolios. The term "merchant banking", where an investment bank will use its own money / capital to take a major stake on its own account in a deal, for example M&A deal They were called merchant banks because they helped companies export overseas in the days of the British empire, an activity which is now called Trade Finance and is carried out by commercial banks.

According to the Reserve Bank of India Amendment Act 1997 the *Non Banking Finance company* was defined as under:-

⇒ A financial institution which is a company,

⇒ A non banking institution which is a company and whose principal business is to receiving of deposits under any scheme/arrangement/in any other manner or lending in any manner and

⇒ Other non banking institutions/class of institutions as the RBI may specify.

The directions apply to a Non banking financial intermediaries which is defined to include only *non-banking institution*, which is any hire-purchase finance, loan or mutual benefit financial company and an equipment leasing company but excludes an insurance company/stock exchange/stock broking company /merchant banking company.

The RBI (Amendment) Act, 1997 defines ***non banking financial intermediaries'*** as an Institution or company whose principal business is to accept deposits under any scheme or arrangement or in any other manner, and to lend in any manner. As a result of this new definition, a number of loan and investment Companies registered under the Companies Act by Business houses for the purpose of making investments in group of companies are now included as Non banking financial intermediaries.

3.5 Definition of Bank

A financial intermediary is defined as a bank when it performs both savings mobilisation and lending

3.5.1 Definition of a Non-Bank Financial Intermediary

if a financial intermediary is only active on "one side of the balance sheet" (i.e. it offers deposits but does not lend out to the public, or it offers loans but gets funding from sources other than private savings).

Non-bank financial intermediary is a collection of institutions, which range from leasing, factoring and venture companies as well as those who conduct contractual savings and institutional investors. They compete with banks and force them to be more efficient in delivery of services. They are also actively involved in the securities markets and allocation of long-term financial resources. We may say Non-bank financial institutions (NBFI) also played an important role in the build-up and transmission of risks leading up to the financial crisis.

Non-Bank Financial Institutions (NBFIs) play important dual roles in a financial system. They complement the role of commercial banks by filling in financial intermediation gaps by offering a range of products and services. They also compete with commercial banks, forcing the latter to be more efficient and responsive to their customers' needs. Non-banking financial institutions (NBFIs) are an important part of the Indian financial system. The NBFIs at present consist of a heterogeneous group of institutions that cater to a wide range of financial requirements. The major intermediaries include financial institutions (FIs), non-banking financial companies (NBFCs) and primary dealers (PDs).

The non-banking financial sector is witnessing a consolidation process, with smaller Non banking financial intermediaries (deposit taking) opting for either merger or closure and some larger ones getting converted into non-deposit taking Non banking financial intermediaries. Non banking financial intermediaries are comfortably placed with higher capital. The financial performance of deposit-taking Non-Banking Financial Companies (NBFCs-D) showed an improvement as reflected in the increase in their operating profits mainly emanating from growth in fund-based income systemically Important-Non-deposit taking Non banking financial intermediaries (NBFCs-ND-SI) segment continued to rely on bank finances for their resource requirement. There is sign of deterioration in the quality of assets in respect of Non-banking financial intermediaries-ND-SI. The set of regulations prescribed for Non-banking financial intermediaries sector is expected to make the Non banking financial intermediaries more resilient in the medium term. The combined balance sheets of financial institutions (FIs) expanded and operating profit as well as net profit have increased significantly. The impaired assets of the FIs showed increase and are a matter of concern.

The Financial intermediaries in Indian Financial System are broadly characterized by Public owned, Monopoly or Oligopoly or Monopolistic market structure and are centralized. The Indian financial system has another part which comprises a large number of private owned, decentralized, and relatively small sized financial intermediaries and which makes a more or less competitive market. Some of them are fund based, and are called (NBFCs) and some are provide financial services (NBFSCs) Both NBFIs.

Non banking financial intermediaries are

(1) Loan companies (LCs)

(2) Investment companies or ICs

(3) Hire-Purchase finance companies or HPFCs

(4) Lease finance companies or LFCs

(5) Housing finance companies (or) HFCs

(6) Mutual Benefit financial companies or MBFCs

(7) Residuary non-banking companies or RNBCs

(8) Merchant Banks

(9) Venture capital funds

(10) Factors

(11) Credit Rating Agencies

(12) Depositories and custodial services.

Three new categories of Non banking financial intermediaries have been created – Infrastructure Debt Funds (NBFC-IDF), Micro Finance Institution (NBFC-MFI) and Non banking financial intermediaries Factor.

NBFCs are classified into two categories, based on the liability structure, *viz.*, Category ‘A’ companies (NBFCs accepting public deposits or non banking financial intermediaries-D), and Category ‘B’ companies (NBFCs not raising public deposits or Non banking financial intermediaries-ND). NBFCs-D are subject to requirements of capital adequacy, liquid assets maintenance, exposure norms (including restrictions on exposure to investments in land, building and unquoted shares), ALM discipline and reporting requirements; in contrast, until 2006Non banking financial intermediaries-ND were subject to minimal regulation.

Since April 1, 2007, non-deposit taking Non banking financial intermediaries with assets of 1 billion and above are being classified as Systemically Important Non-Deposit taking Non banking financial intermediaries (NBFCs-ND-SI), and prudential regulations, such as capital adequacy requirements and exposure norms along with reporting requirements, have been made applicable to them. The asset liability management (ALM) reporting and disclosure norms have also been made applicable to them at different points of time.

NBFCs are also classified in terms of activities into Asset Finance Companies (AFC), Investment Companies (IC), Loan Companies (LC), Infrastructure Finance Companies (IFC), Core Investment Companies (CIC), Infrastructure Debt Fund - Non-Banking Financial Companies (IDF-NBFC), Non-Banking Financial Company–Micro Finance Institutions (NBFC-MFI) and non banking financial intermediaries-Factors. During 2011-12, two new categories of non banking financial intermediaries, *viz.*, Infrastructure Debt Funds –Non banking financial intermediaries (NBFC-IDF) and Micro Finance Institution (NBFC-MFI) – were created and brought under separate regulatory framework. In addition, a new category of Non banking financial intermediaries-Factors was introduced in September 2012. Earlier in April 2010, a regulatory framework for Systemically Important Core Investment Companies (CIC NDSI) was created for companies with an asset size of `1 billion and above, whose business is investment for the sole purpose of holding stakes in group concerns, are not trading in these securities and are accepting public funds. Prudential requirements in the form of Adjusted Net Worth and leverage were also prescribed for CIC-ND-SIs as they were given exemption from NOF, capital adequacy and exposure norms.

Non banking financial intermediaries-MFI is defined as a non-deposit taking Non banking financial intermediaries (other than a company licensed under Section 25 of the Indian Companies Act, 1956) that fulfils the following conditions:

(i)Minimum Net Owned Funds of `5 crore (`2 crore for the North-eastern Region),

(ii) Not less than 85 per cent of its net assets are in the nature of "qualifying assets",

(iii) The income it derives from the remaining 15 per cent assets in accordance with the regulations specified in that behalf.

Non-banking financial intermediaries which do not qualify as non banking financial intermediaries-MFI shall not extend loans to the micro finance sector, in excess of 10 per cent of its total assets. Given the functional hardship faced by the MFI sector following the Andhra Pradesh Micro Finance Institutions (Regulations of Money Lending) Ordinance, 2010 and to give reprieve to the sector, the Reserve Bank modified the regulatory framework for MFIs to allow for time for compliance to regulations and allow them to register with the Bank as Non banking financial intermediaries-MFI early. Considering the importance of this sector for the development and regulation of micro-finance institutions to promote financial inclusion, the Micro-Finance Institutions (Development and Regulation) Bill, 2012 was introduced in the Lok Sabha on May 22, 2012 (Box VI.1). 6.17 The ownership pattern of Non banking financial intermediaries-ND-SI as well as deposit-taking Non banking financial intermediaries as at end-March 2012, suggested that government owned companies have a share of below 3 per cent.

micro-finance institution (MFI) as an organisation, other than a bank, providing micro-finance services as micro credit facilities not exceeding `5 lakh in aggregate, or with the Reserve Bank's specification of `10 lakh per individual. Subsidiary services like collection of thrift, pension or insurance services and remittance of funds to individuals within India also come under these services.

3.5.2 Evolution of Non-Banking Financial Companies

India soon after independence launched on a programme of rapid industrialization which needed long term investment in capital assets. Industries which were essential and required huge investments were setup by the Government of India in the public sector. The government also extended guarantees whenever loan was obtained by the public sector industries from the foreign agencies. Public financial institutions were established for instance, the Industrial Development Bank of India and the statutory Finance Corporations. The development banks have been providing large and medium industrial concerns direct finance assistance and small and medium industrial concerns through the State Financial Institutions. These corporations issue bonds and debentures and also accept deposits from the public. But the private sector had to rely mostly on the commercial banks which were also not grown to such a scale as to provide corporate funds required by the promoters. Traditionally banks have been financing manufacturing activity by providing working capital. With the shortage of financial resources against expanding activities the companies were mostly depending on credit deals. Capital goods such as machinery, equipment etc., were imported on deferred payment terms. With the inadequacy of the financial institutions and the services provided by them companies were set up in the private sector under the Companies Act whose main business was to do non-banking financial business. To set up a non-banking financial company is a very attractive proposition. There is no gestation period. The capital investment in equity is also not huge as in the case of manufacturing companies. In most of the companies the equity was built up on long term by successful operation. The advantages of securing additional assets through non-banking financial companies came to be realised in the seventies. Acquisition of equipment and capital assets through leasing was favoured to overcome the disabilities arising out of the MRTP Act which prescribed asset qualification for declaration of an undertaking as a giant. The MRTP Act declared any undertaking having ì.100 crore assets as disclosed in the balance sheet as an MRTP company. As assets secured on lease are owned by the lessor company and not by the lessee and are not also in theory transferable to the lessee the leased equipment or assets did not form the constituent of gross block of the borrowing manufacturing company. Many industrial groups or manufacturing companies set up non banking financial companies as associate finance companies. There are no special advantages derived under the MRTP Act now as the concept of MRTP company has lost its significance when the pre-entry sanctions under that Act were removed.

The non banking financial sector in India has recorded marked growth in the recent years, in terms of the number of Non-banking financial companies (NBFCs), their deposits and so on. Keeping in view the growing importance of Non banking financial intermediaries, the banking laws (miscellaneous provisions) act, 1963 was introduced to regulate them. To enable the regulatory authorities to frame suitable policy measures, several committees have been appointed from time to time to conduct an in depth study of these institutions and make suitable recommendations for their healthy growth, within the given regulatory frame work. The suggestions/recommendations made, by them in the context of the contemporary financial scenario, formed the basis of the formulation of policy measures by the regulatory authorities/Reserve Bank of India (RBI). The committees that deserve specific mention in this regard are the: Bhabatosh Datta study group (1971), James Raj study Group (1975), Chakravarthy Committee (1985), Vaghul committee (1987), Narasimham Committee on Financial systems (1991) and Shah committee 1992)). The Shah committee, as a follow-up to the Narasimham committee, was the first to suggest a comprehensive regulatory framework for non banking financial intermediaries. While, in principle, endorsing the Shah Committee's frame work of regulations for Non banking financial intermediaries, the RBI had implemented a number of its recommendations and incorporated them in the RBI Directions that regulate and supervise the working and operations of such companies. The Khanna Group, 1996, had suggested a supervisory framework for Non banking financial intermediaries. In pursuance of its recommendations, the RBI Act was amended in January 1997. As a further follow-up, the RBI Acceptance of public deposits directions, the RBI Non banking financial intermediaries Prudential norms directions and the RBI NBFCs auditors report directions were modified /issued in January 1998. The RBI acceptance of public deposits directions were modified in December 1998, as recommended by the Vasudev Task Force Group.

3.5.3 The Resources of Non-Banking Financial Intermediaries

The resources of non banking financial intermediaries are derived from deposits (regulated and exempted), and ne net owned funds. Deposits means, any money received by a non-banking company by way of a deposit or loan or in any other form.(apart from usual deposits, i.e. interoperate loans, borrowing by Pvt. Limited Non banking financial intermediaries from their shareholders. Regulated deposit means, a deposit which is subject to certain ceiling and other restrictions imposed by regulatory measures. It includes

(a) nonconvertible debentures

(b) deposits received by companies from their shareholders

(c) deposits guaranteed by directors

(d) fixed deposits etc. received from the public.

(e)interoperate deposits.

Exempted deposits signify those types of deposits/borrowings which are outside the scope of the regulatory measures. It includes

(a) borrowings from banks and specified financial institutions.

(b)money received from central/state/foreign governments.

(c)security deposits.

(d) Advances received against orders

(e) convertible debentures, and net-owned funds means the aggregate of paid up capital and free reserves.

3.5.4 Reasons for the Growth of Non Banking Finance Companies are

a) they provide tailor made services to the clients;

b) there has been a comprehensive regulation of Non banking financial intermediaries;

c) customers have been attracted to them by their higher level of customer-orientation, lesser ore/post sanction requirements, simplicity and speed of their services;

d) the monetary and credit policies have created an unsatisfied fringe of borrowers, i.e. the borrowers outside the purview of banks. The Non banking financial intermediaries have catered to the needs of this section of borrowers;

e) the relatively higher interest rates offered by them on deposits have attracted a large number of small savers towards them

3.5.5 Classification of non banking financial intermediaries

Classification of non banking financial intermediaries as given in the Reserve Bank Amendment Act 1997,

1) Equipment leasing company (ELC): Carrying on as its Principal Business, the activity of leasing of equipment.

2) Hire Purchase finance company (HPFC): Carrying hire purchase transactions (or) financing of such transactions.

3) Housing finance company (HFC).

4) Investment Company (IC): Carrying the business of acquisition of securities.

5) Loan Company (LC): Financing by making loans and advances. (Does not include ELC, HPFC, HFC).

6) Mutual Benefit companies (MBFC).

7) Residual non-banking company (RNBC): Company which receives any deposit under any scheme and arrangement, in one lump sum or in instalments by way of contributions or subscriptions or by sale of units or certificates or other instruments or in any other form according to definition of Non banking financial intermediaries.

8) Miscellaneous non-banking companies (MNBC): Managing, conducting or supervising as a promoter foreman or agent of any transaction or arrangement. Ex: conducting any other form of Chit and Kuri which is different from type of business mentioned above.

After the above classification the Non Banking Financial companies were re-classified twice, during 1998 it was classified as four types they were

1) Equipment leasing,

2) Hire Purchase,

3) Investment Company and

4) Loan Companies.

During 2006 the Non-banking financial intermediaries were reclassified as three types they are

1) Asset Finance companies (in this both Equipment Leasing and Hire Purchase companies were merged),

2) Investment Companies and

3) Loan Companies

Apart from those classifications, in order to operate these Non banking financial intermediaries smoothly certain regulations/directions were issued they are

a) Regulations for deposits for Non banking financial intermediaries accepting deposits,

b) Regulations for Non banking financial intermediaries not accepting deposits and

c) Regulations for core investment companies to smooth functioning of their businesses as well as to give confidence to the participants as well as operators.

In a very broad sense, NBFIs would include even financial institutions like insurance companies, Life insurance Corporation of India, Unit Trust of India, Industrial Credit and Investment Corporation of India Ltd., Industrial Finance Corporation of India and Industrial Reconstruction Corporation of India Ltd., as also State Financial Corporations.

But for the purpose of our present study, the scope of the term is confined to the types of financial companies enumerated in clause (p) of paragraph 2(1) of the Non-Banking Financial Companies (Reserve Bank) Directions, 1966, which mobilize savings of the community by way of deposits or otherwise and utilize them for the purpose of lending or investment. Thus the Non banking financial intermediaries that we shall discuss here are hire-purchase finance, housing finance, investment, loan, miscellaneous financial or mutual benefit financial companies but excluding insurance, stock exchange or stock broking companies.

Non-banking financial companies (NBFCs) encompass an extremely heterogeneous group of intermediaries. They differ in various attributes, such as, size, nature of incorporation and regulation, as well as the basic functionality of financial intermediation. Notwithstanding their diversity, Non banking financial intermediaries are characterised by their ability to provide *niche* financial services in the Indian economy. Because of their relative organisational flexibility leading to a better response mechanism, they are often able to provide tailor-made services relatively faster than banks and financial institutions.

The non-banking financial companies (NBFCs) flourished in India in the decade of the 1980s against the back drop of a highly regulated banking sector. While the simplified sanction procedures and low entry barriers encouraged the entry of a host of Non banking financial intermediaries, factors like flexibility, timeliness in meeting credit needs and low operating cost provided the Non banking financial intermediaries with an edge over the banking sector.

Non banking financial intermediaries proliferated by the early 1990s. This rapid expansion was driven by the scope created by the process of financial liberalization in fresh avenues of operations in areas, such as, hire purchase, housing, equipment leasing and investment. The business of asset reconstruction has recently emerged as a green field within this sector following the passage of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002.

NBFCs are financial intermediaries engaged primarily in the business of accepting deposits delivering credit. They play an important role in channelizing the scarce financial resources to capital formation. Non banking financial intermediaries supplement the role of banking sector in meeting the increasing financial needs of the corporate sector, delivering credit to the unorganised sector & to small local borrowers. All Non banking financial intermediaries are under direct control of RBI in India. A Non-Banking Financial Company (NBFC) is a company incorporated under the Companies Act, 1956 and conducting financial business as its principal business. In contrast, companies incorporated under the same Act but conducting other than Financial business as their principal business is known as non-banking non-financial Companies.

NBFCs are different from banks in that Non-banking financial intermediaries cannot accept demand deposits, issue checks to customers, or insure deposits through the Deposit Insurance and Credit Guarantee Corporation (DICGC).

In India, the non-banking financial sector comprises a multiplicity of institutions, which are defined under Section 45I (a) of the Reserve Bank of India Act, 1934. These are equipment-leasing companies (EL), hire purchase companies (HP), investment companies, loan companies (LCs), mutual benefit financial companies (MBFC), miscellaneous non-banking companies (MNBC), housing finance companies (HFC), insurance companies (IC), stock broking companies (SBC), and merchant banking companies (MBC).

A non-banking company which conducts primarily financial business and belongs to none of these categories is called a residuary nonbanking company (RNBC). While most institutions of India's non-banking financial sector are also found in other countries financial systems, two of them, MBFCs and MNBCs, better known as Nidhis and Chit Fund Companies, respectively, are genuinely Indian institutions and rarely found outside South Asia. Inside India, they are most popular in TamilNadu and Kerala, from where they have originated. A Nidhi does business only with its equity share holders. Much like a cooperative bank, a Nidhi accepts deposits and makes loans, which are mostly secured by jewelry. A chit fund, in Kerala also known as kuri, is a particular form of a rotating savings and credit association (ROSCA), which is most easily explained by means of an example. Twenty people, say, agree to contribute a fixed amount of ì.1,000 every month . So the group Pools in ì.20,000 each month as prize money. Every month an auction is held and in each auction, the bidder who offers the highest discount is given the prize money 1 minus the discount. For example, when a member bids ì.4, 000, she/he will be paid ì.16,000. The discount of ì.4,000 is equally shared by all members. In this example, each member thus earns a dividend of ì.200. The winner of an auction continues to pay the monthly contribution but is not eligible to bid in subsequent auctions. According to this system, after 20 months each member will receive the prize exactly once, at which point the chit fund comes to an end. MNBC or Chit Fund Company acts as commercial organizer of Chit Funds. Financial intermediation in chit funds takes place instantly and members' contributions do not appear as deposits on Chit Fund Companies balance sheets. For 2004, the turnover in registered chit funds is estimated at ì. 20,000 crore.

NBFCs are essential to a country's financial system. Non banking financial intermediaries provide services not well suited for banks. Banks primarily provide payment services and liquidity. Since banks have to maintain the value of deposits, they tend to have mostly debt-type, as opposed to equity-type, items on both side of their balance sheet. In contrast, Non banking financial intermediaries can finance riskier borrowers and intermediate equity claims. They thus offer a wider range of risks to investors, which encourage investment and savings, and create a market for risks. Second, Non banking financial intermediaries' unbundled services that are bundled within a universal bank, and thus foster competition, which benefits customers. Third, through specialization, Non banking financial intermediaries can gain informational advantages over banks in their narrowly- defined fields of operation. Fourth, Non-banking financial intermediaries diversify the financial sector, which may alleviate a systemic crisis. Are the functions performed by Non-banking financial intermediaries important for economic growth? Recent research with cross-country data sets has established that development of the financial sector has the potential to accelerate economic growth. However, no research on the particular role of NBFCs in this process has yet been undertaken. Nevertheless, international comparisons show that economies with lower per capita income tend to have a smaller range of equity type claims and a smaller market share of Non-banking financial intermediaries relative to banks. An important and widely-discussed issue in the context of financial institutions is regulation. Non banking financial intermediaries are particularly important for facilitating storage of value and intermediation of risk. Moreover, like other financial institutions, they are sensitive to runs and herding behaviour. If the financial sector does not work smoothly, high transaction costs, lack of confidence and short-sightedness of economic actors, as well as a culture of corruption may result.

The objectives of financial sector regulation are protection against systemic risks (like depositor runs), consumer protection, efficiency enhancement, and social objectives. The regulations may be structured either institutional or functional level. Under the former, each financial institution has its own regulatory agency, e.g. one for each category of NBFC. Under the latter, there are separate agencies for each function of non banking financial intermediaries, e.g. one for deposit-taking activities, one for lending, one for market-conduct etc. India's legislators have chosen a mix between these two models. RBI regulates ELs, HPs,

Investment Companies, LCs and RNBCs. Similarly, HFCs, ICs, SBCs and MBCs report to the National Housing Bank, the Insurance Regulation and Development Agency (IRDA), and the Stock and Exchange Board of India (SEBI), respectively. All these are instances of institutional regulation. In contrast, Nidhis report to the Department of Company Affairs (DCA) and Chit Fund Companies to the State Registrar of Chit Funds for their general operations, as well as to RBI for their deposit-taking activities, an instance of functional regulation.

To achieve the objectives of efficiency enhancement and protection against systemic risks, regulation has to be neutral. This means that institutions providing the same or similar services should be subject to identical regulatory requirements. Regulatory neutrality fosters efficiency-enhancing competition between institutions as each service will be provided by the institution which can provide it at the lowest cost. Deviations from regulatory neutrality, on the other hand, likely cause efficiency losses. Suppose that two institutions can provide a particular service at the same cost under regulatory neutrality but that, for no apparent reason, one of the two institutions is regulated less strictly. If regulatory requirements are costly to firms, that institution obtains a regulatory comparative advantage and will drive the more regulated one out of the market, an example of regulatory arbitrage. Moreover, if differences in regulatory requirements are big, less regulated institutions may drive out more efficient ones. In this worst case, the outcome will be both inefficient and fragile, as institutions which meet the lowest among all regulatory standards dominate the market.

Much of the history of non banking financial intermediaries in India over the last fifty years can serve as a case study of non-neutral regulation and consequent regulatory arbitrage. Before 1997, RBI's supervision of Non-banking financial intermediaries was limited to prescription of prudential norms and thus the structure of Non-banking financial intermediaries. Assets no requirements were in place regarding minimum capital, amount and term structure of deposits, and interest rates on deposits and loans. At the same time the banking sector was heavily regulated through excessive statutory liquidity requirements, directed lending initiatives, and interest rate caps. Non banking financial intermediaries, who were not subject to any of these rules, thus enjoyed a substantial regulatory comparative advantage for several bank-type activities, most notably lending and deposit taking. Consequently, between 1981 and 1996, the number of Non banking financial intermediaries grew more than seven-fold and the share of non-bank deposits increased from 3.1 to 10.6 per cent. Several companies were extremely leveraged and deposits-to-Net owned funds (NOF) ratios in excess of 40 not uncommon. Numerous bankruptcies of Non banking financial intermediaries in the early 1990.s prompted RBI to take action. The measures sanctioned in 1997, most notably minimum NOF and a maximum deposits-to-NOF ratio of 1.5 and 4 (depending on the company's rating), brought Non banking financial intermediaries standards closer to those of the banking sector. Subsequently the number of registered NBFCs shrank by seventy per cent between 1997 and 2003. Nevertheless, non banking financial intermediaries continue to enjoy regulatory privileges. The 1997 provisions were not applied uniformly across Non banking financial intermediaries. In particular, Nidhis as well as RNBCs were exempt from maximum deposits-to-NOF ratios and, partly, from interest rate ceilings. As it stands, substantial deviations from regulatory neutrality and resulting inefficiencies continue to be common features of the non banking financial intermediaries sector. While the regulatory measures implemented over the last ten years are steps into the right direction, regulators still have to go long ways to create an environment in which banking and non-banking financial institutions compete on even grounds.

3.6 Regulatory Focus in Respect of NBFCs in India

Development of Regulatory Frame Work for Non Banking Financial Intermediaries

The regulatory frame work for non banking financial intermediaries had been in existence since 1963 under the provisions of Chapter III B of the Reserve Bank of India Act and the Directions issued.

The regulation of the deposit acceptance activities of the Non-Banking Finance Companies (NBFCs) was initiated in the sixties with a view to safeguard depositors' interests and to ensure that the Non banking financial intermediaries function on healthy lines. Accordingly, in 1963, a new Chapter III B was inserted in the Reserve Bank of India Act, 1934 to effectively supervise, control and regulate the deposit acceptance activities of this institution s. The Bhabatosh Datta Study Group (1971) set up to examine the role and operations of NBFCs. Recommended that non banking financial intermediaries should be classified into 'approved' and 'non approved' categories and the regulation should be centered primarily on the 'approved' (i.e. those which satisfy certain additional requirements such as adequate amount of capital, reserves, liquid assets, etc.) non banking financial intermediaries. Subsequently, the regulatory frame work suggested by the James Raj Study Group (1974) aimed at keeping the magnitude of deposits accepted by non banking financial intermediaries within reasonable limits and ensuring that they were in conformity with the objectives of monetary and credit policy.

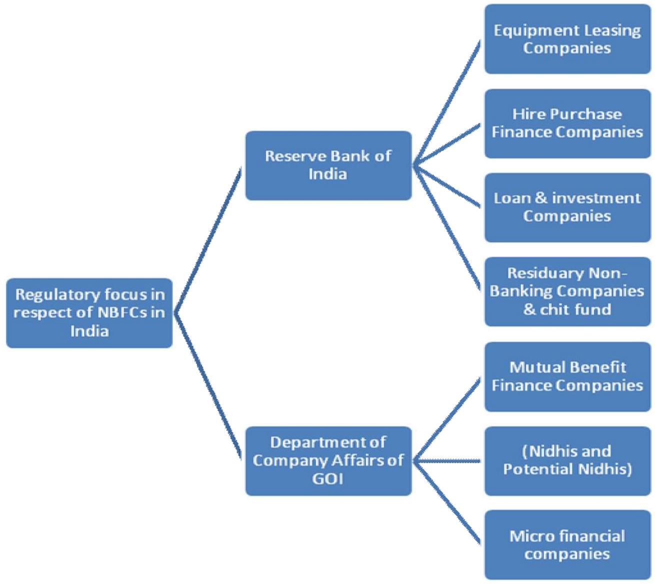


Figure 3.2 : Regulatory Focus

The provisions of Chapter III B of the RBI Act, 1934, however, conferred very limited powers on the Reserve Bank. The legislative intent was aimed at moderating the deposit mobilization of non banking financial intermediaries and thereby to providing indirect protection to depositors by linking the quantum of deposit acceptance to Net Owned Fund. Thus, the directions were restricted to the liability-side of the balance sheet, and too, solely to deposit acceptance activities. It did not extend to the asset-side of the balance sheets of non banking financial intermediaries.

Subsequently, several experts/working groups which examined the functioning of non banking financial intermediaries were unanimous about the inadequacy of the legislative frame work and reiterated the need for enhancing the extant frame work. The Chakravarthy Committee, in its Report submitted in 1985, recommended for the introduction of a system of licensing for non banking financial intermediaries in order to protect the interests of depositors. Thereafter, the Narasimham Committee (1991) outlined a frame work for streamlining the functioning of Non banking financial intermediaries. The Narasimham committee was of the view that, keeping in mind the growing importance of NBFCs in the financial intermediation process and their resource to borrowing, regulatory frame work to govern these institutions should be specified. Such frame work should include, in addition to the existing requirements of gearing and liquidity ratios, norms relating to capital adequacy, debt-equity ratio, credit concentration ratio, adherence to sound accounting practices, uniform disclosure requirements and asset valuation. Further, the committee argued that the supervision of these institutions should come within the purview of the proposed agency to be set up for this purpose under the aegis of the Reserve Bank of India. The introduction of suitable legislation was deemed as essential not only for ensuring sound and healthy functioning of non banking financial intermediaries, but also for safeguarding the interests of depositors.

3.7 Guidelines on Fair Practices Code for Non Banking Financial Intermediaries

The Reserve Bank has revised the guidelines on Fair Practices Code (FPC) for all non banking financial intermediaries issued on September 28, 2006 in the light of the recent developments in the Non banking financial intermediaries sector. The salient features of the revised circular dated March 26, 2012 are as follows:

General

(a) All communications to the borrower shall be in the vernacular language or a language as understood by the borrower.

(b) Loan application forms should include necessary information that affects the interests of the borrower.

(c) Loan agreement should contain all details.

(d) Non banking financial intermediaries should refrain from interference in the affairs of the borrower except for the purposes provided in the terms and conditions of the loan agreement.

(e) In the matter of recovery of loans, the Non banking financial intermediaries should not resort to undue harassment and ensure that the staffs are adequately trained to deal with customers.

(f) The Board of Directors of Non banking financial intermediaries should also lay down the appropriate grievance redressed mechanism within the organisation.

(g) The Fair Practices Code should be put in place by all Non banking financial intermediaries with the approval of their Boards. The same should be put up on their website.

(h) Boards of Non banking financial intermediaries should lay out appropriate internal principles and procedures to determine interest rates and processing and other charges.

(i) The Board of each Non banking financial intermediaries shall adopt an interest rate model taking into account relevant factors, such as cost of funds, margins and risk premium.

(j) Non banking financial intermediaries must have a built-in re-possession clause in the contract/loan agreement with the borrower which must be legally enforceable.

(k) To ensure transparency, the terms and conditions of the contract/loan agreement should also contain provisions regarding:

- ✓ notice period before taking possession;
- ✓ circumstances under which the notice period can be waived;
- ✓ the procedure for taking possession of the security;
- ✓ a provision regarding final chance to be given to the borrower for repayment of loan before the sale / auction of the property;
- ✓ the procedure for giving repossession to the borrower and

- ✓ the procedure for sale/ auction of the property. Non banking financial intermediaries-MFIs

In addition to the general principles above, Non banking financial intermediaries-MFIs are required to adopt the following fair practices that are ***specific to their lending business and regulatory framework.***

(a) A statement shall be made in vernacular language and displayed by Non banking financial intermediaries-MFIs in their premises and in loan cards articulating their commitment to transparency and fair lending practices;

(b) Field staff should be trained to make necessary enquiries with regard to existing debt of the borrowers, and training, if any, offered to the borrowers shall be free of cost.

(c)The effective rate of interest charged and the grievance red ressal mechanism set up by the Non banking financial intermediaries-MFIs should be prominently displayed in all its offices;

(d) A declaration that the MFI will be accountable for preventing inappropriate staff behaviour and timely grievance redressal shall be made in the loan agreement;

(e) All sanctioning and disbursement of loans should be done only at a central location and more than one individual should be involved in this function ;

(f) All Non banking financial intermediaries-MFIs shall have a Board-approved standard form of loan agreement, preferably in the vernacular language;

(g) The loan card should reflect the details, including the effective rate of interest charged;

(h) Non-credit products issued shall be with the full consent of borrowers and the fee structure shall be communicated in the loan card itself;

(i) Recovery should normally be made only at a central designated place;

(j) BFC-MFIs shall ensure that a Board-approved policy is in place with regard to Code of Conduct by field staff.

Lending against collateral of gold jewellery

(a) Adequate steps to ensure that the KYC guidelines stipulated by the RBI are complied with and to ensure that adequate due diligence is carried out on the customer before extending any loan.

(b) Proper assaying procedure for the jewellery received.

(c) Internal systems to satisfy ownership of the gold jewellery.

(d) The policy shall also cover putting in place adequate systems for storing the jewellery in safe custody, reviewing the systems on an on-going basis, training the concerned staff and periodic inspection by internal auditors to ensure that the procedures are strictly adhered to.

(e) Loans against the collateral of gold should not be extended by branches that do not have appropriate facility for storage of the jewellery.

(f) The jewellery accepted as collateral should be appropriately insured.

(g) The Board-approved policy with regard to auction of jewellery in case of non-repayment shall be transparent and adequate prior notice to the borrower should be given before the auction date.

(h) The auction should be announced to the public by issue of advertisements in at least 2 newspapers, one in vernacular language and another in national daily newspaper.

(i) As a policy the non banking financial intermediaries themselves shall not participate in the auctions held.

(j) Gold pledged will be auctioned only through auctioneers approved by the Board.

(k) The policy shall also cover systems and procedures to be put in place for dealing with fraud, including separation of duties of mobilisation, execution and approval.

Table 3.2 Number of Non-Banking Financial Companies Registered with the Reserve Bank (During 1999 to 2012)

(Figures are in NOs)

End –June	Number of Registered NBFCs	Annual Growth Rate	NBFCs Accepting Public Deposits	Annual Growth Rate
1999	7855	-	623	-
2000	8451	7.59	679	8.99
2001	13815	63.47	776	14.29
2002	14077	1.9	784	1.03
2003	13849	-1.62	710	-9.44
2004	13764	-0.61	604	-14.93
2005	13261	-3.65	507	-16.06
2006	13014	-1.86	428	-15.58
2007	12968	-0.35	401	-6.31
2008	12809	-1.23	364	-9.23
2009	12740	-0.54	336	-7.69
2010	12630	-0.86	308	-8.33
2011	12409	-0.02	297	-0.04
2012	12385	-0.001	271	-0.09

Source: Report on Trend and Progress of Banking in India, RBI, Mumbai-various issues.

3.8 Role of Non Banking Financial Intermediaries

NBFCs like banks and other financial institutions act as intermediaries between the ultimate savers and the ultimate borrowers. The rationale of their existence derives from the fact that in an economy there are surplus units which save and deficit units which are in need of such savings and a mechanism is needed to bring the two together. Surplus units (savers) can lend to the deficit units (borrowers) directly. This, however, is normally inconvenient to both the savers and borrowers and is certainly not the most efficient means of flow of funds between the units. With the mediation of financial institutions, there is a reduction in the degree of risks involved and there is also a more efficient utilization of the resources in the economy. Financial intermediaries can provide a more economical service because of the economies of scale, their professional expertise and their ability to spread the risk over a large number of units.

Thus, their operations give to the saver the combined benefits of higher return, lower risk and liquidity. The borrowers on the other hand also get a wider choice on account of intermediation of financial institutions. It may be of relevance to note that while the loans granted by commercial banks are, by and large, for industrial, commercial and agricultural purposes, those granted by Non banking financial intermediaries are generally for transport, trading, acquisition of durable consumer goods, purchase and repair of houses or just for plain consumption. Since their activities are not controlled by monetary authorities to the same extent as those of commercial banks, the credit extended by Non banking financial intermediaries may not necessarily be in consonance with national objectives and priorities. The major function of financial intermediaries is to transfer the savings of surplus units to deficit units; hence, they can play a useful role in the economy of the country. To the extent that they help in monetizing the economy and transferring unproductive financial assets into productive assets, they contribute to the country's economic development. In fact, the nature and diversity of financial institutions themselves have become measures of economic development of a country. The Reserve Bank of India expert committees identified the need of non banking financial companies in the following areas:

- Development of sectors like transport and infrastructure
- Substantial employment generation
- Help and increase wealth creation
- Broad base economic development
- Irreplaceable supplement to bank credit in rural segments
- Major thrust on semi-urban, rural Areas and first time buyers/users
- To finance economically weaker sections.
- Huge contribution to the state exchequer.

3.8.1 Differences between Banking & Non Banking Financial Intermediaries

The difference between banks and Non-banking financial intermediaries is mainly in the nature of the liabilities of the two and, to some extent, in the structure of their assets. While the liabilities of commercial banks usually consist of demand and time deposits, those of Non banking financial intermediaries do not ordinarily include demand deposits, the mutual benefit financial companies, commonly known as Nidhis, being notable exceptions. Since demand deposits which are withdrawal by cheque are considered to be a component of 'money', it is the degree of moneyless of the liabilities of the two types of institutions which constitutes a major difference between the two.

From the point of view of assets held, it may be said that commercial banks hold a wide variety ranging from short-term and medium-term to long term credits and they also use various credit instruments like overdrafts, cash credits, bills, etc. On the other hand, the assets of Non banking financial intermediaries are more specialized. For instance, hire purchase finance companies confine their operations mainly to the financing of transport operations and consumer credit while housing finance companies make loans for housing purpose. It may, however, be stated that the difference in the nature of assets held by commercial banks on the one hand and those held by Non banking financial intermediaries on the other does not clearly demarcate the respective fields of the two because commercial banks are also, of late, making advances in fields like transport and consumer credit, which were earlier considered as out of their purview.

Many activities and functions of Non banking financial intermediaries' are similar to those of banks. The distinction between them has become considerably blurred. It is true that Non banking financial intermediaries, unlike banks, are still not a part of payments mechanism. They cannot create money but in many other respects, they are substitution and complementary with banks. NBFCs are doing functions akin to that of banks; however there are a few differences:

(i) A non banking financial intermediaries cannot accept demand deposits;

(ii) A Non banking financial intermediaries is not a part of the payment and settlement system and as such an NBFC cannot issue cheque drawn on itself; and

(iii) Deposit insurance facility of Deposit Insurance and Credit Guarantee Corporation is not available for non banking financial intermediaries' depositors unlike in case of banks.

3.8.2 Significance of Non Banking Financial Intermediaries in India

NBFIs' state of development is usually a good indicator to the state of development of a country's financial system as a whole. They play important roles in complementing the facilities offered by the commercial banks, as well as being key players in the development of the capital markets. As sophisticated and well-developed as capital markets are considered to be as the hallmark for a market-based economy worldwide,

According to the Economic Survey 2011-12, it has been reported that Non banking financial intermediaries as a whole account for 12.4 per cent of assets of the total financial system. With the growing importance assigned to financial inclusion, non banking financial intermediaries have come to be regarded as important financial intermediaries particularly for the small-scale and retail sectors. In the multi-tier financial system of India, importance of non banking financial intermediaries in the

Indian financial system is much discussed by various committees appointed by RBI in the past and RBI has been modifying its regulatory and supervising policies from time to time to keep pace with the changes in the system.

NBFCs have turned out to be engines of growth and are integral part of the Indian financial system, enhancing competition and diversification in the financial sector, spreading risks specifically at times of financial distress and have been increasingly recognized as complementary of banking system at competitive prices. The Banking sector has always been highly regulated, however simplified sanction procedures, flexibility and timeliness in meeting the credit needs and low cost operations resulted in the non banking financial intermediaries getting an edge over banks in providing funding.

Since the 90s crisis the market has seen explosive growth, as per a Fitch Report the compounded annual growth rate of non banking financial intermediaries was 40% in comparison to the CAGR of banks being 22% only. Non banking financial intermediaries have been pioneering at retail asset backed lending, lending against securities, Micro finance etc and have been extending credit to retail customers in under-served areas and to unbanked customers.

3.8.3 Current Scenario of Non Banking Financial Intermediaries

Global credit crisis followed by increase in interest rates in October and November 2008 resulted in widespread crisis of confidence. Chain of events after the collapse of Lehman Brothers is still fresh in the minds of investors. Non-Banking Finance Companies (NBFCs) in India were severely impacted due to economic slowdown coupled with fall in demand for financing as several businesses deferred their expansion plan. Stock prices of NBFCs' crashed on the back of rising non-performing assets and several companies closed their operations. International Non banking financial intermediaries' still continues to close down or sell their back end operations in India.

The positive news however is that, this crisis has forced Non-banking financial intermediaries to improve their operations and strategies. Industry experts opine that they are much more mature today than they were during the last decade. Timely intervention of RBI helped reduce the negative effect of credit crunch on banks and Non-banking financial intermediaries. In fact, aggressive strategies helped LIC Housing Finance to grab new customers (including customers of other banks) and increase its market share in national mortgage market. Surprisingly it was able to maintain its profitability in 2009 (around 37%). HDFC, the largest Non-banking financial intermediaries in India, however experienced a slowdown in customer growth due to stiff competition, especially from LIC Housing Finance and tight monetary conditions. Other Non banking financial intermediaries that were stable during this period of credit crunch are Infrastructure Development Finance Company (IDFC) Power Finance Corporation (PFC) and Rural Electrification Corporation (REC). Growth prospects are strong for these companies given the acute shortage of power in the country and expected increase in demand for infrastructure projects. The segment which was hit hardest was Vehicle Financing. Companies financing new vehicle purchases experienced a drastic reduction in new customer numbers. Fortunately, since vehicle finance is asset-based business, their asset quality did not suffer as against other consumer financing businesses. Contrary to this, Shri ram Transport Finance, the only NBFC which deals in second-hand vehicle financing was able to maintain its growth primarily due to its business model which does not entirely depends on health of the auto industry.

There are thousands of market players in the non banking financial intermediaries sector. About 41,000Non banking financial intermediaries were there during 1997. The majority of the non banking financial intermediaries are private limited companies and rest being public limited companies. The number of non banking financial intermediaries which regularly report or submit returns to the RBI/NHB is quite small in relation to the total number of companies at work.

3.9 Summary

Non-Banking Finance Companies (NBFCs) in India were severely impacted due to economic slowdown coupled with fall in demand for financing as several businesses deferred their expansion plan. Stock prices of NBFCs' crashed on the back of rising non-performing assets and several companies closed their operations. International NBFCs' still continue to close down or sell their back end operations in India. The positive news however is that, this crisis has forced NBFCs to improve their operations and strategies. Industry experts opine that they are much more mature today than they were during the last decade. Timely intervention of RBI helped reduce the negative effect of credit crunch on banks and NBFCs. In fact, aggressive strategies helped LIC Housing Finance to grab new customers (including customers of other banks) and increase its market share in national mortgage market. Surprisingly it was able to maintain its profitability in 2009 (around 37%). HDFC, the largest NBFC in India, however experienced a slowdown in customer growth due to stiff competition, especially from LIC Housing Finance and tight monetary conditions. Other NBFCs that were stable during this period of credit crunch are Infrastructure Development Finance Company (IDFC) Power Finance Corporation (PFC) and Rural Electrification Corporation (REC).

Growth prospects are strong for these companies given the acute shortage of power in the country and expected increase in demand for infrastructure projects. The segment which was hit hardest was Vehicle Financing. Companies financing new vehicle purchases experienced a drastic reduction in new customer numbers. Fortunately, since vehicle finance is asset-based business, their asset quality did not suffer as against other consumer financing businesses. Contrary to this, Shri ram Transport Finance, the only NBFC which deals in second-hand vehicle financing was able to maintain its growth primarily due to its business model which does not entirely depends on health of the auto industry. There are thousands of market players in the NBFCS sector. About 61,000 NBFCS were there during 2011. The majority of the NBFCS are private limited companies and rest being public limited companies. The number of NBFCS which regularly report or submit returns to the RBI/NHB is quite small in relation to the total number of companies at work. The important reasons for the growth of non banking finance companies are a) they provide tailor made services to the clients; b) there has been a comprehensive regulation of NBFCS; c) customers have been attracted to them by their higher level of customer-orientation, lesser ore/post sanction requirements, simplicity and speed of their services; d) the monetary and credit policies have created an unsatisfied fringe of borrowers, i.e. the borrowers out side the purview of banks. The NBFCS have catered to the needs of this section of borrowers; e) the relatively higher interest rates offered by them on deposits have attracted a large number of small savers towards them.

Financial intermediaries play very important role in a developing economy by performing multifarious activities in development process. The financial intermediaries transform primary securities into indirect securities which have low investment costs and are divisible into convenient units. With a diversified portfolio, they can reduce the risk of investment to the minimum. Financial Intermediaries increase the liquidity of securities by creating claims which are more liquid than the securities they buy, and issue them to the savers. Thus they canalize more savings into investment activity. The intermediaries can also facilitate the expansion of markets through distributive techniques. These activities will be particularly important for export promotion and marketing of machinery, producer goods, intermediary products, etc. The supply of funds depends upon aggregate savings and credit creation by the banking system, while the need for funds depends upon demand for investment, consumer durables, housing, and so on. The functions of a financial system are to establish a bridge between savers and investors and thereby to encourage saving and investment, to provide finance in anticipation of saving, to enlarge markets over space and time, and to allocate financial resources efficiently for socially desirable and productive purposes. The ultimate goal of the financial system is to accelerate the rate of economic development. Financial markets accelerate development, they themselves, in turn, develop with economic development. The relationship between economic development and financial development is thus symbiotic. The efficient financial markets are characterized by the absence of information-based gain, by correct evaluation of assets, by maximization of convenience and minimization of transaction costs, and by maximization of marginal efficiency of capital.

3.10 Self Assessment Questions

1. Do you have knowledge about the role of banking intermediaries in Indian economy, if yes please mention?
2. Can you put in plain words role of non banking financial intermediaries in Indian economy if yes, give details?
3. Do you be acquainted about guidelines given to non banking financial intermediaries by RBI, if yes, give brief details?
4. What are significant benefits of non banking financial intermediaries according to you?
5. What are the important financial instruments used in Indian financial system according to you?
6. According to you, which financial intermediaries best for Indian economy and why?

3.11 Reference Books

- Abma, R.C.N. & Fase, M.M.G. (2003). Financial environment and economic growth in selected Asian countries. *Journal of Asian Economics* 14, 11-21.
- Acharya, V., Engle, R. and Richardson, M. (2012). 'Capital shortfall: A New Approach to Ranking and Regulating Systemic Risks', American Economic Review: Papers and Proceedings, Vol. 102, No. 4, pp. 59-64.
- Allen franklin, Santomero Anthony, what do financial intermediaries do? ,journal of banking & finance Vol.25, page no. 271-294.
- Bengsston, E. (2011). 'Shadow Banking and Financial Stability: European Money Market Funds in the Global Financial Crisis', Systemic Risk, Basel III, Financial Stability and Regulation 2011, February 28.
- Biasias, D., Flood, M., Lo, A. W. And Valvanis, S. (2012), 'A survey of systemic risk analytics', U.S. Department of the Treasury, Office of Financial Research, Working Paper No 0001, January.
- Bond Philips,2003, banking and non banking intermediaries
- Bouveret, A. (2011). 'An assessment of the shadow banking sector in Europe', preliminary draft, mimeo.
- Cerruti, E., Claessens S. and McGuire, P. (2012), 'Systemic Risks in Global Banking: What Can vailable Data Tell Us and What More Data Are needed', BIS Working Paper No. 376, April.
- Danielsson, J., James, K. R., Valenzuela, M. and Zer I. (2011), 'Model Risk of Systemic Risk Models Dealing With Systemic Risk When We Measure Systemic Risk Badly', Presentation at SUERF/ Deutsche Bundesbank/IMFS Conference The ESRB at 1. 8-9 November, 2011.
- European Commission (2012). 'Green Paper Shadow Banking', Brussels, 19.3.2012 COM(2012) 102 final.
- Heller, D. and Vause, N. (2011). 'Expansion of central clearing', BIS Quarterly Review, June, pp. 67- 81.
- Holló, D., Kremer, D. And Lo Duca, M. (2012), 'CISS – A composite indicator of systemic stress in the financial system', ECB Working Paper No. 1426, March.
- King, R. G. & Levine, R. Finance and growth: Schumpeter might be right**.** *Quarterly* Journal of Economics 108, 717-737.
- Murphy, P. L. & Musalem, A. R. (2004). Pension Funds and National Savings. Working paper serie*s-3410*, World Bank.
- Singh, M. and Aitken, J. (2010). 'The (sizable) role of rehypothecation in the shadow banking system', IMF Working Paper 10/172,
- Turner, A. (2012), 'Shadow Banking and Financial Instability', Presentation to Cass Business School

Unit - 4 : Banking Services

Structure of Unit:

4.0 Objectives

After completing this unit, you would be able to:

- Understand the meaning of bank
- Different services offered by bank
- Nature of various banking services
- Conceptual knowledge of Securitization, Letter of Credit, Bancassurance
- Study the significance of banking services for the economy
- Future Scope of banking services in India

4.1 Introduction

Dynamic changes can be seen in the banking industry in the last two decades. The banking industry has experienced tectonic shifts because of changing financial system. To build loyalty and drive profitability banks have started offering different services. Doorstep banking services are being offered by some banks to cater the changing lifestyle of customers. With a change in the Indian economy from a manufacturing sector to a service sector, banking as a whole has gone through an undergone change. A larger portion of consumers is getting translated into demand for more financial products and customization of services. In order to provide a pro poor growth policy and also to ensure that the poor have ready access to institutional credit, an informal system was promoted through an overall domineering policy which resulted in bank nationalization in 1969 and there was a introduction of the concept of social banking into the sphere of economic literature. Economic growth is a necessary condition for elimination of poverty. Banking is a service industry which touches the life of many people.

4.2 What is Bank?

Banking sector acts as the backbone of modern business. The development of any country mainly depends upon the banking system. A bank is a financial institution which deals with deposits and advances and other related services. A bank accepts money from the people in the form of deposits which are usually repayable on demand or after the expiry of a fixed period. The Banking Regulation Act, 1949 defines banking as an activity of accepting funds from the public for the purpose of lending or investment. The banking structure played a major role in the mobilization of savings and promoting economic development. It gives safety to the deposits of its customers. It also acts as a custodian of funds of its customers. Banks offer the following services to its account holders like multi-city / payable at par (PAP) cheque facility, anywhere banking, trade services, phone banking, internet banking, credit card, debit/ATM card, mobile banking and Real Time Gross Settlement (RTGS).

With the change in economic sector, the banks are also witnessing a growth in their non-interest or fee-based incomes. Banks provide loans for pursuing higher studies in engineering, medical etc. They also provide loan to young entrepreneurs. Through these activities banks participate in human capital formation and also help in developing entrepreneurial activities. Treasury incomes of banks are no longer the major revenue driver and have been coming down as a result of rising interest rates. Changing interest rates is compelling banks to increase their fee based income. The non-fund based income comprises of revenues from both financial commitment and services rendered. Commercial banks are banking institutions which accept deposits from the public and grant short-term loans and advances to their customers. In India, there are nationalized (public sector) commercial banks as well as private sector banks which are corporate organizations.

4.3 Different Services Offered by Bank

Saving Account

A saving account is generally opened by salaried person or by fixed regular income. Saving accounts are opened to encourage the people to save money and collect their savings. This facility is also given to students, senior citizens, pensioners. Saving account is of continuing nature. There is no maximum period of holding. A minimum amount has to be kept on saving account to keep it functioning. Equated monthly installments for housing loan, personal loan, car loan, etc., are paid through saving bank account. The main objective of saving account is to promote savings. It provides immediate funds as and when required through ATM.

Current Account

A current account is a bank account used to deposit money that is needed on a regular basis. Current bank account is opened by businessmen who have a higher number of regular transactions with the bank. The main objective of current bank account is to enable the businessmen to conduct their business transactions smoothly. Generally, bank does not pay any interest on current account. Nowadays, some banks do pay interest on current accounts.

Recurring Deposit Account

A fixed amount is deposited on a periodically basis. Recurring Deposit is a special type of deposit account which enables a depositor particularly in fixed income group to save by paying into the account an agreed fixed sum of money monthly over a stipulated period. RTGS facilitates fund transfer from one bank account to the other on real-time basis without any waiting time. Further, gross settlement emphasizes that the transaction is settled on one to one basis.

Real Time Gross Settlement

This is a system where the processing of funds transfer instructions takes place at the time they are received (real time). Also the settlement of funds transfer instructions occurs individually on an instruction by instruction basis (gross settlement). RTGS is the fastest possible interbank money transfer facility available through secure banking channels in India.

National Electronic Fund Transfer

The NEFT is a nationwide payment system facilitating one-to-one funds transfer. Under this system, individuals, firms and corporate can electronically transfer funds from any bank branch to any individual, firm or corporate having an account with any other bank branch in the country participating in the system.

Corporate Banking

Corporate banking includes a wide range of financial services offered to corporate entities. It provides syndicated loans, infrastructure loans, cash management products and trade finance products. It provides services to corporate clients, midsized companies, real estate developers, international trade finance. Corporate banking is different from retail banking as it concentrates more on the corporate entities and high value transactions.

Retail Banking

In retail banking the primary focus is on individual customer. It includes installment loans, residential mortgages, equity credit loans, deposit services. Retail banks deal with a smaller number of large value transactions. It is a high volume business with many service providers competing for market share. These banks accept saving and current deposits, sanction personal loan, housing loan, educational loan, travel loan, car loan etc.

Letter of Credit

A letter of credit is a letter issued by the banker of the foreign buyer, at the latter's request, in favour of the exporter informing him that the issuing banker undertakes to accept the bills drawn in respect of exports made to the foreign buyer specified therein. It is a written intimation from the overseas buyer's bank that they have been instructed to open a credit for a certain amount of goods to be exported under certain terms and conditions. The banker issuing a letter of credit is called issuing bank. This bank gives an undertaking to the exporter. Therefore, the value of the letter of credit depends upon the goodwill and reputation of the issuing bank. The exporter in whose favour a letter of credit is opened is called the beneficiary because he gets the benefit of the undertaking given by the opening bank to honour the bills drawn on the opener.

The opening bank generally sends the letter of credit to the beneficiary through its own branch in the beneficiary's country or its correspondent banker in that country. Such branch or bank is called the advising bank.

Bank Draft

A bank draft is issued for consideration received in advance. The purchaser of the draft.i.e., the person intending to remit money is required to pay the amount to be remitted to the banker, who thereafter issues him a draft. The issuing banker charges a commission for rendering this service, the amount of commission depends upon the drawer branch, the drawee branch and the payee.

Salary Account

It is a unique product designed to suit the salaried class. Salary account is advantageous to both employer and employee. For the employer it reduces paper work, saves remittance cost. Employees are benefited by the use of ATM banking, net banking, mobile banking etc.

Loans

Lending of funds to the traders, business and industrial enterprises constitutes the main business of the bank. The major part of the bank's funds is employed by way of loans and advances which is the most profitable employment of its funds. The major part of bank's income is earned from interest and discount on the funds so lent. The first principle of banking constituent is of safety. Banks should ensure safety of funds i.e., the borrower should be in the capacity to repay the loan along with interest as per the terms of loan contract.

Educational Loans

Higher studies and specialization in certain fields call for additional financial support from time to time. India has got a big potential in this area as a huge percentage of population is youth. Education is an important tool for empowering youth and this can be done by providing the facility of educational loan. To pursue professional degree or diploma or any other course educational loan is taken. Generally the loan is disbursed in stages like semester wise or annual payments as per the requirement of the institution.

Debit Card

Debit cards are more widely accepted than cheques. Since debit cards use the customer's own money, not his credit, they are often easier to get than credit cards. The customer does not have to carry a cheque book or large sums of cash. A debit card is a pay now card. There is no interest accrued against the use of debit cards. Opening of an account and maintenance of required balance is essential for debit cards.

Credit Card

The growth of credit card culture in India has been predominant in the last 5- 10 years. A credit card is an instrument which provides instantaneous credit facilities to its holder to avail a variety of goods and services at the merchant outlets. It is made of plastic and hence popularly called as plastic money. Such cards are issued by banks to persons with incomes above certain minimum limits and are accepted by a variety of business establishments which are notified by the card issuing bank. The three parties to a credit card are the issuing bank, the card holder and the member establishments. Following are some of the benefits accrue to customers from the usage of credit cards like deferred payment of bills, revolving credit, rewards from card issuers. The benefits to merchandise are immediate payment, assured payment and increased consumer spending.

E Cheque

It is an electronic document which is used to substitute the paper document. As the cheque is in electronic form, it can be processed in fraction of seconds and has more security features.

It is an electronic document written by the payer incorporating the legal requirements of a cheque digitally signed by him. The payee receives the cheque over e mail verifies the payer’s digital signature, writes out a deposit and digitally signs it.

Bancassurance

Banks have been expanding their business to securities and insurance and other sectors to recover losses from their own business such as deposits, installment savings and loans. Bancassurance is distribution of insurance products through a bank’s branch network. It is a service that can fulfill both banking and insurance needs at the same time. Banks are acting as agents for insurance companies to offer the insurance products to their customers. It is beneficial for banks as it brings in a new source of income in the form of service charge. The insurance sector offers ample opportunity for the banks to widen their horizon of financial intermediation. Bancassurance enables to develop a sales culture within the bank. It helps to change the traditional working of banking companies.

Factoring

Factoring involves a continuous arrangement under which a financing institution assumes the credit control/ protection and collection functions of the client, purchases his receivables as they arise in return for the provision of post- sale finance, maintains the sales ledger, performs other book keeping functions associated with such account receivables and attends to other auxiliary functions. Commercial banks in India provide working capital finance to trade and industry. This includes working capital for receivables.

Merchant Banking

According to the Securities and Exchange Board of India (Merchant Bankers) Rules, 1992, “ A merchant banker has been defined as any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities or acting as manager, consultant, adviser or rendering corporate advisory services in relation to such issue management. The activities undertaken by merchant bankers include corporate counseling, project counseling, loan syndication, management of capital issue, corporate advisory services, portfolio management, and advisory services to mergers and takeovers. The scope of merchant banking is going to widen up with the growth of primary market.

Offshore Banking

An offshore bank is the one located outside the country of residence of the depositor. This sort of banking takes place due to strong privacy, low or no taxation, easy access to deposits, less restrictive legal regulation and protection against financial instability. Interest is generally paid by offshore banks without tax deduction. These banks provide access to politically and economically stable jurisdictions.

Securitization of Debt

Securitization of debt or asset refers to the process of liquidating the illiquid and long term assets like loans and receivables of financial institutions like banks by issuing marketable securities against them. Through securitization, a long term, non-negotiable and high valued financial asset like hire purchase is converted into securities of small values which can be tradable in the market just like shares. With the liberalization of the financial markets, there is bound to be more demand for capital.

Traveller's Cheques

It is mainly used by those who have to carry a lot of money during business trips, college excursions, holiday trips, study tours. It is risky to carry cash as there is always a possibility of it being stole or lost. It is obtained by remitting to a bank the amount required to be carried on. The bank issues traveller's cheque on receipt of the amount in different denominations as required by the buyer. The buyer has to sign on the cheque at the place provided for at the time of purchase. After that again the buyer has to sign it in the presence of the person encashing them.

Loan Syndication

Loan syndication is an arrangement between two or more lending institutions to provide a borrower a credit facility using common loan documentation. Syndication is an arrangement where a group of banks, which may not have any other business relationships with the borrower, participate for a single loan. A syndicated loan agreement simplifies the borrowing process as the borrower uses one agreement covering the whole group of banks and different types of facility rather than entering into a series of separate bilateral loans, each with different terms and conditions. Generally, when a group of banks get together, they select a lead bank which handles all the dealings with the company, such as negotiating the interest rates, and hence a deal is signed between the company and the banks. Loan syndication is basically done to share the total loss or liability.

Safe Deposit Vaults

Leading banks provide safe deposits vaults to the public at their selected branches. For this purpose the banks arrange strong rooms, preferably under the ground floor, equipped with safe deposit lockers. These lockers are of different sizes and are hired to the public at a reasonable rent.

Lien

In lien, the banker is empowered to retain all securities of the customer, in respect of the general balance due from him. The ownership of such securities is not transferred from the customer to the banker. The latter gets the right to retain the securities handed over to him in his capacity as a banker.

Pledge

Pledge can be defined as bailment of goods as security for payment of a debt or performance of a promise. The person who offers the security is called the pledger and the bailee is called the pledge. In pledge, there should be bailment of goods and the objective of such bailment should be to hold the goods as security for the payment of a debt or the performance of a promise.

Hypothecation

In hypothecation the ownership and possession of goods is not transferred to the creditors but an equitable charge is created in favour of the latter. The goods remain in the possession of the borrower, who binds himself, under an agreement, to give the possession of the goods to the banker, whenever the latter requires him to do so. The charge of hypothecation is thus converted into that of a pledge and the banker or the hypothecation is thus converted into that of a pledge and the banker or the hypothecate enjoys the powers and rights of a pledge.

Assignment

It is one of the modes of providing security to the lending banker. Assignment means transfer of a right, property or a debt existing or future. The borrower may assign any of his rights, properties or debts to the banker to secure a loan from the latter. The transferor is called the assignor and the transferee the assignee. In banking business, a borrower may assign to the banker the book debts, money due from government or government organization and life insurance policies. Assignment may be either a legal assignment or an equitable assignment.

Virtual Banking

These days the customers wish to avoid going to the banks for transacting their business. Virtual banks are designed without a traditional banking infrastructure. As it is a cost saving feature, the banks are in a position to offer a higher interest rate on saving account. The main types of virtual banking services are automated teller machines, electronic funds transfer, internet banking and mobile banking. These banks incur a low cost of handling a transaction.

Discounting of Bills

Bills of exchange are negotiable instruments which enable the debtors to discharge their obligations towards their creditors. Such bills of exchange arise out of commercial transactions both in inland trade and foreign trade. When the seller of goods has to realize his dues from the buyer at a distant place immediately or after the lapse of an agreed period of time, the instrument of bill of exchange facilitates this task with the help of banking institution. In bill discounting, the banker credits the customer's account with the amount. In the case of a time, bill of exchange, three days of grace is allowed.

Microcredit

Microcredit is provided to the unemployed, to poor entrepreneurs and to others living in poverty. It enables the people to engage in self employment projects which allow them to generate income. This concept was originated in Bangladesh. These individuals lack collateral, steady employment and a good credit history, thus cannot meet the minimum requirement to gain access to traditional credit.

Personal Loans

Personal loans are basically unsecured in nature and are backed by personal guarantees only. Generally public sector banks give loan to salaried class employed in government, public sector undertakings, reputed private organizations and institutions. Professional, self employed and business people are additionally covered by private sector banks.

Services provided by E- Banking

Banks offer a comprehensive range of transactions across multiple products through its net banking. Customers can check their account balance, book fixed deposit and recurring deposit, pay their bills, recharge mobile connection and many more.

Automated Teller Machine

It is also known as Any Time Money as it allows customers to withdraw money at any time from the bank. It increases existing business and generates new business. It allows the customers to transfer money to and from accounts, deposits cheques or cash. It is the most convient way to withdraw cash. It helps banks by providing customer service, large penetration. The services of ATMs are made available at convenient locations in suitable public places in cities. It enables the customers to have access to money round the clock in a day and throughout the year.

Electronic Funds Transfer

Electronic Funds Transfer automatically transfers money from one account to another. It is a great convience to customers as the sender and the receiver of funds may be located in different cities and may even bank with different banks. Payments of insurance premium are also electronically transferred from the bank to the respective accounts periodically. It helps in quick movement of deposit money from the bank account of the customer to the other bank account of other customers.

Mobile Banking

Mobile Banking allows customers to conduct a number of financial transactions through a mobile phone. The scope of offered services may include facilities to conduct bank and stock market transactions, to administer accounts and to access customized information. The mobile banking services can be classified in two ways: push based or pull based and transaction based or enquiry based. Push is when the bank sends out information based upon an agreed set of rules. Pull is when the customer clearly requests a service or information from the bank.

4.4 Scope of Banking Services in Rural India

The rural market in India has a huge potential. It is still an untapped and unorganized market in certain sectors. The product and service required rural areas are different as compared to urban area. The difference is due to many reasons like difference in income level, educational level, expenditure capacity, social, cultural and environmental differences etc. This creates gaps in the services offered as the consumer taste and preferences also differ which creates gaps. Banks should clearly understand these gaps and should try to make such strategies and services that these gaps can be filled effectively as well as efficiently. The rural market has a huge potential for banking services which are provided at affordable prices like saving account and deposits, agricultural loan, educational loans, housing loans, personal loans and automobile loans. The focus of the service quality should be customer driven and hence need to be tailored as per the rural requirements of customers having low income group as major target group. Therefore more of benefits driven by the customer from savings schemes should be incorporated in the Services provided through accounts maintenance with the banks. The rural customers should be made aware clearly about the services offered by the bank through effective physical evidence and promotions. It should be made as simple as possible so that rural customers understand it properly. The support should be provided on a regular basis to the customers to educate them about the current as well as prospective facilities and benefits derived from the banking services provided. The service providers should be clearly aware of the local languages, culture and behaviour of the rural customers. Banks should hire local employees as it would be beneficial for the banks to deal with the customers more effectively. The employee contribution in the service delivery to the banking sector is more in rural markets than urban markets as the employees need to constantly educate and assist the customers about the service process, price, product and at the same time talk about the benefits as well as the precautions and risks involved with the services being offered. Services such as loan and microfinance should be provided at lower prices to the consumers with flexible interest rates and customized repayment options should be offered. As the transport facility is not very good in rural areas, banks should judiciously select its location and layout.

The focus of the services offered must be customer driven and thus should be tailored as per the rural requirements of customers having low income group as major target group. Before providing service banks should properly educate the customer about the details of the product and process of service so as to avoid confusion and transparency. Banks should focus more on building long term relationship with the customers by paying more attention on the service quality, building brand loyalty, improving market share, reaching to the customers and building prospective future customers and by providing new services and facilities as per the requirement of the customer.

4.5 KYC Norms

The main purpose of KYC norms is to restrict money laundering practice. RBI had directed all banks and financial institutions to put in place a policy framework to know their customers before opening any account. This is done in order to prevent identity theft, identity fraud, money laundering, terrorist financing, etc. Mandatory details required under KYC norms are proof of identity and proof of address. Passport, voter's ID card, PAN card or driving license are accepted as proof of identity, and proof of residence can be a ration card, an electricity or telephone bill or a letter from the employer or any recognized public authority certifying the address. To ease the burden on the prospective customers in complying with KYC requirements for opening new accounts, the RBI advised, if the address on the document submitted for identity proof by the prospective customer is same as that declared by him / her in the account opening form, the document may be accepted as a valid proof of both identity and address. RBI has asked banks to exercise full KYC procedure at least every two years for high risk individuals and entities, from the earlier directive of not less than once in two years.

4.6 Future Scope of Banking Services

In the last few years the health of banking industry has improved in profitability, productivity, asset quality and capital adequacy. The banking structure played a major role in the mobilization of savings and promoting economic development. The financial soundness of the Indian commercial banking system matches up with most of the advanced and emerging countries. The banking system needs to be flexible and competitive in the long run. Competition can be effective in producing desired outcomes if it is done in a healthy manner. In future there would be more consolidation of large-sized banks with a view to having a few global banks

Internet banking is gaining ground these days. The function of banking is no longer just acceptance of deposits for lending. In today’s scenario, it refers to intermediation and managing risks. For future, banks need to develop sound corporate governance practices to face the changing environment. Banks in India have to be complimented on the introduction of modern technology in a large way in their day to day operations. Technology in banking refers to total branch automation which has given way to a core banking system.

4.7 Summary

The Indian banking industry has seen an unprecedented growth in the last two decades. The growth is not limited to urban areas only but the outreach in rural areas has also increased. There has been a considerable innovation in the banking business. Some of the services offered by bank are credit cards, merchant banking, mutual funds, leasing. RBI has advised banks to give priority sector lending so that there is growth in those areas which are important from the economic and social point of view like agriculture, small industry, cottage industry etc. Banks have been advised to place greater emphasis on the purpose for which the loans are required as also the viability and credit worthiness of the project rather than security and guarantee aspects. More banking facilities should be given in the rural, semi- urban and other undeveloped areas. In the present competitive environment the success of any bank depends on their effective functioning with efficient staff which provides quality service to their customer. Today banking has broken all geographical barriers and therefore demand from customers relates to anywhere and anytime banking.

4.8 Self Assessment Questions

1. What do you mean by Banks and State the future scope of banking services in India?
2. What are the different types of services offered by banks?
3. Distinguish between retail banking and corporate banking.
4. What do you understand by merchant banking?
5. What is the scope of rural banking in India?
6. Explain the various electronic banking services provided by banks.

4.9 Reference Books

- P.N.Varshney (2009) 'Banking Law and Practice'; Sultan Chand & Sons, New Delhi
- Punithavathy Pandian (2009) 'Financial Services and Markets'; Vikas Publishing House
- Preeti Singh (2009) 'Dynamics of Indian Financial System'; Ane Books Pvt. Ltd.
- Jain, Rathi, Sharma (2009) 'Banking Services Operations'; Ramesh Book Depot
- Gordon, Natarajan (2011) 'Financial Markets and Services'; Himalaya Publishing House
- Sandeep Goel (2012) 'Financial Services'; PHI Learning Private Ltd.
- Clifford Gomez (2011) 'Banking and Services'; PHI Learning Private Ltd.

Unit - 5 : Merchant Banking

Structure of Unit:

5.1 Objectives

After completing this unit, you would be able to:

- Understand the meaning and definition of Merchant Banking
- Explain the main objectives and nature of Merchant Banking
- Discuss obligations, responsibilities and code of conduct of Merchant Banking
- Differentiate Merchant Banking and Commercial Banking
- Understand the functions of a Merchant Banking
- Know the regulations of Merchant Banking in India
- Point out scope of Merchant Banking in India

5.2 Introduction

Merchant banking, although a non-banking financial activity, resembles banking functions. The function of merchant banking which originated, and grew in Europe, was enriched by American patronage, and these services are now being provided throughout the world by both banking and non-banking institution. The word "Merchant Banking" originated among the Dutch and the Scottish traders, and was later on developed and professionalized in Britain.

5.3 Merchant Banking- Meaning and Definition

A set of functions and services rendered by a merchant banker may be termed as 'merchant banking'.

1. According to ***Randon House Dictionary,*** "merchant bank is an organization that underwrites securities for corporations, advises such clients on merger and is involved in the ownership of commercial ventures. These organizations

are sometimes banks which are not merchants and sometimes merchants who are not banks and sometimes house which are neither merchants nor banks.

2. According to ***Charles P. Kindleberger***, "merchant banking is the development of banking from commerce which requently encountered a prolonfed intermediate stage known in England originally as merchant banking."
3. According to the ***Securities and Exchange Board of India*** (Merchant Bankers) Rules, 1992, "A merchant banker has been defined as any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities or acting as manager, consultant, adviser or rendering corporate advisory services in relation to such issue management."
4. According to ***Cox, D.*** "merchant banking defined as, "merchant banks are the financial institutions providing specialist services which generally include the acceptance of bills of exchange, corporate finance, portfolio management and other banking services".
5. According to ***Rosenberg, M.J.*** "merchant banking is an organization that underwrites securities for corporations, advises such clients on mergers and is involved in the ownership of commercial ventures". The meaning of the merchant bank refers to an organization that underwrites securities and advises such clients on issue like corporate managers in the ownership of commercial ventures".

Thus merchant banks undertakes the task of new issue management, project counseling, preparation of feasibility reports, selection of underwriters/brokers and bankers to issue. They are responsible for clearing off all legal formalities from the SEBI for making the public issue. Merchant bankers have been handling growing number of public and right issues. The profession of merchant banking is concerned with catering the needs of trade and industry by playing a role of intermediary, consultant, liaison officer and a banker. There is a strong need for the merchant banking agencies because of a major chunk of public savings lying untapped. However, they have been playing a useful role in procuring the support of capital market for the corporate a useful role in procuring the support of a capital market for the corporate sector for financing their operations. Merchant bankers are working for the long-term end of the markets that create a niche for a specialized banker.

5.4 Nature of Merchant Banking

The role and scope of merchant bankers have widened in the last few years. Merchant bankers now perform a number of activities in the capital market, starting from issue management and underwriting lo private placement, venture capital, and mezzanine financing, bought out deals, buy-back of shares, mergers and acquisitions. Depending upon the resources and expertise available, such as capital, foreign tie-ups, and special skills, merchant bankers can perform any of the activities mentioned above. Merchant banking is a skill based activity that involves sewing the financial need of all clients. Some of the reasons why specialist merchant hunks have a crucial role to play in India include the following:

- Channelizing and mobilizing savings from the public into productive investment avenues
- Ensuring the compliance with complex rules, regulations, and procedures governing the securities market
- Promoting the role of new issue market
- Facilitating the new of capital in the market
- Providing encouragement to the small and medium enterprises who require specialized services
- For developing backward areas and states which require different criteria
- Exploring the possibility of joint ventures abroad and in foreign markets

5.5 Main Objectives of Merchant Banking Company

Merchant bankers render their specialized assistance in achieving the main objectives which are presented below:

1. To carry on the business of merchant banking, assist in the capital formation, manage advice, underwrite, provide standby assistance, securities and all kind of investment issued, to be issued or guaranteed by any company, corporation, society, firm, trust, person, government, municipality, civil body, public authority established in India.
2. The main object of merchant banker is to create secondary market for bills and discount or re-discount bills and acts as an acceptance house.
3. Merchant bankers involved in assistance and promotion of economic endeavor, identification of projects, promoters, preparation of project reports, project feasibility studies, market research, pre-investment studies and investigation of industries at micro and macro level.
4. Merchant bankers another objective is to set up and provide services for the venture capital technology funds.
5. They also provide services to the finance housing schemes for the construction of houses and buying of land.
6. They render the services like foreign exchange dealer, money exchange, authorized dealer, and to buy and sell foreign exchange currencies in all lawful ways in compliance with the relevant laws of India.
7. They are involved in acquiring and holding one or mare membership in stock exchange/national stock exchange, trade associations, commodity exchange, clearing house or associations or otherwise in India or any part of the world.
8. They will help to promote or procure incorporation, formation or setting up of concerns and undertakings whether as a company, body corporate, partnership or any other association or persons for engaging in any other association or persons for engaging in any industrial, commercial or business activities.
9. Their objectives is to perform financial services including factoring and syndication of both the loan short term and long term with the financial

institutions, banks and other to manage mutual funds and to provide financial software programs.

10. The objective of the merchant banking is to carry on the business of financing industrial enterprises.
11. They will invest in buying and selling of transfers, hypothecate and deal with dispose of shares, socks, debentures, securities and properties of any other company.

5.6 Obligations and Responsibilities of Merchant Bank

Merchant bankers have the following obligations and responsibilities:

1. Merchant banker should maintain proper books of accounts, records and submit half yearly/annual financial statement to the SEBI within stipulated period of time.
2. No merchant banker should associate with another merchant banker who is not registered in the SEBI.
3. Merchant bankers should not enter in to any transactions on the basis of unpublished information available to them in the course of their professional assignment.
4. Every merchant banker must submit himself to the inspection by SEBE when required for and submit all the records.
5. Every merchant banker must disclose information to the SEBI when it requires any information from them.
6. All merchant bankers must abide by the code of conduct prescribe for them.
7. Every merchant banker who acts a lead management must enter into an agreement with issuer setting out mutual rights, liabilities, obligations, relating to such issues with particular reference to disclosure allotment, refund etc.

5.7 Code of Conduct

According to the 13 regulation of the SEBI of 1992 (Merchant bankers), every merchant banker should comply with following codes of conduct. They are:

1) The merchant banker must observe high standard of integrity and fairness in all his dealings.
2) He shall render at all times high standards of services, exercise due diligence, exercise independent professional judgment.
3) If necessary, he must disclose to his clients the possible sources of conflict of duties and interests.
4) The merchant banker should indulge in unfair practices or unfair competition with other merchant bankers.
5) He should not make any exaggerated statement about his capacity or achievement.

6) He should always endeavor to give the best possible advice and prompt efficient and cost effective service.

7) He should maintain the secrecy of all the confidential information received during the course of service to his client.

8) He should not engage in the creating of a false market or price rigging or manipulation.

5.8 Merchant Banking in India

After the termination of the managing agency system in India, a strong need of legal and financial services to the corporate sector which required an alternative service to the corporate sector which required an alternative agency. On such situation the emergence of merchant banking has aroused. Merchant Banking System in India was introduced by National Grindlays Bank in 1967. It was the first bank which received license from the RBI. It started with the management of capital issues, rendering the services according to the needs of emerging new class entrepreneurs for diverse financial service to large and medium range companies. The Citi Bank set up its merchant banking wing in 1970. Later on the Banking Commission, 1972 felt the need for the setting up merchant banking institutions to offer services like syndication or financing, promotion of projects, investment management advisory services to the corporate sector. The SBI became the First Commercial Bank in India to launch its merchant banking division in 1972 Indian banks were allowed to enter into this segment. Later other Commercial Banks and Financial Institutions like Indian Bank, Punjab National Bank, Indian Overseas Bank, Bank of Baroda, Syndicate Bank, Chartered Bank, LIC, GIC, UTI etc., also started merchant banking divisions. Some brokerage houses were diversified into this area like J.M. Financial and Investment Consultancy Services Pvt. Ltd., DSP Financial consultancy Ltd., Bajaj Capital Investment Centre Pvt. Ltd., Tata Consultancy Services Ltd. Among the Development Banks ICICI started merchant banking activities in 1973 followed by IFCI in 1986 and IDBI in 1991.

5.9 Merchant Banks and Commercial Banks

There are differences in approach, attitude and areas of operations between commercial banks and merchant banks. The differences between merchant banks and commercial banks are summarized below:

1. Commercial banks basically deal in debt and debt related finance and their activities are appropriately arrayed around credit proposals, credit appraisal and loan sanctions. On the other hand, the area of activity of merchant bankers is ‘equity and equity related finance’. They deal with mainly funds raised through money market and capital market.

2. Commercial banks are asset oriented and their lending decisions are based on detailed credit analysis of loan proposals and the value of security offered against loan. They generally avoid risk. The merchant bankers are management oriented. They are willing to accept risks of business.

3. Commercial bankers are merely financiers. The activities of merchant bankers include project counseling, corporate counseling in areas of capital

restructuring, amalgamations, mergers, takeover etc., discounting and rediscounting of short-term paper in money markets, managing, underwriting and supporting public issues in new issue market and acting as brokers and advisers on portfolio management in stock exchange. Merchant banking activities have impact on growth, stability and liquidity on money markets.

5.10 Functions of Merchant Banking

Merchant banking, being a service-oriented industry, renders the same service in India as merchant banks in UK and other European countries. In the U.S.A., Investment bankers cater to the needs of business enterprises carrying out merchant banking functions. The functions of merchant banks in India can broadly be divided in two parts. One is service based another is fund based.

5.10.1 SERVICE BASED FUNCTIONS

(i) Project counseling

The first step to launch a business unit is selection of a viable project. Merchant bankers undertake this assignment on a very large scale since they have experts with them in diverse fields. Project counseling covers a variety of sub assignments. Illustrative list of services which can be rendered under this category is :

- Guidance in relation to project viability i.e. project identification and counseling. It may be for setting up new units, expansion or improvement of existing facilities.
- Selection of consultants for preparation of project reports/market surveys etc. Sometimes merchant bankers also engage in preparation of project reports or market surveys.
- Advice on various procedural steps including obtaining of governmental approvals clearance etc. e.g. for foreign collaboration.
- Proposing a suitable capital structure laying broad as well as specific features.
- Techno- economic soundness of the project and marketing aspects. Financial engineering i.e. selection of right mix of financing pattern specifically for short term requirements.
- Organization and management set up for a strong base and efficient working of the project.

ii) Credit syndication

Normally every project has to raise debt funds for different sources as per need. Substantial debt rising may be required for a new and capital intensive project. For such project merchant bankers may undertake credit syndication. Credit syndication is credit procurement service. As per the requirements, such syndication can be from national as well as international sources. Some of the important credit syndication services offered are:

- Preparing applications for financial assistance to be submitted to financial institutions and banks.

- Monitoring the sanction of funds while acting as a specialized liaison agency.
- Negotiating the term of assistance on behalf of client.
- Post sanctions formalities with these institutions and banks.
- Assistance in drawl of term loans and or bridging loans.
- Assessing working capital requirements and arranging it.

Need of syndication arises due to the fact that especially in big projects one institution may hesitate to meet the whole debt requirement of the project. They want to spread the risk. Further shortage of funds availability with one lender also requires credit syndication. The merchant banker by rendering credit syndication services saves the time of the borrower.

The modus operandi of syndication is really quite simple. The borrower approaches several banks which might be willing to syndicate a loan, specifying the amount and the tenor for which loan is to be syndicated. On receiving a query, the syndicator scouts for banks who may be willing to participate in the syndicate. Based on an informal survey, it communicates its desire to syndicate the loan at an indicative price to the corporate borrower, all in a matter of days. After reviewing the bids from various banks, the borrower awards the mandate to the bank that offers him the best terms.

The syndicator, on his part, can underscore his willingness to syndicate the loan on a firm commitment basis or on a best-efforts basis. The former is akin to underwriting and will attract capital adequacy requirements. That may reduce the bank's flexibility. "In India, given the fact that banks may not be willing to maintain capital in the interim period, most syndicates the likely to be done on a best-efforts basis."

Best-efforts, as the name suggests, limits the obligation of the syndicator, as he is not compelled to provide the loan on his own, in case he fails to arrange the loan.

However, more often than not, the syndicator would try to fulfill his commitments for the inability to do so would tarnish his reputation. Once the syndicator has been awarded a mandate, the borrower has to sign a 'clear market clause' which stops him from seeking a syndicated loan from any other bank, till such time as the documentation for the syndication is drawn up by the syndicate manager. This may take about three-four weeks.

In the interim period, the syndicate manager gets the banks to agree to syndicating the loan. It can do this on a 'broadcast' basis, by sending taxes to the concerned banks inviting participation. If the company is well known, the loan uncomplicated and the market liquid, such a method would work well. However, if the corporate tends to keep a low profile and the loan structure is complicated; the syndicate manager would have to woo the participant banks with offer documents or an information memorandum on the company. The document is similar to a prospect but less detailed. Nevertheless drawing up such a document does call for a lot of homework. The syndicate manager has to be very careful because he can be held responsible for any inaccuracy or omission of material facts.

The participants, after reviewing the prospects, decide whether or not to join the syndicate. However, given the fact that most of the participants may be smaller Indian banks, they may take weeks to give the final nod. Once the bank decides to become a member of the syndicate, it indicates the amount and the price that it is likely to charge on the loan. Based on information received from all participants, the syndicate manager prepares a common document to be signed by all the members of the syndicate and the borrowing company. The document usually lists out details of the agreement with regard to tenor, interest prepayment clause, security, covenants, warranties and agency clause.

iii) Issue management

Traditionally this is one of the main functions of merchant banker. Whenever an issue is made whether it is public issue or private placement and further whether it is for equity shares, preference shares or debentures, the merchant banker has a crucial role to play. Raising of funds from public has many dimensions and formalities which are not possible for the concerned companies to comply with, where merchant banker comes to their rescue. Marketing effort to convince the prospective investor needs special attention. Here again merchant bankers are specialists. The specific important activities related to issue management performed by merchant banks are mentioned here:

- Advise the company about the quantum and terms of raising funds.
- Advise as to what type of security may be acceptable in the market as well as to the concerned lending institutions at the time of issue.
- Advise as to whether a fresh issue to be made or right issue to be made or if both, then in what proportion, obtaining the desired consents, if any, from government or other authorities.
- Advice on the appointment of bankers, brokers to the issue.
- Advice on the selection of issue house or Registrar to the issue, printer advertising agency etc.
- Fixing the terms of the agencies engaged to facilitate making a public issue.
- Preparation of a complete action plan and budget for total expenses of the issue.
- Drafting of documents like prospectus, letter of offer and getting approval from concerned agencies.
- Assisting in advertisement campaigns, holding the press, brokers' and investors' conferences etc. for grooming the issue.
- Advise the company for the issue period and days of opening and closing the issue.
- Monitoring the collection of funds in public issue.
- Coordination with underwriters, brokers and bankers to the issue and stock exchange etc.

- Strict compliance of post issue activities.

iv) Corporate Counseling

Although the functions discussed up till now are also covered under corporate counseling but here other dimensions will be deliberated. Corporate counseling is to rejuvenate the corporate units which are otherwise having signals to low productivity, low efficiency and low profitability. The merchant bankers can play a substantial role in reviving the sick units. They make mergers and acquisition exercise smooth, They can advise on improvement in the systems operating in managing the show of a corporate unit. Some of the specific assignments for the merchant banker are:-

- Rejuvenating old line and ailing/sick unit or appraising their technology and process, assessing their requirements and. restructuring their capital base.
- Evolving rehabilitation programs/packages which can be acceptable to the financial institutions and banks.
- Assisting in obtaining approvals from Board for Industrial and Financial Reconstruction (BlFR) and other authorities under the Sick Industrial Companies (special provisions) Act1985 (SICA).
- Monitoring implementation of schemes of rehabilitation.
- Advice on financial restructuring involving redeployment of corporate assets to refocus companies line of business.
- Advice on rearranging the portfolio of business assets through acquisition etc.
- Assisting in valuing the assets and liabilities.
- Identifying potential buyers for disposal of assets if required. Identify the candidates for takeover.
- Advice on tactics in approaching potential acquisition.
- Assisting in deciding the mode of acquisition whether friendly or unfriendly or hostile.
- Designing the transaction to reap the maximum tax advantages. Acting as an agent for leveraged buyout (LBO), involving heavy use of borrowed funds to purchase a company or division of a company.
- Facilitating Management Buy outs (MBO) i.e selling a part of business to their managers by a company.
- Clearly spelling out organization goals.
- Evolving corporate strategies to achieve the laid down goals.
- Designing or restructuring the organizational pattern and size.
- Evolving Management Information System.

Corporate advisory services should offer real value addition to the client. Highly specialized in nature, these services should be clearly distinguished from the gamut of other financial services offered by NBFCs such as underwriting or fund-based activities of leasing and hire purchase. In India corporate advisory has a good potential. The Indian industry is going through an unprecedented churning, bracing itself for global com-petition. The Indian corporate sector has been on a restructuring spree. Groups have been shedding companies. Companies in turn, have been dropping divisions as they struggle to become fit to survive in the new milieu. Free pricing of issues and the opportunity to tap the international market through the Euro-issue route has greatly enhanced the need for expert advisory services. In areas of restructuring, strategic alliances and corporate planning is now advising foreign companies in their plans for development of infrastructure in India. Merchant bankers have a great role to play.

Strategic product consolidation is another recent phenomenon. Units in which the company does not plan to become a market leader are spun off to others. A good corporate advisor is always on the alert to seize such opportunities. The process of acquisition cannot be done overnight. It requires a patient search for the right company which can be acquired, the proper evaluation of the financial impact of the acquisition, a sound strategy in blending the business acquired within the fold of the group, followed by negotiation and execution of the agreement. Occasionally, advisory services are required in cases of splits within the family group. In such cases, there is a need to split the company into different units amongst the disputing family members. At the same time, the shareholders interest is to be kept in mind by the corporate advisor.

v) Portfolio management

Merchant bankers as a body of professionally qualified persons also undertake assignments of managing an individual investor's portfolio. Portfolio management is being practiced as an investment management counseling in which the investor is advised to seek financial assets like government securities, commercial papers, debentures, shares, warrants etc. that would grow in value and/or provide income. The investors whether local or foreigners with substantial amount for investment in securities seek portfolio management services of authorized merchant bankers. The functioning of portfolio manager can be regulated or unregulated. Portfolio manager may use totally his discretion or may act only after getting signal from investor for each transaction of sale or purchase. A diverse range of services which may be rendered by merchant banker include: -

- Advising what and when to sell and buy.
- Arranging sale or purchase of securities.
- Communicating changes in investment market to the client investor
- Compliance of regulations of different regulating bodies for sale of purchase of portfolio.
- Collection of returns and reinvest as per directions of clients.
- Evaluating the portfolio at regular intervals or at direction of investors.
- Advising on tax matters pertaining to income from and investment in portfolio

vi) Stock broking and Dealership

The merchant bankers who have requisite professional knowledge and experience may also act as share broker on a stock exchange and even as dealer for Over The Counter trading. To venture into this area it is normally desired that the merchant banker has reasonable network. Their actions and activities are regulated by rules and regulations of the concerned stock exchange. They are at liberty to appoint sub brokers and sub dealers to ensure wider net work of their operations. They can be broker for inland as well as foreign stock exchanges. In India the merchant bankers who desire to act as brokers are regulated by SEBI (Stock Broker and Sub-brokers) Rules 1992.

vii) Joint venture abroad

Depending on economic and political considerations many countries may permit joint ventures by local businessmen abroad. Here again merchant bankers can play a decisive role. They facilitate meeting of foreign partner, get sanctions under various provisions, make techno economic surveys, legal documentations under local as well as foreign legal provisions etc.

viii) Debenture trusteeship

The merchant bankers can get themselves registered to act as trustee. These trustees are to protect the interests of debenture holders as per the terms laid down in trust deed. They are, as trustees, to undertake redress of grievances of debenture holders. They are to ensure that refund monies are paid and debenture certificates are dispatched in accordance with the Companies Act. Debenture trustees are expected to observe high standards of integrity and fairness in discharging their functions. They can call

5.10.2 FUND BASED FUNCTIONS

(i) Bill discounting

Bill discounting is a service against which merchant banker has to arrange funds against the bills which have been discounted. This service is undertaken by merchant bankers generally if bill market is big as well as mature. Otherwise bill discounting is undertaken by banks only. Depending on their credibility they may also undertake the assignment of bill acceptance. These bills accepted and or discounted can be foreign and merchant bankers can specify what types of bills they entertain. They charge commission for these services.

(ii) Venture capital

Venture capital is the organized financing of relatively new enterprises to achieve substantial capital gains. Such new companies are chosen because of their potential for considerable growth due to advance technology, new products or services or other valuable innovations. A high risk is implied in the term and is implicit in this type of investment. Since certain ingredients necessary for success of such projects are missing in the begging but are added later on. Merchant bankers undertake to arrange and if necessary, to provide such venture capital since traditional sources of finance like banks, financial institutions or public issue etc. may not be available. Since expected returns on projects involving venture capital is high, these are normally provided on soft terms. Such scheme is also popular as seed capital or risk capital scheme. Merchant bankers deeply study such proposals before releasing the money. At opportune time such investment can be disinvested to keep the cycle of venture capital more on.

(iii) Bought out deals

When a promoter envisages that if public issue made to raise capital will not clinch, he may approach merchant bankers (bought out dealer or sponsor) and places the shares of company initially with him which are offered to public at a later stage, this route is known as bought out deal. Many a time a syndicate of merchant bankers jointly sponsor a bought out deal to spread the risk involved. In contract to venture capital, there is no role to be played by non-traditional technology. Such bought shares by sponsor can be disposed off at an opportune time on 'over the counter' or other stock exchanges.

(iv) Lease financing and hire purchase

Depending on the funds available, merchant bankers can also enter the field of lease or hire purchase financing. Lease is an agreement whereby the lesser (merchant banker in our case) conveys to the lessee (the user), in return for rent, the right to use an asset for an agreed period of time. On the other hand in hire purchase the user at the end of the agreed period has an option to purchase the asset which he has used till date. The merchant bankers can advise the client to go in for leasing or hire purchase system of financing an asset. A comparative study may be communicated to the prospective client showing benefits of these alternatives. The client can also depend on merchant banker for acquiring the needed asset and complying with all formalities.

(v) Factoring

Factoring is a novel financing innovation. It is a mixed service having financial as well as non financial aspects. On one hand it involves management and collection of books debts which arise in process of credit sale. The merchant bankers can take up this assignment and are required to perform activities like sales ledger administration, credit collection, credit protection, evolving credit policy, arranging letter of credit etc. On the other hand there is involvement of finance. Against factored debts the merchant banker may provide advance with a certain margin. The released funds can be used by client to manage its liquidity and working capital. Merchant bankers are entitled to service charges for factoring services. The merchant banker's role is thus to:

- Maintain the books of accounts pertaining to credit sales
- Make a systematic analysis of relevant information for credit monitoring and control.
- Provide full or partial protection against bad debts and accepting the risk of non realization.
- Provide financial assistance to the client.
- Provide information about prospective buyers.
- Provide financial counseling and assisting managing the liquidity.

vi) Underwriting

It refers to a contract by means of which merchant banker gives an assurance to the issuing company that the former would subscribe to the securities offered in the event of non-subscription by the persons to whom it was offered. The liability of merchant banker arises if the issue is not fully subscribed and this liability is restricted to the commitment extended by him. The merchant bankers undertaking underwriting make efforts on their own to induce the prospective investors to subscribe to the concerned issue. Such assignment is accepted after evaluating viz :

- Company's standing and its past record.
- Competence of the management.
- Purpose of the issue.
- Potentials of the project being financed.
- Offer price and terms of the issue.
- Business environment.

The financial involvement of merchant banker in underwriting arises in case of development. To get their blocked funds released, the merchant bankers have stock exchange as exit route. They get underwriting commission. These are some of the prominent activities being undertaken by merchant bankers world over. The practices may differ from country to country depending on maturity of financial sector of their economy. The multifarious activities of the corporate sector and spectacular growth of industry gives new dimensions to merchant banking activities. In the phase of globalization of economies merchant bankers are facing new challenges. The changing international financing environment has rather pushed merchant bankers to operate at international level creating more opportunities to serve the world business community in diverse ways.

5.11 Merchant Banking Regulations

SEBI (Merchant Bankers') Regulations 1992 define merchant banker as "any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities or acting as manager, consultant, adviser or rendering corporate advisory service in relation to such issue management." Thus regulations are applicable only to limited activities undertaken by merchant banker. On the basis of regulations, merchant banking activities can be categorized as 'authorized' and 'not authorized' activities. The merchant bankers are required to get themselves registered under regulations only for authorized activities. The authorized activities are undertaking issue management assignment, as manager, consultant, adviser, underwriter port folio manager.

(a) Merchant Banking Activities not requiring SEBI's registration are:

- Project Counseling
- Corporate Counseling
- Factoring

- Credit Rating
- Bill acceptance and discounting
- Loan syndication
- Merger and amalgamation

(b) Merchant Banking Activities requiring SEBI's registration under different regulations but not under Merchant Banking regulations:

- Venture Capital
- Mutual Funds
- Depository
- Portfolio Management
- Trusteeship of debentures
- Share Broking
- Custodian Service
- Foreign Institution of Investor
- Share Transfer

Another angle from which authorized activities can be identified is the activities specified for each categories of merchant banker.

5.11.1 CATEGORIES OF MERCHANT BANKERS

The merchant banking regulations require that any body seeking registration as merchant banker has to apply in one of the following four categories:

Category I: These merchant bankers can carry on any activity of the issue management, which will *inter-alia* consist of preparation of prospectus and other information relating to the issue, determining financial structure, tie up of financiers and final allotment and refund of subscription. They can also act as adviser, consultant, manager, underwriter, portfolio manager.

Category II: Such merchant bankers can act as adviser, consultant, co-manager, underwriter and portfolio manager. This means they can not undertake issue management of their own.

Category III: These merchant bankers can neither undertake issue management nor act as co-manager. They cannot conduct business of portfolio management. Thus the area of their operation restricts to act as underwriter, adviser and consultant to the issue.

Category IV: Such merchant bankers do not undertake any activities requiring funds. They can act only as adviser or consultant to an issue.

5.11.2 REGISTRATION

Any agency to operate as merchant banker has to register itself under SEBI Regulations. Application is to be submitted in the prescribed format. To get registration and certificate to operate as merchant banker, the agency has to fulfill two sets of criteria

(i) Operational Capabilities: As mentioned earlier, the regulations desire the merchant banker to be professional, fair and competent to serve investors. In this context SEBI before granting 'certificate to operate as merchant banker' makes sure that concerned agency is competent on these parameters. To be more specific these are :

a) It is necessary that to serve the clients and investors the merchant banker should have sufficient physical infrastructure. It is desired that the applicant has the necessary infrastructure like adequate office space, equipments and manpower to effectively discharge his activities.

b) To ensure that services rendered are the best, SEBI desires the applicant to have at least two persons who have the experience to conduct the business of the merchant banker.

c) In order to avoid excessive registration SEBI makes sure that a person directly or indirectly connected with the applicant has not been already granted registration. Such persons include an associate, subsidiary, interconnected or group company of the applicant.

d) The applicant or his partner or director should be man of integrity. SEBI requires that applicant or its main officials should not be involved in any litigation connected with the securities market which has an adverse bearing on the business of the applicant.

- They should not at any time be convicted for any offence involving moral turpitude or has been found guilty of any economic offence.
- The applicant is to have professional qualification from any recognized institution.
- SEBI is to make sure that such registration should be in the interest of investors.

Only those applicants who qualify on all these points are granted registration.

(ii) Capital adequacy: In the categories where in fund based activities are involved, SEBI desires them to have sufficient capital. The concept of adequate capital is expressed in terms of 'net worth'. 'Net worth' means the value of capital contributed to the business plus free reserves. At the time of registration as well as subsequently following pattern of 'net worth' should be at least maintained:

Category of Merchant Banker	**Minimum Net-worth**
Category I	Rs. 5,00,00,000
Category II	Rs. 50,00,000
Category III	Rs. 20,00,000
Category IV	NIL

Those applicants who qualify on both fronts are granted registration. The registered applicants are granted certificate of registration in 'Form B' in which SEBI specifies for which category registration has been granted. If the applicant is granted a category lower than applied for, the applicant is free to approach SEBI for higher category but within one year from date of such registration. When certificate is finally granted the registered merchant bankers are to submit required fees. Registration is granted for three years at one time. To keep the registration operative, merchant bankers are to pay registration fee. The registration fee pattern is as under:

Category	**Fee for first two years**	**Third year**
Category I	Rs. 2.5 lakh per year	Rs. 1 lakh
Category II	Rs. 1.5 lakh per year	Rs. 0.5 lakh
Category III	1 lakh per year	Rs. 0.25 lakh
Category IV	Rs. 5,000 per year	Rs. 1,000

Once registration granted is about to expire, merchant bankers are to get this registration renewed. Application for such renewal is again to be made. To ensure that there is no break in registration, such application has to be made within 3 months before the expiry of the certificate. Although it is termed as renewal, but application is processed as for new registration that is why application is again made in 'Form A'. Once registration is renewed due fee is to be paid which is as under:

Category	**Fee for first two years**	**Third year**
Category I	Rs. 1 lakh per year	Rs. 20,000
Category II	Rs. 0.75 lakh per year	Rs. 10,000
Category III	Rs. 50,000 per year	Rs. 5,000
Category IV	Rs. 5,000 per year	Rs. 2,000

5.11.3 CODE OF CONDUCT

Once merchant bankers are registered to ensure that they maintain high standard of services, regulations require them to adhere to a code of conduct specified in the Schedule III of the Regulations while acting as merchant bankers. Some important provisions of code are as under:

- Maintain high standard of service.
- Exercise due diligence, ensure proper care and exercise independent professional judgment.
- Disclose to the clients, possible sources of conflicts of duties and interest while providing unbiased services.
- Conduct business observing high standard of integrity and fairness in all his dealings with clients and other merchant bankers.

- Maintain secrecy about client.
- Do not engage in unfair competition.
- Not to make misrepresentation.
- Provide true and adequate information to investors.
- Not to create false market or engage in price rigging.

5.11.4 LEAD MANAGER

It is required under regulations that every issue should be managed by at least one merchant banker acting as 'lead manager'. Such lead manager is not required if:

- The issue is right issue.
- The size of issue is not exceeding rupees 50 lakh.

The merchant banker acting as lead manager must enter into an agreement with the concerned company. This agreement must state their mutual rights, liabilities and obligations relating to such issue. Agreement terms pertaining to particulars to disclosures, allotment and refund should be clearly defined, allocated and determined.

In bigger issues more than one lead manager can be appointed but their number is subject to norms laid down by SEBI.

Size of Issue	***Maximum Number of Lead Manager***
Less than Rs. 50 crore	2
Rupees 50 crore but less than 100 crore	3
Rupees 100 crore but less than 200 crore	4
Rupees 200 crore but less than 400 crore	5
Rupees 400 crore and above	5 or more as agreed by SEBI

5.11.5 DUTIES OF MERCHANT BANKER/LEAD MANAGER

(i) In case more than one merchant bankers are engaged as lead manager, they have to clearly demark their duties and responsibilities. A statement of such division of job and responsibilities is to be furnished to SEBI at least one month before opening of the issue. Where the circumstances warrant joint and several responsibility of lead manager for a particular activity, a coordinator designated from among the lead managers shall furnish to SEBI with report, comments etc. on the matters relating to the joint responsibility. The activities where division is normally sought is on 'pre-issue activities' and 'post issue activities', SEBI requires that 'post issue activities' should be the responsibility of one lead manager. It involves essential follow up steps like finalization of basis of allotment/weeding out multiple applications, listing of instrument, dispatch of certificates and refunds etc.

(ii) A merchant banker cannot be a lead manager to an issue made by anybody corporate which is an associate of the lead merchant banker.

(iii) A lead manager is not to associate with an issue if any merchant banker associated with the issue is not holder of certificate of registration.

(iv) A lead manager who is category I merchant banker has to accept a minimum underwriting obligation of 5 per cent of the total underwriting commitment or Rs.25 lakh whichever is less. This is to ensure his financial involvement in the issue.

(v) It is his duty to submit SEBI a due diligence certificate in 'Form C'. This is to ensure that the contents of the prospectus or letter of an offer are verified and are reasonable. This certificate is to reach at least two weeks prior to opening of an issue.

(vi) SEBI requires lead manager to submit specified documents like particulars to the issue, draft letter of offer or prospectus.

(vii) Lead manager to incorporate changes in prospectus etc. if desired by SEBI.

(viii) Lead manager has to continue as lead manager with the issue till the subscribers have received the certificates or refunds of excess money.

(ix) Merchant bankers are prohibited from entering into any transaction, directly or indirectly in securities on the basis of unpublished price sensitive information obtained by them during the course of any professional assignment. It is referring to insider trading.

(x) SEBI is to be informed, by merchant banker about the acquisition of securities of the boy corporate whose issue is being managed by the merchant banker, within 15 days from the date of entering into such transaction.

(xi) A merchant banker has to disclose to SEBI the following information :

a. His responsibilities with regard to the management of the issue.

b. Any change in the information or particulars previously furnished which have a bearing on the certificate granted to it.

c. The name of body corporate whose issues he has managed or has been associated with.

d. Any default in capital adequacy requirements.

e. His activities as a manager, underwriter, consultant or adviser to an issue as the case may be.

(xii) Every merchant banker shall keep and maintain the required books of accounts, records and documents like balance sheet, income statement, auditor's report, a statement of financial statement. Such records are to be maintained for 5 years. They are to submit half yearly unaudited financial results when required by SEBI with a view to monitor the capital adequacy of the merchant banker.

(xiii) When SEBI initiates inspection of the said records, the merchant banker has to cooperate. SEBI shall give notice before inspection.

5.11.6 LIABILITIES OF MERCHANT BANKERS

Many provisions are incorporated in the MB Regulations to regulate the activities of merchant bankers. To make them more responsible and accountable SEBI has provisions to impose penalty in case of defaults by them. The merchant bankers are subject to penalty if they

a) Fail to comply the conditions subject to which certificate has been granted

b) Fail to comply with the provisions of the concerned rules and regulations

Two types of penalties can be imposed by SEBI on defaulting merchant bankers. One is suspension of registration and second is cancellation of registration.

a) Suspension of registration : Under the following circumstances the registration of a merchant is banker stands suspended when a merchant banker:

- **a.** Violates the provisions of the Act, rules and regulations and terms of registration
- **b.** Fails to furnish required information to SEBI or provides false information
- **c.** Fails to satisfy the investors and SEBI about the complaints of investors
- **d.** Manipulates or rigs the price of securities
- **e.** Misconducts or adopts unprofessional practices
- **f.** Fails to maintain required capital adequacy or pay the required fees

b) Cancellation of registration : In cases where there are grave misconducts or defaults, the registration of a merchant banker can even be cancelled. Some of such situations are where a merchant banker:

- **a.** Indulges in deliberate manipulation or price rigging or other activities against the interest of investors.
- **b.** Fails to maintain satisfactory financial status which may lead to dilution in services to investors.
- **c.** Involves in fraud or is convicted of a criminal offence
- **d.** Indulges repeatedly in defaults resulting in suspension of registration.

In these regulations SEBI has deviated from the earlier penalty point system announced by SEBI in guidelines for merchant bankers in 1991. Defaults were categorized in four types, general default (Type I), minor defaults (Type II), major defaults (Type III) and serious defaults (Type IV). Penalty points are assigned to each type of defaults these being one, two, three and four respectively. The defaults in each type was specified specifically e.g.

a. non receipt of :

(i) Draft prospectus,

(ii) Inter-se allocation of responsibilities,

(iii) Due diligence certificate etc. constituted general default,

b. (i) exaggerated information

(ii) Non compliance of advertisement code

(iii) Delay in refunds

(iv) Allotment of securities etc. constituted minor default,

c. (i) failure to take mandatory underwriting,

(ii) Engaging more lead manager than warranted under guidelines

(iii) Association with unauthorized merchant banker etc. were termed as major defaults and

d. (i) unethical practices

(ii) Violation of code of conduct

(iii) Non-cooperation with SEBI constituted serious defaults.

Any merchant banker reaching cumulative penalty points of 'eight' attracted action from SEBI.

5.12 Merchant Bankers Commission

As determined by the finance ministry, Government of India, Merchant Bankers are eligible to charge commission/fee from their clients as detailed below:

(i) A Merchant Banker can charge 0.5% as the maximum as commission for whole of the issue.

(ii) They can charge project appraisal fees.

(iii) A lead manager can claim a commission of 0.5% upto Rs. 25 crore and 0.2% in excess of Rs. 25 crore.

(iv) Underwriting Commission (as follows)

Types of Security	On amount developing on Underwriters (percent)	On amount subscribed by public (percent)
Equity shares	2.50	2.50
Preference shares/ debentures		
(a) Upto Rs. 5 lakh	2.50	1.50
(b) Excess of Rs. 5 lakh	2.00	1.00

(v) Brokerage commission 1.5%

(vi) Other expenses like advertising, printing, Registrar's expenses, stamp duty etc., in connection with the issue can be reimburses from its client.

5.13 Problems of Merchant Bankers

1. SEBI guidelines have authorized merchant bankers to undertake issue related activities only with an exception of portfolio management. These guidelines have made the merchant bankers either to restrict their activities or think of separating these activities from the present one and float new subsidiary and enlarge the scope of its activities.
2. SEBI guidelines stipulate a minimum net worth of Rs. 1 crore for authorization of merchant bankers. Small but professional and specialized merchant bankers who do not have a net worth of Rs. 1 crore may have to close down their business. The entry is denied to young, specialized professionals into merchant banking business.
3. Non-co-cooperative of the issuing companies in timely allotment of securities and refund of application money is another problem or merchant bankers. The guidelines have put the responsibility on the merchant bankers. They have to seek the co-operation of the issuing company to shoulder the responsibility.

5.14 Scope for Merchant Banking in India

In the present era, capital market scenario, the merchant banks play the role of encouraging and supporting farce to the entrepreneurs, corporate sectors and investors. There is vast scope for merchant bankers to enlarge their operations both in domestic and international market.

(i) Growth of New Issue Market: the growth of new issue market is unprecedented since 1990-91. The amount of annual average of capital issues by non-government public companies was only about 90 crores in the 70s, the same rose to over Ra. 1,000 crores in the 80's and further to Rs. 12,700 crores in the first four years of 1990's. The number of capital issues has also increased from 516 in 1991-92 to more than 5000 in 2010. The trend is expected to continue in future.

(ii) Entry of Foreign Investors: an outstanding development in the history of Indian capital market was its opening up in 1992 by allowing foreign institutional investors to invest in primary and secondary market and also permitting Indian companies to directly' tap foreign capital through euro issues. Foreign direct investments made by NRIs have risen considerably due to number of incentives offered to them. They need the services of Merchant Bankers to advise them for their investment in India. The increasing numbers of joint ventures abroad by Indian companies also require expert services of Merchant Bankers.

(iii)Changing policy of Financial Institutions: with the changing emphasis in the lending policies of financial institutions from security orientation to project orientation, corporate enterprises would require the expert services of merchant bankers for project appraisal, financial management ets. This policy of decentralization and encouragement of small and medium industries will further increase the demand for technical and financial services which can be provided merchant bankers.

(iv) **Development of Debt Market:** The concept of debt market has set to work through National Stock Exchange and the Over the Counter Exchange of India. The development of debt market will offer tremendous opportunity to Merchant Bankers.

(v) **Innovational in Financial Instruments:** The Indian capital market has witnesses innovations in the introduction of financial instruments such as non-convertible debentures with detachable warrants, cumulative convertible preference shares, zero coupon bonds, deep discount bonds, triple option bonds, secured premium notes, floating rate bonds, auction rated debentures etc. This has further extended the role of Merchant Bankers as market for these instruments.

(vi) **Corporate Restructuring:** As a result of liberalization and globalization the competition in the corporate sector is becoming intense day by day. To survive in the competition, companies are reviewing their strategies, structure and functioning. This had led to corporate restructuring including mergers, acquisition, splits, disinvestments and financial restructuring. This offers good opportunity to Merchant Bankers to extend to area of their specialization.

The above discussion highlights, that the scope of merchant banking is vast and there lies immense opportunities ahead of Merchant Bankers. They should develop adequate infrastructure including expertise in order to provide full range of merchant banking services to corporate sector.

5.15 Summary

Merchant banking is a type of financial service that involves project counseling, corporate counseling, issue management and other related activities. Merchant bankers are the institutions engaged in the providing merchant banking services to corporate entities. There are several kinds of services rendered by merchant bankers. These include corporate counseling, project counseling, credit syndication, mutual funds, portfolio management, working capital finance, venture capital, lease financing, project appraisal, etc.

Services provided towards ensuring efficient running of a corporate enterprise are called corporate counseling. Pre-investment studies involved detailed feasibility explorations, with a view to evaluating alternative avenues. Credit syndication is concerned with extending finance, in bath Indian rupees and foreign currency, on a consortium basin. Project appraisal is concerned with the assessment of the viability of a project. SEBI has brought out codes of conduct for the merchant banker. Besides this, operational guidelines are required to be followed by merchant bankers in the discharge of their duties. They have pre-issue and post-issue obligations, which are a part of issue management. In the present era, capital market scenario, the merchant banks play the role of encouraging and supporting farce to the entrepreneurs, corporate sectors and investors. There is vast scope for merchant bankers to enlarge their operations both in domestic and international market.

5.16 Self Assessment Questions

1. What do you mean by Merchant Banking? Discuss its nature and objectives.
2. What are the obligations and responsibilities of Merchant Bank?
3. ‘The scope of Merchant banking in India is great’. Discuss this statement in detail.
4. What are the different functions of Merchant Banking?
5. Explain the role of SEBI in regulating the Merchant Banking operations in India.
6. Who is a lead manager? Explain its duties, liabilities and responsibilities in detail.

5.17 Reference Books

- Gordon G. and Natarajan, K. (2010) ‘Financial Markets and Services’. Himalaya Publishing House, New Delhi
- Mattish S. K. (2011) ‘Management of Financial Institutions and Services’. Vrinda Publications (P) Ltd., New Delhi
- Siddaian T. (2011) ‘Financial Services’. Person Education, New Delhi
- Vij M. and Dhawan, S. (2012) ‘Merchant Banking and Financial Services’. Tata McGraw-Hill Education Private Ltd., New Delhi
- Gurusamy G. (2009) ‘Merchant Banking and Financial Services’. Tata McGraw-Hill Education Private Ltd., New Delhi
- Jain T. R. (2011) ‘Indian Financial System’. V K Global Publication Pvt. Ltd., New Delhi
- Gurusamy G. (2009) ‘Financial Services’. Tata McGraw-Hill Education Private Ltd., New Delhi
- Khan M.Y. (2010) ‘Financial Services’. Gurusamy G. (2009) ‘Merchant Banking and Financial Services’. Tata McGraw-Hill Education Private Ltd., New Delhi

Unit - 6 : SEBI Regulations

Structure of Unit:

6.0 Objectives

After completing this unit, you would be able to:

- Understand the concept of financial services and its various types in India;
- Know about various regulations made by SEBI for regulating the working of Merchant Banking in India;
- Point out the SEBI guidelines issued for the smooth functioning of various mutual fund agencies in India;
- Understand rules and regulations implemented by SEBI for frictionless working of Venture Capital finance in India;
- Learn about the SEBI regulations regarding the operations of depository system in India;

6.1 Introduction

After the liberalization of the economy and opening the stock markets to foreign institutional investors the objective of the regulation of the stock and financial market is to ensure the growth of a normal market in a stable manner. Stability is an essential prerequisite for vibrancy and vitality of the stock markets. Stability ensures fair and orderly price movements and builds up investor confidence. A major objective of regulation of stock exchange is investor protection for healthy and stable market. However a stable market should reflect not only demand but market values based on a good performance of the corporate sector in terms of earnings and cash flows against the backdrop of overall growth and prospects of the economy.

6.2 What is Financial Services?

Financial services are rendered through specialized institutions which organize the work of the client to raise funds, manage funds and transform savings into investments. The financial services consist of market players, financial instruments, specialized institutions and regulatory bodies. The specialized financial services are merchant banking, underwriting, leasing, hire-purchase, consumer and housing finance, venture capital finance, factoring services, securitization and credit rating. The financial services offer different types of financial instruments like equity, debt, hybrid and financial engineering instruments and specialized institutions in the market are the discount houses, depositories, venture capital institutions, acceptance houses, credit rating agencies and many others. The main regulatory bodies are the Reserve Bank of India, Securities Exchange Board of India, Insurance Regulatory Development Authority, Department of Banking and Insurance of the Central Government.

6.3 Types of Financial Services in India

There are different types of financial services in India. These are:

- ***The fund based financial services*** comprise of equipment leasing and hire-purchase, venture capital, housing finance, factoring, bills discounting and loans and investments.
- ***The fee based financial services*** are corporate counseling, issue management, portfolio management, loan syndication, foreign collaboration, mergers and acquisitions and capital restructuring.
- ***The commercial financial services*** are largely bank based services. These are advisory and custodian services, letter of credit for financing trade, financial management and transaction services and credit card services.
- ***The securities related financial services*** are mutual fund services, private placement, underwriting services, securities trading, clearance, and lending and settlement services.

6.4 SEBI Regulations regarding Merchant Banking

Merchant banking is a financial service which has the function of providing advice in corporate matters. It is an intermediary between issuers and purchasers of securities. Merchant bankers in India take up a number of services, but their focus is on issue management, portfolio management, project feasibility device, financial counseling, credit syndication, venture financing, lease financing and foreign currency financing.

SEBI (Merchant Bankers') Regulation Act, 1992 defines 'merchant banker' as "any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities or acting as manager, consultant, adviser or rendering corporate advisory service in relation to such issue management". At present no organization can act as a 'merchant banker' without obtaining a certificate of registration from the SEBI. However, it must be noted that a person/organization has to get himself registered under these regulations if he wants to carry on or undertake any of the authorized activities, i.e., issue management assignment as manager, consultant, advisor, underwriter or portfolio manager. To obtain the certificate of registration, one has to apply in the prescribed form and fulfill two sets of norms (i) operational capabilities and (ii) capital adequacy norms. The following are rules and regulations provided by SEBI for Merchant banking in India:

Classification of Merchant Bankers: The SEBI has classified 'merchant bankers' under four categories for the purpose of registration:

1. ***Category I Merchant Bankers***. These merchant bankers can act as issue manager, advisor, consultant, underwriter and portfolio manager.
2. ***Category II Merchant Bankers.*** Such merchant bankers can act as advisor, consultant, underwriter and portfolio manager. They cannot act as issue manager of their own but can act co-manager.
3. ***Category III Merchant Bankers.*** They are allowed to act as underwriter, advisor and consultant only. They can neither undertake issue management of their own nor they act as co-manager. They cannot undertake the activities of portfolio management also.
4. ***Category IV Merchant Bankers.*** A category IV merchant banker can merely act as consultant or advisor to an issue of capital.

Registration: Merchant bankers have to register themselves with SEBI for conducting their services to clients. They require compulsory registration for acting as sponsors of a capital issue. Although merchant bankers are of four types, since 1997 there is uniformity and only Category I merchant bankers are allowed do issue management. In the function of issue management they have to prepare prospectus of the company, its capital structure, allot shares and also refund subscriptions. They have to advise the company as its consultant and manager. They take the role of a lead manager to an issue. If they act as underwriters or portfolio manager of the company they must obtain from SEBI a separate registration certificate.

Capital Adequacy Requirements: SEBI has prescribed capital adequacy norms for registration of the various categories of merchant bankers. The capital adequacy is expressed in terms of minimum net worth, i.e., capital contributed to the business plus free reserves. The registration fees have been raised to Rs. 5 lakhs since 1999. The four categories had to apply for different types of renewal fees but from 1999 the renewal fees is Rs. 2.5 lakhs per annum for 3 years.

Code of Conduct: The merchant bankers are governed by a code of conduct. According to this code they have to follow a high standaerd of integrity and provide good quality to their clients. They have to be honest and fair in their dealings while advising their customers. While providing advice they should be professional and give the adequate information to their clients. They should comply with the Act, rules and regulations relevant to their functioning. They should not discriminate amongst their cleints. They should also not make any oral or written statements which misrepresents their cleints in any way. The merchant bankers have to obtain certain clearances for carrying out their business as per operational guidelines of SEBI.

Fees: According to the SEBI (Merchant Bankers) Amendment Regulations, 1999, w.e.f. 30.09.1999, every merchant banker shall pay a sum of Rs. 5 lakhs as registration fees at the time of grant of certificate by the Board. The fee shall be paid by the merchant banker within 15 days of receipt of intimation from the Board. Further, a merchant banker to keep registration in force shall pay renewal fee of Rs. 2.5 lakhs every three years from the fourth year from the date of initial registration.

Inspection of Records: The merchant banker has to comply with the rules and regulations of SEBI. He has to submit all information regarding the records and books relating to its business. At any time SEBI can inspect the books and records of the merchant banker in order to protect the interest of the investors. SEBI can also ask for explanations from merchant banker if it finds that the rules and regulations are not complied with. SEBI has right of appointing an auditor and inspection committee which is qualified to inspect the books of account of a merchant banker.

GENERAL OBLIGATIONS AND RESPONSIBILITIES OF MERCHANT BANKERS

The following are some of the important obligations and responsibilities of the merchant bankers:

1. **Merchant banker not to associate with any business other than that of the securities market.** No merchant banker, other than a bank or a public financial institution, who has been granted a certificate of registration under these regulations shall carry on any business other than that in the securities market.
2. **Maintenance of book of accounts, records, etc.** Every merchant banker shall keep and maintain the following books of accounts, records and documents, namely:

   (a) a copy of balance sheet as at the end of each accounting period;

   (b) a copy of profit and loss account for that period;

   (c) a copy of the auditor’s report on the accounts for that period; and

   (d) a statement of financial position.

   Every merchant banker shall intimate to the Board the place where the books of accounts, records and documents are maintained.
3. **Submission of half-yearly results.** Every merchant banker shall furnish to the Board half-yearly unaudited financial results when required by the Board with a view to monitor the capital adequacy of the merchant banker;
4. **Maintenance of books of accounts, records and other documents.** The merchant banker shall preserve the books of accounts and other records and documents for a minimum period of five years.
5. **Report on steps taken on auditor’s report.** Every merchant banker shall within two months from the date of the auditors’ report take steps to rectify the deficiencies, made out in the auditor’s report.
6. **Acquisition of shares prohibited.** No merchant banker or any of its directors, partner or manager or principal officer shall either on their respective accounts

or through their associates or relatives enter into any transaction in securities of bodies corporate on the basis of unpublished price sensitive information obtained by them during the course of any professional assignment either from the clients or otherwise.

7. **Information to the Board.** Every merchant banker shall submit to the Board complete. particulars of any transaction for acquisition of securities of anybody corporate whose issue is being managed by that merchant banker within fifteen days from the date of entering into such transaction.

8. **Disclosures to the Board.** A merchant banker shall disclose to the Board as and when required, the following information, namely:

   (i) his responsibilities with regard to the management of the issue;

   (ii) any change in the information or particulars previously furnished, which have a bearing on the certificate granted to it;

   (iii) the names of the body corporate whose issues he has managed or has been associated with;

   (iv) the particulars relating to breach of the capital adequacy requirements;

   (v) relating to his activities as a manager, underwriter, consultant or adviser to an issue as the case may be.

PENALTY OF MERCHANT BANKERS

A merchant banker can be penalized by suspension of his registration if he violates the Acts, rules or regulations of SEBI. He can be suspended from his activity of merchant banking if he submits incorrect documents giving false information or is not co-operative at the time of an enquiry. If he does not submit periodical returns he faces penalty. In the following cases his certificate of registration can be suspended:

- When he does the activity of price rigging, manipulation or cornering of share prices.
- When he is guilty of unprofessional and unethical conduct in his work.
- When he does not pay his fees in time.
- When he does not comply with the registration of SEBI.

In serious cases merchant banker's registration can be cancelled. In the following cases registration can be cancelled:

- When his improper activities affect the interest of the investor in the securities market.
- When he misrepresents his financial statement and SEBI on inspection finds out that merchant banker is guilty of fraud.
- When a merchant banker is convicted in the case of a criminal offence.
- When the merchant banker does not improve in his activities after his suspension his registration can be cancelled.

In the above cases if SEBI decided to cancel the registration of the merchant banker, he will have to refrain from any activity of merchant banking. SEBI will publish the suspension or cancellation of the merchant banker's registration in to leading daily news paper.

Penalty Points of Merchant Bankers: Merchant Bankers will get penalty points in case of defaults. The defaults may be of different kinds. They can be general, minor, major or serious defaults.

- ***General Defaults*** are when the lead manager does not submit the draft prospectus/letter of offer from lead manager, certificate of due diligence, certificate of subscription of minimum of 90% of the issue. Another general default is when the shareholders refund orders or share certificates are not sent in time.
- ***Minor Defaults*** are when a circular or an advertisement relating to the issue is not in accordance with SEBI guidelines or prospectus is drafted incorrectly or adequate disclosure is not provided to shareholders. Such defaults also occur when there are delays in mailing refund or allotment letters. If investor grievances are not handled within a time framework and there are delays it will be taken as a minor default.
- ***Major Defaults*** are when the merchant banker does not conduct underwriting according to the mandatory regulations and the number of lead managers is more than required for the issue. If unauthorized merchant bankers are hired it is a major defaults.
- ***Serious Defaults*** are when a merchant banker violates his code of conduct and his activities are unethical. If a merchant banker does not co-operate in providing information or documents required by SEBI it is a serious default.

When the merchant banker gets eight penalty points his registration can be suspended or cancelled by SEBI. In a single issue the merchant banker can get a maximum of four penalty points. If there are a number of lead managers associated with an issue and they have joint responsibility, each one of them will get four penalty points.

Negative points and Grading points: The merchant banker can also get general negative points if they have not highlighted the risk factors or listing details. Deficiencies in preparing a prospectus will get negative points. The prospectus is graded according to the points. The prospectus get full 10 points if it is correct in all respects and graded A+, A, B or C according to the number of points.

REGULATIONS REGARDING LEAD MERCHANT BANKERS

1. **Appointment of lead merchant bankers.** All issues should be managed by at least one merchant banker functioning as the lead merchant banker: Every lead merchant banker shall before taking up the assignment relating to an issue, enter into an agreement with such body corporate setting out their mutual rights, liabilities and obligations relating to such issue and in particular to disclosures, allotment and refund.
2. **Restriction on the appointment of lead managers.** The number of lead merchant bankers may not, exceed in case of any issue of:

Size of Issue	No. of lead merchant bankers
(a) Less than rupees fifty crores	Two
(b) Rupees fifty crores but less than rupees one hundred crores	Three
(c) Rupees one hundred crores but less than two hundred crores	Four
(d) Rupees two hundred crores but less than rupees four hundred crores	Five
(e) Above rupees four hundred crores may be	Five or more as agreed by the Board.

3. **Responsibilities of lead managers.**

    (1) Lead manager shall agree to manage or be associated with any issue unless his responsibilities relating to the issue mainly, those of disclosures, allotment and refund are clearly, defined, allocated and determined and a statement specifying such responsibilities is furnished to the Board at least one month before the opening of the issue for subscription.

    (2) Provided that, where there are more than one lead merchant bankers to be issue the responsibilities of each of such lead merchant banker shall clearly be demarcated and a statement specifying such responsibilities shall be furnished to the Board at least one month before the opening of the issue for subscription.

    (3) No lead merchant banker shall, agree to manage the issue made by anybody corporate, if such body corporate is an associate of the lead merchant banker.

4. **Lead merchant banker not to associate with a merchant banker without registration.** A lead merchant banker shall not be associated with any issue is a merchant banker who is not holding a certificate is associated with the issue.

5. **Underwriting obligations.** In respect of every issue to be managed, the lead merchant banker holding a certificate under Category I shall accept a minimum underwriting obligation of five per cent of the total underwriting commitment or rupees twenty-five lacs, whichever is less:

    Provided that, if the lead merchant banker is unable to accept the minimum underwriting obligation, that lead merchant banker shall make arrangement for having the issue underwritten to that extent by a merchant banker associated with the issue and shall keep the Board informed of such arrangement.

6. **Submission of due diligence certificate.** The lead merchant banker, who is responsible for verification of the contents of a prospectus or the letter of offer in respect of an issue and the reasonableness of the views expressed therein, shall submit to the Board at least two weeks prior to the opening of the issue for subscription, a due diligence certificate in Form C.
7. **Documents to be furnished to the Board.** The lead manager responsible for the issue shall furnish to the Board, the following documents, namely:
   (i) particulars of the issue;
   (ii) draft prospectus or where there is an offer to the existing shareholders, the draft letter of offer;
   (iii) any other literature intended to be circulated to the investors, including the shareholders; and
   (iv) such other documents relating to prospectus or letter of offer, as the case may be.

   The documents referred to in sub-regulation (1) shall be furnished at least two weeks prior or date of filing of the draft prospectus or the letter of offer, as the case may be, with the Registrar of Companies or with the Regional Stock Exchanges, or with both.

   The lead manager shall ensure that the modifications and suggestions, or any, made by the Board on the draft prospectus or the letter of offer, as the case may be, with respect to information to be given to the investors are incorporated therein.
8. **Continuance of association of lead manager with an issue.** The lead manager undertaking the responsibility for refunds or allotment of securities in respect of any issue shall continue to be associated with the issue till the subscribers have received the share or debenture certificates of refund or excess application money.

   Provided that where a person other than the lead manager is entrusted with the refund or allotment of securities in respect of any issue, the lead manager shall continue to be responsible for ensuring that such other person discharges the requisite responsibilities in accordance with the provisions of the Companies Act and the listing agreement entered into by the body corporate with the stock exchanges.

6.5 SEBI Regulations regarding Mutual Fund

The Securities and Exchange Board of India (SEBI) as the regulator of Indian capital market had come out with its first mutual fund regulations in 1993. The need for creation and compliance mechanism for mechanism for mutual fund industry was expressed by SEBI in these guidelines. These regulations were revised and enlarged subsequently in 1996. Apart from sharply focused normative standards the regulatory mechanism laid greater emphasis on market discipline through enhanced transparency and disclosure requirements. With SEBI regulations, all mutual funds have been brought under a common regulatory framework to ensure greater degree of transparency in their operations and adherence to a common structure. This act spells out numerous restrictions and requirements designed to protect the interests of the investors, and ensure that each mutual fund scheme is managed and operated in the best interest of its unit holders.

(1) **Legal character of mutual funds in India:** To begin with, it is useful to understand the legal composition of a mutual fund. A mutual fund is a legal entity. In India it is organized in form of a trust. The SEBI (Mutual Fund) Regulations, define a mutual fund as a fund established in the form of a trust by a sponsor, to raise monies by the trustees, through the sale of units to the public under one or more schemes for investing in securities in accordance with these regulations. This imposes three limitations on a mutual fund and determines its basic legal character. First, it allows the mutual fund to raise resources through sale of units to the public. Second, it permits the mutual fund to invest only in securities prescribes in the SEBI (MF) Regulations. This implies that mutual funds cannot invest in property or a real estate or in any other assets, as the securities prescribed in the regulations are only shares, debentures and equity-linked instruments. Third, it requires the mutual fund to be set up in the form of a trust under the Indian Trust Act. This is reinforced by clause (b) of regulation 8, which requires as a condition of registration that mutual funds should be set up only as trusts.

(2) **Formation:** The SEBI Mutual Fund Regulations have defined the structure of a mutual fund and segregated the various constituents into separate legal entities. The mutual funds are set up as trusts are to be managed by a separate asset management companies (AMCs). The custody of the assets is to be with a custodian, which is independent of the sponsors and the AMCs. Arms-length relationships have been sought to be built into the various constituents of a mutual fund, primarily through the requirement that two third of the trustees and also 50% of the board of directors of the AMC must be independent and not associated or affiliated to the sponsor. Various documentation viz. trust deed, investment management agreement, which are to be executed, delineate the responsibilities of the asset management companies and the trustees.

(3) **Registration:** In January 1993, SEBI prescribed registration of mutual funds taking into account track record of a sponsor, integrity in business transactions and financial soundness while granting permission.All mutual funds are required to register with the Securities and Exchange Board of India. Registration is intended to provide adequate and accurate disclosure of material facts concerning the mutual fund. SEBI regulations have laid down an eligibility criteria u/s 7, for the purpose of grant of a certificate of registration with a view to ensure that players have a sound track record and general reputation of fairness and integrity in all their business transactions.

Regulation 20(e) states that the AMC shall have a minimum net worth of Rs.10 crores. This is to serve both as an entry barrier as well as to enable the AMC to provide for its own infrastructure such as office space, personnel and systems independent of the sponsor. Any shortfall in the net worth would have to be made up by the sponsor immediately. The initial contribution to the net worth should be in the form of cash and all assets should be held in the name of the AMC. This is necessary to bring about a complete arms length relationship with the sponsor and its affiliates. In case the AMC wants to carry out other fund management businesses, it should satisfy the capital adequacy requirement for each such business independently.

(4) **Documents:** The offer documents of schemes launched by mutual funds and the scheme particulars are required to be vetted by SEBI. A standard format for mutual fund prospectuses is being formulated.

(5) **Code of advertisement:** Mutual funds must adhere to specific rules regarding the sale, distribution and advertising of mutual funds. Advertisements or sales literature must be carefully worded and explained. The advertisement for each scheme shall disclose investment objective for each scheme. The offer document and advertisement materials shall not be misleading or contain any statement or opinion, which is incorrect or false. These steps ensure that potential investors are aware of the benefits as well as the potential risks involved in mutual fund investing. With a view to ensure that an asset management company may not in promoting its schemes use untrue and misleading information or withhold important facts from investors SEBI has prescribed an advertisement code. Advertisements in respect of every scheme shall be in conformity with the Advertisement Code.

(6) **Governance of mutual funds:** Mutual fund schemes are repositories of trust and of investor's hard earned money. The task of providing protection to them is a difficult one. Mutual funds are unique in a way as that they are organized and operated by people whose primary loyalty and pecuniary interest lies outside the enterprise. Consequently the very structure of mutual funds has inherent conflicts of interest, creating great potential for abuse. The existing SEBI Regulations have tried to address the issue, through separation of various entities which constitute a mutual fund – sponsor, trustees asset management companies and custodian, and also requiring that 2/3rd of the trustees and half of the board of directors of AMC must be independent of sponsor or its affiliates.

(7) **Assurance on returns:** SEBI has introduced a change in the Securities Control and Regulations Act governing the mutual funds. Now the mutual funds were prevented from giving any assurance on the land of returns they would be providing. However, under pressure from the mutual funds, SEBI revised the guidelines allowing assurances on return subject to certain conditions. Hence, only those mutual funds which have been in the market for at least five years are allowed to assure a maximum return of 12 per cent only, for one year. With this, SEBI, by default, allowed public sector mutual funds an advantage against the newly set up private mutual funds. As per basic tenets of investment, it can be justifiably argued that investments in the capital market carried a certain amount of risk, and any investor investing in the markets with an aim of making profit from capital appreciation, or otherwise, should also be prepared to bear the risks of loss.

(8) Minimum corpus: The current SEBI guidelines on mutual funds prescribe a minimum start-up corpus of Rs.50 crore for a open-ended scheme, and Rs.20 crore corpus for closed-ended scheme, failing which application money has to be refunded. The idea behind forwarding such a proposal to SEBI is that in the past, the minimum corpus requirements have forced AMCs to solicit funds from corporate bodies, thus reducing mutual funds into quasi-portfolio management outfits. In fact, the Association of Mutual Funds in India (AMFI) has repeatedly appealed to the regulatory authorities for scrapping the minimum corpus requirements.

(9) Disclosure Requirements: Mutual funds are required to disclose to SEBI regular, comprehensive disclosures of their operations. In addition, each fund must provide unit holders with annual report along with a statement on portfolio holdings, and it must furnish unit holders and prospective investors with an up-to-date prospectus. The prospectus contains full disclosures on the fund's management, investment objectives, purchase redemption procedures and other business practices, including load charges, if any. The offer document discloses the constitution of the mutual fund including the details regarding the sponsor, the trustees, the AMC, the custodian and the responsibilities and functions of each constituent of the mutual fund, the detailed investment objective of the scheme and the investment pattern likely to be followed by the AMC, the risk profile of the investments and risk factors. The offer documents also contains other information pertaining to the redemption of units, the tax benefits available to unit holders, the principles of valuation of investments, the method of calculation of NAV, frequency and mode of distribution of income, the duration of the scheme, the detailed breakup of the expenses that will be incurred for the management of the scheme and the extent to which expenses are loaded on the scheme.

(10) Institutionalisation: The efforts of SEBI have, in the last few years, been to institutionalise the market by introducing proportionate allotment and increasing the minimum deposit amount to Rs.5000 etc. These efforts are to channel the investment of individual investors into the mutual funds.

(11) Investment of funds mobilised: In November 1992, SEBI increased the time limit from six months to nine months within which the mutual funds have to invest resources raised from the latest tax saving schemes. The guideline was issued to protect the mutual funds from the disadvantage of investing funds in the bullish market at very high prices and suffering from poor NAV thereafter.

(12) Investment in money market: SEBI guidelines say that mutual funds can invest a maximum of 25 per cent of resources mobilised into money-market instruments in the first six months after closing the funds and a maximum of 15 per cent of the corpus after six months to meet short term liquidity requirements. Private sector mutual funds, for the first time, were allowed to invest in the call money market after this year’s budget. However, as SEBI regulations limit their exposure to money markets, mutual funds are not major players in the call money market. Thus, mutual funds do not have a significant impact on the call money market.

(13) **Valuation of investment:** The transparent and well understood declaration or Net Asset Values (NAVs) of mutual fund schemes is an important issue in providing investors with information as to the performance of the fund. SEBI has warned some mutual funds earlier of unhealthy market

(14) **Inspection:** SEBI inspect mutual funds every year. A full SEBI inspection of all the 27 mutual funds was proposed to be done by the March 1996 to streamline their operations and protect the investor’s interests. Mutual funds are monitored and inspected by SEBI to ensure compliance with the regulations.

(15) **Underwriting:** In July 1994, SEBI permitted mutual funds to take up underwriting of primary issues as a part of their investment activity. This step may assist the mutual funds in diversifying their business.

(16) **Conduct:** In September 1994, it was clarified by SEBI that mutual funds shall not offer buy back schemes or assured returns to corporate investors. The Regulations governing Mutual Funds and Portfolio Managers ensure transparency in their functioning.

(17) **Voting rights:** In September 1993, mutual funds were allowed to exercise their voting rights. Department of Company Affairs has reportedly granted mutual funds the right to vote as full-fledged shareholders in companies where they have equity investments.

(18) **Grievance mechanism:** Mutual funds need to specify in the offer document the name of contact person whom unit holders may approach in case of any query, complaints or grievances. The names of the directors of Asset Management Company and trustees are also given in the offer documents; and they can also be approached. Historical information about the investor's complaints and redressal form a part of the offer document. Investors can also approach SEBI for redressal of their complaints. On receipt of complaints, SEBI takes up the matter with the concerned mutual fund and follows up with them till the matter is resolved.

6.6 SEBI Regulations regarding Venture Finance Capital

SEBI has been a regulatory body for venture capital companies or funds with effect from January 25, 1995. It issued certain guidelines on 4^{th} December, 1996 which defines venture capital fund as “fund established in the form of a company or trust which raises moneys through loans, donations, issue of securities or units as the case may be, and makes or proposes to make investments in accordance with these regulations”. SEBI has made many regulations in India for protecting the investors. In 1996, the Venture Capital Funds Regulation was passed and in 2000 SEBI Foreign Venture Capital Investors Regulation was enacted. In January 2000, Chandrasekhar Committee was appointed to identify the problems of venture capital industry in India and to suggest methods for their growth. The committee recommended that the regulation should be simplified and the venture capital fund structure should be amended. They also recommend resource raising, investments and exit regulations. Some of the important regulations are following:

- **Registration:** Venture capital funds must be registered with SEBI for doing business in India. They have to apply for registration after taking approval from RBI. The applicant has to be in the prescribed form showing the eligibility of the fund by providing the track record of experience, financial soundness and competence. They also have to submit registration fee of US$10,000.
- **Custodian:** A domestic custodian has to be appointed to make arrangements with the banker. The custodian has to be registered with SEBI.
- **Investment Norms:** SEBI has prescribed norms for investing the funds of the venture capitalist. They cannot invest more than 25% in one venture capital unit. A minimum of 75% of their funds invested should be in utilized equity shares, equity linked instruments, preference shares, share warrants and convertible securities compulsorily convertible in to equity and 25% of the funds to be invested as subscription to initial public offer.
- **Responsibilities:** The foreign venture capitalist have to maintain for term period of 8 years their books of account, documents and records. SEBI may ask for the documents at any time. Further they have to be monitored by their custodian in India for their domestic investments. They also have the responsibility of furnishing periodical reports to SEBI.
- **Investigation:** SEBI has the right to investigate and inspect books of account maintained by the venture capitalist. They have the power to examine any person or record of the activity of the venture capitalist. SEBI may order them to dispose of any security or investment. It may even prohibit the fund from entering into the capital market for a specified period of time.
- **Suspension:** SEBI may suspend the venture capital if it does not furnish information required as per law. It may also suspend it if it gives any misleading statements or does not cooperate with it at the time of equity.
- **Cancellation:** Venture capital fund may be cancelled if they are guilty of fraud or have been convicted in a moral turpitude or guilty of repeated defaults or suspension of registration.

6.7 SEBI Regulations regarding Underwriting

The main function of underwriting is to subscribe to the new issues that are not fully subscribed. The underwriters commit before the new issue, the number of shares they would like to subscribe to. They have the option to subscribe the shares themselves or by other underwriters but they have to give the names of the underwriters in advance of the issue. The underwriters are appointed by the merchant bankers or lead managers to the issue by signing a contract between the company and the underwriter. The contract is called a Memorandum of Understanding (MoU). Since 1995 underwriting is not mandatory for the issuing company. However, it is an important service and underwriting continues to exist in the new issue market.

SEBI GUIDELINES ON UNDERWRITING

a) As per the original Guidelines issued by SEBI on 11.06.1992, underwriting was mandatory for full issued and minimum requirement of 90% subscription was also mandatory for each issue of capital to public. However, as per the Revised Guidelines issued by SEBI on 10.10.94, underwriting is not mandatory now and the issuers have the option of deciding whether the issue is to be underwritten or not. Number of underwriters would also be decided by the issuers.

b) If the issue is not underwritten and if the minimum subscription of 90% of the offer to the public is not received, the entire amount received as subscription would have to be returned in full.

c) If the issue is underwritten and if the company does not receive 90% of the issued amount from public subscription plus accepted development from underwriters, within 60 days of the opening of the issue, the company should refund the amount of subscription. In case of disputed development, the company should refund the subscription if the above conditions are not met.

d) The lead manager(s) must satisfy themselves about the net worth of underwriters and the outstanding commitment and disclose the same to SEBI. A statement to this effect should be incorporated in the prospectus.

e) The underwriting agreement may be filed to SEBI.

SEBI (UNDERWRITERS) RULES AND REGULATIONS, 1993

The Central Government has made certain rules and regulations in regard to underwriters. Some of the important ones are discussed below:

Certificate of Registration: In order to become an underwriter a certificate of registration has to be applied for to the SEBI. To grant this certificate SEBI inspects the following details of the applicant:

- The infrastructure of the applicant relating to office space, manpower and equipment required for carrying out the business of underwriting.
- The experience of the applicant in the functioning of underwriting. If he does not have any past experience he should have at least two employees who have experience in underwriting.
- The applicant past record. The person should not have any record of negligence of duty or any disciplinary action taken against him.
- The applicants past record should not show any criminal offence against him or any of his partners for which he or any of them was convicted.
- The applicant should have a capital adequacy requirement of a minimum amount of Rs. 20 lakhs of net worth which includes capital and free reserves.

If after inspection the records of the underwriter are clear SEBI will grant them a certificate of registration for commencement of business after they have paid a fees and have understood the code of conduct that they have to follow to do business.

Fees: SEBI charges a fees from the date of granting a certificate. Since 1999 the fees is Rs. 5 lakhs for the first year and there is a renewal fees of Rs. 2 lakhs for every 3 years. In order to continue with the business renewal of registration has to be applied for.

Code of Conduct: The following code of conduct has to be maintained by underwriters to continue the business:

- An underwriter has to be professional in his dealings with his clients and carry out the business efficiently and promptly.
- He must protect the interest of his clients honestly and be fair in his dealings with them.
- He has to maintain a high standard of integrity and not misrepresent his clients in any oral or written statement made by him.
- He has to disclosed all information in the interest of his clients and avoid any conflict of interest and has to be objective and unbiased in his dealings with them.
- He cannot discriminate amongst his clients except for carrying out moral responsibility and obligations.
- He cannot participate in price rigging or manipulation of information to any person about securities listed with stock exchange.
- He has to follow the guidelines acts and rules of SEBI and comply with the OMBUDSMAN regulations 2003 as advised by SEBI.
- He must follow good corporate governance and corporate policies by acting within the sphere of law.

Memorandum of Agreement: An underwriter has to enter into a contract with the issuing company. The contract should state clearly the responsibilities and obligations of the underwriter. It should also have clear written agreement on the number of shares to be subscribed, period of underwriting contract and commission and brokerage to be received for the service undertaken. The underwriter can take a maximum subscription of shares up to 20 times his own net worth. He has to subscribe to shares within 45 days of receiving a notification from the issuing company.

Inspection: SEBI has the right to inspect the books of account and records of the underwriter. If the underwriter fails to comply with the conditions of SEBI, he will be faced with cancellation or suspension of his certificate of registration.

Maintenance of books of accounts and records: Every underwriter shall, after the close of each financial year s soon as possible but not later than six months from the close of said period, furnish to the Board, if so required, copies of the balance sheet, profit and loss account, statement of capital adequacy requirement such other documents as may be required by the Board.

Appointment of Compliance Officer: Every underwriter shall appoint a compliance officer who shall be responsible for monitoring the compliance of the Act, rules and regulations, notifications, guidelines, instructions, etc. issued by the Board or the Central Government and for redressal of investor's grievances [(Inserted by SEBI) (Investment Advice by Intermediaries) (Amendment) Regulations, 2001, w.e.f. 29.05.2001].

Liability in case of Default: An underwriter or a stock broker or a merchant banker entitled to carry on business of underwriting, who fails to comply with any conditions subject to which certificate has been granted or who contravenes any of the provisions of the Act, rules and regulations shall be dealt with in the manner provided under the Securities and Exchange Board of India (Procedure for Holding Enquiry by Enquiry Officer and Imposing Penalty) Regulations, 2002.

6.8 SEBI Regulations regarding Depository System

The following are the SEBI (Depositories and Participants) Regulations, 1996 applicable to the depositories:

A. Application for grant of certificate of registration

(1) An application for the grant of a certificate of registration as a depository shall be made by the sponsor in Form A along with a fee of Rs. 50,000 in the form of a demand draft or bankers cheque payable to the "Securities and Exchange Board of India" at Mumbai.

(2) The application shall be accompanies by draft bye-laws of the depository that is proposed to be set up.

(3) The Board may reject an application which is not complete in all respects after giving a reasonable opportunity of being heard to the sponsor.

(4) The sponsor shall remove, within 30 days of the date of communication of rejection, the objections indicated by the Board.

(5) The sponsor must furnish all information or clarification or appear personally, as may be required by the Board for the grant of certificate of registration.

B. Who can be a depository? :

An applicant in order to be qualified as a depository shall belong to one of the following categories, namely:

(1) a public financial institution as defined in section 4A of the Companies Act, 1956.

(2) a bank included for the time being in the Second Schedule to the Reserve Bank of India Act 1934.

(3) a foreign bank operating in India with the approval of the Reserve Bank of India;

(4) a recognized stock exchange within the meaning of clause (i) of section 2 of the Securities Contracts (Regulation) Act, 1956.

(5) a body corporate engaged in providing financial services where not less than seventy-five percent of the equity capital is held by any of the institutions mentioned in sub-clause (i), (ii), (iii) or (iv) jointly or severally;

(6) a body corporate constituted or recognized under any law for the time being in force in a foreign country for providing custodial, clearing or settlement services in the securities market and approved by the Central Government;

(7) an institution engaged in providing financial services established outside India and approved by the Central Government; or

(8) the applicant is a fit and proper person.

C. Conditions for the grant of certificate of registration

After the Board is satisfied that the applicant is qualified to act as a sponsor/depository, it may grant a certificate of registration in Form B provided the following conditions are satisfied, namely:

(a) the depository shall pay the registration fee of Rs. 25 lakhs by way of demand draft or a banker's cheque payable to SEBI at Mumbai within 15 days of receipt of intimation from the Board.

(b) the depository shall comply with the provisions of the Depositories Act, the bye-laws, agreements and these regulations.

(c) the depository shall not carry on any activity other than that of the depository unless the activity is incidental to the activity of the depository;

(d) the sponsor shall, at all times, hold at least fifty-one per cent of the equity capital of the depository and the balance of the equity capital of the depository shall be held by its participants;

(e) no participants shall at any time, hold more than five per cent of the equity capital of the depository;

provided that for the purposes of clause (d) and clause (e) no foreign entity individually for collectively either as a sponsor or as a participant or as a sponsor and participant together shall hold more than 20% of the equity capital of a Depository.

(f) if any information previously submitted by the depository or the sponsor to the Board is found to be false or misleading in any material particular, or if there is any change in such information, the depository shall forthwith inform the Board in writing.

(g) The depository shall redress the grievances of the participants and the beneficial owners within thirty days of the date of receipt of any complaint from a participant or a beneficial owner and keep the Board informed about the number and the nature of redressals;

(h) The depository shall make an application of commencement of business within one year from the date of grant of certificate of registration under this regulation; and

(i) The depository shall amend its bye-laws from time to time as may be directed by the Board.

D. Payment of annual fee

A depository who has been granted a certificate of registration is required to pay an annual fee of Rs. 10 lakh by way of demand draft or banker's cheque payable to SEBI at Mumbai.

E. Rejection of an application

The Board may reject the application if it does not satisfy any of the conditions mentioned above. The decision of the Board shall be communicated to the applicant in writing within 30 days of such decision stating therein the reasons for rejection.

F. Application for grant of certificate of commencement of business

After obtaining the certificate of registration, the depository shall apply, within one year from the date of obtaining such certificate, in form C, for the grant of certificate of commencement of business.

(1) The Board shall take into account for considering grant of certificate of commencement of business, all matters which are relevant to the efficient and orderly functioning of the depository and in particular, the following, namely, whether:

(a) the depository has a net worth of not less than rupees one hundred crore;

(b) the bye-laws of the depository have been approved by the Board;

(c) the automatic data processing systems of the depository have been protected against unauthorized access, alteration, destruction, disclosure or dissemination of records and data;

(d) the network through which continuous electronic means of communications are established between the depository, participants, issuers and issuers' agents is secured against unauthorized entry or access;

(e) the depository has established standard transmission and encryption formats for electronic communications of data between the depository, participants, issuers and issuers' agents;

(f) the physical or electronic access to the premises, facilities, automatic data processing systems, data storage sites and facilities including back up sites and facilities and to the electronic data communication network connecting the depository, participants, issuers and issuers' agents is controlled, monitored and recorded;

(g) the depository has a detailed operations manual explaining all aspects of its functioning, including the interface and method of transmission of information between the depository, issuers, issuers' agents, participants and beneficial owners;

(h) the depository has established adequate procedures and facilities and arrangements have been made for maintaining back up facilities at a location different from that of the depository;

(i) the depository has made adequate arrangements including insurance for indemnifying the beneficial owners for any loss that may be caused to such beneficial owners by the wrongful act, negligence or default of the depository or its participants or of any employee of the depository or participants; and

(j) the grant of certificate of commencement of business is in the interest of investors in the securities market.

(2) The Board shall, before granting a certificate of commencement of business, make a physical certification of the infrastructure facilities and systems established by the depository.

G. Grant of certificate of commencement of business

After considering the application and making physical verification, if the Board is satisfied that the depository is eligible to commence business as a depository, it shall grant a certificate of commencement of business in Form D.

(1) If the Board is of the opinion that the depository shall not be granted a certificate of commencement of business, it may either:

(a) direct the depository to conform to the matters specified above

(b) reject the application after giving the applicant an opportunity of being heard.

(2) The decision of the Board to reject the application shall be communicated to the depository in writing within thirty days of such decision, stating therein the grounds on which the application has been rejected.

H. Agreement between depository and issuer

(1) Either on the issuer or on the investor exercising an option to hold his securities with a depository in dematerialized form, the issuer shall enter into an agreement with the depository to enable the investor to dematerialize the securities.

(2) Where the issuer has appointed a Registrar to the Issue or Share Transfer Agent, who has been granted certificate of registration by the Board under sub-section (1) of the 12 of the Act, the depository shall enter into a tripartite agreement with the issuer and the Registrar to the Issue or Share Transfer Agent, as the case may be, in respect of the securities to be declared by the depository as eligible to be held in dematerialized form.

I. Obligations of depositories

The depositories in addition to the obligations laid down in the Depositories Act and the bye-laws shall have the rights and obligations arising from the agreements entered into by them. Some of them are listed below:

1. **Systems and procedures**. Every depository shall have systems and procedure which will enable to co-ordinate with the issuer or its agent, and the participants, to reconcile the records of ownership of securities with the issuer or its agents, as the case may be, and with participants, on a daily basis.

2. **Connectivity.** Every depository shall maintain continuous electronic means of communication with all its participants, issuers or issuer's agents, as the case may be, clearing houses and clearing corporations of the stock exchanges and with other depositories.

3. **Transfer to be affected only after payment.** The depository shall satisfy the Board that it has a mechanism in place to ensure that the interest of the persons buying and selling securities held in the depository are adequately and shall register the transfer of a security in the name of the transferee only after the depository is satisfied that payment for such transfer has been made.

4. **Withdrawal by participant.** Every depository shall allow any participant to withdraw or transfer its account, if the request for such withdrawal or transfer is in accordance with conditions stipulated therefore in the bye-laws of the depository.

5. **Internal monitoring, review and evaluation of systems and controls.** Every depository shall have adequate mechanisms for the purpose of reviewing, monitoring and evaluating the depository's controls, systems, procedures and safeguards.

6. **External monitoring, review and evaluation of systems and controls.** Every depository shall cause an inspection of its controls, systems, procedures and safeguards to be carried out annually and forward a copy of the report to the Board.

7. **Insurance against risks.** Every depository shall take adequate measures including insurance to protect the interests of the beneficial owners against risks likely to be incurred on account of its activities as a depository.

8. **Manner of keeping records.** Where records are kept electronically by the depository, it shall ensure that the integrity of the automatic data processing systems is maintained at all times and take all precautions necessary to ensure that the records are not lost, destroyed or tampered with and in the event of loss or destruction, ensure that sufficient back up of records is available at all times at a different place.

9. **Records to be maintained.**

    (1) Every depository shall maintain the following records and documents, namely:

    (a) Records the securities dematerialized and rematerialized;

    (b) the names of the transferor, transferee and the dates of transfer of securities;

    (c) a register and an index of beneficial owners;

    (d) details of the holdings of the securities of the beneficial owners as at the end of the each day;

    (e) records of instructions received from and sent to participants, issuers, issuers' agents and beneficial owners;

(f) records of approval, notice, entry and cancellation of pledge or hypothecation, as the case may be;

(g) details of participants;

(h) details of securities declared to be eligible for dematerialization in the depository; and

(i) such other records as may be specified by the Board for carrying on the activities as a depository.

(2) Every depository shall intimate the Board the place where the records and documents are maintained.

(3) Subject to the provisions of any other law, the depository shall preserve records and documents for a minimum period of five years.

10. **Co-operation with other entities.** Every depository shall extend all such co-operation to the beneficial owners, issuers' agents, custodians of securities, other depositories and clearing organizations as is necessary for the effective, prompt and accurate clearance and settlement of securities transactions and conduct of business.

11. **Prohibition of assignment.** No depository shall assign or delegate to any other person its functions as a depository, without the prior approval of the Board.

J. Inspection of Depositories, A Participant, An Issuer and A Beneficial Owner

SEBI (Depositories and Participants) Regulations, 1996 from 59 to 64 lays down the procedure to be followed for carrying out the inspection of depositories, a participant, an issuer and a beneficial owner. These regulations are reproduced below:

(a) Board's right to inspect. The Board may appoint one or more persons as inspecting officer to undertake inspection of the books of accounts, records, documents and infrastructure, systems and procedures, or to investigate the affairs of a depository, participant, beneficial owner, issuer or its agent.

(b) Notice before inspection and investigation. Before ordering an inspection or investigation the Board shall give not less than 10 days notice to the depository, participant, beneficial owner, issuer or its agent, as the case may be.

(c) Obligations on inspection by the Board. it shall be the duty of the depository, participant, beneficial owner, issuer or its agent whose affairs are being inspected to investigated, and of every director, officer and employee thereof, to produce to the inspecting officer such books, securities, accounts, records and other documents in its custody or control and furnish him with such statements and information relating to his activities.

(d) Submission of report to the Board. The inspecting officer shall, as soon as possible, on completion of the inspection or investigation as the case may be, submit a report to the Board and in some case may submit interim reports also.

(e) Communication of findings, etc.

(1) The Board shall, after consideration of the inspection report communicate the finding of the inspecting officer to the depository, participant, beneficial owner, issuer or agent, as the case may be and give him an opportunity of being heard.

(2) On receipt of the reply, if any, from depository, participant, issuer or its agent, as the case may be, the Board may call upon him to take such measures as the Board may deem fit in the interest of the securities market and for due compliance with the provisions of the Depositories Act, regulations, the bye-laws and agreements.

(f) Appointment of auditor. The Board shall have the power to appoint an auditor to inspect or investigate, into the books of account, records, documents, infrastructures, systems and procedures or affairs of a depository, a participant, a beneficial owner, n issuer or its agent.

(g) Board to recover the expenses. The Board shall be entitled to recover from the depository, participant, beneficial owner, issuer or agent, as the case may be, such expenses including fees paid to the auditors as may be incurred by it for the purposes of inspecting or investigating the books of account, records, documents, infrastructures, system and procedures of the depository, participant, beneficial owner, issuer or agent, as the case may be.

(h) Suspension of certificate. The Board may suspend the certificate of registration granted to a depository or a participant, if such depository or participant:

(a) contravenes any of the provisions of the Act, the bye-laws, agreements and these regulations;

(b) fails to furnish any information relating to its activity as a depository or participant s required under these regulations;

(c) does not furnish the information called for by the Board or furnishes information which is false or misleading in any material particular;

(d) does not co-operate in any inspection or investigation or enquiry conducted by the Board;

(e) fails to comply with any direction of the Board; or

(f) fails to pay the annual fee.

6.9 SEBI Regulations regarding Credit Rating Agencies in India

SEBI Regulations, 2003 require every credit rating agency to follow the code of conduct as given below:

1. A credit rating agency shall make all efforts to protect the interests of investors.
2. A credit rating agency, in the conduct of its business, shall observe high standards of integrity, dignity and fairness in the conduct of its business.

3. A credit rating agency shall fulfill its obligations in a prompt, ethical and professional manner.
4. A credit rating agency shall at all times exercise due diligence, ensure proper care and exercise independent professional judgment in order to achieve and maintain objectivity and independence in the rating process.
5. A credit rating agency shall have a reasonable and adequate basis for performing rating evaluations, with the support of appropriate and in depth rating researches. It shall also maintain records to support its decisions.
6. A credit rating agency shall have in place a rating process that reflects consistent and international rating standards.
7. A credit rating agency shall not indulge in any unfair competition nor shall it wean away the clients of any other rating agency on assurance of higher rating.
8. A credit rating agency shall keep track of all important changes relating to the client companies and shall develop efficient and responsive systems to yield timely and accurate ratings. Further a credit rating agency shall also monitor closely all relevant factors that might affect the creditworthiness of the issuers.
9. A credit rating agency shall disclose its rating methodology to clients, users and the public.
10. A credit rating agency shall, wherever necessary, disclose to the clients, possible sources of conflict of duties and interests, which could impair its ability to make fair, objective and unbiased ratings. Further it shall ensure that no conflict of interest exists between any member of its rating committee participating in the rating analysis, and that of its client.
11. A credit rating agency shall not make any exaggerated statement, whether oral or written, to the client about its qualification or its capability to render certain services or its achievements with regard to the services rendered to other clients.
12. A credit rating agency shall not make any untrue statement, suppress any material fact or make any misrepresentation in any documents, reports, papers or information furnished to the Board, stock exchange or public at large.
13. A credit rating agency shall ensure that the Board is promptly informed about any action, legal proceedings, etc., initiated against it alleging any material breach or non-compliance by it, of any law, rules, regulations and directions of the Board or of any other regulatory body.
14. A credit rating agency shall maintain an appropriate level of knowledge and competence and abide by the provisions of the Act, regulations and circulars, which may be applicable and relevant to the activities carried on by the credit rating agency. The credit rating agency shall also comply with award of the Ombudsman passed under Securities and Exchange Board of India (Ombudsman) Regulations, 2003.

15. A credit rating agency shall ensure that there is no misuse of any privileged information including prior knowledge of rating decisions or changes.

16. (a) A credit rating agency or any of his employees shall not render, directly or indirectly any investment advice about any security in the publicly accessible media.

    (b) A credit rating agency shall not offer fee-based services to the rated entities, beyond credit ratings and research.

17. A credit rating agency shall ensure that any change in registration status/any penal action taken by Board or any material change in financials which may adversely affect the interests of clients/investors is promptly informed to the clients and any business remaining outstanding is transferred to another registered person in accordance with any instructions of the affected clients/investors.

18. A credit rating agency shall maintain an arm's length relationship between its credit rating activity and any other activity.

19. A credit rating agency shall develop its own internal code of conduct for governing its internal operations and laying down its standards of appropriate conduct for its employees and officers in the carrying out of their duties which the credit rating agency and as a part of the industry. Such a code may extend to the maintenance or professional excellence and standards, integrity, confidentiality, objectivity, avoidance of conflict of interests, disclosure of share-holdings and interests, etc. Such a code also provide for procedures and guidelines in relation to the establishment and conduct of rating committees and duties of the officers and employees serving on such committees.

20. A credit rating agency shall provide adequate freedom and powers to its compliance officer for the effective discharge of his duties.

21. A credit rating agency shall ensure that the senior management, particularly decision makers have access to all relevant information about the business on a timely basis.

22. A credit rating agency shall ensure that good corporate policies and corporate governance are in place.

23. A credit rating agency shall not, generally and particularly in respect of issue of securities rates by it, be party to or instrumental for —

    (a) creation of false market;

    (b) price rigging or manipulation; or

    (c) dissemination of any unpublished price sensitive information in respect of securities which are listed and proposed to be listed in any stock exchange, unless required, as part of rationale for the rating accorded.

6.10 Summary

There are many financial services in India. Most of these services have developed after the opening up of the financial sector in 1990s. These services require a lot of improvement to be organized and highly developed for the requirements of the investors. SEBI has the responsibility of creating investor awareness and providing investors' protection as well. Since the financial market is the most dynamic constituent of the financial system and it is the responsibility of the SEBI to make various financial services more efficient, transparent and responsive to the emerging needs of the system. Still various financial services are at their nascent stage and they require proper guidelines and protection from the regulatory authority of India. Also there is need of reviewing and future amendments in the current guidelines.

6.11 Self Assessment Questions

1. What has been the policy of the Government towards merchant banking in India? Give various categories of merchant bankers and the guidelines issued by SEBI for its smooth functioning.
2. Who has the primary authority for regulating Mutual Funds in India? How does the structure of Mutual funds protect the interests of unit holders in India?
3. What is the need of underwriting of new issues? Explain briefly the SEBI guidelines on advisory services rendered by underwriters in India.
4. What are the major guidelines issues by SEBI with regard to the Venture Capital Funds? Disuses various VCFs promoted by Specialized Financial Institutions in India.
5. What are the rights and obligations of depositories, participants, issuers and beneficial owners as given under the Depositories Act, 1996?
6. Explain the credit rating process and methodology adopted by various credit rating agencies in India to rate various securities. What are the regulations made by SEBI regarding rating of securities by different agencies in India?

6.12 Reference Books

- Government of India, Securities Contracts (Regulation) Act, 1956.
- Mayya M.R., Regulation of Stock Markets and Investor Protection, Seminar on Capital Markets, BSE, February 4, 1992.
- Reserve Bank of India, Annual Report, 1992-93, 2000-2001 and 2003-04.
- Securities and Exchange Board of India, Venture Capital Funds Regulations, 1996.
- Securities and Exchange Board of India, Portfolio Managers Regulations, 1993.
- Securities and Exchange Board of India, Merchant Bankers Regulations, 1992.

Unit - 7 : Insurance Services

Structure of Unit:

7.0 Objectives

After completing this unit, you would be able to:

- Understand the meaning and nature of insurance
- Understand the principles of insurance
- Meaning of life insurance
- Types of life insurance
- Concept of general insurance and types.
- Understand the importance of insurance in today's scenario.

1.1 Introduction

Insurance provides protection against financial loss, arising on the happenings of an unexpected event. There is a tremendous potential for growth in the insurance industry because of the diversity and depth of the market. Both life and general insurance see real opportunities and challenges in the market. The main strength of the market is a strong consumer demand for insurance products which is expected to remain in the years to come.

7.2 What is Insurance?

Insurance means the equitable transfer of the risk of a loss, from one entity to another in exchange for payment. It is a form of risk management mainly used to hedge against the risk of a contingent or uncertain loss. Insurance institutions have the main function of offering social security and investing the savings of individuals. It can be defined as a contract between two parties by which one party undertakes to make good or indemnify any financial loss suffered by other party, in consideration of a sum of money, on the happening of a specified event e.g. fire, accident or death. Insurance applies to situations where a loss may or may not occur.

7.3 Nature of Insurance

1. Insurance is a device to share the financial losses which might occur on an individual or his family on the happening of a specified event. The event may be death in case of life insurance, fire in fire insurance etc. If insured the loss arising from any such mishappenings can be shared in the form of insurance.
2. One of the important features of each insurance plan is the **cooperation** of large number of persons who, in effect, agree to share the financial loss occurring due to a particular risk which is insured. Otherwise, an insurer would be not in a position to compensate all losses from his capital.
3. In insurance, the probability of loss is calculated at the time of insurance. If there is expectation of more risk, higher premium may be charged. Premium is charged on the basis of risk assessed prior to insurance.
4. In insurance if the contingency occurs, payment is made. In case of life insurance there is of certainty, since the contingency, the death or the expiry of term, will certainly occur, and so the payment is certain. In other insurance contracts like fire or the marine perils etc., contingency may or may not occur. On the occurrence of event payment is made, otherwise no amount is given to the policy-holder.
5. The amount of payment made by the insurance company depends upon the value of loss occurred due to the particular insured risk provided insurance is there up to that amount.
6. Insurance is not a gambling.

7.4 Principles of Insurance

Principle of Indemnity

It means that the insured in case of loss against which the policy has been insured, shall be paid the actual amount of loss not exceeding the amount of the policy. The insured is not entitled to make a profit on his loss. The purpose of contract of insurance is to place the insured in the same financial position, as he was before the loss.

Principle of Utmost good faith

The insured and the insurer should have a good faith towards each other. There should not be any fraud, non-disclosure or misrepresentation concerning the material facts. . A material fact is a fact which would influence the mind of an insurer in deciding whether he should accept the risk, on what terms and what premium he should charge. The insurer's liability gets void if any facts about the subject matter of insurance are either hidden, omitted or misrepresented in any manner. The insurer must provide complete information. This principle is applicable to all types of insurance like life insurance, marine insurance or fire insurance etc.

Principle of Insurable interest

It means that the insured must have an insurable interest in the subject matter of insurance. Insurable interest is that interest which considerably alters the It means that the insured must position of the assured in the event of loss taking place and if the event does not take place assured remains in the same position as before. Insurable insurance in life insurance means to the life insured. In marine insurance it is enough if the insurable interest exists only at the time of occurrence of the loss. In fire and general insurance the insurable interest must exist both at the time of the proposal and at the time of claims.

Principle of Proximate cause

This principle says that the cause of the loss must be proximate or immediate and not remote.

The cause of loss must be direct and an insured one in order to claim for compensation. If the proximate cause of the loss is a risk insured against, the insured can get the claims. But if the loss is the result of a remote cause, which is not insured against, then the insurer is not bound to pay compensation. It means that in deciding whether the loss has arisen through any of the risks insured against, the proximate or the nearest cause should be considered. If the loss has been brought about by two or more causes, than for the policy to cover the loss must have an insured peril must occur in the chain of causation that links the proximate cause with the loss. This principle is found very useful when the loss occurred due to series of events. Insurers are liable to pay claims arising out of losses caused by insured perils and not those losses caused by excepted or uninsured perils.

Principle of Subrogation

This principle says that when an insured has received full indemnity in respect of his loss, all rights and remedies which he has against third person will pass on to the insurer. This means the insurer has the right to stand in the place of the insured after settlement of claims in so far as the insured's right of recovery from an alternative source is involved. The insurer's right of subrogation arises only when he has paid for the loss and this right extends only to the rights and remedies available to the insured in respect of the thing to which the contract of insurance relates. The right may be exercised by the insurer before the settlement of the claim. The purpose of subrogation is to hold the careless person responsible for the loss and prevent the insured from collecting twice for the same loss. In other words, subrogation is the right of insurers to stand in the shoes of the policyholder to pursue any recovery of their outlay from any third party owing a duty to the insured and being in breach of that duty.

Principle of Contribution

Contribution arises when there is more than one policy. The aim of contribution is to distribute the actual amount of loss among the different insurers who are liable for the same risk under different policies in respect of the same subject matter. Contribution generally applies when it is insurance by the same person having the same rights and does not apply where different persons insure in respect of different rights. This principle of contribution enables the total claim to be shared in a fair way. The doctrine of contribution operates as a corollary of the doctrine of Indemnity and hence is applicable in case of general insurance. Under this principle the insured can claim the compensation only to the extent of actual loss either from any one insurer or all the insurers.

Principle of Mitigation of loss

This principle says that the insured must take all possible steps to mitigate or minimize the loss to the subject matter of insurance in case of any mishapen. The insured must take all possible measures and necessary steps to control and reduce the losses in case of such an event. The insured must not neglect and behave irresponsibly during such events just because the property is insured. He should act in the same manner in which he would have acted in the absence of the insurance cover.

7.5 Life Insurance

Life insurance provides a sum of money to the family if something happens to insured. It protects the family from financial crises. Life insurance ensures that your family will receive financial support in your absence. Life Insurance is an agreement that guarantees payment of a stated amount of monetary benefits at the end of a specified term or on the death of the life insured. It provides security and protects your family from gratuitous incidents. It also acts as a flexible money saving scheme which empowers you to accumulate wealth and also helps in retirement planning. It also gives tax saving advantage.

Life insurance is a unique investment that helps us to meet the dual needs – saving for life's important goals, and protecting your assets. Life insurance is unique in that it gives the customer the reassurance of asset protection, along with a strong element of asset appreciation. The core benefit of life insurance is that the financial interests of one's family remain protected from circumstances such as loss of income due to critical illness or death of the policyholder. Life Insurance provides for financial security in the event of death or on the inability to earn due to physical disabilities. Simultaneously, insurance products also have a strong inbuilt wealth creation proposition. Life insurance is the only investment option that offers specific products tailor-made for different life stages. The benefits offered to the customer reflect the needs of the customer at that particular life stage, and hence ensures that the financial goals of that life stage are met. Life insurance is an effective tool that assists to plan for the future such that one is financially equipped to meet all the goals.

Following factors should be considered before taking a life insurance policy:

- Age and number of dependents
- Annual income and annual expenses
- Outstanding liabilities like home loan, car loan, etc
- Investments / savings
- Lifestyle expenses
- Money that will be required in future

It is generally suggested that one should have an insurance cover of around 5 to 10 times of the annual income. The cost of life insurance depends on three factors: your age, health and your income.

Nomination

Nomination is a right conferred on the life insurance policyholder to appoint a person or persons to receive the policy monies in the event of the policy becoming a claim by death. Any policyholder, who is a major and the life insured under a policy, can make a nomination. A nominee is the person designated by the policyholder to receive the proceeds of an insurance policy, upon the death of the insured. It is necessary to fill full name of the nominee, address, age and the relationship between you and the nominee.

Types of Life Insurance

The following are the various types of life insurance policies available:

Term Life Insurance- Term Life Insurance protection plans gives the coverage only for a specified term. The main advantage of this policy is that it is economical on pocket and gives the highest amount of coverage and safeguards family against financial liability and provides tax benefits. Term life insurance ensures that your family receives a large lumpsum amount, called the sum assured, in the unfortunate event of death of the policyholder. By offering this benefit at extremely competitive rates, Term insurance plans provide an opportunity to get the protection of insurance cover at extremely affordable prices.

As term life insurance protection plans have no face value and hence the premium on such policies is comparatively lower when compared to other policies. The drawback of the policies are, if one survives the period of the policy, the insured does not get any return at the end of the policy. The premium on such policies becomes expensive with age mainly because the risk of death of is higher with age. There is an increase in term life insurance policies being taken up as earlier people use to depend on their extended joint family system to take care of their near and dear ones in case of their absence. However, the share of families with more than 5 members has come down drastically and is expected to decrease more. The share of lifestyle diseases in India is also increasing and people in senior management are more prone to lifestyle diseases.

Whole Life Insurance- It is the policy that remains as long as the policyholder is alive. In this case the risk is covered for the entire life of the policyholder. The amount and bonus are payable only to nominees upon death of the policyholder. The disadvantage of whole life insurance policy is that the premiums will be more expensive.

Endowment Policy- In endowment policy, risk is covered for a period specified by the insurer. Endowment is type of permanent life insurance in which the premium paying period is shorter than whole life insurance and the insurance amount is paid out within a certain period. Death benefits paid at the time of death or a lump sum paid on maturity. There are three different types of endowment policies: with-profit, unit-linked and low-cost endowments insurance. Endowments comprise of a limited premium-payment period, which builds cash value faster. It is also beneficial for someone who is a risk averse person and wants guaranteed return.

Money Back Policy- In a money back plan, the insured person gets a percentage of sums assured at regular intervals, instead of getting the lump sum amount at the end of the term. The money back policy is structured in such manner so as to provide sums required as anticipated expenses over a stipulated period of time. This type of policy should be taken by someone who requires money at regular intervals.

Retirement Plans- Retirement insurance ensures that you or your family members receive a regular pension amount post a retirement date. You have the flexibility to choose the retirement date and the manner in which you receive the pension. Average life spans are increasing in India and hence, the retirement years are likely to be longer. With the rise in inflation you will need more money to live in comfort. Earlier, people could depend on their children to take care of them post retirement. However, as a modern individual, would you not like to maintain your financial independence post retirement also?

Unit Linked Insurance Plans- ULIP is an insurance policy which provides dual advantage of Insurance as well as Investment. Here the premium which you pay is divided into parts – one part (small portion) is used to provide insurance and the other part (the larger one) is used to buy units for investment. Hence it enables the buyer to secure some protection for his family in the event of his untimely death and at the same time provides him an opportunity to earn a return on his premium paid. The value of investments alters with the performance of the underlying fund opted by investor. Hence the investment risk is borne by the investor. Unit Linked Insurance Plans give you flexibility to invest as per your risk profile, financial commitments and convenience. You can choose to invest either in equity, or in debt or in hybrid fund and even change your investment strategy. Unit Linked Insurance Plans allow partial withdrawals, subject to conditions and switching between funds by paying some charges, if necessary.

Child Plan- The costs of education are increasing at a rapid pace across all levels. So in order to ensure that timely payment is made for children's educations one need to start saving at the earliest. Education solutions ensure comprehensive financial planning for child's education/ developmental needs. In this type of plan the premium could be paid regularly or in a single lump sum and during the key educational landmark of the child one can withdraw the money partially. It offers financial protection to the child's future in the unfortunate event of parent's death. Education insurance offers the unique features which ensure that this objective is achieved and it helps in strengthening the child's dreams. Some plans offer benefits such as sum assured would be paid to the beneficiary, future premiums would be paid by the company till the maturity of the policy and policy benefits would continue for the child's educational and developmental needs, as planned by parents, in case of death of parent.

Life Insurance Contract Terms

The most common terms used in a life insurance contract are:

Premium- It is the amount paid for the contract of insurance. It is the amount paid by insurer to insured for covering the risk.

Riders- Riders are the extra benefits added in the primary life insurance policy purchased by the insured. It provides additional term coverage for the amount specified.

Indisputability Clause- The insurance company is allowed, usually during the first two years of the policy, to challenge the validity of the policy on the basis that some material information is held back. The policy would be void in case of misrepresentation of facts.

Suicide Provision- The suicide clause in the policy specifies that the insurance company will not pay the money if the insured attempts or commits suicide within a specified period from the beginning of the coverage.

Reinstatement Clause- In case the policy has been lapsed due to non-payment of premium, one can revive it by paying all the past outstanding premiums along with interest.

Settlement options- Insured have the provision to collect the settlement proceeds as per the options offered by the company.

Excluded Risks- As per the terms and conditions of the policy, death under circumstances like war or an aviation accident may or may not be covered.

Grace Period: Insurance company's provide a grace period if premiums are not paid when due because of financial problems.

Life Insurance Claims

Life insurance claims can be classified into the following:

1. **Death Claims:** In case of a claim under your life insurance policy, your beneficiary will need to provide the insurer
   - A fully filled claim form
   - Original policy bond or contract
   - An original, or certified copy of the policyholder's death certificate
   - Proof of identity as the beneficiary

2. **Maturity Claim:** In case of maturity of your life insurance policy to avail the benefits of your policy you need to submit the following to your insurer
   - Original Policy Bond
   - Maturity Claim form

The claim process varies from one insurance company to other.

7.6 General Insurance

General insurance is basically an insurance policy that protects you against losses and damages other than those covered by life insurance. The coverage period for most general insurance policies and plans is usually one year, whereby premiums are normally paid on a one-time basis.

The main products of general insurance includes:

Motor Insurance- The owner of the vehicle is lawfully liable for any injury or damage to third party life or property caused by or arising out of the use of the vehicle in a public place. It is mandatory for all vehicles in India to have third party insurance. Motor insurance gives protection to the vehicle owner against- the damages to his/her vehicle and pays for any Third Party Liability determined as per law against the owner of the vehicle. The Sum Insured under a Motor Insurance policy reflects the value of the motor vehicle determined on the basis of Insured's Declared Value. The value arrived on the basis of manufacturer's present value and depreciation based on the life of the vehicle. Motor vehicle insurance costs vary widely among the states, and some companies' premiums tend to be more expensive than others. The documents that are to be kept in the vehicle while plying in public places are certificate of Insurance, xerox copy of registration certificate, Pollution under control Certificate, copy of Driving License of person who drives the vehicle. There are two types of insurance policies that offer motor insurance cover: first one is Liability Only Policy and the second one Package Policy which covers liability policy as well as damage to owner's vehicle.

Fire Insurance- It covers the risk of loss due to fire. Any movable or immovable property having a monetary value is covered under a fire insurance policy. In fire insurance claim is settled when there is actual ignition, the fire is purely accidental or by chance in origin as far as the insured is concerned and the fire has burnt or damaged the property of the insured. Fire claims are paid to the insured as a proportion of the actual value of the property, at the time of loss. In fire insurance, risk on account of fire is insured for a specific time. The maximum coverage under this policy shall be up to the total amount of the insurance policy. The property owner must disclose all the relevant information to the insurance company while insuring their property. The fire policy shall be voidable in the event of misrepresentation, or non-disclosure of any material information. The fire insurance will be valid only if the person who is insuring the property is owner or having insurable interest in that property.

Marine Insurance- It is defined as a contract whereby the insurer undertakes to indemnify the insured in a manner and to the extent thereby agreed upon against marine losses. It covers the risk arising from and incidental to marine operations related to cargo, freight, hull etc. The marine contract is based on utmost good faith on the part of the parties. The insured should give full information about the subject to the insured. He should not withhold any information. The insured might not have an insurable interest at the time of getting a marine insurance policy, but he should have a reasonable, expectation of acquiring such interest. The insured must have insurable interest at the time of loss or damage, or else he will not be able to claim for returns. There are four types of marine insurance- hull insurance, cargo insurance, freight insurance and liability insurance.

Health Insurance- Health insurance insures you and your family against expenses arising due to a medical emergency and uncertainty of health such as a hospitalization or the onset of a critical illness. It prevents a medical emergency from becoming a financial one; it ensures your health care needs are taken care of without you having to dip into your existing savings or compromising your future goals. Indians today suffer from high levels of stress. Long hours at work, little exercise, unhealthy diet food have weakened the immune systems and put everyone at an increased risk of contracting illnesses. 30% of the population suffers from heart attacks before the age of 40 years. Rare non-communicable diseases are now becoming common, affecting an increasing number of urban Indians.

Travel insurance- It is a form of insurance coverage that provides medical cover while abroad as well as covering the policyholder's possessions and money while travelling.

Reinsurance

Reinsurance is primarily an insurance of risks assumed by the primary insurer known as the ceding company. The risk is shifted to another insurer known as the reinsurer. It is used to increase the company's underwriting capacity which would help in rendering improved services. Reinsurance also helps in spreading the risks with as many insurers as possible. It helps to provide catastrophic losses arising due to natural disasters. There are two types of reinsurance- facultative and treaty. In facultative reinsurance the reinsurer can accept or reject any risk presented by the ceding company. The reinsurer has the freedom to reject sub- standard risk if it so desires. In treaty reinsurance, the ceding company is obliged to cede and the reinsurer is obliged to accept an agreed share of all reinsurance of the type defined in the contract.

Insurance Regulatory and Development Authority (IRDA)

The Insurance Regulatory and Development Authority (IRDA) was constituted to regulate and develop insurance business in India. It was set up in the year 1999. The main objective of IRDA is to protect the interests of policyholders, to regulate, promote and ensure orderly growth of the insurance industry and for matters connected therewith or incidental thereto.

Role, duties and responsibilities of IRDA:

- It provides a certificate of registration to insurance companies
- IRDA can renew, modify, withdraw, suspend or cancel the certificate of registration.
- It frames regulations on protection of policyholders' interests.
- It offers policyholders the right to voice their complaints against insurers or insurance companies.
- It has set up the grievance redressal cell to take up the complaints of the policyholder.
- It specifies the requisite qualifications, code of conduct and practical training for intermediaries or insurance intermediaries and agents.
- It specifies the code of conduct for surveyors and loss assessors
- It promotes efficiency in the conduct of insurance businesses
- It promotes and regulates activities of professional organizations connected with life insurance
- It levies fees and other charges to carry out the purposes of the IRDA Act
- It can call for information from, undertake the inspection of, conduct enquiries and investigations including the auditing of insurers, intermediaries, insurance

intermediaries and other organizations connected with the business of life insurance

- It specifies the form and manner in which books of account should be maintained and statements of accounts should be rendered by insurers and other insurance intermediaries
- It regulates the investment of funds by insurance companies
- It regulates the maintenance of margins of solvency
- It adjudicates disputes between insurers and intermediaries or insurance intermediaries;
- It specifies the percentage of premium income of the insurer to finance schemes for the promotion and regulation of certain specified professional organizations
- It specifies the percentage of life insurance business to be undertaken by an insurer in the rural or social sector

Source: http://www.policyholder.gov.in/What_We_Do.aspx

http://www.maxlifeinsurance.com/insurance-explained/Role-Of-IRDA.aspx

Life Insurers in India

Following is the list of some of life insurance companies:

- Life Insurance Corporation of India Limited
- Alliance Bajaj Life Insurance Company Limited
- Birla Sun Life Insurance Company Limited
- HDFC Standard Life Insurance Company Limited
- ICICI Prudential Life Insurance Company Limited
- SBI Life Insurance Company Limited
- Tata AIG Life Insurance Company Limited
- ING Vyasya Life Insurance Company Ltd.
- Aviva Life Insurance Company Ltd.

Non Life Insurers in India

Following is the list of some of non life insurers:

- National Insurance Company Limited
- New India Assurance Company Limited
- Oriental Insurance Company Limited
- United India Insurance Company Limited
- Bajaj Allianz General Insurance Company Limited

- ICICI Lombard General Insurance Company Limited
- Tata AIG General Insurance Company Limited
- Royal Sundaram General Insurance Company Limited
- Cholamandalam General Insurance Company Limited
- Reliance General Insurance Company Limited

7.7 Summary

With the liberalization in insurance sector there is a transformation of the industry from a government monopoly to a competitive environment. Free markets allow for better resource allocation and creation of wealth and opulence of people and the country. It facilitates in the growth of health care, education and infrastructure of the country. In a liberalized insurance market, people are able to choose from different insurance providers having a wide range of products. For the growth in insurance sector there should be sound competition law in the country with efficient and reliable regulation, there should be phased liberalization, consistency and impartiality between competitors and efficient disclose and dissemination of information to the society.

7.8 Self Assessment Questions

1. Define insurance. Discuss in detail the main characteristics of Insurance.
2. Explain in brief the principles of insurance.
3. What are the different kinds of life and non- life policies in India?
4. What is General Insurance? How do they operate and do business in India?
5. What do you understand by marine insurance?
6. What do you understand by endowment policy?

7.9 Reference Books

- Singh Preeti (2009); 'Dynamics of Indian Financial System'; Ane Books Pvt. Ltd., (2009), New Delhi.
- Khan.M.Y. (2010); 'Indian Financial System'; Tata McGraw Hill Education Private Limited,(2010), New Delhi.
- Dr Punithavathy Pandian (2009); 'Financial Services and Markets'; Vikas Publishing House Pvt Ltd, (2009), New Delhi
- Gordan, Natarajan (2011); 'Financial Markets and Services'; Himalaya Publishing House (2011), Mumbai
- Bharti V. Pathak (2011); 'The Indian Financial System'; Pearson Education, (2011), New Delhi

Unit - 8 : Venture Capital

Structure of Unit:

8.0 Objectives

After reading this unit, you will be able to understand:

- Meaning of venture capital.
- The various methods of venture financing.
- The various steps for analyzing venture capital proposals.
- The guidelines issued by government of India.
- The various forms of organisation for venture capital.
- The exit mechanism from venture capital financing.

8.1 Introduction

In the sector of industrial financing in India venture capital is growing very fastly. In India, many financial institutions are doing commendable work to promote industries. Some new institutes such as mutual funds, hire purchase companies etc. are gaining importance as another source of finance to industries But these institutes do not provide assistance to the risky ventures when they are undertaken by new or relatively unknown entrepreneurs. Most of these institutes provide debt finance and other schemes like seed capital, risk capital etc. to the promoters. Before providing financial assistance, these institutes consider the factors such as security, safety, profitability and liquidity but not potentiality. Now, India is growing with new breed of entrepreneurs with professional temperament and technical knowhow. To make them entrepreneurs of successful business venture, support in all respects and more specifically in the form of financial assistance is most essential. This has emerged the need of setting up of venture capital financing companies during the last 2-3 decades.

8.2 Meaning and Definition

The term ‘venture capital’ may be understood in two ways

In narrow sense:

Investment in new and risky enterprises that are lacking a stable record of growth.

In broader sense:

Venture Capital refers to capital as shareholding / equity related investment for the formulation and setting up of growth oriented small/ medium business.Venture capital is a typical ‘Private equity investment’.

It is not merely an injection of funds into a new firm, it is a simultaneous support of skills to exploit market opportunities with a view to obtaining long term capital gains. It is an association with successive stages of firm’s development with distinctive type of financing appropriate to each stage of development. Venture capital involves the provision of risk bearing capital, normally in the form of equity participation to companies with strong potential for growth.

A Venture capital fund aims to provide support to entrepreneurs to create upscaleable business with sustainable growth with the expectation of higher rewards, for the higher risks they assume. It is really a popular method by which investors support entrepreneurial talent with finance and business skills for the new business and professional activities that carry a higher degree of success and failure as well.

1. **According to Dr. Neil Cross**, a senior executive with 3i, one of the world’s largest and oldest venture capital companies, and a former chairman of the European Venture Capital Association, “Venture Capital investment is defined as the provision of risk bearing capital, usually in the form of a participation in equity, to companies with high growth potential. In addition, the venture company provides some value added in the form of management advice and contribution to overall strategy. The relatively high risks for the venture capitalist are compensated by the possibility of high return, usually through substantial capital gains in the medium term.”
2. **According to the Bank of England Quarterly Bulletin of 1984**, ‘Venture Capital investment is defined as an activity by which investors support entrepreneurial talent with finance and business skills to exploit market opportunities and thus obtain long-term capital gains.

8.3 Features

Venture Capital financing has following important features

1. **Mode of investment :** Venture capital is usually in the equity financing method. In addition, it may also take the form of long term debt or convertible debt to ensure a running yield on the portfolio of the venture capitalists.
2. **New enterprise :** Venture Capital investment is normally provided in new ventures which apply new technology to produce new products in expectation of high rewards.
3. **High-risk return projects :** Venture capital is made only in high risk-return projects. Venture capitalists normally create huge capital gains at the time of exit.
4. **Commercialisation of new ideas :** Venture capital investment is only for commercialisation of new ideas .These funds are not available for the trading, agency, banking,research and development engaged firms.
5. **Continuous involvement:** There is continuous involvement of venture capitalist with the client's investment by providing finance or other type of support.
6. **Nature of firms:** Investment is usually for small and medium sized enterprises during their early stages of development. Maximum of the firms are new, high technology-oriented companies.
7. **Objective:** The main objective of a venture capitalist is to yield a huge capital gain at the time of exit. In real sense ,its aim is to setup the firm, design its marketing strategy interalia manage and organise it.
8. **Liquidity**
   Liquidity of venture capital investment depends on the success of new venture.When the venture has achieved the full potential the venture capitalist disinvests share either to the promoters or in the markets.

8.4 Methods of Venture Financing

In India, venture capital is usually in three forms, these are-

1. **Equity :** Venture capital finance is provided in the form of equity by maximum number of companies in India. Usually their contribution does not exceed 49% of the total equity capital. Ultimately these companies sell their share when the venture reaches the full potential and make a huge capital gain.
2. **Conditional Loan :**This is also an important method of venture financing. In this, conditional loan is provided and it is repayable in the form of royalty. These loans are generally interest free but venture capital finance company. charges royalty.
3. **Income Note:** This method includes the features of both conventional loan and conditional loan. For these income notes entrepreneurs have to pay both interest and royalty on sales.

8.5 Stages of Venture Capital Financing

Venture capital may be provided for various forms at different stages starting from the development of an idea up to establishment of that project. These important stages are being described below:

1. **Seed Capital :** For the initial stage venture capitalists provide seed capital. This stage involves primarily R & D financing. The European Venture Capital Association defines seed capital as, "the financing of the initial product development or the capital provided to an entrepreneur to provide the feasibility of a project and quality for startup capital ."

   Seed capital is provided at this stage where there is no guarantee of success but involve serious risk.

   But venture capitalist considers following points for their safeguard:

   - Past performance record, previous experience of the entrepreneurs.
   - Successful past performance of similar products or technology.
   - Actual business plan with realistic future expectations.
   - Future technical innovation in the enterprise and qualities of the business management.

2. **Start-up Financing :** Venture capital finance is provided to the firms when the setup to manufacture a products or service is complete. Venture capitalists provide finance to take advantages of the capital gain from such projects.

   The European Venture Capital Association defines start-up capital as "Capital needed to finance the product development, initial marketing and the establishment of product facilities".

   When a entrepreneur apply for venture capital, he should furnish the following information with his proposal-

   1. Business history of entrepreneur.
   2. Detail of product/service to be manufactured.
   3. Brief detail of the project.
   4. Description of the market including competition level, market share, growth prospects etc.
   5. Technical know-how details for the project.
   6. Description of financial history.

   Before appraising any proposal, venture capitalist takes following points into consideration.

   1. Performance record of entrepreneur.
   2. Technical performance assumption about the product and service
   3. Realistic cost assumption of the product/ service
   4. Competitive price structure
   5. Existing market size, future growth of the product
   6. Domestic and international competition level.

3. **Early Stage Financing :** The European Venture Capital association defined early stage finance as "finance provided to companies that have completed development stage and require further funds to initiate commercial manufacturing and sales. They will not yet be generating profit"

In this situation firm enters into the stage of manufacturing a product but facing teething problem. This type of funding may also be required when the startup has been successful but not be able to generate adequate funds.

4. **Follow on Financing :** At this stage, project has reached at the point of acceptability and proved success. So this is a most attractive stage for venture capitalist to invest in terms of earning potential.

   he European Venture Capital Association defines it as, "the provision of capital to a firm which has previously been in receipt of external capital but whose financing needs have subsequently expanded".

5 **Expansion Financing :** This type of finance is used by entrepreneur to increase production capacity, product development, additional working capital etc.

   The European Venture Capital Association defines expansion financing as "the finance provided to fund the expansion or growth of a company which is breaking even or trading at a small profit."

6 **Turnaround Financing :** This is the stage where, after launching of commercial production, the enterprise is becoming unprofitable. Now, the existing venture capitalist provide funds and specialist skill to recover or even to sustain the current operations of the enterprise.

8.6 Steps to Analyse Venture Capital

A Venture capitalist should kept in mind the following factors before selecting a proposal –

1. Fundamental Analysis
2. Financial Analysis
3. Portfolio Analysis
4. Divestment Analysis

Fundamental Analysis : According to Bovaird Chris, "fundamental analysis refers to an examination of the fundamental aspects of the business, without which the investor cannot even begin to make an informed decision".

In fundamental analysis following point should be considered.

1. Brief history of that company and past progress.
2. Quality of management.
3. Detailed information about the market including size, nature, potential competition.
4. Detailed description about the products and services of the company.
5. Information about manufacturing process, technology used, capacity, resources of supply etc.

Financial Analysis : Financial analysis is considered by venture capitalist to determine the financial viability of the project. Following point should be kept in mind for financial analysis:

1. Earning capacity
2. Growth potential

3. Expected Sales margins
4. Likely fluctuations on cash flows
5. Financial risks

Portfolio Analysis : Venture Capitalists invest in a project for the aim for making huge gain at the success time. For a huge gain it is necessary to evaluate its portfolio. Venture Capitalist's portfolio in terms of size, development, industry sector.

The valuation basis should be consistent fair and conservative.

Following aspects are considered by venture capitalist for portfolio analysis-

1. Investment Size
2. Geographically collaboration with local fund
3. Development stage
4. Industry sector

Divestment Analysis : Venture Capitalist has an ultimate target to exit at an opportune time. So the exit is a prerequisite to earn huge gain. When venture capitalist is entering he should plan about the exit. Exit may be by disposing investment by many ways like-

1. Trade sale
2. Sale to entrepreneurs
3. Floatation or pubic issue
4. Private placement to a new investor

8.7 Importance of Venture Capital

1. Venture capital proves ' Dreams comes true'. A venture capital institute reduces or even ends the gap between technological innovation and its commercial exploitation.
2. Venture capital works as a cushion to support business idea.
3. It there is no venture capital the entrepreneur has to require public issue For this purpose he has to convince the underwriters, brokers and thousands of investors.
4. But by the venture capital, entrepreneur only require to sell his idea to justify the officials of the venture fund.
5. A venture capital institute work as a link between entrepreneur, who needed capital and the investors looking for the returns.
6. Venture capital provides help for exploiting a new idea with full potential and free from corporate bureaucratic atmosphere.
7. By the venture capital funds, public can invest in these funds, who in turn will invest in equity of new business with their expertise in the field VCF would be able to stop malpractices by management.
8. Venture capital is an easy and cost saving method of financing as comparison to public issue. Because to public issue has 10 to 15 percent cost of nominal value and various recurring costs like- stock exchange listing fee, expenditure on printing, annual reports printing etc,
9. Venture capital provides the way for the private sector to share the responsibility with public sector.

8.8 Guidelines

The following are the guidelines issued by the Government of India. The public sector financial institutions, State Bank of India, scheduled banks foreign banks, and their subsidiaries are eligible for setting the venture capital funds with a minimum size of Rs. 1 crore and a debt equity ratio of 1:1.5.If they desire to raise funds from the public, promoters will be required to contribute a minimum of 40 percent of capital. Foreign equity up to 25 percent subject to certain conditions would be permitted.

1. The guidelines provide for Non-Resident Indians investment up to 74 percent on a repatriable basis and 25 percent to 40 percent on a non repatriable basis. It should invest 60 percent of its funds in venture capital activity. The balance amount can be invested in new issue of any existing or new company in equity, cumulative convertible preference shares, debentures, bonds or any other security.
2. The venture capital companies and venture capital funds can be set up as joint venture between stipulated agencies and non institutional promoters but the equity holding of such promoters should not exceed 20 percent and should not be largest single holder .
3. Venture capital assistance should go to enterprises with a total investment of not more than Rs 10 crore.
4. The venture capital company or venture capital fund should be managed be professionals and should be independent of the parent organisation.
5. The venture capital company/venture capital fund will not be allowed to undertake activities such as trading, broking, money market operations, bills discounting, inter corporate lending. They will be allowed to invest in leasing to the extent of 15 percent of the total funds developed. The investment on revival of sick units will be treated as a part of venture capital activity.
6. Listing of venture capital company or venture capital fund can be according to the prescribed norms and underwriting of issues at the promoter's discretion.
7. A person holding a position of full time chairman/president, chief executive,managing director or executive director/whole time director in a company will not be allowed to hold the same position simultaneously in VCC or VCF.
8. The Venture Capital assistance should be extended to
   (i) The enterprise having investment upto Rs 10 crores in the project.

   (ii) The technology involved should be new and untried or it should incorporate significant improvement over the existing technologies in India.

   (iii) The promoters should be new, professionally or technically qualified with inadequate resources.

   (iv) The enterprise should be established in the company form employing professionally qualified person for maintenance of accounts.

9. Share pricing at the time of disinvestment by a public issues or general sale offer by the company or fund may be done subject to this being calculated an objective criteria and the basis disclosed adequately to the public.

8.9 Forms of Organization

Lee, S.J. in his book"Venture Capital Manual" Writes about the forms of organisation as- The structural aspects of venture capital companies greatly determine their profitability and their contributors and participants. While designing the structures of such companies, objectives such as limited liability of investors, simple operation of funds, tax transparency of the fund in the sense that double taxations avoided, tax exemption of the carried interest defined as the extra incentive/profit to the managers over and above the share attributed to their capital contribution and the management fee, maximum tax benefits to investors, etc. are considered. A brief description of the generally adopted forms of organisation by the venture capital companies is being presented below:

Limited Partnership: Although the partnership form of business organisation carries unlimited liability, limited liability partnership has evolved to cater to the needs of the venture capital industry in the USA. It is their most favoured method of structuring a venture capital company. The two types of partners in a limited partnership are general and limited. The liability of the general partner, is limited. The limited partners does not participate in the actual operations of the business. It is the general partners who actively participate in the affairs of the investee company by carrying out functions such as business identification and development, interments appraisal and investigation of potential investment , negotiation monitoring, advice and assistance to investee companies, arrangement for sale of shares at the exit time, and other fund management functions .

Investment Company: Investment company is a simple form of organisation for venture capital companies. The investment company manages the portfolio of its investments in a wide range of undertakings. Both the venture capital company and the investee company attract taxation.

Investment Trust : Being in the nature of a trust, it is generally not liable to tax on chargeable gains/dividends. However, its other incomes are taxable. The availability of tax concessions is subject to stipulations such as the fact that incomes should be derived wholly/mainly from investment in shares/securities, holding in any single company other than another investment trust should not exceed 15 percent of the value of the investment , the shares are listed ,it distributes at least 85 percent of listed the income from shares/securities, and so on.

Offshore Investment Company : A company that is incorporated in a country other than the country in which the offshore company makes an investment is known as 'offshore investment Company'. Its tax liability depends on the tax laws applicable to the resident status of the company.

Offshore Unit Trust : It resembles offshore investment company in organisation, but enjoys tax concessions and is very flexible in structure.

Small Business Investment Company : This type of organisation is followed by banks, which participate in ventures in the form of equity and long term debt. They are prohibited from investing more than 20 percent of their capital and reserves.

Similarly, they are not allowed to acquire controlling interest in a a single company. The loans must be for more than 5 years. This is a very flexible structure of equity investment.

8.10 Exit Mechanism

This is also known as disinvest mechanism. After accomplishment of the purpose of the venture capital ,every venture capital investment is usually liquidate. The aim of the venture capitalist is to sell his investment at attractive capital gains. Usually venture capitalist decides in advance the time of exit, sometimes even at the time of financing the venture companies. Venture capital companies considers some factors like-market condition, nature of the venture, style of functioning, actual and expected competition level etc. before deciding the exit.The disinvestment options available for the venture companies are as follows:-

1. **Floatation:-**

   This is most a popular method of exit. This method is also known as Initial Public Offer method or Going public method.

   In India, promoters are allowed to buy equity of their enterprise.The main benefit of this method is that it provide liquidity of investment by listing on stock exchanges.This method has some other benefits like better image and credibility with public,customers and financial institutes.The main disadvantage of this method is that it involves higher issue costs, increased accountability to shareholders etc.

2. **Trade sales:-**

   This is also a popular method of exit. Through this method complete entrepreneur's company is sold to another company at an agreed price through management buy-in or buy outs. The purchase of the venture capitalist's holding by another, which may be same nature of the business .

3. **Sale of shares method:-**

   Under this method, exit takes place through sale of shares by venture capitalists to the promoters who have promoted the venture. For this purpose, the entrepreneur is given an option at time of investment.

4. **Puts and calls method:-**

   This is fairly popular disinvestment route. For this exit method puts and calls are used. The put option means right to sell and the call option is the right of the entrepreneurs to buy.

   The put and call values are decided as follows:-

   (a) P/E Ratio

   This is used for put and call option.Under this method earning per share is multiplied by the P/E ratio for price determination.

(b) Agreed Price

In this method, the price at which equity is to be given is agreed at the time of financing.

(c) Book Value

Under this method, price is decided by the book value of net assets. This method is usually used by mature companies which have stability in operations.

(d) Valuation by Experts

An independent outside experts determine the value of investment on the basis of net realizable value of assets, less the liabilities.

(e) Percentage of Sales Method

Price is determined by using pre-tax earnings of the investee company with a modified P/E ratio

5. Liquidation

Liquidation is also a popular method of existing the venture capital investment. This situation of exit is present under technology failure, poor management, stiff competition creating utter failure. This type of exit takes place in an unpleasant and involuntary manner.

8.11 Origin and Initiative In India

Venture Capital Financing as a new phenomenon originated in the USA after World War II and developed world wide, when investors came forward to invest their funds in new ventures. In 1946, the first venture capital organization-American Research and Development Corporation was formed. The main object of this Corporation was to promote new technologies developed institute like Massachusetts Institute of Technology. Thereafter, spectacular growth was witnessed in venture capital financing. Some of the present day giants like Microsoft, Xerox, Apple are beneficiaries of venture capital financing. Now UK secured a second place after US in terms of investment in venture capital. The UK had massive growth of industry during 70's and 80's.

The high growth and success of venture capital in these countries motivated other countries to implement and promote venture capital financing. Origin of Venture Capital in India was very late, is still in its infancy. More than 150 years ago, many of the managing houses worked as venture capitalists by providing both facilities-finance and skills to risky projects. After abolition of managing agency system, public sector lending institutes fulfill the venture capital requirements to the high tech projects in the form of seed capital and risk capital.

At that time, many hi-tech industries faced many problem in availing the funds from banks like conservative attitude, rigid security parameters, risk awareness. In these situation these institutes supported to sound technological projects. In India, Venture Capital's growth passed through various stages. It was the R.S. Bhatt Committee(committee on Development of small and medium entrepreneurs) in the year 1972,recommended the formation of Rs.100 crore venture capital fund. The committee emphasized the requirement for providing such fund to support new entrepreneurs and technologists for setting up industries.The Seventh Five year plan urged the need for developing a system of venture capital funding. In May 1986, access of 5% on all payment made for purchase of technology from abroad was introduced.

Some of the important venture capital funds in India, briefly described below:-

- **Seed capital scheme :-**This fund was launched by IDBI in 1976, with the objective of supporting technologists and professionals to promote new industries.
- **Risk capital foundation :-** This was the first venture capital fund launched by Industrial Financial Corporation of India.RCF was developed in a view to encourage new industries of technologists and professionals.
- **Venture capital scheme :-** This venture capital scheme was launched by ICICI in 1986, for providing assistance in the form of venture capital to economic activities having risk, but also high profit potential.
- **PACT :-** This Program for Application of Commercial Technology(PACT) was launched by ICICI, aided by USAID.
- **Government fund :-** This venture capital fund was created by central Government in 1986. IDBI worked as nodal agency for this fund. For the source of this venture capital fund, government imposed a Research and Development levy on all payments done for the purchase of technology from abroad.
- **TDICI :-** Technology Development and Information company of India Ltd. Was developed by ICICI in 1988.
- **RCTFC :-**IFCI developed this scheme by converting Risk Capital Foundation into Risk capital and Technology Finance Corporation Ltd. In 1988. This RCTFC worked as venture capital fund.
- **VECAUS :-** This Venture Capital Unit Scheme was sponsored by UTI in 1989. Technology Development and Information company of India Ltd.was appointed as its manager.

The present institutions, can be broadly divided in four categories :-

(a) Companies set up by commercial banks

(b) Companies set up by the private sector

(c) Companies set up by financial institutions

(d) Companies set up by state level financial institutions

8.12 Suggestions for the Growth of Venture Capital Funds

Venture capital funds provide support to innovate entrepreneurs in all respect and more particularly in the form of financial assistance. it plays a motivating role to the professionally qualified talents and energetic technocrats, but for the high growth and development of the venture capital in India the following suggestions may be applied-

1. **Income tax incentives :**

   It is suggested that by lowering the rate of income tax incentives may be given, An allowance of say 20%may be given under section 80-CC of Income tax for investment in new venture.

2. **Exemption from capital gains :**

   Venture Capital funds involves fund in highly risky and in expectation of high return projects.

   These projects have long gestation period, which after 4-5 years gives returns. This type of returns are taxed under capital gains. Capital gains by corporate bodies in India are taxed at a higher rate than of individual investors.

   So, for the growth of venture capital funds it is suggested that VCC's should be exempted from tax. It is also advisable that capital gains reinvested in new ventures should also be exempted from tax.

3. **Review of the existing Laws :**

   It is suggested to government to review the existing law in view of growth of venture capital funds because this is a new breed of venture capital available to entrepreneurs.

4. **Private sector involvement :**

   USA & UK occupies top two places in world in terms of investment in venture capital where private sector played a significant role.

   It is recommended that for the development of venture capital, private sector also include, in addition to the banks and public financial institutions.

   Private sector can play a significant role because ,

   1. This sector is often willing to put money in high risk business in expectation of high returns.
   2. In private sector, leading business giants have a pool of experienced professional managers who have managing capabilities in the field of finance, marketing and production.

8.13 Summary

Venture Capital investment is generally made in new enterprise that use new technology to produce new products with the objective of obtaining equity ownership in such enterprise. This type of investment is in expectation of high gains or sometimes, spectacular return. Venture capital financing originated in the USA after World War II. The American Research and Development Corporation was formed as the first venture capital organisation in the year 1946. Then after spread world widely. In India , Bhatt committee recommended formation of venture capital fund in 1973. Financing by venture capital is supported at different stages viz. seed capital start-up financing, Early stage financing, follow on financing, expansion financing etc. In fact the economy with well developed venture capital institutes motivate a huge number of entrepreneur and technocrats to convert their ideas in reality, by helping them in establishing industries. Now in India venture capital may be commercial Banks, private sector financial institution and state level financial institutions. For a Venture Capitalist, the source of funds include loan from banks and financial institutions, along with their own capital. As we know that venture capital funds can play a catalytic role the development of entrepreneurship skill so it is suggest that some measures may be taken for the development of venture capital funds like income tax concessions, concessions from capital gains, development of regional stock market etc.

8.14 Self Assessment Questions

1. What is Venture capital?
2. What are the features of Venture Capital financing?
3. Discuss the scope of Venture capital in India.
4. Discuss the various types of Venture Capital \.
5. Discuss the importance of Venture capital.
6. Trace the origin and growth of venture Capital in India.
7. Discuss briefly the various methods available for a venture capital to exit from Investee Company.
8. Explain the various stages involved in venture capital financing.
9. Explain the rationale for Venture capital financing.
10. How venture capital proposal analyzed? Explain the factors for it.
11. Explain the factors to be considered while carrying out the ‘financial analysis’ of Venture capital proposal.
12. Differential between ‘portfolio analysis’ and ‘divestment analysis’?
13. State the factors considered as part of ‘fundamental analysis’?.
14. Make suggestions for the success of Venture capital in India.
15. Explain the strategic role of Venture capital in the development of a country.

8.15 Reference Books.

- Pandey, I.M., Venture Capital in India, Prentice Hall of India, New Delhi
- Verma, J.C., Venture Capital Financing in India, Sage Publication India (P) Ltd., New Delhi
- Mishra, Asim Kumar, Venture Capital Financing, Shipra publication, Delhi
- Khan, M.Y., Financial Services, Tata Mcgraw-Hill publishing Ltd., New Delhi
- Ramesh, S. Gupta, Arun, Venture Capital & Indian Finance Sector, Oxford University Press, New Delhi

Unit - 9 : Mutual Funds

Structure of Unit:

9.0 Objectives

After completing this unit, you would be able to:

- Understand the meaning of mutual fund;
- Types of mutual fund;
- Significance of investing in mutual fund;
- Advantages and disadvantages of investing in mutual fund;
- Guidelines for investing in mutual fund;
- Understand the terms used in mutual fund.

9.1 Introduction

Mutual funds are dynamic financial institutions (FIs) which play a crucial role in an economy by mobilizing savings and investing them in the stock-market, thus providing a direct link between savings and the capital market. Mutual funds have both short-and long-term impact on the savings pattern, growth of capital markets and the economy. Mutual funds, thus, assist the process of financial deepening and inter-mediation. They mobilize funds from the savings market to deploy the same in the Capital Market. The economic development model adopted by India in the post-independence era has been characterized by mixed economy with the public sector playing a dominating role and the activities in private industrial sector control measures emaciated from time to time. The last two decades have seen a phenomenal expansion in the geographical coverage and financial spread of our financial system.

9.2 What is Mutual Fund?

A mutual fund is a collective investment scheme that pools money from investors to purchase in securities. This money is then managed by fund managers who have specialized knowledge. Investors with common investment objective put their contributions that are to be invested with the investment objective of the scheme. In other words, mutual fund is formed by combining together a number of investors who transfer their surplus money to a professional asset management company, in which the fund is managed by professionally trained fund manager. An investor in mutual fund own units, which represents the portion of the fund you hold. Minimum investment requirements on many funds are low enough that even the smallest investor can get started in mutual funds. The mutual funds generally come out with a number of schemes with different investment objectives which are launched from time to time.

It is essential in case of mutual fund to get registered with Securities and Exchange Board of India (SEBI) which regulates securities markets before it can collect funds from the public. . There are equity funds, debt funds, gilt funds and many others that cater to the different needs of the investor. The availability of these options makes them a good option. While equity funds can be as risky as the stock markets themselves, debt funds offer the kind of security that is aimed for at the time of making investments. Money market funds offer the liquidity that is desired by big investors who wish to put surplus funds for very short-term periods. Balance Funds cater to the need of investors having an appetite for risk greater than that of the debt funds but less than the equity funds. Investors choose to invest in mutual fund because of safer returns and lower degree of risk as compared to other markets.

9.3 History of Mutual Funds in India

The growth of mutual fund industry has been divided into different phases as follows:

Phase I

The first mutual fund came into existence in India, in 1963 when Unit Trust of India was incorporated as a statutory corporation. It was set up by the Reserve Bank of India and functioned under the Regulatory and administrative control of the Reserve Bank of India. In 1978 UTI was de-linked from the RBI and the Industrial Development Bank of India (IDBI) took over the regulatory and administrative control in place of RBI. The first scheme launched by UTI was Unit Scheme 1964. The Unit Trust of India played a creditable role by launching a number of open as well as close ended schemes for everyone targeted from a new born child to a retired person.

Phase II

In 1987 the public sector mutual funds set up by public sector banks and Life Insurance Corporation of India and General Insurance Corporation of India came into existence. The monopoly of Unit Trust of India came to an end in that year. SBI Mutual Fund was the first non-UTI Mutual Fund established in June 1987 followed by others like Canbank Mutual Fund in December 1987. Punjab National Bank Mutual Fund and Indian Bank Mutual Fund came into existence in 1989. Thereafter, Bank of India and Bank of Baroda Mutual Fund came in 1990 and 1992 respectively. The Government permitted Insurance Corporation in the public sectors to establish mutual funds. LIC established its mutual fund in June 1989 and offered insurance protection to investors as an addition to the benefits of return, liquidity and safety. The General Insurance Corporation of India also entered mutual fund industry in 1990.

Phase III

A new era started in the mutual fund industry with the entry of private sector funds in India in 1993. In the same year the first Mutual Fund Regulations also came into being which was latter substituted by a more comprehensive and revised Mutual Fund Regulation in 1996. The erstwhile Kothari Pioneer (now merged with Franklin Templeton) was the first private sector mutual fund registered in July 1993. With the entry of private sector in mutual fund industry, the declaration of NAV of the schemes became regular. Several foreign mutual funds houses in India were set up, the industry also witnessed many mergers and acquisitions in this sector.

Phase IV

The Unit Trust of India Act 1963 was repealed in 2003. UTI was bifurcated into two separate entities. Under the Specified Undertaking of the Unit Trust of India, the US 64 schemes was brought. The other one was UTI Mutual Fund Ltd sponsored by SBI, PNB, BOB and LIC. In this stage, the mutual fund industry has entered its current phase of consolidation and growth.

9.4 Formation of Mutual Funds

There are three important parties in mutual funds i.e. Sponsor, Mutual Fund Trust and Asset Management Company. They are supported by other independent agencies like transfer agents, depository participants, banks and others etc.

Sponsor-

The sponsor of a fund is similar to the promoter of a company as he gets the fund registered with SEBI. The sponsor should have a sound track record and general reputation of fairness and integrity in all his business. The sponsor and any of the directors or principal officers to be employed by the mutual fund, should not have been found guilty of fraud or convicted of an offence involving moral turpitude or guilty of economic offences. The sponsor forms a trust and appoints a Board of Trustees. He also appoints an Asset Management Company as fund managers.

Mutual Fund as Trust

A mutual fund in India is constituted in the form of a public Trust created under the Indian Trusts Act, 1882. The sponsor forms the Trust and registers it with SEBI.

Asset Management Company

The trustees appoint the Asset Management Company (AMC) with the prior approval of SEBI. The AMC is a company formed and registered under the Companies Act, 1956, to manage the affairs of the mutual fund and operate the schemes of such mutual funds. It charges a fee for the services it renders to the mutual fund trust. It acts as the investment manager to the Trust under the supervision and direction of the trustees. The AMC, in the name of the Trust, floats and then manages the different investment schemes as per SEBI regulations and the Trust Deed. The AMC should be registered with SEBI.

ASSETS UNDER MANAGEMENT AS ON JANUARY 31, 2014
CATEGORY & TYPE WISE

(Rs. in Crore)

	Open End	Close End	Interval Fund	TOTAL	% to Total
INCOME	279,170	141,130	11,644	431,944	48
INFRASTRUCTURE DEBT FUND	-	375	-	375	@
EQUITY	149,703	2,503	-	152,206	17
BALANCED	16,034	13	-	16,047	2
LIQUID/MONEY MARKET	258,980	-	-	258,980	29
GILT	7,393	-	-	7,393	1
ELSS - EQUITY	21,070	2,145	-	23,215	2
GOLD ETF	8,996	-	-	8,996	1
OTHER ETFs	1,371	-	-	1,371	@
FUND OF FUNDS INVESTING OVERSEAS	2,728	-	-	2,728	@
TOTAL	745,445	146,166	11,644	903,255	100

@ Less than 1 %.

(Source: AMFI Monthly January 2014)

Formation of Mutual Fund

A mutual fund is set up in the form of a trust, which has Sponsor, Trustees, Asset Management Company (AMC) and Custodian. The trust is established by a sponsor or more than one sponsor who is like promoter of a company. The trustees of the mutual fund hold its property for the benefit of the unit holders. Asset Management Company (AMC) approved by SEBI manages the funds by making investments in various types of securities. Custodian, who is registered with SEBI, holds the securities of various schemes of the fund in its custody. The trustees are vested with the general power of superintendence and direction over AMC. They monitor the performance and compliance of SEBI Regulations by the mutual fund.

SEBI Regulations require that at least two thirds of the directors of trustee company or board of trustees must be independent i.e. they should not be associated with the sponsors. Also, 50% of the directors of AMC must be independent. All mutual funds are required to be registered with SEBI before they launch any scheme.

9.5 Types of Mutual Funds

Open Ended Funds

In open ended funds, the size of the scheme is not predetermined. The investors are free to buy or sell any number of units at any point of time. They are available for subscription and repurchase on a continuous basis. These schemes do not have a maturity period. Prices are fixed on the basis of Net Asset value, which is declared daily. Liquidity is the main advantage of this scheme.

Close Ended Funds

These schemes have a definite period. The corpus amount as well as the number of units is prefixed. When the subscription reaches the predetermined level, the entry of investors is closed. After the closure of the subscription period, investors can buy and sell the units of the scheme at the stock exchanges where the units are listed. The main objective of this fund is capital appreciation. The entire corpus is disinvested after the maturity period and the proceeds are distributed among the investors in proportion to their respective unit holdings.

Money Market Mutual Funds

Money market funds invest in money market instruments, which are fixed income securities with a very short time to maturity and high credit quality. These funds invest in highly liquid and safe securities like commercial paper, certificates of deposits, treasury bills, banker's acceptance etc. These funds are appropriate for corporate and individuals investors to invest their money for a short period.

Growth Funds

The main aim of growth funds is to give capital appreciation for a medium to long period. These funds primarily invest their money in equity shares. This makes them more prone to risk. The fund suits to investors who have high risk taking capacity. These funds don't offer regular income as they aim at capital appreciation for long period of time.

Income Funds

The main aim of these funds is to provide regular income. The objective of these funds is to declare regular dividends and not capital appreciation. Investors with low risk appetite invest in income funds. Generally old age people and retired persons like to invest in these funds as they don't have other source of income.

Balanced Funds

The aim of balanced funds is to provide both growth and regular income as such schemes invest in both equities and fixed income securities as mentioned in the scheme related offer document. The objective of these funds is to provide a balanced mixture of safety, income and capital appreciation. It is basically a combination of income and growth funds.

Sector Specific Funds

Sector funds are targeted at specific sectors of the economy such as financial, technology, health, etc. Sector funds are extremely volatile. There is a greater possibility of huge gains, but these funds are very risky also as compared to diversify funds. The return in these funds depends on the performance of the industries.

Tax Saving Funds

Investment in these schemes provides tax rebates to the investors under the Income Tax Act 1961. These schemes are growth oriented and invest pre-dominantly in equities. Their growth opportunities and risks associated are like any equity-oriented scheme.

Gilt Funds

These funds invest in government securities. These funds are less risky as compared to other funds. These are also known as G- Sec funds. Net Asset Value of these schemes also fluctuates due to change in interest rates and also due to other economic factors.

Exchange Traded Funds

Exchange Traded Funds are popularly known as ETFs. They select a market index and make

investments in the basket of stocks drawn from the constituents of that index. The fund may

invest in any or all of the stocks constituting that index but not necessarily in the same proportion. These are passively managed funds that track a particular index and have flexibility to trade like a common stock. They are priced throughout the day and can be bought and sold at any time during trading hours.

Fund of Funds

A fund of fund scheme is a mutual fund scheme that invests in other mutual fund schemes.

9.6 Launching of Mutual Fund Schemes

Every mutual fund scheme is required to be approved by the trustees and a copy of the Offer document needs to be filed with SEBI.

The offer document needs to contain adequate information to enable the investors to make informed investments decisions. The offer documents and advertisements should not contain any misleading information or any incorrect statement or opinion. The advertisements for a scheme have to be submitted to SEBI within seven days from the issue date. The investment objective of the scheme needs to be disclosed in the advertisement. No advertisements can contain information whose accuracy is dependent on assumption. The advertisements need to carry the name of the sponsor, the trustees, the AMC of the fund. The risk factor needs to be disclosed in the advertisement. All advertisements shall clarify that investment in mutual funds are subject to market risk and the achievement of the fund's objectives cannot be assured. An advertisement cannot carry a comparison between two schemes unless the schemes are comparable and all the relevant information about the schemes is given. When a scheme is open for subscription, no advertisement can be issued stating that the scheme has been subscribed or over subscription.

Mutual funds are required to provide an abridged version of the offer document to the investor, which contains all the useful information. The Securities and Exchange Board of India (SEBI) has prescribed minimum disclosures in the offer document. Schemes main features, risk factors, initial issue expenses and recurring expenses, entry and exit loads, performance of other schemes launched by the funds, sponsors track record, qualification and experience of fund managers must be clearly mentioned.

An offer document or a prospectus is a document that all mutual funds are required to provide to investors. It must contain the following:

1. **Date of issue:** The starting date and the end date must be clearly mentioned in the New Fund Offer.

2. **Minimum investment to be made**: In this, Mutual funds prescribe the minimum amount to be invested through new fund offers and multiple amounts in addition to the prescribed minimum.
3. **Investment objectives:** In this section the broad criteria that the mutual fund will follow with regard to investing in a particular security is mentioned.
4. **Investment policies:** The offer document will also describe the general strategies the fund managers will implement, types of investments, and asset allocation pattern considered appropriate for the fund.
5. **Risk factors:** The offer document is required to describe the risks associated with investing in the fund in this section. Investor should be familiar with the differences between varieties of risk, why these risks are inherent in particular funds, and how these risks fit in with risks in the overall portfolio.
6. **Benchmarks used:** The section details with the benchmarks chosen by the fund to ensure that its relative performance is appropriate.
7. **Fees and expenses:** Offer documents are also required to list the limits on fees, including entry and exit loads, switching charges, annual recurring expenses, management fees and investor servicing costs. The prospectus also indicates the impact these have had on fund investment.
8. **Key personnel:** The qualifications and professional experience of the top management in the fund company, including those of the chief executive officer (CEO) and fund managers is mentioned.
9. **Tax benefits information:** Mutual funds enjoy significant tax benefits. Investors should careful read the tax benefits mentioned in the scheme before investing
10. **Investor services:** The details of services such as automatic reinvestment of dividend and systematic investment/withdrawal plans that a mutual fund provides for an investor’s convenience is mentioned.

Load Charges

In a load fund from the NAV a percentage is charged for entry or exit from the scheme. Each time the investor buys or sells units in the fund, a load is charged. The fund uses this charge to meet its marketing and distribution expenses. The loads must be into consideration before investing, as these affect the returns. Investor also needs to factor in the fund’s performance track record and service standards. The efficient funds often offer high returns despite the loads. A no-load fund is one that does not charge for entry or exit. It means that the investor can enter the fund or scheme at NAV and no additional charges are payable on purchase or sale of units.

Significant points to be considered before investing:

- Investor should read the offer document carefully before investing.
- Investments in mutual funds may be risky, and do not necessarily result in gains.

- Invest in a scheme depending upon your investment objective and risk appetite.
- The past performance of a scheme or a fund is not indicative of the scheme's or the fund's future performance. Past performance may or may not be sustained in the future.
- Regular track of the NAV of the schemes should be kept in which investor have invested.
- Investor should ensure that he/she receives an account statement for your investments/ redemptions.

Investors Can Earn from a Mutual Fund in Three Ways:

- **Dividend Payments**: - A fund may earn income in the form of dividends and interest on the securities in its portfolio. The fund then pays its shareholders nearly all of the income (minus disclosed expenses) it has earned in the form of dividends.
- **Capital Gains Distributions**: - The price of the securities a fund owns may increase. When a fund sells a security that has increased in price, the fund has a capital gain. At the end of the year, most funds distribute these capital gains (Minus any capital losses) to investors.
- **Increased NAV**: - If the market value of a fund's portfolio increases after deduction of expenses and liabilities, then the value (NAV) of the fund and its shares increases. The higher NAV reflects the higher value of your investment.

Mutual funds have two basic type of investment strategy:

1. **Onetime payment –** when the payment is made in lump sum manner. All amount is paid at one time.
2. **Systematic Investment Plan (SIP) –** allows an investor to make small periodic investments in place of a onetime heavy payment. It works on the principle of regular investment. SIP facilitates investors to get into the habit of saving. Even an average person with a budget to invest of Rs. 500 or Rs. 1000 on a regular basis can make investment in mutual fund. Systematic Investment also gives you the benefit of compounding returns. Compounding works best when investor begins early as the returns on returns deliver a snow ball effect to the investment. The number of units one gets each time depends on the prevailing Net asset value at the time of the investment. The higher the NAV, the lower the number of units and the lower the NAV the more units the investor will receive.

9.7 Advantages of Mutual Fund

Professionally Managed - Mutual funds are managed by full time, high level professional who manage the funds, which is otherwise difficult to obtain by individual investors.

Diversification- Mutual funds invest in a broad range of securities. This limits investment risk by reducing the effect of a possible decline in the value of any one security.

Convenience and Flexibility- In mutual funds, the unit holder just by holding one security can enjoy the benefits of a diversified portfolio with a wide range of services. It's easy to purchase and redeem mutual fund shares, either directly online or with a phone call.

Creates Investors Confidence- A normal investor who applies for share in a public issue of any company is not assured of any firm allotment. But mutual funds which subscribe to the capital issue made by companies get firm allotment of shares. Mutual fund latter sell these shares in the same market and to the promoters of the company at a much higher price. Hence, mutual fund creates the investors' confidence.

Promotes Saving- Dividends and capital gains are re-invested automatically in mutual funds and hence are not fritted away. The automatic reinvestment feature of a mutual fund is a form of forced saving and can make a big difference in the long run.

Foreign Investors- The mutual fund attracts foreign capital flow in the country and secures profitable investment avenues abroad for domestic savings through the opening of off shore funds in various foreign investors. Lastly another notable thing is that mutual funds are controlled and regulated by S E B I and hence are considered safe.

Investment in Mutual Fund for Tax Advantage

For long term investment mutual funds are ideal for retail investors. Some of the benefits which are available for retail investors are:

- Investors can avail deductions under section 80C of the Income Tax Act by investing upto a maximum of Rs. 1 lakh by investing in Equity Linked Savings Schemes. These schemes have a lock in period of 3 years to avail tax advantage.
- No tax is to be paid for redemption of units of an equity scheme held for over a year.
- No tax is to be paid on dividends. The fund deducts a dividend distribution tax at source in case of non-equity schemes.
- For first time retail investors in equity with a gross total income upto Rs. 12 lakh can invest upto Rs. 50,000 in specific MF schemes under Rajiv Gandhi Equity Savings Scheme (RGESS) and benefit from deductions under Section 80 CCG
- No tax is to be paid on dividends. The fund deducts a dividend distribution tax at source in case of non-equity schemes.

9.8 Disadvantages of Mutual Fund

Lack of Knowledge - There is a wide range of mutual fund products available in India. The availability of so many products sometimes creates confusion in the mind of the investor as to which product to select.

Poor Performance of Mutual Fund - The performance of mutual funds depends on how the share market is performing and also on how the economy in general is behaving. Many investors are disappointed with the returns that they get from the mutual funds. If the entry and exit timing of an investment is not properly calculated, the results could be different from what is expected.

Risk - Mutual Funds invest their funds in the stock market on shares which are volatile in mature and are also not risk free. There are certain type of risk associated with mutual fund also like market risk, scheme risk, investment risk, business risk and political risk.

Psychology of Investors - Investors often compares their units with that of shares and expects a high price. They expect high results in a short span of time and often make wrong decisions. Mutual Funds are for those who have the patience to wait for a long period of 3 to 5 years.

Lack of Qualified Manpower - Management of a fund requires expertise knowledge in portfolio management. In the absence of professional agents and intermediaries, it cannot be managed efficiently.

Lack of Transparency - Adequate information as required by investors is not available may a times.

9.9 Performance of a Mutual Fund

The Net Asset Value of mutual funds is required to be published in newspapers. It is also available on the web sites of mutual funds and the sites related to it. All mutual funds are also required to put their NAVs on the web site of Association of Mutual Funds in India (AMFI) www.amfiindia.com and from there the investors can access NAVs of all mutual funds at one place. Half- yearly results of the mutual fund including their returns/yields over a period of time like one year, three year, and five year and from their inception are required to be published. The mutual funds are also required to send annual report or abridged annual report to the unit holders at the end of the year. The mutual funds are required to disclose full portfolios of all of their schemes on half-yearly basis which are published in the newspapers. Some mutual funds send the portfolios to their unit holders.

Investment Decision

Investors must read the offer document of the mutual fund scheme very cautiously. They should also look into the past track record of performance of the scheme or other schemes of the same mutual fund. Comparison of the performance of other schemes with the same investment objective should also be done. Past performance of any scheme should not be considered as the only factor for making investment decisions. Other factors like track record of the fund manager and overall performance of the market should also be given importance. In case of debt oriented schemes, other than looking into past returns, the investors should also see the quality of debt instruments which is reflected in their rating. A scheme with lower rate of return but having investments in better rated instruments may be safer. In case of equities schemes also, investors should look for quality of the portfolio.

Association of Mutual Funds in India

The Association of Mutual Funds in India (AMFI) was established in 1993 when all the mutual funds, except the UTI, came together realizing the need for a common forum for addressing the issues that affect the mutual fund industry as a whole. The AMFI is dedicated to developing the Indian mutual fund industry on professional, health, and ethical lines and to enhance and maintain standards in all areas with a view to protecting and promoting the interests of mutual funds and their unit-holders. (Source: www.amfiindia.com)

SEBI (Mutual Funds) Regulations, 1996 (source: www.sebi.gov.in)

The provision of this regulation pertaining to AMC is:

- All the schemes to be launched by the AMC need to be approved by the trustees and copies of offer documents of such schemes are to be filed with SEBI.
- The offer documents shall contain adequate disclosures to enable the investors to make informed decisions.
- Advertisements in respect of schemes should be in conformity with the SEBI prescribed advertisement code, and disclose the method and periodicity of valuation of investment sales and repurchase in addition to the investment objectives.
- The listing of close-ended schemes is mandatory and every close-ended scheme should be listed on a recognised stock exchange within six months from the closure of subscription. However, listing is not mandatory in case the scheme provides for monthly income or caters to the special classes of persons like senior citizens, women, children, and physically handicapped; if the scheme discloses details of repurchase in the offer document; if the scheme opens for repurchase within six months of closure of subscription.

  Units of a close-ended scheme can be opened for sale or redemption at a predetermined fixed interval if the minimum and maximum amount of sale, redemption, and periodicity is disclosed in the offer document.
- Units of a close-ended scheme can also be converted into an open-ended scheme with the consent of a majority of the unit-holders and disclosure is made in the offer document about the option and period of conversion.
- Units of a close-ended scheme may be rolled over by passing a resolution by a majority of the shareholders.
- No scheme other than unit-linked scheme can be opened for subscription for more than 45 days. The AMC must specify in the offer document about the minimum subscription and the extent of over- subscription, which is intended to be retained. In the case of over-subscription, all applicants applying up to 5,000 units must be given full allotment subject to over subscription.
- The AMC must refund the application money if minimum subscription is not received, and also the excess over subscription within six weeks of closure of subscription.

- Guaranteed returns can be provided in a scheme if such returns are fully guaranteed by the AMC or sponsor. In such cases, there should be a statement indicating the name of the person, and the manner in which the guarantee is to be made must be stated in the offer document.
- A close-ended scheme shall be wound up on redemption date, unless it is rolled over, or if 75% of the unit-holders of a scheme pass a resolution for winding up of the scheme; if the trustees on the happening of any event require the scheme to be wound up; or if SEBI, so directs in the interest of investors.

9.10 Summary

The Indian mutual fund industry has witnessed significant growth in the past few years driven by several favourable economic and demographic factors such as rising income levels and the increasing reach of Asset management companies (AMC) and distributors. Innovative strategies of AMCs and distributors enabling support from the regulator SEBI and pro- active initiatives from the industry bodies CII and AMFI are likely to be the key components in defining the future shape of the industry. But still, the problem of lack of information, professional advice and limited resources is faced by a large amount of small investors. In mutual fund investors pool their savings which is invested under the guidance of a professional team. It helps to minimize risk and ensures safety and steady return on investments. Mutual funds would be one of the major instruments of wealth creation and wealth saving in the years to come, giving positive results. The consistency in the performance of mutual funds has been a major factor that has attracted many investors.

9.11 Self Assessment Questions

1. What do you understand by ‘Mutual Funds’? Explain in detail.
2. What are the different types of Mutual Funds?
3. List the advantages and disadvantages of mutual fund.
4. Differentiate between the open ended and close ended mutual funds schemes.

9.12 Reference Books

- Gordon, Natarajan (2011) ‘Financial Markets and Services’; Himalaya Publishing House
- Bharti V. Pathak (2011) ‘The Indian Financial System’ ; Pearson
- Punithavathy Pandian (2009) ‘Financial Services and Markets’; Vikas Publishing House
- Preeti Singh (2009) ‘ Dynamics of Indian Financial System’; Ane Books Pvt. Ltd.

Unit - 10 : Housing Finance

Structure of Unit

10.0 Objectives

After completing this unit, you would be able:

- To elucidate the concept of housing loan.
- To provide the basic and elementary information on housing loan.
- To make the reader comprehend the present scenario of housing finance in India.
- To be acquainted with the different key players in housing finance company.
- To describe different benefits and drawback of housing loan.

10.1 Introduction

Home is an integral part of an individual, who since his / her birth and childhood, dreams to have living space of his/ her own. Once in a lifetime investment requires loan to accomplish it and that is how the housing loan comes into scheme of things. Buying a home is dream for everyone. Owing to the rising price of properties, it has almost become impossible f or an average earning person to buy a home on a lump sum payment. Therefore, the concept of home loan has come in existence. There are plethora of housing finance companies and equal number of banks that offer housing loans. The task of selecting one company and one offer for housing loan amidst the thousands available options have become a very complex task owing to the burgeoning housing finance market in the country. Apart from this, there are intricate business jargons and technicalities that make this task more difficult. In this study, I propose to give the basic information of housing loan technicalities, so that when a person applies for the housing loan, he / she can understand the basics and help themselves remain away from the duping elements in the market.

10.2 Importance of Housing Loan

The need for housing loans arises not because property prices are heading upwards all the time but because housing loans make great sense from a long-term savings perspective. Not only are housing loans a handy tool for the common man to own a roof over his head but they also help save money in the long run.

- With skyrocketing real estate prices, people are increasingly opting for housing loans to acquire their dream home. Interest rates are coming 76 down all the time and the banks and the housing finance companies are literally falling over each other to lure the prospective home-seekers.
- Notwithstanding the tax breaks and generous lending rates, a lot of people still cannot arrange resources for the down-payment, which comes out to be at least 15 per cent of the property value. Taking cognizance of the situation, Banks are coming up with housing loan products called 'zero down payment loans' wherein 100 per cent funding is provided for select properties. These lucrative offers are other major reasons for why people are opting for loans.
- Even if one can afford to buy a home with one's own money, housing loans should be availed because they act as good savings instrument. According to industry estimates, the long term average return in investing in a home is about 20% p.a. while the average cost of borrowing funds in the market today is about 7% p.a. (considering all tax breaks).
- For salaried employees, housing loans are the best way to avail of tax benefits. Many people simply go for the housing loans in order to avail these benefits. Interest payments up to 1.5 lakh on housing loans are deductible from the taxable income and there is a further deduction of taxable income maximum up to 1 lakh against repayment of principal portion per annum. In case a person stays in a rented house, the cost of the loan will be nearly zero per cent since he will be saving a decent amount on rent.

Housing loans are an attractive and popular means of buying a dream house for most people. In India, the demand for housing loans has increased diverse in the last decade. Every day numerous people apply for housing loans to own a perfect habitat for themselves. The fact that housing loans come with added plusses (like tax benefits) is the icing on the cake.

Lenders provide housing loans not only for buying houses but for a variety of related purposes. The housing loan market is bursting with diverse housing loan products which outfit to different needs of individual customers.

Housing finance is a broad topic, the concept of which can vary across continents, regions and countries, particularly in terms of the areas it covers. For example, what is understood by the term "housing finance" in a developed country may be very different to what is understood by the term in a developing country.

The International Union for Housing Finance, as a multinational networking organisation, has no official position on what the best definition of housing finance is: "Housing finance brings together complex and multi-sector issues that are driven by constantly changing local features, such as a country's legal environment or culture, economic makeup, regulatory environment, or political system". "Put simply, housing finance is what allows for the production and consumption of housing. It refers to the money we use to build and maintain the nation's housing stock. But it also refers to the money we need to pay for it, in the form of rents, mortgage loans and repayments." "There is recognition of other relevant forms of housing finance [apart from residential mortgage finance] such as developer finance, rental finance, or microfinance applied to housing. Developer finance is often in the form of unregulated advance payments by buyers, and developers sometimes provide long-term finance to buyers through instalments sales when mortgages markets are not accessible. Microfinance for housing is typically used for home improvement or progressive housing purposes. Loans are typically granted without pledging properties. Although the overall impact of microfinance in housing remains limited, this activity can represent an important source of funding for those in the informal sector."

10.3 Process of Housing Finance

Preparation

Before you begin looking for a mortgage, become familiar with the different types of loans, rates and terminology. Read the local newspaper's real estate section and browse online mortgage broker sites that offer information about loans. Make a list of any questions you might have about the information you find. Prepare a monthly budget and determine what mortgage payment you can comfortably afford. This will become your benchmark.

Considerations

The most important step you can take in the mortgage process is to find the right lender and loan officer. It is the loan officer's job to shepherd you and your loan file smoothly through to loan approval. He should be knowledgeable, experienced, responsive and prompt, as well as willing to take the time to answer questions, explain the loan process, programs and terms. Personal recommendations from friends, colleagues, family and real estate professionals can help narrow down some choices. Make appointments with several loan officers.

Documentation

Prepare for your appointments by making copies of your essential paperwork for each lender. You will need your Social Security number and driver's license, the past two years of W-2s and one month's pay stubs to verify income. If you are self-employed, you will need tax returns for the past two years. You will also need the past three months' bank statements and statements for any accounts that hold your down payment money. In addition, bring a copy of any credit account or loan statements you pay on a monthly basis, and court-ordered payments such as alimony or child support. The loan officer will also pull a credit report on you.

Pre-Qualification

The loan officer will take all of this information and determine what kind of loan you are pre-qualified for based on the information she has on hand. A Good Faith Estimate and Truth in Lending statement are generated detailing the terms of the loan and the closing costs. This is the document you will use to compare loan offers. They should be fairly close, so go with the best deal from the loan officer you can work with the best.

Approval Process

After you choose a loan officer and lender, she will submit your application to the loan processor, who will compile the file, order the appraisal and gather any additional information and verification. The loan processor may ask the loan officer for additional information from you, which you need to supply promptly. When the file is finished and the appraisal is complete, she will give the file to the underwriter, who will decide if the loan is approved. After approval, all that is left is the closing, where you will sign all the loan documents and complete the property transfer. The process usually takes around 30 days. following are some popular types of housing loans available in the Indian housing finance market:

1. Land purchase loans

Land purchase loans are taken to buy a plot of land on which a borrower wishes to construct her/his house. Most banks offer up to 85 per cent of the price of the land. These loans can be availed for residential as well as for investment purposes. Almost all leading banks offer this loan like ICICI Bank (land loan), Axis bank (loan for land purchase) etc.

2. Home purchase loans

The home purchase loans are the most popular and the most commonly available housing loan variants. These loans can be used to finance the purchase of a new residential property or an old house from its previous owners.

In this type of loan also, lenders usually finance up to 85 per cent of the market value of the house. These loans are provided either on fixed interest rates or floating interest rates or as hybrid loans.

All banking institutions and housing finance companies provide this type of loan.

3. Home construction loans

These loans can be availed by those individuals who want to construct a house according to their wishes rather than purchasing an already constructed one. The loan application and approval process for home construction loans are somewhat different from those of the commonly available housing loans.

The plot of land on which the borrower wishes to construct the house should have been bought within a year for the cost of the land to be included as a component for calculating the total price of the house. If the plot has been purchased more than a year ago, then the above clause is not applicable.

The borrower has to make a rough estimate of the cost that will be incurred for the construction of the house and then apply for the loan with the same amount. The lender then takes over from there and analyses the application to decide whether or not to sanction the loan.

The approval or disapproval of the same is intimated by the lender to the applicant. The loan amount may be disbursed at one go or in several instalments according to the progress in the construction of the house. Banks like Canara Bank, UCO Bank, Bank of Baroda provide these loans.

4. Home expansion/Extension loans

Home expansion or extension loans are useful in situations when people want to expand their existing house. Expansion includes alteration in the current structure of the residence to add extra space such as constructing a new room, a floor, a bigger bathroom or enclosing a balcony. Though many banks provide loans for these purposes as part of home expansion loans, some banks lend for the same purposes as part of their home improvement loans.

It depends on how a bank categorises its loans. Some popular banks which provide home expansion loans are HDFC Bank (HDFC Home Extension Loan), Bank of Baroda etc.

5. Home improvement loans

Home improvement loans are availed by individuals who already own a house but lack the funds to renovate it. All kinds of renovations and repair works can be financed using this variant of home loans such as internal and external painting, external repair works, electrical work, water-proofing and construction of underground or overhead water tank etc.

ICICI Bank, Vijaya Bank and Union Bank of India are among those banks which provide specialised home improvement loans.

6. Home conversion loans

Those borrowers who have already purchased a house by taking a home loan but now want to buy and move to another house opt for the home conversion loans. Through these loans, they can fund the purchase of the new house by transferring the current loan to the new house. There is no need to repay the loan on the previous home.

Though useful, this segment of housing loans is accused of being quite expensive. This housing finance scheme is provided by HDFC Bank among others.

7. NRI housing loans

NRI housing loans is a specialised housing loan variant which has been developed to assist non-residents in acquiring housing finance to buy residential property in India. These loans are meant exclusively for the non-resident Indians.

The formalities of availing this segment of housing loans is similar to the regular housing loans which are offered to residents, only the paperwork is a bit elaborate. Almost all public and private sector banks provide NRI housing loans.

8. Balance transfer loans

Balance transfer option can be availed when an individual wants to transfer his housing loan from one bank to another bank. This is usually done to repay the remaining amount of loan at lower interest rates or when a customer is unhappy with the services provided by his existing lender and wants to switch to another lender.

9. Stamp duty loans

Stamp duty loans are provided to pay off the stamp duty charges on the purchase of a property. The amount from this loan can be used solely for this purpose. This segment of housing loans has yet not gained much popularity.

10. Bridged loans

Bridge loans are short term loans which are meant for people who already own a residential property but are planning to buy a new house. It helps borrowers to fund the purchase of the new house until a buyer is identified for the old house.

It is extended for a period of less than two years and requires the mortgage of the new house with the lender. Some banks offering this type of loan is Vijaya Bank, HDFC Bank etc.Bank, ICICI Bank, Kotak Mahindra Bank offer this facility among other lenders.

10.4 Overview of Housing Finance Industry in India

Housing finance is a relatively new concept in India comparing to other financial services that are widely available in the country since a long year back. However, the speedy development in housing and various housing activities have understandably led to the growth of Indian housing finance market. As a result, a number of players have barged into the market. Here, find the list of top 10 housing finance companies in India.

It was in the year 1970 when Housing and Urban Development Corporation (HUDCO) was established to finance various housing and urban infrastructure activities. However, the Housing Development Finance Corporation (HDFC) was the India's first private sector housing finance company came into existence in 1977. Since then, the housing finance in India has been flying high. It's expected to grow at a growth rate of 36% in the coming years.

As the commercial banks started expanding housing-related disbursements, the market share also started growing up. In 2000, the Indian housing finance companies accounted for 70 per cent of the disbursements, while their collective share decreased to 36 per cent within 5 years. In 2005, banks accounted for 64 per cent of the disbursements.

India’s housing finance industry mainly comprises banks and HFCs, and to a certain limited extent, smaller institutions such as community-based organisations, self-help groups, etc. The NHB operates as the principal agency for promoting, regulating and providing financial and other support to HFCs at local and regional levels, while banks and NBFCs are managed and regulated by the RBI. Housing Finance industry India As of February 5, 2013, 56 companies have been granted certificates of registration by NHB to act as HFCs. Historically, the housing finance industry was dominated by HFCs. However, towards the end of the 1990s, the scheduled commercial banks became very active in lending to the housing sector in the backdrop of lower interest rates, rising disposable incomes, stable property prices and fiscal incentives by the government.

While banks depend on their own equity and reserves and large deposit base for funding their housing loan portfolios, HFCs primarily depend on funding sources such as loans from banks and financial institutions, financing from NHB, borrowing through bonds and debentures, commercial paper, subordinate debt and fixed deposits from public, besides their own equity and reserves. Increased competition in the housing finance industry has also led to the introduction of new mortgage products in the market, such as variable interest rate loans, loan for repairs and renovation, and customised products with features like ballooning EMI, depending on the need and eligibility of the borrowers concerned.

In addition, some banks and HFCs also offer home equity loans (loans against the mortgage of existing property), which may be used for non-housing purposes.

Disbursements:

As per CRISIL estimates, housing finance disbursements are estimated to have grown by around 16.1% in Fiscal 2012 to Rs 2,044 billion (as compared with Rs 1,760 billion in Fiscal 2011). Over the next 5 years, housing finance disbursements are projected to grow at a CAGR of 16% to reach Rs 4,269 billion by Fiscal 2017. Increase in transaction volumes, rise in property prices and higher loan to value ("LTV") ratios are some of the key drivers behind the growth in disbursements in the housing finance industry.

Outstanding Loans

The quantum of outstanding loans is impacted by a combination of disbursements, repayments and pre-payments. As per CRISIL estimates, housing finance outstanding portfolio, i.e. the total loan book of a housing finance player, grew by around 19% Y-o-Y in Fiscal 2012 (to Rs 6,150.5 billion as compared with RS 5,173.6 billion in Fiscal 2011), due to a steady growth in disbursements and lower prepayments. The housing finance outstanding portfolio is expected to grow at a CAGR of 17% to reach Rs 13,602.8 billion in Fiscal 2017

Growth in housing stock

For the housing finance industry to grow, there has to be an available stock of houses, which can be mortgaged. Any growth in this available stock of houses will provide additional impetus to the growth of the housing finance industry. The annual addition to housing stock in India peaked in Fiscal 2008 after a period of continued growth driven by increase in demand, especially in urban areas. As per CRISIL Research, housing stock is estimated to grow at a CAGR of 2.3% over the next five years (Fiscal 2012 – Fiscal 2016) with a higher growth expected in the urban segment (CAGR of 3.3% from Fiscal 2012 – Fiscal 2016) as compared to the rural segment (CAGR of 1.8% from Fiscal 2012 – Fiscal 2016). The share of rural housing stock, as a percentage of total housing stock is expected to fall marginally by Fiscal 2016 as compared to Fiscal 2011 on account of increasing migration from rural to urban regions because of better job opportunities.

10.5 Key Players in Housing Finance in India

Find below a list of some of the top housing finance companies of India:

10.5.1 HDFC (Housing Development Finance Corporation Ltd.)

Housing Development Finance Corporation Ltd (HDFC) is one of the leaders in the Indian housing finance market with almost 17% market share as on March 2010. Serving more than 38 lakh Indian customers as on March 2011, HDFC also offers customized solutions that fit to the need of the customer. In the FY 2010-11, it registered a net profit of `4528.41 crore. It also registered a net profit of ` 971 crore in the quarter ended September 30, 2011.

Vision Statement

"*The most successful & admired life insurance company, which means that we are the most trusted company ,the easiest to deal with, offer the best value of money & set the standard in the industry, in Short "the Most obvious choice for all "*

HDFC Limited, India's premier housing finance institution has assisted more than 3.4 million families own a home, since its inception in 1977 across 2400 cities and towns through its network of over 271 offices. It has international offices in Dubai, London and Singapore with service associates in Saudi Arabia, Qatar, Kuwait and Oman to assist NRI's and PIO's to own a home back in India. As of December 2012, the total asset size has crossed more than Rs. 204,560 crores including the mortgage loan assets of more than Rs.102,400 crores. The corporation has a deposit base of over Rs. 93,000 crores, earning the trust of nearly one million depositors. Customer Service and satisfaction has been the mainstay of the organization. HDFC has set benchmarks for the Indian housing finance industry. Recognition for the service to the sector has come from several national and international entities including the World Bank that has lauded HDFC as a model housing finance company for the developing countries. HDFC has undertaken a lot of consultancies abroad assisting different countries including Egypt, Maldives, and Bangladesh in the setting up of housing finance companies.

10.5.2 State Bank of India Home Finance (SBI)

State Bank of India is another major player in the Indian housing finance market with 17% of the market share, same as HDFC's share as on March 2010. The SBI Housing Loan schemes are specifically designed to meet the varied requirements of the customers. It offers housing loan for various purposes including new house/flat, purchase of land, renovation/alteration/extension of existing house/flat etc. SBI Housing Finance registered a net profit of ` 24.63 crore in the year ended March 31, 2009.

10.5.3 Housing Urban Development Corporation (HUDCO)

Through its 'Niwas' scheme, HUDCO offers housing loans for the buying/constructing house/flat. Loans are also offered for renovation/extension/alteration of existing house/flat. In the financial year 2009-10 (ended on March 31, 2010), HUDCO registered a net profit of ` 495.31 crore, comparing to ` 400.99 crore of the previous year.

10.5.4 LIC Housing Finance Ltd.

Vision

To be the best Housing Finance Company in the country.

Mission

Provide secured housing finance at affordable cost, maximizing shareholders value with higher customer sensitivity.

LIC Housing Finance Ltd. is one of the largest Housing Finance company in India. Incorporated on 19th June 1989 under the Companies Act, 1956, the company was promoted by LIC of India and went public in the year 1994. The Company launched its maiden GDR issue in 2004. The Authorized Capital of the Company is Rs.1500 Million (Rs.150 Crores) and its paid up Capital is Rs.850 Millions (Rs.85 Crores). The Company is recognized by National Housing Bank and listed on the National Stock Exchange (NSE) & Bombay Stock Exchange Limited (BSE) and its shares are traded only in Demat format. The GDR's are listed on the Luxembourg Stock Exchange.

The main objective of the Company is providing long term finance to individuals for purchase / construction / repair and renovation of new / existing flats / houses. The Company also provides finance on existing property for business / personal needs and gives loans to professionals for purchase / construction of Clinics / Nursing Homes / Diagnostic Centres / Office Space and also for purchase of equipments.

The Company possesses one of the industry's most extensive marketing network in India : Registered and Corporate Office at Mumbai, 7 Regional Offices, 13 Back Offices and 190 marketing units across India. In addition the company has appointed over 1241 Direct Sales Agents (DSAs), 6535 Home Loan Agents (HLAs) and 782 Customer Relationship Associates (CRAs) to extend its marketing reach. Back Offices spread across the country conduct the credit appraisal and administrative functions.

The Company has set up a Representative Office in Dubai and Kuwait to cater to the Non-Resident Indians in the GLCC countries covering Bahrain, Dubai, Kuwait, Qatar and Saudi Arabia. Today the Company has a proud group of over 10,00,000 prudent house owners who have enjoyed the Company's financial assistance.

10.5.5 ICICI Home Finance Company Limited

ICICI is the third largest housing finance company in India with almost 13% market share. It offers various types of home loans for its customers which may have tenure up to 20 years. The housing loan interest rate is connected to the ICICI Bank Floating Reference Rate (FRR/PLR). Here it can be added here that, the PLR has been increased to 17.5% from its previous rate of 17% since February 23, 2011. As on March 31,2010, ICICI HFC has 2009 branches with an asset of ` 363400 crore. The net profit of the company rose 45.19% to Rs 233.29 crore in the year ended March 2011 compared to Rs160.68 crore profits it earned during the previous year.

10.5.6 IDBI GROUP

IDBI Bank is a pioneer Institution in Nation building. To cater to its ever-expanding needs, IDBI Bank has formed subsidiaries & joint ventures across diverse areas of Banking & Financial System.

IDBI Bank Ltd. is a Universal Bank with its operations driven by a cutting edge core Banking IT platform. The Bank offers personalized banking and financial solutions to its clients in the retail and corporate banking arena through its large network of Branches and ATMs, spread across length and breadth of India. We have also set up an overseas branch at Dubai and have plans to open representative offices in various other parts of the Globe, for encashing emerging global opportunities. Our experience of financial markets will help us to effectively cope with challenges and capitalize on the emerging opportunities by participating effectively in our country’s growth process.

IDBI Bank is the youngest, new generation, public sector universal bank that rides on a cutting edge core banking Information Technology platform. This enables the Bank to offer personalized banking and financial solutions to its clients. The Bank had an aggregate balance sheet size of Rs. 3, 22,769 crore and total business of Rs 4, 23,423 crore as on March 31, 2013. IDBI Bank's operations during the financial year ended March 31, 2013 resulted in a net profit of Rs. 1882 crores.

Our vision for the Bank is “TO BE THE MOST PREFERRED AND TRUSTED BANK ENHANCING VALUE FOR ALL STAKEHOLDERS”.

IDBI Bank Housing Loan

With attractive interest rates, flexible tenure and lower processing IDBI Bank Home Loan makes your journey into the new home a pleasant one. We also work towards helping you make this journey faster and offer home loans to both salaried and self employed professionals.

Advantage in IDBI:-

Simple Documentation: Our representative will guide you through the easy home loan application process to make it hassle free

Maximum Funding: IDBI Bank will help you get a higher sanction for funding your dream home

EMI on Daily Reducing Balance: Home Loan EMI on daily reducing helps you save on interest paid on your home loan

Attractive Interest Rates: In this escalating real estate market we endeavour to provide our customers with competitive interest rates at all time

Personalised Doorstep Service: We offer personalised service to make your loan process faster and also offer technical and legal assistance

Choice between Floating rate and Fixed rate Home Loans: Choice of a fixed rate home loan or a flexible rate home loan to suit your needs.

Features in Home Loan in IDBI

Home Loan Tenure: Tenor of a home loan can be up to 20 years for a resident individual (salaried & self employed professional) whereas for Self employed (resident Indian) & NRIs(salaried) the maximum tenure is 15 years subject to maximum age of 65 years at termination of loan.

Home Loan Funding: Normally, loan can be applied for a maximum of 80% of the property value. However, loans up to 20 lacs would be eligible for 90% of property value. The quantum of loan is determined based on the repayment capacity of the customer, as assessed by IDBI Bank.

Home Loan Eligibility Criteria: Parameters considered include age, income, number of dependents, financial stability and co-applicant's income.

10.5.7 PNB Housing Finance Limited

PNB Housing Finance Limited offers a wide range of loans for purchase/construction of property to resident Indians as well as NRIs. It also offers housing finance for renovations, repairs and enhancement of immovable properties. In the last financial year (ended on March 31, 2011), PNB Housing Finance Limited registered a net profit of ` 69.37 crore, which is 3.93% more than the net profit of its previous financial year of ` 66.75 crore.

10.5.8 Dewan Housing Finance Corporation Limited

DHFL, India’s second largest private housing finance company

DHFL was established by Late Shri Rajesh Kumar Wadhawan (16th April, 1949 – 30th September, 2000), a visionary Indian businessman.

The Founder Chairman observed the sad truth that most Indians couldn’t get a housing loan on fair terms. He believed that owning a home is a critical element to the building of an identity for every Indian. He thus set out on a mission to manage this social need. On April 11, 1984, DHFL was established to enable access to affordable housing finance to the lower and middle income groups in semi-urban and rural parts of India. DHFL is the second housing finance Company to be established in the country, however, with a unique mission, which is today benchmarked as a model of financial inclusion in the Indian financial services sector.

While most experts lauded Shri Rajesh Kumar Wadhawan’s altruism, they posed pragmatic apprehensions on the possibility of this Vision becoming a reality. However, that did not influence the visionary’s mission. DHFL disbursed funds from its own equity contribution and had a return of less than 8% at a time when interest rates were about 18%. But, what DHFL ascertained was the difference between those who see things as they are and the visionaries who see things as they can be.

DHFL – Changing Rules, Changing Lives

Over 29 years have passed since the Company’s inception and today DHFL stands strong as one of India’s largest housing finance companies (and the second largest in the private sector). Today, led by Mr. Kapil Wadhawan, the Company is still living the Founder’s Dream and enabling access to home ownership. It is profitably doing what its Founder intended it to do.

DHFL takes pride in its purpose-driven team of enthusiastic people who are willing to carry on the Founder's vision and transform the housing sector in India by providing affordable housing finance.

The Company has encouraged hundreds of thousands of people to make that upward journey by simplifying financial access and providing them with the privilege of home loan products, insurance services and unique fixed deposit schemes tailor made to suit their needs.

Based in India's commercial capital Mumbai, DHFL strives continually to reach out to its customers through its extensive network of over **165 Branches, 75 Service Centers, 31 Camps and 8 Regional Processing Offices** spread across the length and breadth of the country. DHFL also has tie-ups with leading public and private sector banks namely Punjab & Sind Bank, United Bank of India, Central Bank of India and YES bank to provide home loans to customers through a housing loan syndication agreement. DHFL has also set up representative offices in London and Dubai to serve the ever increasing NRI population in these regions. It has also tied up with UAE Exchange to offer its housing loan products through the various UAE Exchange centers in the GEC countries.

10.5.9 GIC Housing Finance Limited

GIC Housing Finance Limited, one of the leading housing finance companies in India, was initially established as 'GIC Grih Vitta Limited' on December 12, 1989. Promoted by General Insurance Corporation of India,GIC Housing Finance Limited offers extensive range of housing finance solutions to its customers through its wide network of 24 Business Centres and 3 Collection Centres across the nation. In the financial year 2010-11, GIC Housing Finance Limited registered a profit (after tax) of ` 113.76 crore. Furthermore, in the quarter ended June 30, 2011, it registered a profit of ` 1756 lakhs.

10.5.10 Can Fin Home Limited (CFHL)

Can Fin Homes Limited is another big player in the Indian housing finance market with an extensive network of 40 branches. It is also the first and one of the biggest bank-sponsored (sponsored by Canara Bank) housing finance companies in India. In the financial year 2010-11, Can Fin Homes Limited registered a net profit of ` 4201.6 lakhs. It also registered a net profit of ` 814 lakh in the quarter ended on September 30, 2011.

10.6 Trends in the Housing Finance Industry in India

HFCs gaining market share

Over the years, the market share of housing finance companies (HFCs) has significantly improved vis-à-vis banks on account of robust growth in disbursements of the former. In recent times, with slowdown in corporate credit, banks are aggressively focusing and competing with HFCs in the home loan segment. However, with strong origination skills and diverse channels of sourcing business, HFCs will continue to gain market share.

Focus on salaried segment, self-employed borrowers ignored

Historically banks and HFCs have largely focused on the salaried class, as can be seen by the fact that salaried borrowers account for 80-85% of the total outstanding loans. The key reason behind this skew towards the salaried segment is the ease in validating the income levels and the repayment capabilities of salaried borrower vis-à-vis self-employed persons. Further, lenders have traditionally viewed the salaried segment as one with stable cash flows and, hence, consider it as lower risk.

However, this has also resulted in the self-employed borrowers being largely ignored by the organised lenders, forcing them to rely on personal loans or loans from unorganised sources at higher interest rates.

HFCs have been able to maintain net profit margins

According to CRISIL, HFCs, despite having a higher cost of funds as compared to banks, have been able to maintain comparable gross spreads and with improved efficiencies, lower operating costs and better risk management practices, have a net profit margin slightly higher than the banks. As per their estimates, HFCs are expected to maintain a net profit margin of 1.6-1.7% of loan book as against banks at 1.5-1.6% of loan book based on incremental disbursements.

10.7 Diversification of Sources of Funds by HFCs

The typical funding sources for HFCs include bank loans, non-convertible debentures ("NCD"), fixed deposits, and commercial papers, NHB refinancing and other loans. Larger HFCs have been able to build a more diverse funding base due to their superior credit rating and their ability to target the NCD market for funds. In contrast, smaller HFCs have leveraged the NHB refinance facility for priority sector/rural lending, which is offered at lower than market interest rates. This has helped the smaller HFCs to compete with banks and larger HFCs by reducing their cost of funds.

Floating rate loans account for bulk of market

All housing loans in India typically carry a fixed interest rate or a floating interest rate. A fixed rate loan is one where the rate of interest remains constant throughout the tenure of the loan or for a specific number of years. Whereas, in a floating rate loan, the borrower pays interest at a rate that is linked to the benchmark prime lending rates of financiers. The rate charged on fixed rate loans is generally higher than that charged on floating rate loans, due to the higher interest rate risk in case of the former.

Due to the long-term nature of the housing loans and medium-term nature of the lender's liabilities, lenders prefer to lend at floating rates, as it allows them to re-price the loans as and when their cost of funds increases. The proportion of floating rate loans has been increasing for the last several years, primarily due to the indirect push from the lenders side by way of a higher spread between fixed rate loans and floating rate loans, which in some cases was around 275 bps. Post 2009-10, the rising interest rate scenario made borrowers opt for floating rate loans in anticipation of reduction or stabilization of interest rates in the later years. According to CRISIL, the proportion of floating rate loans is expected to continue rising and reach around 97% in Fiscal 2017.

10.8 Emerging Trends in Housing Loans

S MAYURA

Burgeoning home prices in India, especially in top metros like Mumbai and Delhi have added to worries of home buyers. In the last one year, the rate of interest payable on new home loans has corrected by over 75 basis points and now the cheapest home loan is available at 10 per cent. This year too, interest rates are expected to go down further. With the RBI announcing its quarterly review in the last week of January, experts are anticipating a 25 basis point rate cut whereas for the year they expect around 75 to 100 basis points reduction in interest rates. CIBIL credit scores are also playing an active role in the home loan market. Pankaj Maalde, head, financial planning at apnapaisa.com explains, every lender will first call for CIBIL report. However one should know that if he stood as guarantor then any default by original borrower will also affect his scoring.

Smart home loans are available for customers, where borrower can park his idle funds with bank in a current account and save on the interest for the time he has kept the money in the current account. Tailor made life insurance products covering the housing loan outstanding too are on offer, to ensure that the housing loans remains with the family, in case the borrower dies before paying off the loan.RBI too has come out with directions for banks and housing finance companies to do away with prepayment penalties on housing loans. Barring the balance transfer on fixed rate loans, all other prepayments of loans do not attract any prepayment penalties.

Rajiv Raj, director of Credit Vidya explains, however, before they switch, they should do the math on the benefits of doing the transfer to the lower rate. Customers are expected to benefit further, as recently an RBI panel suggested banks to offer housing loans up to 30 year tenure which should also qualify for priority sector advances. The potential borrowers benefit on the back of low equated monthly instalment compared to an EMI payable on a 20-year loan.

(Economic Times, kolkatta)

PNB Housing Fin Deal: Emerging Trend

By: **Kaushal Trivedi |** 11 February 2009

GE Capital, Carlyle, New Silk Route and **Tata Capital** are bidding for a significant stake in **Punjab National Bank's** housing finance company. The second largest state-owned bank is planning to sell a 49% stake in its subsidiary, **PNB Housing Finance**.Five bidders have been short-listed and the due diligence is likely to be completed in 10 days.

PNB Housing Finance has an asset base of Rs 2,000 crore. The mortgage lender, which has 28 branches across major cities, reported a net profit of Rs 40.59 crore for the year ended March 31, 2008.

Punjab National Bank had to recently call off a proposal to sell another subsidiary, **PNB Gilts**, due to lukewarm investor response. They have an easy access to funds because of their parent company said a person close to the development.

There is an increasing interest in the housing loan market in India, with a sharp rise in housing loan disbursements. The share of housing loans in total bank credit rose sharply from 3.2% in 1998-99 to 12-13% in 2007-08.

And in the retail loan segment, the proportion of housing loans rose sharply from 27.7% at the end of March 1998 to 54-55% at end-March 2008.Housing loans have grown in excess of 30% over the past few years. But the pace is expected to slow to 8-10% this year. The global private equity firm Carlyle Group invested $28 million in the Chennai-based **Repco Home Finance**, a subsidiary of **Repatriates Co-operative Finance and Development Bank**, last year.

The French financial services major **BNP Paribas** acquired a stake of nearly 50% in **Sundaram Home Finance** for Rs 196.98 crore and **AIG Capital** bought 75% in Chennai's **Vivek Hire Purchase**. **Barclays**and **Societe Generale** bought into Chennai's **Rank Investments** and **Apeejay Finance** respectively.

The Importance of Home Loans in Indian Residential Real Estate

By Prodipta Sen

The rising cost of residential accommodation has led to the popularity of Home Loans in India. Home loan is the finance borrowed from a bank or financial institution to buy or modify a residential real estate property. Any Resident or Non-resident individual who is planning to buy a house in India can apply for a Home loan. If you have decided to buy a property in the near future you can even apply for a loan before you select your property. It becomes easier if the property you are planning to buy is in a condominium or township that is pre-approved by a bank or financial institution.

The steep rises in the real estate prices in India are mainly due to the disparity in supply and demand of quality residential accommodation. The largest group of the Indian demography, the middle-class Indian population avails the major bulk of home loans in India. Home loans are facilitated by all public and private sector banks operating in India. Financial institutions specializing in home financing are also cashing in on the latest boom in home loans.

The recent downturn in the economy resulted in buyers constituting the 'end-users' segment rather than investors and speculators. Since the new class of buyers is a relatively younger set of customers, more aware of legal documentation, approvals and due diligence, we have seen the much-needed professionalism and accountability become more prevalent in the industry.

Today, the amount of money that a city dweller spends on rent is roughly the same, or only slightly less than the amount he pays as the EMI (Equated Monthly Instalments) on a housing loan. Home loans are made available by financial institutions to both Indian and NRI applicants at floating or fixed rate of interest and also at attractive EMI options:

• For construction or buying a new home
• For purchase of plots for construction of house
• For home repairs and renovations or extension of an existing house or flat
• Against mortgage of property
• Purchase of home consumer durables and furnishings as included in the project cost

The buyers should try to take loan from established banks and financial institutions that screen the entire project before approving a loan for an apartment or plot in that project. In the course of approving a project, these institutions ensure that the developer has all the requisite approvals and sanctions. The government has recently announced interest rate subsidy of 1% for housing loans up to Rs. 10 lakhs and earmarked Rs. 1,000 crores for the scheme. The subsidy of 1% will be available for the first 12 EMIs on loans up to Rs. 10 lakhs for houses costing less than Rs. 20 lakhs.

For those planning to take a loan to buy a house, there is good news. The prevailing home loan rates from nationalized banks and housing finance companies are fairly reasonable:

• State Bank of India (SBI): 8% – 8.5% for Rs. 30-50 lakhs loan for 20 years (8% fixed for 1st year and 8.5% fixed for the next two years)
• Punjab National Bank (PNB): 8.5% for Rs. 30 lakhs and 9.25% for Rs. 30-50 lakhs loan for 20 years (fixed for three years)
• Life Insurance Corporation (LIC): 8.75% for Rs. 30-50 lakhs loan for 20 years (floating home loan rates)
• HDFC: 9% for Rs. 30-50 lakhs loan for 20 years (floating home loan rates)
• ICICI: 9.25% for Rs. 30-50 lakhs loan for 20 years (floating home loan rates)
• Dewan Housing Finance Corporation Limited (DHFL): 9.25% for Rs. 30-50 lakhs loan for 20 years (floating home loan rates)

Further, various banks and finance companies are coming up with schemes ahead of Diwali. Deals include low, adjustable introductory rates for initial years, with some lenders giving the option to shift to either fixed or floating rates in subsequent years. Lenders like Canara Bank, Bank of Maharashtra and Dena Bank are offering fixed-rate loans for the first 5 years, and subsequently, linking the loans to their prime lending rates. While others like Bank of India are offering fixed-rate loans for the first 2 years. India's largest bank SBI is offering fixed rates for the first 3 years. Development Bank of Credit introduced a fixed rate of 7.95% for the first year, the lowest, at least, for the first year.

Moreover, in order to attract investors, Housing Finance Companies are offering incentives like:
•Free accident insurance & property insurance
• Waiving of pre-payment penalty & processing fee

My advice to all prospective home buyers: Be diligent, be bold and fulfill your dream as it is a buyers' market at present. Just one word of caution; check the credentials and track record of the Developer you are buying from.

10.9 Summary

Housing finance is a broad topic, the concept of which can vary across continents, regions and countries, particularly in terms of the areas it covers. For example, what is understood by the term "housing finance" in a developed country may be very different to what is understood by the term in a developing country.

Housing finance is important topic for all individuals, families, and households as they moves though life. For most, the cost of housing is one of the largest expenditures in monthly budget. How individuals, families, choose to house themselves depends on their different factors. The financial aspect of housing is important to consumers because financing of home cover a huge portion of family budget. According to survey most of Indian family pays 27% his/her income in form of rent of house which is huge portion of his/her income in same manner many families may take the housing loan for buy their own home, At present many housing financing companies provides loans with different attractive schemes but customers must aware about the real pictures of this times of schemes. High interest rate is the big issue for low income families. Many decision are involved in the process of procuring housing, because purchasing a home is a such huge investment for the middle class families it is life time investment with the help of housing financing companies middle class can affords the big prices of house, due to increase population and industrialisation the space for house is decrease so prices of the land and house increase day by day. In same manner the prices of raw material which is use in create of home continuously increase so how can middle class income families purchase their own homes?

The housing market in India was economically strong during the last decade of the 20th century. When individual have their own house then many advantages connected with it i.e. they can change as they wish, decorating and remodelling to their preferences. If a person takes Housing loan then he can get different advantages:-

1. The household usually builds saving by means of their investment at present purchase a land or home is treated as a profitable investment.
2. They can use as income tax saving schemes by taking housing loans.
3. They can control their housing expenses

Home loan provides for purchase, construction, extension, repair/renovation etc. means it is very important for people in current time. Different financial companies which provides loan for home which have discussed in above paragraph play an important role.

Most of the customers are aware about the different schemes provides by different companies but most of the housing financing companies take some hidden charges from customers which make negative impression on customers.

10.10 Self Assessment Questions

1. Name the housing finance company which comes in your mind at first and why?
2. Would you like to be a customer of housing financing company if yes/no why?
3. Do you know about the benefits of housing finance, if yes give details?
4. Discuss the role of housing finance to uplift social and economic standard of Indian population.

10.11 Reference Books

- Bamberger, Lori. (2010). Scaling the Nationwide Energy Retrofit of Affordable Multifamily Housing: Innovations and Policy Recommendations. Washington, DC: What Works Collaborative.
- Belsky, Eric S., Karl E. Case, and Susan J. Smith. 2008. “Identifying, Managing and Mitigating Risks to Borrowers in Changing Mortgage and Consumer Credit Markets.” Understanding Consumer Credit 08-14. Cambridge, MA: Joint Center for Housing Studies, Harvard University.
- Capone, Charles A., Jr. 1996. *Providing Alternatives to Mortgage Foreclosure: A Report to Congress.* Washington, DC: U.S. Department of Housing and Urban Development.
- Chiquier Loic (2009) , Housing Finance Policy in Emerging Markets, p. xxxii.
- Courchane, Marsha and Peter M. Zorn. 2011. “The Differential Access and Pricing of Home Mortgages: 2004 to 2009.” Available at SSRN: http://ssrn.com/abstract=1850827 or http://dx.doi.org/10.2139/ssrn.1850827
- Council on Environmental Quality (2009). “Recovery through Retrofit.” Washington, DC: Middle Class Task Force.
- Federal Housing Finance Agency. 2011. *Fannie Mae and Freddie Mac Single-Family Guarantee Fees in 2009 and 2010*. Washington, DC: Federal Housing Finance Agency.
- Griffin, Ann, and Ben Kaufman. (2009). “Certified Home Performance: Assessing the Market Impacts of Third Party Certification on Residential Properties.” Portland, OR: Earth Advantage Institute.
- king peter(2009) , Understanding Housing Finance – Meeting Needs and Making Choices, p.3.

Unit - 11 : Plastic Money

Structure of Unit:

11.0 Objectives

After completing this unit, you would be able to:

- Understanding the concept behind plastic money
- Classification of types of plastic money.
- Classification of development and properties of plastic money
- Know about operations of plastic money

11.1 Introduction

Economists define money to be any commodity that is used as a means of payment. As the first segment of the tape shows, many different commodities have played the role of money through history and recent trends have allowed money to exist without any physical manifestation at all, simply as entries in a computerized database. A means of payment—money—is whatever we exchange for goods and services that we buy. After we give someone the appropriate amount of money, our indebtedness is fully extinguished. (This is why we often treat credit cards as some- thing subtly different from money: after we "pay" with a credit card, we still owe money to the issuer of the credit card.)

Another important role that money plays is to act as a "unit of account." This means that the prices of all other commodities are measured in terms of money. Money is the most important invention of modern times. It has undergone a long process of historical evolution. In the absence of money when goods were exchanged for goods it was called barter exchange. The inconveniences of barter, led to the invention of a medium of exchange i.e. money. Earlier commodity money in form of shells, utensils, animal skins, etc. was prevalent. This gave way to metallic money (gold, silver, alloy metals), then came paper money, Bank money and plastic money.

11.2 What is Plastic Money?

Plastic money is a term that is used predominantly in reference to the hard plastic cards we use every day in place of actual bank notes. They can come in many different forms such as cash cards, credit cards, debit cards, pre-paid cash cards and store cards. The tape segment describes the founding of the Diner's Club Card in 1950, which is widely regarded as the beginning of the modern general-purpose payment card. Department stores, oil companies, and some other companies issued credit cards to their regular customers in the early twentieth century, but these card programs were run in-house by the retailers themselves and the cards could not be used at other establishments. What was new about Diner's Club was that it could be used at a large number of unrelated retailers and that it was run as an independent enterprise.

11.3 Types of Plastic Money

The various types of plastic money available in the market are:

11.3.1. Credit Cards

Again this card will permit the card holder to withdraw cash from an ATM, and a credit card will allow the user to purchase goods and services directly, but unlike a Cash Card the money is basically a high interest loan to the card holder, although the card holder can avoid any interest charges by paying the balance off in full each month. A Credit card is a card or mechanism which enables cardholders to purchase goods, travel and dine in a hotel without making immediate payments. The holders can use the cards to get credit from banks up to 50 days free of cost. The credit card relieves the consumers from botheration of the carrying cash and ensures safety. It is a convenience of extended credit without formality. Thus credit card is a passport to, "safety, convenience, prestige and credit."

A credit card is a plastic card having a magnetic strip, issued by a bank or business authorizing the holder to buy goods or services on credit. Any card, plate or coupon book that may be used repeatedly to borrow money or buy goods and services on credit is called credit card. A credit card is a card establishing the privilege of the person to whom it is issued to charge bills. Most retail firms accept credit cards. Credit cards allow consumers to make purchases without paying cash immediately or establishing credit with individual stores. They eliminate the need to check credit ratings and to collect cash from individual customers. The issuing institution establishes the card's terms, including the interest rate, annual fees, penalties, the grace period, and other features. Credit card debt is typically an unsecured debt. Repossession is not easily accomplished by the lender to ensure payment. Banks have often priced the product assuming maximum risk exposure.

A credit card is a device which enables the holder to obtain goods on credit from specified supplies. The holder of the card, in some cases, has to pay the yearly subscription and the suppliers also have to pay commission on sales to the bank or the body issuing the card. The suppliers are paid promptly and so are protected against bad debts, while the holder makes a single monthly payment to cover all his purchases for that period. Credit cards are issued only after the applicant's credit worthiness has been accepted as satisfactory. According to credit rating, holder of the credit card may be allowed a specified amount of credit from one month to another.

The features of modern credit cards such as owner identification, credit limit for its cardholders and floor limit for its merchant establishments, convenience and safety to add value of cards, wider usage or popularity all over the world and dependence on technology to keep operating cost to the minimum, have been a runaway success for credit cards. Along with convenient, accessible credit, credit cards offer consumers an easy way to track expenses, which is necessary for both monitoring personal expenditures and the tracking of work-related expenses for taxation and reimbursement. Credit cards are accepted worldwide, and are available with a large variety of credit limits, repayment arrangement, and other perks (such as rewards schemes in which points earned by purchasing goods with the card can be redeemed for further goods and services or credit card cash back). Some countries, such as the United States, the United Kingdom, and France, limit the amount for which a consumer can be held liable due to fraudulent transactions as a result of a consumer's credit card being lost or stolen. A credit card is part of a system of payments named after the small plastic card issued to users of the system. The issuer of the card grants a line of credit to the consumer (or the user) from which the user can borrow money for payment to a merchant or as a cash advance to the user. A credit card is different from a charge card, which requires the balance to be paid in full each month. In contrast, credit cards allow the consumers to 'revolve' their balance, at the cost of having interest charged. Most credit cards are issued by local banks or credit unions, and have the same shape and size, as specified by the ISO 7810 standard.

Advantages

- They allow you to make purchases on credit without carrying around a lot of cash.
- They allow accurate record-keeping by consolidating purchases into a single statement.
- They allow convenient ordering by mail or phone.
- They allow you to pay for large purchases in small, monthly instalments.
- Under certain circumstances, they allow you to withhold payment for merchandise which proves defective.

Disadvantages

a) The ease of using credit cards, combined with impulsive buying, may result in over- spending.

b) High interest rates, as well as other costs make credit cards a relatively expensive method of obtaining credit.

c) Lost or stolen cards may result in some expense (Rs. 100) and causes inconvenience.

d) The use of multi-credit cards can get even further into debt.

e) Fraudulent or unauthorized charges may take months to dispute, investigate, and resolve.

11.3.2. Debit Cards

This type of card will directly debit money from your bank account, and can directly be used to purchase goods and services. While there is no official credit facility with debit cards per se, as it is linked to the bank account the limit is the limit of what is in the account, for instance if an overdraft facility is available then the limit will be the extent of the overdraft. ATM and debit card transactions take place within a complex infrastructure. To the consumer and merchant, they appear to be seamless and nearly instantaneous. But, in fact, a highly complex telecommunications infrastructure links consumers, merchants, ATM owners and banks. The common attribute of all ATM and debit card transactions is that the transaction is directly linked to the consumer’s bank account – that is, the amount of a transaction is deducted (debited) against the fund in that account. A Debit card transaction involves the purchase of goods or services. In this case, the consumer presents a debit card (which again was issued by the bank holding the checking account) to a merchant, and the consumer either enters a PIN (online debit) or signs a receipt (offline debit) to verify the consumer’s identity. The merchant, in turn, sends information about the transaction across one or more debit card networks, and if the transaction is approved, the consumer receives the goods or services and the checking account is correspondingly debited. The merchant is reimbursed by a credit to its bank account. An ATM card is typically a dual ATM /Debit card that can be used for both ATM and debit card transactions. Many ATM/Debit cards offer the consumer both types of debit card transactions, online and offline.

The history of debit cards is an interesting one. The late 1960s marked the beginning of modern ATM and Point of Sale (POS) systems, although the concept of ATMs and debit cards existed prior to this. It might be argued that the first ATMs were cash-dispensing machines. England’s Barclays Bank, for example, installed the first cash dispenser in 1967. But it did not use magnetic-stripe cards. Customers were issued paper vouchers after that were fed into the machine, which retained the voucher and dispensed a single £10 note. Don Wetzel has been credited with developing the first modern ATM. The idea came to him in 1968 while waiting in line at a Dallas bank, after which he proposed a project to develop on ATM to his employer, Docutel. A major part of the development process involved adding a magnetic stripe to a plastic card and developing standards to encode and encrypt information on the stripe. A working version of the Docutel ATM was sold to New York’s Chemical Bank, which installed it in 1969 at its Rockville center (Long Island, N.Y.) office. Although the Docutel ATM did the modern magnetic stripe access card, the technology remained primitive compared with today’s. The Docutel ATM only dispensed cash and was an offline machine. To enable payment processing, the machine printed a transaction record that was MICR encoded. By the early 1970 ATM technology advanced to the system. ATMs were first accessed primarily with credit cards, but in 1972, City National Bank of Cleveland successfully introduced a card with an ATM but on debit card function. ATMs were developed that could take deposits, transfer money from cheque to saving or savings to cheque, provide cash advances from a credit card, and take payments. ATMs also were connected to computers, allowing real-time access to information about card holder account balances and activity. By connecting a string of ATMs to a centralized computer, banks established ATM network. At first, ATMs were located on the premises of bank offices, but off-premises ATMs soon followed. Grocery stores and convenience stores quickly recognized the benefits of installing ATMs on their premises.

Grocery stores also led in installing POS debit systems, starting with the Massachusetts grocery chains of Angelo’s and star markets in 1976. By the early 1980s, serious testing of POS debit began at many of the large gas station chains. However, throughout the 1980s and into the 1990s, the volumes of POS debit transactions remained modest, mired by conflicts between merchants and banks over payment of transaction fees and the cost of POS terminals, and by the existence of multiple technical standards. The 1980s marked several important developments for Electronic Fund Transfer (EFT) networks. In contrast to POS debit, the ATM system was flourishing. In 1982, VISA acquired ownership positions in the regional network plus and began to build a national EFT network. Perhaps more important, in 1985 the U.S. Supreme Court held that ATM’s did not represent bank branches. Until the time there had been considerable legal uncertainty about the legal status of ATMs. If ATMs were considered branches, the limitation on interstate branching would affect their placement and, in turn, might put any EFT network that operated across state lines in legal jeopardy.

The decision by the U.S. Supreme Court encouraged interstate EFT networks. By removing a potential barrier to forming networks across state lines, it also was a factor in beginning a trend toward consolidation of shared networks. In the mid-1990s most of EFT development was in the debit arena. The impasse between merchants and banks finally broke down as merchants sought to reap the benefits of on line debit and banks pushed for more efficient payment systems. Debit terminal installation accelerated and the number of online and offline debit transactions grew rapidly. Perhaps following the trend toward consolidation of ATM networks, POS networks started to consolidate. Debit cards have been used more extensively in recent years for a number of possible reasons. It is relatively easy to add a debit function to an ATM card and because the base of ATM card holders was well established in the 1980s, it was not difficult for banks to establish a similar base of debit cardholders. Aggressive marketing on the part of banks helped familiarize debit card holders with the instrument, as did the emergence of Visa and MasterCard’s offline debit products, which opened up their credit card infrastructures to debit cardholders. Debit cards are designed for customers who like paying by placard but do not want credit.

A debit card is a plastic card which provides an alternative payment method to cash when making purchases. Functionally, it is similar to writing a cheque as the funds are withdrawn directly from either the bank account or from the remaining balance on the card. The debit card is thus ideal for those who have a tight budget and want to keep within it. There are two types of debit cards, namely, on-line debit cards and off-line debit cards. Making a purchase with an online debit card is similar to withdrawing cash from an Automated Teller Machine (ATM). The card is passes through a traditional magnetic reader, which is connected by a phone to a computer. On entering the personal identification number (PIN), computer verifies the PIN and checks to see if one has enough money in the bank to cover the transaction, all of which will not take more than a few seconds. Off-line debit cards work more like cheques, because there is no direct connection between store and bank. Off-line debit cards can be used wherever VISA or MASTER CARD is accepted.

Difference between Credit Card and Debit Card

Debit cards and credit cards are accepted at the same places. Debit cards all carry the symbol of one of the major types of credit cards on them, and can be used anywhere that credit cards are accepted. They both offer convenience. The fundamental difference between a debit card and a credit card account is where the cards pull the money. A debit card takes it from you banking account and a credit card charges it to your line of credit.

Debit cards offer the convenience of a credit but work in a different way. Debit cards draw money directly from your checking account when you make the purchase. They do this by placing a hold on the amount of the purchase. Then the merchant sends in the transaction to their bank and it is transferred to the merchants account. It can take a few days for this to happen, and the hold may drop off before the transaction goes through. For this reason it is important to keep a running balance of your checking account to make sure you do not accidentally overdraw your account. It is possible to do that with a debit card. A credit card is a card that allows you to borrow money in small amounts at local merchants. You use the card to make your basic transactions. The credit card company then charges you interest on your purchases, though there is generally a grace period of approximately thirty days before interest is charged if you do not carry your balance over from month to month.

In the past many people felt that you needed a credit card to complete certain transactions such as rent a car or to purchase items online. They also felt that it was safer and easier to travel with a credit card rather than carrying cash or trying to use your cheque book. However debit cards offer the same convenience without making you borrow the money to complete the transactions.

11.3.3. Smart Card

The proliferation of plastic cards started in the USA in the early 1950s. The first all-plastic payment card for general use was issued by the Diners Club in 1950. Acceptance of these cards was initially restricted to more select restaurants and hotels, which led to this type of card being referred to as a ‘travel and entertainment card’. The entry of VISA and MasterCard into the field led to a very rapid proliferation of plastic money, at first in the USA, with Europe and the rest of the world following a few years later. At first, the cards’ functions were quite simple. They initially served as data carriers that were secure against forgery and tampering. General information, such as card issuer’s name, was printed on the surface, while personal data elements, such as the cardholder’s name and the card number, were embossed. Furthermore, many cards had a signature field, in which the cardholder could sign his or her name for reference. In these first-generation cards, protection against forgery was provided by visual features, such as security printing and the signature field. With increasing proliferation in card use, these rather basic features no longer proved sufficient, all the more so since treats from organized crime were growing apace. The first improvement consisted of a magnetic strip on the back of the card. This allowed digital data to be stored on the card in machine-readable form, as a supplement to the visual data. However, the customer's signature on a paper receipt, as a form of personal identification, still remains a requirement in classical credit card applications. New applications can however be devised in which paper receipts are unnecessary.

The use of a secret personal identification number (PIN) that it compared to a reference number has become generally accepted. The embossed card with a magnetic strip is still the most commonly used type of payment card. Magnetic strip technology suffers from a crucial weakness; however in that the data stored on the strip can be read, deleted and rewritten at will by anyone with access to the appropriate equipment. It is thus unsuitable for the storage of confidential data. Additional techniques must be used to ensure confidentiality and to protect against tampering. For example, the reference value for the PIN can be stored either in the terminal or in the host system in a secure environment, instead of on the magnetic strip. Most systems that employ magnetic-strip cards thus have on-line connections to the system's host computer for security reasons. However, this generates considerable data transmission costs. In order to reduce costs, solutions must be sought that allow card transactions to be executed off-line without putting the system's security at risk. The development of the smart card, combined with the expansion of electronic data processing, has created completely new possibility for solving this problem. The enormous progress in microelectronic in the 1970s made it possible to integrate data storage and arithmetic logic on a single silicon chip measuring a few square millimetres. The idea of incorporating such an integrated circuit into an identification card was contained in a patent application field by the German investors Jurgens Dethloff and Helmut Grotrupp as early as 1968. This was followed in 1970 by a similar patent application, made by Kunitaka Arimura in Japan. However, the first real progress in the development of Smart card came when Roland Morena registered his smart card patents in France in 1974.

Since the basic inventions in smart card technology come out of Germany and France, it is not surprising that these countries played the leading role in the development and marketing of smart cards. The great break through was achieved in 1984, when the French Postal and telecommunications services (PTT) successfully carried out a field trial with telephone cards. In this field trial, the smart cards immediately proved to meet all expectations with regard to protection against tampering and high reliability. A pilot project was conducted in Germany in 1984-85, using telephone cards based on the variety of technologies. Magnetic-strip cards, optical-storage (halographic) cards and smart cards were used in comparative tests. The smart card proved to be the winner in this pilot study. In addition to a high degree of reliability and security against tampering, smart card technology promised greatest flexibility in future applications. Further developments followed the successful trials of telephone cards, first in France and then in Germany, with breathtaking speed. By 1986, several million 'smart' telephone cards were in circulation in France alone. The total number reached nearly 60million in 1990 and several hundred million worldwide in 1997. Germany experienced a similar development, with a time lag of about three years. These systems were marketed throughout the world after the successful introduction of the public smart cards in France and Germany. Telephone cards incorporating chips are currently used in over 50 countries. Progress was significantly slower in the field of bank cards, which is partly due to their greater complexity in comparison to telephone cards. With the general expansion of electronic data processing in the 1960s, the field of cryptography experienced a sort of quantum leap. Cryptography had previously been a covert science in the private reserve of the military and secret services.

The smart card proved to be an ideal medium. It made a high level of security (based on cryptography) available to everyone, since it can safety store secret keys and also execute cryptographic algorithms. The French banks were the first to introduce this fascinating technology in 1984, following a trial with 60,000 cards in 1982-83. It took another 10 years before all French bank cards incorporated chips. In Germany, the first field trials took place in 1984-85 with a multifunctional payment card incorporating a chip. However, the Zentrale Kreditaussechub (ZKA), which is a committee of the leading German banks, did not manage to issue a specification for multifunctional Euro cheque cards incorporating chips until 1996. In 1997, all German savings associations and many banks issued the new Smart Cards. In the 2000, multifunctional Smart Cards with POS functions, an electronic purse and optional additional applications were issued in all of Austria. This made Austria the first country in the world to have a nationwide electronic purse system. An important milestone for the future worldwide use of smart cards for financial transactions was the completion of the EMV specification, which was a product of the joint effort of Euro pay, MasterCard and VISA. The first version of this specification was published in 1994. It contained detailed descriptions of credit cards incorporating microprocessor chips and it guaranteed the mutual compatibility of the future Smart cards of the three largest credit card organizations. Electronic purse systems have proven to be an additional drawing card for the international use of Smart cards for financial transactions. The first such system, called Donmont, was put into operation in Denmark in 1992. There are currently more than 20 national systems in use in Europe alone, many of which are based on the preliminary European standard prEN 1546.

The use of such systems is also increasing outside of Europe. Even in the USA, where Smart card systems have hardly taken root up to now a smart card purse system was tried out by visa during the 1996 Olympic Summer Games in Atlanta. However, the problems associated with making small payments securely but anonymously throughout the world via the public internet have not yet been solved in a satisfactory manner. Smart Card could play a decisive role in the solution of these problems. Yet another application has meant that almost every German citizen these days owns smart card. When health insurance cards incorporating chips were introduced, more than 70 million smart cards were issued to all persons covered by the national health insurance plan. The smart card's high degree of functional flexibility, which even allows a card already in service to be reprogrammed for new applications, has opened up completely new areas of use that extend beyond traditional card applications. Smart cards, sometimes called chip cards, contain a computer chip embedded in the plastic. It has the capacity to store up to 80 times more information than other magnetic stripe cards. Smart cards carry the electronic proof of its holder's identity enabling its holder to make secure purchases anywhere on the globe, leading to a dramatic increase in electronic commerce. It is estimated that by the year 2018, five billion smart cards will be in use in over 100 countries covering 24 percent of the world populations. Presently, smart cards are used primarily for telephones, healthcare, transportation, movies, fast food outlets, internet banking and loyalty programs. There are two types of Smart cards. First, contact Smart cards that require insertion into a reader and contact less smart card which requires only close proximity to an antenna via radio waves.

11.3.4. Pre-paid Cash Cards

As the name suggests the user will add credit to the card themselves, and will not exceed that amount. These are usually re-useable in that they can be 'topped up' however some cards, usually marketed as Gift Cards are not re-useable and once the credit has been spent they are disposed of.

11.3.5. Store Cards

These are similar in concept to the Credit Card model, in that the idea is to purchase something in store and be billed for it at the end of the month. These cards can be charged at a very high interest rate and can are limited in the places they can be used, sometimes as far as only the store brand that issued it. It is also known as in-house cards. These cards are issued to customers by a retailer or company and in general can only be used in that retailers outlet or for purchasing the company's products. Store cards are enticing because they offer shoppers discounts for signing up, such as 10% or 15% off the first item cardholder buy. After that cardholders receive special offers and membership evenings to be a part of their little club.

11.4 Properties of Plastic Money

On implementing the concept of plastic money into the maeket, a big effort has been made to make plastic money as close as possible to real, physical money. Okamoto and Ohta (1972) presented the following six properties of an ideal electronic payment system:

1. The security of plastic money does not depend on a special physical conditions. No special hardware is necessary and money can be sent over the network.
2. Plastic money cannot be copied, modified, or double-spent.
3. Anonymity and non-traceability. Privacy of user is protected. No-body can deduce the link between user and his payment. The customer may perform operations anonymously.
4. The Protocol for plastic payment between customer and merchant can be performed off-line. No direct link to third party (e.g. bank) is necessary.
5. The plastic money can be transferred to any other user.
6. The plastic coin C can be divided to any number of other coins. Any of these coins can have any value, smaller than C, and the sum of value of these coins is equal to the C.

11.5 Development of Plastic Money

Plastic money is gradually strengthening its position with the potential of further growth in the future. It is worthwhile to observe how plastic money will evolve in the future in a competitive environment in terms of safety, efficiency and convenience. The use of plastic money has been expanding quite rapidly and its development is a prominent trend in the area of retail payment. There are many evident advantage of an electronic mode of transfer as compared to conventional clearing house because banks are increasingly turning to technology for managing their payments. Some of the value attributes include secure payments, cost-cutting, payment on due date and easier cash management compared to conventional systems. Plastic money in recent years is gaining momentum in India as merchant establishments and customers are realizing the safer mode of making payments compared to conventional payment.

Financial institutions have realized the acceptance of traders and customers, which has motivated them in leveraging on these systems. The plastic culture is influencing into the daily purchasing habits of Indian customers and the payment card business is growing as never before. Over the past few years, customer attitude towards the use of traditional cash and cheques payments has changed drastically leading to improved way of making payment. With the change in technology and the improvement in the payment system has lead to further development in plastic money. This development in plastic money helps the customers to satisfy their ever changing needs.

11.6 Operations of Plastic Money

Cardholder is the person in whose name the card is and who being in possession of the card is legally entitled to buy goods and services from merchant establishment and is under an obligation to pay for the goods and services. The cardholder is an agreement with the issuer to pay for the goods and services bought on the card along with the various applicable charges and the interest due on the card. This agreement is known as the 'cardholder agreement' and is ratified by the cardholder as soon as he receives his card and sign on it. Merchant establishment (MEs) is a shop or establishment which accept the card offered by the cardholder as a mean of payment for the goods and services provided. The merchant establishment (MEs) enters into an agreement with a bank, known as acquiring bank (since it acquires the business from the MEs).

Under this agreement, the merchant establishment provides goods and services to the cardholder on credit and receives money from the acquiring bank within the few days (generally 1-4 days). The MEs has to pay the commission to the acquirer for the services provided. The commission generally ranges between 2%-5% of the total sales value. MEs can be divided into two main categories based on the machines provided to them by the acquirers. The machines are provided based on the volumes of the sale of the MEs. A high volume MEs provided with an electronic data capture (EDC) machine while a low volume MEs is provided generally with an imprinters are known as 'manual merchant'. Such merchants are given 'floor limits' by the acquirers. The floor limit is an amount specified by the acquirer, below which the merchant need not take an approval but he must refer to hot card bulletin. If the transaction amount is above the floor limit, the merchant must take approval from his acquiring bank.

Acquiring bank is retained by the retailer or merchant to process the payment card transaction on their behalf and licenses the merchant to accept credit cards of one or more of the worldwide issuing bodies such as VISA, MASTER, DISCOVER etc. The acquirer need not always be a bank but can be a financial institution. In India, acquirers are known to be banks alone. The acquirers that processes the transaction, routes the authorization request to the card issuing bank. The merchant provides his acquirer with the charge slips for the day's transaction, irrespective of whether the acquirer was the issuer of the cards accepted by the merchant. Thus, it is clear that the acquirer need not necessarily be an issuer of the card which will be accepted at the MEs. The acquirer pays the merchant the total transaction value minus a commission, known as a service fee, which is agreed upon when the negotiations for the acquiring of the merchant were taking place. The merchant thus gets the instant reimbursement for the goods sold. Issuer/Issuing Bank is an institution which has issued the card to the cardholder. The issuer has the responsibility for transaction that are put through on cards that they have issued and responsible for debiting funds from the relevant cardholder's account. The card cycle works when cardholder buys certain goods at a shop and pays through his card. The merchant has three copies of the charge slips, one for his own records, one for the customer (which he signs), and one for his acquirer.

The merchant present the copy of the charge slip to his acquiring bank. The acquiring bank pays the merchant, on the basis of charge slip the amount of transaction minus its own commission. The rate of this commission is lesser than the rate of the merchant commission. The issuer consolidates all transaction for each card issued and presents the charges to the cardholder in the form of monthly bill or 'statement'. The cardholder has two options on receiving the statement. One is that he can pay off the full amount due on his card on or before the due date, in which case, he is said to using his card as a charge card rather than a credit card since he is not utilising card facility on his card. The second option is that he pays the minimum amount due (MAD) before the due date, or any percentage greater than the MAD but lesser than the total amount due and 'roll over' or carry over the balance amount to the next month for a small finance amount charge. The small finance charges generally vary between 1.5% -3% per month. In USA there is law which prohibits issuers from charging finance charges 4% or more per month, unfortunately there is no such law in existence in India at the moment. Of course, if cardholder fails to pay even the MAD, he has to pay either a service charge or fixed finance charge (depending on the rules of the issuer) plus the interest charges. In the certain cases, where the acquirer and the issuer are the same, the cycle has the three players instead of four. In this case, the issuer makes a little more profit than with the presence of an acquirer in the cycle, since he doesn't have to pay the commission to the acquirer. When translated over transactions per day, this means a lot of saving to the issuer. Thus there are many issuers who are vigorously pursuing the business of acquiring too. The actions in this model are: credit (loading) me ans transferring the monetary value from the issuer to the payment instrument (e.g. electronic purse) of client. Debit (purchase, payment) means transferring the monetary value from payment instrument of client to the payment instrument of merchant (that is usually payment terminal). In the terminal is then created payment transaction that contains the electronic money and other payment details.

Transaction collecting means transferring the payment transactions from the merchant to the acquirer. Payment clearing means clearing of payment request between acquirer and issuer. From the security point of view the most sensitive operations are credit and debit. The main threats are concentrated in these two operations. These threats include using of fake payment instrument, modifying communications of payment instrument, and illegal crediting. Other two operations are less sensitive and the probability of security incident during these operations is much smaller. Physical devices, such as smart cards or personal computers, are held by clients and by merchants. Merchants interact with clients and with their acquiring bank or other collection point, such as a third-party payment processor. Issuers receive funds in exchange for prepaid balances distributed to clients and manage the "float" in the system that provides financial backing for the "value" issued to consumers. In some cases, other intermediaries, such as banks, retailers or service providers, distribute stored-value devices and balances directly to consumers. The system may include a central clearing house or system operators.

11.7 Summary

In the present banking scenario plastic money is gradually strengthening its position with the potential of further growth shaping functions of banks. It was observed how plastic money had evolved in the past and managed competition in current dynamic scenario. Plastic Money is subject to safety, efficiency and convenience to cater to the present day need of the society. The use of plastic money has been expanding quite rapidly and its development is a prominent trend in the area of retail payment. Plastic money in recent years is gaining momentum in India as merchant establishments and customers are realizing the safer mode of making payments compared to conventional payment. Financial institutions have realized the acceptance of traders and customers, which has motivated them in leveraging on these systems. The plastic culture is influencing into the daily purchasing habits of Indian customers and the payment card business is growing as never before.

11.8 Self Assessment Questions

1. Define money and also discuss about the plastic money?
2. What is Credit card? Mention the difference between Credit Card and Debit Card?
3. Explain the various types of plastic cards in Indian markets along with their features?
4. Explain the emergence of plastic cards and the properties they carry to their holders?
5. Detail the process of settlement of the plastic money?

11.9 References Book

- K .Aswathappa (2009); ‘Essentials of Business Environment’; Himalaya Publishing House Private Limited, 2009, New Delhi.
- ShaikSaleem (2010); ‘Business Environment’; Pearson Education, 2nd Edition, 2010, New Delhi.
- Tapan K. Panda, ‘Marketing management’, Excel Books
- H. L. Ahuja (2009); ‘Economic Enviroment of Business’; S. Chand & Company Ltd., New Delhi; Fourth Edition, 2009.
- Prasad L.M,(2005) ‘Principles and Practices of Management’, Sultan Chand & Sons Educational Publishers,2009, New Delhi.
- Francis Cherunilam ,(2006) ‘Business Environment’ ,Himalaya publishing House, 2009, Delhi.

Unit – 12 : Securitisation of Debts

Structure of Unit:

12.0 Objectives

After completing this unit, you would be able to:

- Define the debt securitisation
- Know about the parties involved in the debt securitisation
- Understand the advantages of Securitisation
- Understand the mechanism of Securitisation

12.1 Introduction

Securitisation market in India has been in existence since the early 1990s but got significant existence only after 2000 when there established a narrow band of investor community and regular issuers. In the early 1990s, securitisation was essentially a way of two sides' acquisitions of portfolios of finance companies. The creation of securisation of a debt security was very uncommon and the portfolios of securities simply got transferred from the balance sheet of the originator to that of another entity.

These transactions normally incorporated the provisions of different expanses. But in recent years, the sales of different loans have become common through the direct assignment route. Securitisation of auto loans was a prominent form during 1990s but over the time, this market classified into various form *e.i.* housing loans, corporate loans, commercial mortgage receivables, future flow, project receivables, toll revenues, etc that have been securitized.

12.2 Concept of Securitisation

Securitization is the financial practice of pooling various types of contractual debt, such as residential mortgages, commercial mortgages, auto loans, or credit card debt obligations, and selling said consolidated debt as pass-through securities, or collateralized mortgage obligation (CMOs) to various investors. The cash collected from the financial instruments underlying the security is paid to the investors who had advance money for that right.

European Union definition of securitisation

'Securitisation' means a transaction or scheme whereby an asset or pool of assets is **transferred** to an **entity that is separate from the originator** and is **created for or serves the purpose of the securitisation** and/or the credit risk of an asset or pool of assets, or part thereof, is transferred to the investors in the securities, securitisation fund units, other debt instruments and/or financial derivatives issued by an entity that is separate from the originator and is created for or serves the purpose of the securitisation.

12.3 Parties Involved in Securitisation

There are many players in the debt securitized market but following three are the major players in debt securitized market.

1. **Originator:** This is the main organisation who gives money in form of the loan not in form of the debt securitization. In this party, we can include large organizations like RBI, SBI etc.
2. **Special Purpose Vehicle:** Special Purpose Vehicle (SPV) is that party who gets loan or pool of loan from originator and convert it into marketable securities. After converting it into marketable securities or papers or Demat, it will become debt securitized. Then SPV sells it in the money market or any other financial market. These parties include private banks and other private financial institution which you can find their office in your local city**.**
3. **Qualified Institutional Buyers/Investors:** After converting the loans into marketable securities, SPVs advertise for their debt securitised product to sell in the market. But they did not sell them to all. SPVs sell the securities only to those who clear its condition. All these clearing parties are called Qualified Institutional Buyers **(**QIB). The investors/QIBs receive fixed or floating rate from the SPV account funded by the cash flows generated by the portfolio.

In addition to these three players, there are some other players who perform the important role in the securitisation market.

4. **Credit Enhancer:** These are the supporter players who encourage the credit habits among the investors by minimizing the overall credit risk of the securities. They provide credit enhancement by way of facilitating the swaps, hedges, guarantees, insurance etc..

5. **Credit Rating Agency:** This is the agency which provides a rating of the security for the deal based on structure, rating of parties, legal and tax opinion

etc.. Rating of the securitized instrument provides the value addition to security and helps in the decision making of the investors.

6. **Insurance Company / Underwriters:** These are the organizations which provide cover against redemption risk of the securities to the investor and also help the SPVs to avoid the loss due to under-subscription of the securities.
7. **Obligor:** This is the person who is contractual debtor to originator and whose debts and collateral constitute the underlying assets of securitization.
8. **Servicer :** This is the person who collects money from Obligors and monitors and maintains the assets.

Example

Suppose, RBI finds 10 SPV and gives loan of Rs. 200 Crores to them. Now, 10 SPV converts this loan of Rs. 200 in the form of debt securitization and sells to different qualified buyers. These buyers may be 1000 or 100000. One of the best benefits of debt securitization is to reduce risk. If RBI gives Rs. 200 crores to one party, it may be risky. But when it is given 10 SPV, will be less risky.

Some examples of securitisation in the Indian context are:

- First securitisation deal in India between Citibank and GIC Mutual Fund in 1991 for Rs 160 mn.
- India's first securitisation of personal loan by Citibank in 1999 for Rs 2,841 mn.
- India's first mortgage backed securities issue (MBS) of Rs 597 mn by NHB and HDFC in 2001.
- Securitisation of aircraft receivables by Jet Airways for Rs 16,000 mn in 2001
- India's first sales tax deferrals securitisation by Govt of Maharashtra in 2001 for Rs 1,500 mn.
- India's first deal in the power sector by Karnataka Electricity Board for receivables worth Rs 1,940 mn and placed them with HUDCO.
- India's first Collateralised Debt Obligation (CDO) deal by ICICI bank in 2002.
- India's first floating rate securitisation issuance by Citigroup of Rs 2,810 mn in 2003. The fixed rate auto loan receivables of Citibank and Citicorp
- India's first securitisation of sovereign lease receivables by Indian Railway Finance Corporation (IRFC) of Rs 1,960 mn in 2005. The receivables consist of lease amounts payable by the ministry of railways to IRFC.
- India's largest securitisation deal by ICICI bank of Rs 19,299 mn in 2007. The underlying asset pool was auto loan receivables.

12.4 What can be securitised?

A variety of assets or future income streams can be used securitised.

- residential and commercial mortgage loans
- consumer loans
- corporate loans
- government loans

- credit derivatives
- Future revenue.

Some common examples are Trade Receivables, Trade Receivables, Power Purchase, Credit Card/MTNL Billing, Car loan, Home loan etc.

12.5 Type of securitisation debt securities

There are various types of securitisation debt securities. Some important of them are as follows:

1. **Covered bonds :** Covered bonds are such types of corporate bonds which are backed by the yields of an asset or any other loan. Such bonds are very attractive to investors as they are safe in case of originator becomes insolvent. The major advantage of this bond is that the debt and the underlying asset remain the full responsibility of originator. The originator/issuer must ensure that the underlying asset continues to back the bonds.
2. **Mortgage-backed bonds (MBB) :** A mortgage-backed Bond (MBB) is a bond that is secured by a mortgage or a group of mortgages. The originator makes a pool of those mortgages and sells them to special purpose vehicle (SPV). SPV again sells them to investors/ qualified institution buyers. In such type of bonds, the investors get together both the principal and interest in each payment according to terms and conditions applied by the SPV.
3. **Asset-backed securities (ABS) :** Asset-backed securities (ABS) are bonds/securities that are backed by assets like loans, leases, credit card debt, a company's receivables, royalties etc. but these should not be a mortgage-backed security. Asset-backed securities differ from other kinds of bonds in term of their creditworthiness because they are derived from other assets which do not back any other loan. These assets help in maintaining the paying ability of the originator as these are free from any type of back up of payment.
4. **Asset-backed commercial paper (ABCP) :** Asset-backed commercial paper (ABCP) is such type of a commercial paper that is backed by other financial assets. ABCP is typically a short-term instrument that matures between 90 and 180 days. It is very helpful in financing the short-term funds requirements.

   There is set up a Asset-backed commercial paper program called Conduit by a sponsoring financial institution which main purpose is to purchase and hold financial assets of sellers. The conduit finances the assets by selling asset-backed commercial paper to investors. The originator pass the required fund for the payment to investors to Conduit and then conduit paid the funds to investors.

5. **Credit-linked notes (CLN) :** A credit linked note is an instrument to fund the credit derivative. It is a structured security with an embedded credit default swap which helps the issuer to transfer a specific credit risk to investors. It means that issuer is not responsible to repay the loan in case of the specific event happens as decided by issuer with investor. At the maturity, the investors receive the nominal/par value unless the issuer defaults the payment. If the credit defaults at maturity, the investors will get an amount

equal to the recovery rate. Credit-linked notes normally have higher returns in comparison to government securities or corporate bonds.

6. **Colletarised debt obligations (CDO) :** A collateralized debt obligation (CDO) is a type of structured asset-backed security (ABS). It is created by making a pool of similar loans into a single investment that can be bought and sold in the market. The collateralized debt obligation can be divided in different groups according to their characteristics or homogeneities and such groups of CDO are called tranches. Each tranche differs in its risk profile. The tranches are generally created according to the credit rating of each loan. The tranches having higher credit rating (called senior tranches) have low interest rates while the lower rated tranches (called junior tranches) have higher interest rates. The junior tranches offer higher interest rates to compensate for their higher default risk.

12.6 Mechanism of Securitisation

The mechanism of securitization is as follows:

Step 1: Originator : The first step starts with the originator *e.g* a company which has loans as income producing assets. After identifying the various loans and other income producing assets to be removed from its balance sheet, the company (Originator) clubbed them into a portfolio for the purpose of sale.

Step 2: Special Purpose Vehicle : After making a portfolio, the originator sells the assets pool to an issuer (Special Purpose Vehicle) which is a financial institution specially established to purchase that asset pool. After purchasing that assets pool, the SPV finances them by issuing tradable, interest-bearing securities (called securitised debt) that are sold to the capital market.

Step 3: Qualified Institutional Buyers : After securitising the assets pool, SPV advertises for the securitised product to sell. The buyers/investors who fulfil his terms and conditions, SPV sells the product to them.

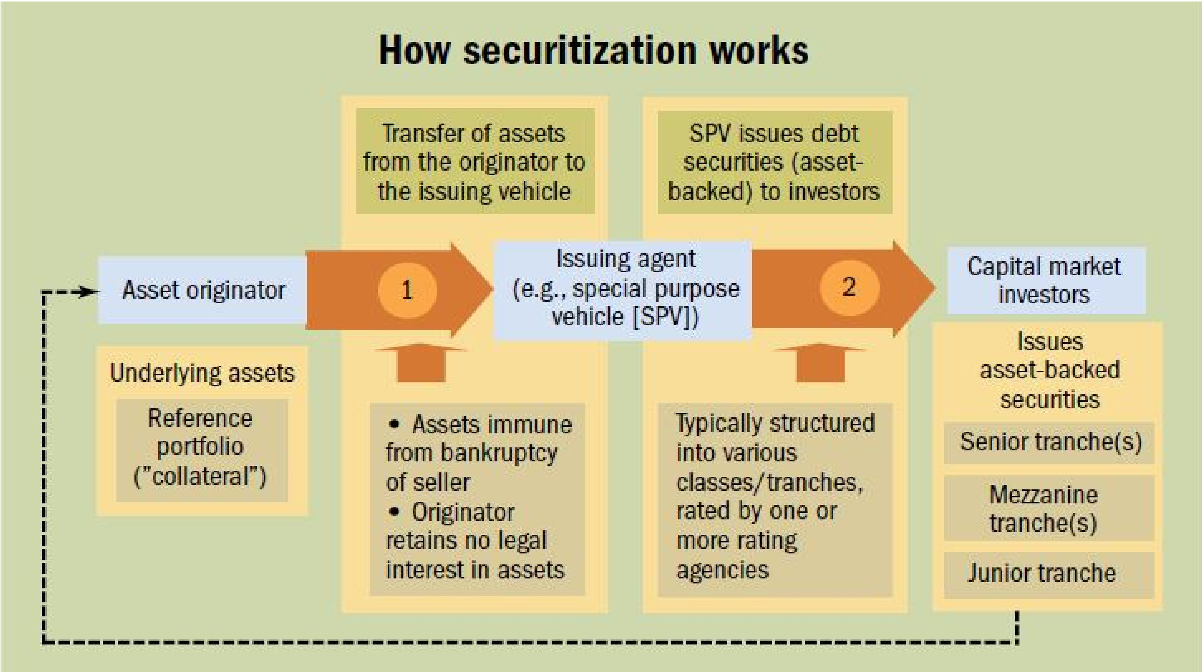
The brief mechanism or process of securitisation is presented in figure 12.1.

12.7 Advantages and Disadvantages of Securitization

Advantages to issuer

1. **Reduces the cost of borrowing**: The securitization helps the originator to reduce the cost of borrowing as the security is independent of the rating of the corporate securitising the assets. For example, a company having BB rating can borrow at AAA rates if it has AAA-worthy cash flow. The difference between BB debt and AAA debt may have larger difference which helps to reduce the cost of borrowing.

Figure : 12.1



Source: Andreas Jobst, Finance & Development September 2008

2. **Reduces asset-liability mismatch**: In the most banks and finance companies, the funding comes from borrowing which is shown in liability book. This type of fund often comes at a high cost. But when these companies use the securitisation as a source of fund, securitization allows such companies to create a self-funded asset book. And this leads ultimately to reduce the asset-liability mismatch.
3. **Lower capital requirements**: Due to legal, regulatory or other reasons, the companies have a limit or range on their permitted leverage. But when these companies securitize the collateral assets, they are able to remove assets from their balance sheets while maintaining the "earning power" of the assets. Thus it helps to lower down the capital requirements.
4. **Transfer the risks:** Securitization makes it possible to transfer risks like credit risk, liquidity risk, prepayment risk, reinvestment risk etc. from originator to investor by separating the risk of the assets.
5. **Earnings**: Securitization helps to record an earnings growth without any real addition to the firm. When a securitization takes place, the sale has normally market value of the underlying assets which is reflected on the parent company's balance sheet. And thus the earnings for that quarter by the amount of the sale are increased which attracts the investors.
6. **Liquidity**: The securitisation also provides better liquidity to the companies by using the future cash flows. When the collateral assets are securitised, the future cash flow is available to the company for immediate spending or investment which increases the liquidity level of the company.

Disadvantages to issuer

1. **Reduce portfolio quality**: If there are different types of rated security in a portfolio and AAA rated or highest rated securitised asset become out, this will reduce the overall quality of portfolio quality. This will be harmful for the issuers.
2. **Enhance costs**: Securitizations also helps to enhance the cost due to management and system costs, legal fees, underwriting fees, rating fees, and ongoing administration.
3. **Size limitations**: Securitizations often require large-scale structuring and thus may not be cost efficient for small- and medium-sized transactions.
4. **Risks**: Since securitization is a structured transaction, it may include par structures and credit enhancements that are subject to risks of impairment, such as prepayment and credit loss.

Advantages to investors

1. **Earn higher rate of return :** The investment in the securitised assets creates a better opportunity to earn a higher rate of return.
2. **Opportunity to invest in a specific pool of high-quality assets**: Securitisations are normally done for AAA, AA, or A rated bonds because companies want to increase their ratings and such types of securitisation helps to achieve this objective. Risk-averse investors normally invest in highly rated assets class to avoid from any type of risk. Such securitisations provide a better opportunity to invest in a pool of high quality assets.
3. **Portfolio diversification**: Depending on the securitization, hedge funds and other institutional investors may prefer investing in bonds created through securitizations because they may be uncorrelated to their other bonds and securities.
4. **Separation of credit risk from the parent entity**: As the assets that are securitized are separated from the assets of the originating company, it may be possible that such securitization may receive a higher credit rating than that of parent company because the underlying risks are different. If it happens, the parent company will pay higher interest to its creditors which will be more profitable for investors.

Disadvantages to investors

1. **Liquidity/Default risk**: The borrower's inability to meet interest payment obligations on time is called default risk. The low rated companies normally suffer such types of problem.
2. **The investors may also suffer from prepayment/reinvestment/early amortization done by the company.**
3. **Currency interest rate fluctuations**:

Like all fixed-income securities, the prices of securitisations move in response to changes in interest rates. Fluctuations in interest rates affect the securitisations more than they affect fixed-rate securities.

4. **Moral risk**: Investors usually rely on the deal manager to price the securitizations' underlying assets. If the manager earns fees based on performance, there may be a temptation to mark up the prices of the portfolio assets. Conflicts of interest can also arise with senior note holders when the manager has a claim on the deal's excess spread.
5. **Servicer risk**: The transfer or collection of payments may be delayed or reduced if the servicer becomes insolvent. This risk is mitigated by having a backup servicer involved in the transaction.

12.8 Regulatory Framework

There is no clear regulatory framework for the securitisation market in India. However, the securitisations originated Banks, FIs and NBFC s are governed by guidelines issued by the RBI. Enactment of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interests Act, 2002 (SARFAESI Act 2002) enabled securitisation of the non-performing assets of Banks.

The recommendations made by Dr.R.H.Patil's High Level Committee on Corporate Debt and Securitisation in 2005 proved a turning point towards the development of securitisation market. Some important recommendations of the Committee on securitisation were as follows:

- **Stamp Duty on Securitized Debt :** The Central Government should consider establishing an appropriate institutional process to evolve a consensus across the States on the affordable rates and levels of stamp duty on debt assignment, Pass through Certificates (PTCs) and security receipts (SRs).
- **Taxation :** An explicit tax pass-through treatment to securitisation SPVs / Trust SPVs should be provided. Wholesale investors should be permitted to invest in and hold units of a close-ended passively managed mutual fund whose sole objective is to invest its funds in securitised paper. There should be no withholding tax on interest paid by the borrowers to the securitisation trust and on distributions made by the securitisation trust to its PTC s and/or SR Holders.
- **Listing of Securitized Debt :** Pass through Certificates (PTC) s and other securities issued by securitisation SPVs / Trust SPVs should be notified as "securities" under SCRA.
- **Issues under SARFAESI :** Large-sized NBFC s and non-NBFC s corporate bodies established in India may be permitted to invest in SRs as Qualified Institutional Buyers (QIBs). Private equity funds registered with SEBI as venture capital funds (VC Fs) may also be permitted to invest in SRs within the limits that are applied for investment by VC Fs into corporate bonds.
- **Credit Enhancement Mechanism:** Introduction of credit enhancement mechanism for corporate bonds should be done. The State Government itself or the Central Government or other willing market participants, including bond insurers, could underwrite some of the tranches so as to enhance the credit rating of tranches of the pooled asset. Credit enhanced CLOs and CDOs should be included as approved investment avenues.

- **Specialized Debt Funds for Infrastructure Financing :** Creation of specialised debt funds to cater to the needs of the infrastructure sector should be done.
- **Fiscal Concession for Municipal Bonds and Infrastructure SPVs :** Government to review interest rates on small savings instruments need to be implemented to ensure that interest rates paid on small savings instruments are aligned with market rates. Fiscal support, like tax benefits, bond insurance and credit enhancement, for municipal bonds and infrastructure SPVs should be enhanced by the government.

In February 2006, the RBI issued guidelines for securitisation of standard assets by Banks, FIs and NBFCs. These guidelines provided the regulatory framework for several critical aspects of securitisation and are expected to take forward the establishment of a robust structured credit market. They clearly defined some of the key aspects such as true sale criteria, capital treatment for credit enhancement, exposure recognition, etc.

The extant law provides for securitization of debt by Asset Reconstruction Companies and National Housing Bank. However, the securitized debts had not included under Securities Contract Regulation Act (SCRA). But In 2007, the Securities Contracts (Regulation) Amendment Act 2007 amended the Securities Contract (Regulation) Act to include "securitised instruments" in the definition of "securities". The amendment has paved way for listing and trading of securitised debt on stock exchanges.

SEBI has released draft regulations for "Public Offer and Listing of Securitised Debt Instruments" in June 2007 which is yet to be formalised. However, these guidelines visualize a very different transaction structure compared to current market practices.

12.9 Summary

In a very simple way, Securitisation means every such process which converts a assets/loan into a security to transact in a financial market. The major players/parties in a securitization process are originator, special purpose vehicle (Issuer) and Qualified Institutional Buyers (QIB). There are various types of securitised products like Covered bonds, Mortgage-backed bonds (MBB), Asset-backed securities (ABS), Asset-backed commercial paper (ABCP), Credit-linked notes (CLN), Colletarised Debt Obligations (CDO) etc.. The securitisation provides many advantages such as it helps to reduce the cost of borrowing, to decrease capital requirements, to maintain liquidity, portfolio diversification etc.. RBI and SEBI are the major governing bodies which keeps their eyes to regulate the securitisation market and save the interest of the issuers and investors.

12.10 Self Assessment Questions

1. Define the securitisation of debt? What assets can be securitised?
2. What are the different types of securitised debt?
3. Explain the different benefits of securitisation.
4. Describe the process of securitisation and parties involved in a securitisation process.

12.11 Reference Books

- Dun and Bradstreet India, Arcil (2008).“*Securitisation in India: The story so far and the way*
- Gaschler, Tara E. *Understanding the Securitization Process and the Impact on Consumer Bankruptcy Cases*, American Bankruptcy Institute
- Jobst, Andreas. *What Is Securitization?*
- Kothari, Vinod. *What is securitization?*
- Litwin, S. M. *et al. Introduction to Securitization*
- Nadauld, Taylor D. (2011) *Did Securitization Affect the Cost of Corporate Debt?*
- Patil, Dr. R. H. (2005). *The Report of the High Level Expert Committee on Corporate Bonds and Securitization*.
- Rao (2011). *Securitization Market in India may*
- RBI (2006). *Guidelines on Securitisation of Standard Assets*
- SEBI (2007) *Public Offer and Listing of Securitised Debt Instruments*

Unit - 13 : Consumer Finance

Structure of Unit:

13.0 Objectives

After completing this unit, you would be able to :

- Understand meaning of consumer finance.
- Know various types of credit facility.
- Locate factors affecting demand for consumer finance and its various sources.
- Put arguments in favour and against of consumer finance.
- Differentiate hire purchase system and instalment credit system.

13.1 Introduction

A great change in economic environment in last one and half decade has tremendously affected the life style of a common man. Now-a-days financial sector is in growing phase. A wide range of products is being offered through multiple delivery channels. On one hand the increasing income of the consumers has enhanced their buying and paying capacity, at the same time they are also enjoying the pleasure of choosing number of different products in the market with the help of credit facilities. A number of options are available in the market for the consumer to easily possess goods. All activities involved in granting credit to consumers are termed as consumer finance. According to Reavis Cox "Business procedure through which the consumers purchase semi-durable and durable other than real estate, in order to obtain from them a series of payments extending over a period of three months to five years and obtain possession of them when only a fraction of the total price has been paid." A wide range of products such as TVs. Computers, sewing machines, refrigerators, washing machines, air-conditioners etc. are covered under consumer financing in India. Some important features e.g., durability, saleability, repairability, serviceability are considered for the products.

13.2 Types of Credit Facility

Various types of credit facilities available to a consumer is being explained here in brief :

Cash Loan :- Banks and financial institutions provide money to consumers to buy articles for their personal consumption. In this situation, seller and lender are not same, therefore, the lender does not bear the responsibility of a seller.

Unsecured Finance :- When a consumer does not pledge any security against money granted to him is known as unsecured finance.

Secured Finance :- A collateral security is pledged with financial institution to grant credit in case of secured finance. Any liquid asset, personal property or real property may be pledged as collateral security to satisfy creditor in case of any default by the borrower.

Fixed Credit :- The situation whereby the financier grants loan for a fixed period of time is termed as fixed credit. Hire purchase and monthly instalment loan are the examples of fixed credit. The borrowing has to pay the loan within a stipulated period of time.

Revolving Credit :- A consumer is sanctioned the credit limit. He may avail credit upto this sanctioned limit. According to S.Gurusamy "An on going credit agreement similar to a bank overdraft, whereby the financier, on a revolving basis, grants credit, is called 'revolving credit'." Credit cards are the best example of revolving credit.

13.3 Factors Affecting Demand for Consumer Finance

It is a well known fact that demand for consumer finance is continuously increasing. Although there are may factors affecting this demand but some important factors are being enlisted here :-

(i) Increase in real some due to generation of various sources of income.

(ii) Increase in income disposal capacity of consumers.

(iii) Nuclear families structure leads to spurt in number of households.

(iv) Easily payment of instalment amount.

(v) Lower charges, down payment and credit contracts.

(iv) Least formalities to avail consumer finance.

13.4 Various Sources of Consumer Finance

A consumer has an option to choose source of finance among various sources available to him. These are being discussed here :-

(A) **Traders :-** Hire purchase concerns, sales finance companies and non-banking financial institutions are included in traders. They are involved predominantly in consumer finance activity.

(B) **Commercial Banks :-** Commercial banks provides consumer finance directly or indirectly. They lend huge money to hire purchase concerns, sales finance companies or to other financial intermediaries. They also provide personal loans directly to consumers without any security. Such type of finance is more cheaper than hire purchase credit.

(C) **Non-Banking Finance Companies :-** Consumer finance companies are non-saving institutions whose prime assets constitute personal cash loan to consumer, sales-finance receivables, short term receivables etc. These companies are also known as licensed lenders, personal finance companies or small loan companies. Consumers approach these companies at last because they charge higher rates of interest in comparison to market rates.

(D) **Credit Card Institutions :-** Credit card institutions provides credit purchase facility through respective banks who issue the credit cards. A person may buy goods on credit through credit card system. The functioning of credit card system may be understood in the following manner

First of all the buyer presents the credit card, after presentation of credit card, the seller prepares three copies of the sales voucher. The first copy is kept by the seller. The second copy is prepared for credit card company or the bank which is forwarded for collection. The Third copy is given to the buyer. The seller's bank sends all such bills to the card issuing company or bank. Therefore, the bank debits customer's account and credits seller's account with that amount. The card issuing company or bank provides a monthly statement to the buyer to pay outstanding amount within a stipulated period. The buyer pays amount without any additional charge. If there is any delay in payment then a predetermined interest has to be paid on outstanding amount.

(E) **Middlemen :-** The dealers of consumer articles as a part of their promotion campaign provides credit facility to consumers to buy goods.

(F) **Credit Unions :-** It is an association of persons. They save their money together. If any member of the association wants to buy goods they provide loan at relatively tower interest rate.

(G) **Other Sources :-** Mutual saving banks and saving and loan associations are also assumed as other sources of consumer finance.

13.5 Terms and Conditions of Finance

The terms and conditions for consumer financing are being explained hereunder :

Eligibility :- Nature of employment, tanure of employment and yearly income of the consumer are taken as the basic eligibility for consumer finance.

Guarantee :- To avoid delay or non-payment of instalments, financiers provides credit on the basis of guarantors. Financial position and sources of income of guarantor are examined with appropriate proofs. If the consumer does not pay the amount, the financier recovers the amount from guarantor.

Tenure :- The value of the assets purchased by consumer determines the tanure of finance. The assets of higher value are given long-term credit while the assets of smaller value are given a comparative shorter term credit. Competition in market is also considering factor to determine tanure of loan.

Rate of Interest :- Finance companies charge different rates of interest. Some of them charge a flat rate of interest while some other charge yearly declining rate of interest. It has also been noticed that some finance companies charge net interest rates. It should be kept in mind that rate of interest in case of consumer finance will be more than the rate of interest in case of business finance. The main reason behind the higher interest in case of consumer finance is that only personal integrity of the consumer is considered in granting consumer finance.

Credit Evaluation :- The consumer produces required documents. The financier varifies the documents to know credit worthiness of the consumer and to ascertain the validity of documents. The finance company itself may examine the documents or may seek services of an independent agency. Capacity, capital, condition and character are verified either through personal enquiry with the applicant or with third person or with employer. The inquiry generally includes address age, employment status, monthly income, marital status, assets owned, type of collateral offered etc.

Mode of Payment :- Monthly instatment may be deducted direct from salary of the employee. For this, it should be brought in notice of the employer. Financier may collect post-dated cheques in advance. A consumer may also pay instalments through Electronic Clearing Services (ECS) on monthly or on agreed basis.

Other Charges :- Processing fees, documentation fees, services charges, lawyer's fees, brokerage, collection cost, examination or verification fees may also be charged by finance companies or banks. Sometimes financier deposits precautionary amount or safeguard against any default in payment.

13.6 Pricing of Consumer Finance

The extent of facility offered determines the pricing of consumer finance. Administration expenses are included while fixing price of consumer credit. If there is any possibility of default, then default risk premium may also be considered. If there is no probability of default, than risk free rate of interest may be considered.

13.7 Consumer Finance Insurance

A consumer is provided credit insurance for consumer finance. The customer pays premium for such insurance. If there is any default in insurance payment, than consumer credit insurance provides coverage. Consumer credit insurance is not popular in india, because people are not interested in paying extra amount as premium.

13.8 Consumer Credit Scoring

Credit worthiness of a consumer is evaluated on the basis of some parameters. Although there are some methods to evaluate credit worthiness of a consumer but some of the commonly used methods are being discussed here :

Dunham Greenberg Formula :-

Various aspects of the consumer's loan proposal are allotted points. Total score will be of 100 and the composition will be as followed :

Parameter	Score (Point)
Applicant's Employment record	20
Applicant's Income	25
Applicant's Finance	10
Type of Security Offered	20
Past Payment Record	25
Total	**100**

If the score of the consumer is 70 or above, he may be considered as a good credit standing.

Specific Fixed Formula :-

Parameters and credit score under this formula is being given here :

Parameter	Score (Point)
Age	0.1 – 0.5
Sex	0.4
Stability of residence	0.042 – 0.42
Occupation	0.16 – 0.55
Industry	0.21
Stability of employment	0.059 – 0.59
Assets	0.20 – 0.45

A score of over 2.5 will be considered as a marginal borrower while a score of over 3.5 will be considered as an excellent borrower.

Machinery Risk Formula :-

Generally government offices use machinery risk formula to grant loans to employees. The amount to be sanctioned is calculated with the help of the following formula :-

Down payment + (0.124 × Monthly income) + (6.45 × length of service in months)

13.9 Mode of Consumer Finance

A consumer may avail consumer finance facility through any one of the following ways :

1. **Credit Card :-** Now-a-days banks have started to participate in the consumer finance field with a high manner. Credit cards are replacing paper money. The wide usage of credit cards is enabling consumers to purchase goods throughout the world.
2. **Revolving Account :-** A consumer is allowed to buy goods during a month and given credit on a deferred payment basic. He may repay the amount by monthly instalment. The financier charges for the credit which is calculated on the agreed percentage of the purchase price. The charge is added to purchase price of the article.
3. **Open Account :-** The retailer allows the customer to purchase articles during a certain period upto a certain value. The customer cannot cross the predetermined value. The seller do not charge any interest on such credit. There is no down payment system under this method.
4. **Cash Loan :-** This type of credit is extended in the form of cash. Consumer may seek cash loan either to purchase goods or to consolidate the existing debt into one lump sum. Finance companies set their own period of payment.
5. **Instalment Account :-** Under this method, the consumer may pay the amount in equal periodical instalments as per agreement. It has become very much popular method because of its convinience.
6. **Option Plan :-** Under this method a statement of account is given to the customer. He is given option to pay the full amount or part thereof. In case the payment is made partly, then the balance is forwarded and interest is calculated on balance outstanding.

13.10 Arguments in Favour of Consumer Finance

In the modern competitive market, consumer finance is playing a vital role in the mass production and distribution of consumer durables. It is being used as the best method for sales promotion. Consumers also feel convinient to buy goods. There are many arguments in favour of consumer finance. The points are being discussed here :

(i) **Convenient Mode :-** Open account is one of the popular mode of consumer finance. It is convenient mode for consmers to acquire finance.

(ii) **Changing Living Standard :-** Through credit facility people may buy a variety of articles to improve their life standard. They may buy a number of articles through various modes of consumer finance.

(iii) **Realisation of Dreams :-** There are many luxurig capital items which are very expensive and to buy them may be out of pocket capacity. Consumer finance provides them instalment facility which may be spread over a fixed future period and paid in easy instalment. In such case there is no need of accumulated savings. Young generation in their beginning years of life may enjoy possession of things without any saving.

(iv) **Compulsory Saving :-** The consumer who acquires articles through consumer finance facility will have to pay the credit amount. Therefore, it indirectly creates their saving and prevents from spending money in unnecessary articles.

(v) **Maximisation of Revenue and Growth of Industrial Development :-** It is too difficult to buy luxury goods without credit facility for mass of customers. Therefore, consumer durables may remain unsold in stock and in turn, it will not create demand. Speedy disposal of goods with credit facility will not only increase manufacturing of goods but also will increase profit of the concern. Production on large scale basis will provide goods at a lower rate which will generate more revenue and employment. As a result, it will lead to rise growth of industrial development.

(vi) **Exportation and Boon to Economy :-** As is has been explained in earlier points that credit facility will lead to industrial development and economic growth of the country. A large number of producers will produce articles on a large scale which may be exported on credit basis. All this will create a better situation for the modern economy.

13.11 Arguments Against Consumer Finance

(i) **Costly Credit :-** It has been noticed that the seller who sell articles on credit generally charge higher price and charges higher rate of interest. Therefore, it becomes costly affair for consumers.

(ii) **Useless Buying :-** Consumers purchase things even if they are useless or not needed. Sometime they do not furnish correct information and purchase more than their paying capacity. It leads to bad debts and negative consequences for business community.

(iii) **Risk to Traders :-** Although trader may repossess the articles sold if buyer has not paid the full amount but it creates risk to resold the article which may remain unsold in stock. There may be many problems in repossession of goods from the customer.

(iv) **Fluctuation in Economy :-** Overbuying in boom situation creates overextension of credit and tightening credit facility in period of recession may create financial problems. Extreme of both leads to fluctuation in economy.

13.12 Hire Purchase System

Under hire purchase system, possession of goods is delivered to a person on condition that the person will pay the agreed amount in periodical amount. The hire purchase price is paid in instalment which is conveniently spread over a fixed period which may be two or three years. Although the possession of goods to the buyer is given on the payment of first instalment but the right of property remains with the seller until the final payment is not made. Legal ownership of the article is transferred to the buyer only after the payment of last instalment. If the buyer fails to pay instalments, the seller may repossess the article by terminating the agreement.

Hire purchase finance helps to create asset without any amount of immediate cash. There is no need to arrange any loan, therefore, hire purchase finance provides a great relief to buyers. It also creates saving habits among consumers. Mass sale, mass production, mass employment and increasing revenue contribute to economic growth and industrial development.

It is necessary to have a regular and stable income of a person to enter in hire purchase agreement. A minor and married woman without an independent source are disqualified for such agreement. Hire purchase system is only for those buyers who are reputed in the society.

13.13 Instalment Credit System

Although the price under instalment credit system is recovered in instalments like hire purchase system but possession and ownership is transferred to the buyer with the payment of the first instalment. In this system the seller has no right to recover the article even if the buyer is defaulter in payment. The seller may recover the dues through court.

13.14 Summary

There is a great change in life style of a common man due to changing economic environment. The consumers are enjoying a wide range of products through credit facility. Cash loan unsecured finance, secured finance, fixed credit and revolving credit are the main types of consumer finance. Increase in real income, increase in income disposal capacity, easy instalment payment , lower charges, least formalities are the factors which affects the demand of consumer finance. A consumer seek finance from various sources like traders, commercial banks, non-banking finance companies, credit card institutions, middle man and credit unions. Consumer finance depends on nature of employment, tanure of employment. To avoid delay or non-payment of instalments, financiers provides credit on the basis of guarantors. Tenure of credit is determined on the basis of the value of the article. Long term credit is given for higher value and short term credit is given for smaller value. Generally rate of interest in case of consumer finance will be higher than business finance. Different finance companies charge different rates of interest. Before providing credit facility to the consumer. The financier evaluates creditworthiness. Mode of payment and other charge are also included in terms and conditions of consumer finance.

The extent of facility offered determines the pricing of consumer finance. Default risk premium or risk free rate of interest are considered for pricing of consumer finance. If a consumer seeks insurance coverage for instalment payment, then he has to pay some extra premium for this. Credit worthiness of a consumer is evaluated on the basis of some parameters. Dunham Greenberg Formula. Specific Fixed Formula and Machinery Risk Formula are generally used to evaluate credit worthiness of a consumer. Credit card and option plans are some ways through which a consumer may avail finance facility. There are many arguments in favour of consumer finance. Convenient mode, changing living standard, realisation of dreams, compulsory saving, maximisation of revenue and growth of industrial development, exportation and boon to economy are some points in favour of consumer finance. Despite of all these points there are some arguments against consumer finance. Costly credit, useless buying, risk to traders and fluctuation in economy are in against of consumer finance. Hire purchase system is a popular method of consumer finance under which possession of goods is delivered to a person on condition that the person will pay the agreed amount in periodical amount. The price is paid in instalment over a fixed. Instalment credit system is similar to hire purchase system but ownership & possession of article in ICS is transferred to buyer on payment of first instalment. Seller has no right to recover the thing even if the buyer is defaulter in payment.

13.15 Self Assessment Questions

1. Define consumer finance.

2. What are the different types of consumer finance.

3. What are the factors which affect the demand of consumer finance. Elaborate.

4. Discuss the various sources of consumer finance in detail.

5. Explain the different modes by which consumer finance is extended.

6. How will you evaluate credit worthiness of a consumer. Explain various formulas in this regard.

7. State the arguments in favour of and against consumer finance.

8. What is hire purchase finance system. Is it different form instalment credit system. Give you views.

13.16 Reference Books

1. Gurusamy, S. Financial Services and System, Vinay Nicole Imprints PVT. Ltd. Chennai.

2. Khan, M.Y., Financial Services, Tata McGraw Hill, Publishina Ltd., New Delhi..

3. Jain, Rathi, Thakur, Solanki, Merketing of Financial Services, RBD Jaipur.

Unit – 14 : Factoring and Forfeiting

Structure of Unit

14.0 Objectives

After completing this unit, you would be able to:

- Understand the concept and types of factoring;
- Know about the nature and mechanics of factoring;
- Point out the various functions and parties to the factoring;
- Learn about the concept and parties of Forfeiting;
- Know about the documentation, costs and mechanism of Forfeiting;

14.1 Introduction

Receivables constitute a significant portion of current asset of a firm. But, for investment in receivables, a firm has to incur certain costs such as costs of financing receivables and costs of collection from receivables. Further, there is a risk of bad debts also. It is, therefore, very essential to have a proper control and management of receivables. In fact, maintaining of receivables poses two types of problems;

(i) the problem of raising funds to finance the receivables, and

(ii) the problems relating to collection, delays and defaults of the receivables.

A small firm may handle the problem of receivables management of its own, but it may not be possible for a large firm to do so efficiently as it may be exposed to the risk of more and more bad debts. At the instance of RBI a committee headed by Sri C.S. Kalyan Sundaram went into the aspects of factoring services in India in 1988, which formed the basis for introduction of factoring services in India. SBI established, in 1991, a subsidiary ─ SBI Factors Limited with an authorized capital of Rs 25 crores to undertake factoring services covering the western zone.

14.2 Meaning and Concept

Factoring is a method of financing whereby a firm sells its trade debts at a discount to a financial institution. In other words, factoring is a continuous arrangement between a financial institution (namely the factor) and a firm (namely a client) which sells goods and services to trade creditors on credit. As per the arrangement, the factor purchases the client' trade debts including accounts receivables either with or without recourse to the client, and thus, exercises control over the credit extended to the customers and administers the sale ledger of his client.

The factoring has been defined in various countries in different ways due to non-availability of any uniform codified law. The study group appointed by International Institute for the Unification of Provide Law (UNIDROIT) Rome during 1988 recommedated, in simple words, the definition of factoring as under:

"Factoring means an arrangement between a factor and his client which includes at least two of the following services to be provided by the factor:

- Finance
- Maintenance of accounts
- Collection of debts
- Protection against credit risks"

The above definition, however, applies only to factoring in relation to supply of goods and services in respect of the following:

(i) To trade or professional debtors

(ii) Across national boundaries

(iii) When notice of assignment has been given to the debtors.

The development of factoring concept in various countries of the world has led to some consensus towards defining the term. Factoring can broadly be defined as an arrangement in which receivables arising out of sale of goods/services are sold to the "factor" as a result of which the title to the goods/services represented by the said receivables passes on to the factor. Hence the factor becomes responsible for all credit control, sales accounting and debt collection from the buyer(s).

14.3 Nature

The factoring service contains the following nature:

1. Factoring is a service of financial nature involving the conversion of credit bills into cash. Accounts receivables, bills recoverable and other credit dues resulting from credit sales appear in the books of account as book credits.
2. The risk associated with credit are taken over by the factor which purchases these credit receivables without recourse and collects them when due.
3. A factor performs at least two of the following functions:

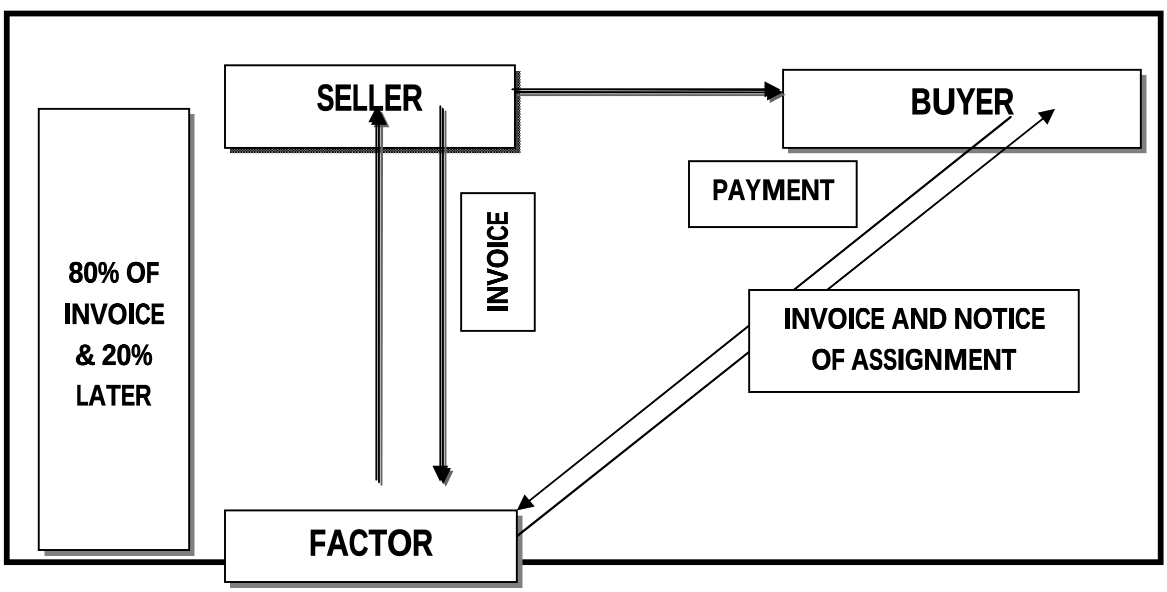
   (i) Provides finance for the supplier including loans and advance payments.

   (ii) Maintains accounts, ledgers relating to receivables.

   (iii) Collects receivables.

   (iv) Protects risk of default in payments by debtors.

A diagrammatic presentation of factoring is given below:



4. A factor is a financial institution which offers services relating to management and financing of debts arising out of credit sales. It acts as another financial intermediary between the buyer and seller.

5. Unlike a bank, factor specializes in handling and collecting receivables in an efficient manner. Payments are received by the factor directly since the invoices are assigned in favor of the factor.
6. Factor is responsible for sales accounting, debt collection an credit control protection from bad debts, and rendering of advisory services to their clients.
7. Factoring is a tool of receivables management to release funds tied up in credit extended to customers and to solve the problems relating to collection, delays and defaults of the receivables.

14.4 Mechanism of Factoring

Factoring business is generated by credit sales in the normal course of business, the main function of factor is realization of sales. Once the credit transaction takes place, the role of factor step is to realize the sales/collect the receivables. Thus, factor act as a intermediary between the seller and the buyer and sometimes along with the seller's bank together.

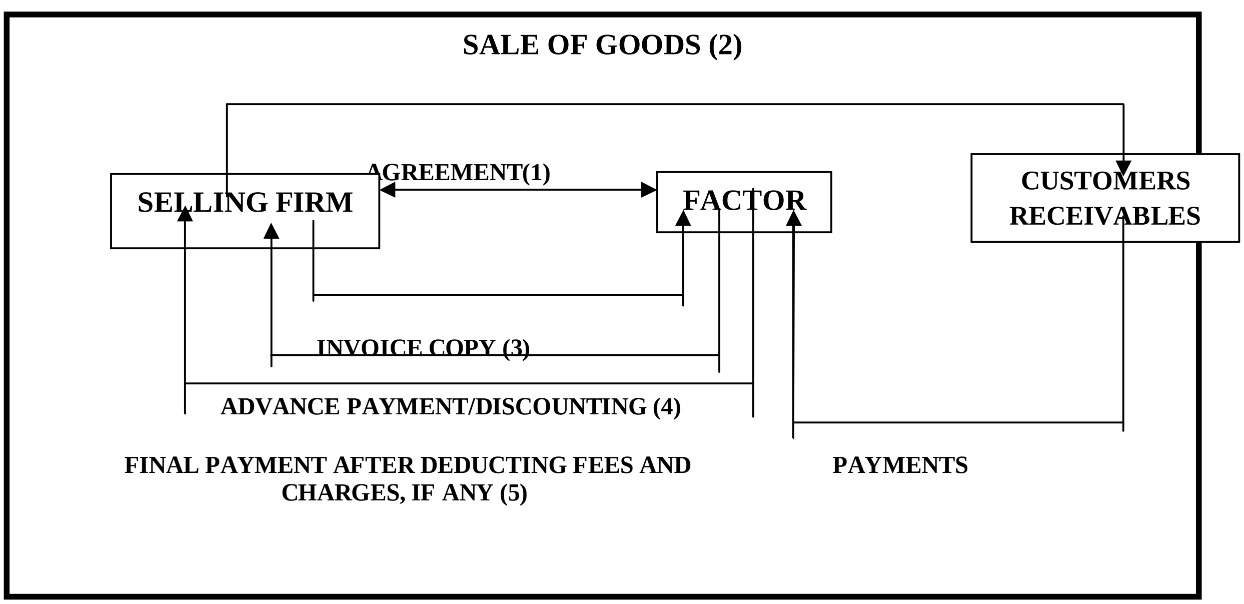
The mechanism of factoring is summed up as below:

(i) An agreement is enters into between the selling firm and the factor firm. The agreement provides the basis and the scope of the understanding reached between the two for rendering factor services.

(ii) The sale documents should contain the instructions to make payments directly to the factor who is assigned the job of collection of receivables.

(iii) When the payment if received by the factor, the account of the selling firm is credited by the factor after deducting its fees, charges, interest etc. as agreed.

(iv) The factor may provide advance finance to the selling firm if the conditions of the agreement so require. The mechanism of factoring has been shown in the following figure:



14.5 Parties to the Factoring

There are basically three parties involved in a factoring transaction:

1. The buyer of the goods.
2. The seller of the goods.
3. The factor, i.e. financial institution.

The three parties interact with each other during the purchase/sale of goods. The possible procedure that may be followed is summarized below:

The Buyer

1. The buyer enters into an agreement with the seller and negotiates the terms and conditions for the purchase of goods on credit.
2. He takes the delivery of goods along with the invoice bill and instructions form the seller to make payment to the factor on due date.
3. Buyer will make the payment to the factor in time or ask for extension of time. In case of default in payment on due date, he faces legal action at the hands of factor.

The Seller

1. The seller enters into contact for the sale of goods on credit as per the purchase order sent by the buyer stating various terms and conditions.
2. Sells goods to the buyer as per the contract.
3. Sends copies of invoice, delivery challan along with the goods to the buyer and gives instructions to the buyer to make payment on due date.
4. The seller sells the receivables received from the buyer to a factor and receives 80% or mare payment in advance.
5. The seller receives the balance payment from the factor after paying the service charges.

The Factor

1. The factor enters into an agreement with the seller for rendering factor services i.e. collection of receivables.
2. The factor pays 80% or more of the amount of receivables/copies of sale documents.
3. The factor receives payment from the buyer on due date dates and pays the balance money to the seller after deducting the service charges.

14.6 Types of Factoring

A number of factoring arrangements are possible depending upon the agreement reached between the selling firm and the factor. The most common feature of practically all the factoring transaction is collection of receivables and administration of sale ledger. However, following are some of the important types of factoring arrangements:

1. **Recourse and Non-recourse Factoring**

   In a recourse factoring arrangement, the factor has recourse to the client (selling firm) if the receivables purchased turn out to be bad, i.e. the risk of bad debts is to be borne by the client and the factor does not assume credit risks associated with the receivables. Thus the factor acts as an agent for collection of bills and does not cover the risk of customer's failure to pay debt for interest on it. The factor has a right to recover the funds from the seller client in case of such defaults as the seller takes the risk of credit and creditworthiness of buyer. The factor charges the selling firm for maintaining the sales ledger and debt collection services and also charges interest on the amount drawn by the client (selling firm) for the period.

   Whereas, in case of non-recourse factoring, the risk or loss on account of non-payment by the customers of the client is t be borne by the factor and he cannot claim this amount from the selling firm. Since the factor bears the risk of non-payment, commission or fees charged for the services in case of non-recourse factoring is higher than under the recourse factoring. The additional fee charged by the factor for bearing the risk of bad debts/non-payment on maturity is called del credere commission.

2. **Advance and Maturity Factoring**

   Under advance factoring arrangement, the factor pays only a certain percentage (between 75% to 90%) of the receivables in advance to the client, the balance being paid on the guaranteed payment date. As soon as factored receivables are approved, the advance amount is made available to the client by the factor. The factor charges discount/interest on the advance payment from the date of such payment to the date of actual collection of receivables by the factor. The rate of discount/interest is determined on the basis of the creditworthiness of the client, volume of sales and prevailing short-term rate. Sometimes, banks also participate in factoring transactions. A bank agrees to provide an advance to the client to finance a part say 50% of the bank (factored receivables ─ advance given by the factor).

   In case of maturity factoring, no advance is paid to client and the payment is made to the client only on collection of receivables or the guaranteed payment data as the case may be agreed between the parties. Thu, maturity factoring consists of the sale of accounts receivables to a factor with no payment of advance funds at the time of sale.

3. **Conventional or Full Factoring**

   Under this system the factor performs almost all services of collection of receivables, maintenance of sales ledger, credit collection, credit control and credit insurance. The factor also fixes up a draw limit based on the bills outstanding maturity-wise and takes the corresponding risk of default or credit risk and the factor will have claims on the debtor as also the client creditor.

   It is also known as Old Line Factoring. Number of other variety of services such as maturity-wise bills collection, maintenance of accounts, advance granting of limits to a limited discounting of invoices on a selective basis are provided. In advanced countries, all these methods are popular but in India only a beginning has been made. Factoring agencies like SBI Factors are doing full factoring for good companies with recourse.

4. **Domestic and Export Factoring**

   The basic difference between the domestic and export factoring is account of the number of parties involved. In the domestic factoring three parties are involved, namely:

   (i) Customer (buyer)

   (ii) Client (seller)

   (iii) Factor (financial intermediary)

   All the three parties reside in the same country. Export factoring is also termed as cross-border/international factoring and is almost similar to domestic factoring except that there are four parties to the factoring transaction. Namely, the exporter (selling firm or client), the importer or the customer, the export factor and the import factor. Since, two factors are involved in the export factoring, it is also called two-factor system of factoring.

   Two factor system results in two separate but inner-related contracts:

   (i) Between the exporter (client) and the export factor.

   (ii) Export factor and import factor.

   The import factor acts as a link between export factor and the importer helps in solving the problem of legal formalities and of lauguage. He also assumes customer trade credit risk, and agrees to collect receivables and transfer funds to the export factoring the currency of the invoice. Export/International factoring provides a non-recourse factoring deal. The exporter has 100% protection against bad debts arising on account of credit sales. To make an agreement the following steps have to take place:

   Step I: The exporter makes an agreement with the export factor and informs in about the goods to be exported to a particular country and a specified importer.

   Step II: The exporter factor will right to the import factor in the importers country to find out details of the importer.

Step III: The exporter delivers goods to the importer with relevant documents. The export receivables are on a non-recourse factoring system.

Step IV: The export factor maintains sales ledger and all documents required for collection of dues from the import factor.

Step V: The import factor on the due date collects the payment from the importer and gives the payment to the export factor as per regulations of the country and currency requirements.

Step VI: The export factor gives the payment to exporters.

5. **Limited Factoring**

   Under limited factoring, the factor discounts only certain invoices on selective basis and converts bills into cash in respect of those bills only.

6. **Selected Seller Based Factoring**

   The seller sells all his accounts receivables to the factor along with invoice delivery challans, contracts, etc. after invoicing the customers. The factor performs all functions of maintaining the accounts, collecting the debts, sending reminders to the buyers and do all consequential and incidental functions for the seller. The sellers are normally approved by the factor before entering into factoring agreement.

7. **Selected Buyer Based Factoring**

   The factor first of all selects the buyers on the basis of their goodwill and creditworthiness and prepared an approved list of them. The approved buyers of a company approach the factor for discounting their purchases of bills receivables drawn in the favour of the company in question (i.e. seller). The factor discounts the bills without recourse to seller makes the payment to the seller.

8. **Disclosed and Undisclosed Factoring**

   In disclosed factoring, the name of the factor is mentioned in the invoice by the supplier telling the buyer to make payment to the factor on due date. However, the supplier may continue to bear the risk of bad debts (i.e. non-payments) without passing to the factor. The factor assumes the risk only under non-recourse factoring agreements. Generally, the factor lays down a limit within which it will work as a non-recourse. Beyond this limit the dealings are done on recourse basis i.e. the seller bears the risk.

   Under undisclosed factoring, the name of the factor is not disclosed in the invoice. But still the control lies with the factor. The factor maintain sales ledger of the seller of goods, provides short-term finance against the sales invoices but the entire transactions take place in the name of the supplier company (seller).

14.7 Functions of a Factor

The purchase of book debts or receivables is central to the function of factoring permitting the factor to provide basic services such as:

1. **Administration of seller's sales ledger.**

   The factor maintains sales ledger in respect of each client. When the sales transaction takes place, an invoice is prepared in duplicate by the client, one copy is given to customer and second copy is given to customer and second copy is sent to the factor. Entries are made in the ledger on open-item method. Each receipt is matched against the specific invoice. On any given date, the customer account indicates the various open invoices outstanding. Periodic reports are sent by factor to the client with respect to current status of receivables and amount reived from customers. Depending upon the volume of transactions, the periodicity of report is decided. Thus, the entire sales ledger administration responsibility of the client gets transferred to the factor. He performs the following functions with regard to the administration of sales ledger:

   (i) He ensures that invoices raised represent genuine trade transactions in respect of goods sold or services provided.

   (ii) He updates the sales ledger with latest invoices raised and cash received.

   (iii) He ensures that monthly statements are sent to debtors, efforts are made to collect the dues on the due date through an efficient mechanism of personal contacts, issuance of reminders, telephone messages, etc.

   (iv) He remits the retention to the clients after collection of the dues. Where the factoring is operating on Fixed Maturity Period (FMP) basis, the factor is to ensure that the client is paid the retention money at the expiry of the said personal.

   (v) He established close links with the client and the customers to resolve the various disputes raised in respect of quantity and quality of the goods/services supplied besides the unauthorized discounts claimed or deducted by the debtors while making payment.

   (vi) He reviews the financial strength of the debtors at periodic intervals to ensure collectability of debts.

   (vii) He submits at periodic intervals reports containing information as to the details of overdue unpaid invoices, disputes, legal cases etc. to the client.

2. **Collection of receivables purchased.**

   The main function of a factor is to collect the receivables in behalf of the client and to relieve him from all the botherations/problems associated with the collection. This way the client can concentrate on other major areas of his business on one hand and reduce the cost of collection by way of savings in labour, time and efforts on the other hand. The factor possesses trained and experienced personnel, sophisticated infrastructure and improved technology which helps him to make timely demands in the debtors to make payments.

3. **Provision of finance.**

   Finance, which is the life blood of a business, is made available easily by the factor to the client. A factor purchases the book debts of his client and debts are assigned in favour of the factor. 75% to 80% of the assigned debts is given as an advance to the client by the factor.

   (a) Where an agreement is entered into between the client (seller) and the factor for the purchase of receivables without recourse, the factor becomes responsible to the seller on the due date of the invoice whether or not the buyer makes the payment to the factor.

   (b) Where the debts are factored with recourse the client has to refund the full finance amount provided by the factor in case the buyer fails to make the payment on due date.

4. **Protection against risk of bad debts/credit control and credit protection.**

   This service is provided where the debts are factored without recourse the factor fixed the credit limits (i.e. the limit up to which the clients can sell goods to customers) in respect of approved customers. Within these limits the factor undertakes to purchase all trade debts and assumes the risk of default in payment by the customers. He factor not only receives the client from the collection work but also advises the client on the creditworthiness of potential customers. Thus the factor helps the client in adopting better credit control policy. The credit standing of the customer of the customer is assessed by the factors on the basis of information collected from credit rating reports, bank reports, trade reference, financial statement analysis and by calculating the important ratio in respect of liquidity and profitability position.

5. **Rendering advisory services by virtue of their experience in financial dealings with customers.**

   These services arise out of the close relationship between a factor and a client. Since the factors have better knowledge and wide experience in field of finance, and possess extensive credit information about customer's standing, they provide various advisory services of the matters relating to:

   (i) Customer's preferences regarding the client's products.

   (ii) Changes in marketing policies/strategies of the competitors.

   (iii) Suggest improvements in the procedures adopted for invoicing, delivery and sales return.

   (iv) Helping the client for raising finance from banks/financial institutions, etc.

   The factor provides his client with a periodical statement in the sanctioned limit, utilized credit and balance outstanding.

14.8 Cost of Services of Factoring

The factor provides various services at some charge in the form of a commission expressed as a value of debt purchased. It is collected in advance. The commission is in the form of interest charged for the period between the date of advance payment and date of collection/guarantee payment date for short term financing as advance part payment. It is also known as discount charge.

The cost of factoring services primarily comprises of the following two components:

1. **Administrative Charges/Factoring fees**

   This is charged towards providing various services to the clients namely (a) sales ledger administration (b) credit control including processing, operational overheads and collection of debts (c) providing protection against bad debts.

   This charge is usually some percent of the projected sales turnover of the client for the next twelve months. It varies between 1 to 2.5 percent of the projected turnover. The quantum of charged depends upon the following factors.

   (a) Type of industry

   (b) Financial strength of the client as well as the debtors

   (c) Volume of sales

   (d) Average invoice trade

   (e) Terms of trade

   (f) Type(s) of service(s) offered

   (g) Required profit margin to the factor

   (h) Extent of competition

   (i) Security to the factor etc.

2. **This is levied towards providing instant credit to the client by way of prepayment.**

   This is normally linked with the base rate of the parent company or the bank from which the factoring institution is borrowing money, say, 1 to 2.5 percent above the said rate.

14.9 Accounting Procedure at Bank

All bills discounted or purchased should be entered in the bills discounted or purchased register in serial order and the serial number is changed annually. Particulars of documents, due date, and other relevant details to be removed legibly.

(1) In realization of the bill, it should be marked off with date of actual realization.

(2) The outstanding items in the bills discounted or purchased register should be reviewed at frequent intervals preferably every Friday, and reminders are to be

sent for the pending bills for clearance. The dates if such reminders are also noted in the remarks column.

(3) The details of the bills returned unpaid should be noted in the “bills returned unpaid register”.

(4) The bills of customers are generally unrealized, therefore there is a need to realize the outstanding liability and to stop the discounting facility given to such customers.

(5) Subsidiary ledger showing party-wise details should be maintained to watch that the bills purchased are within the limit sanctioned.

(6) At periodical intervals, the individual outstanding bills purchased or discounted should be extracted from the register of bills purchased or discounted and tallied with the outstanding in the general ledger.

14.10 Advantages of Factoring

Factoring is becoming popular all over the world on account of various servixes offered by the institutions engaged in it. Factors rendered services ranging from bill discounting facilities offered by the commercial banks to total take over of administration of credit sales including maintenance of sales ledger, collection of accounts receivables, credit control, protection from bad debts, provision of finance and rendering of advisory services to their clients. Thus factoring is a tool of receivables management employed to release the funds tied up in credit extended to customers and to solve problems relating to collection, delays and defaults of the receivables.

A firm that enters into factoring agreement is benefited in a number of ways, some of the important benefits are outlined below:

(1) The factors provides specialized services with regard to sales ledger administration and credit control and relives the client from the botheration of debt collection. He can concentrate on the other major areas of his business and improve his efficiency.

(2) The advance payments made by the factor to the client in respect of the bills purchased increase his liquid resources. He is able to meet his liabilities as and when they arise thus improving his credit standing position before suppliers, lenders and bankers. The factor’s assumption o credit risk relives him from the tension of bad debts losses. The client can take steps to reduce is reserve for bad debts.

(3) It provides flexibility to the company to decide about extending better terms to their clients.

(4) The company itself is in a better position to meet its commitments more promptly due to improved cash flows.

(5) Enables the company to meet seasonal demands for cash whenever required.

(6) Better purchase planning is possible. Availability of cash helps the company to avail cash discounts on its purchase.

(7) As it is an off balance sheet finance, thus it does not affect the financial structure. This would help in boosting the efficiency ratios such as return on asset etc.

(8) Saves the management time and effort in collecting the receivables and in sales ledger management. Where credit information is also provided by the factor, it helps the company to avoid bad debts.

(9) It ensures better management of receivables as factor firm is specialized agency for the same. The factor carries out assessment of the client with regard to his financial, operational and managerial capabilities whether his debts are collectable and viability of his operations. He also assesses the debtor regarding the nature of business, vulnerability of his operations, and assesses the debtor regarding the nature of business, vulnerability of seasonality, history of operations, the term of sales, the track record and bank report available on the past history.

14.11 Limitations of Factoring

The above listed advantages do not mean that the factoring operations are totally free from any limitation. The attendant risk itself is of very high degree. Some of the main limitations of such transactions are listed below:

1. It may lead to over-confidence in the behavior of th client resulting in over-trading or mismanagement.
2. The risk element in factoring gets accentuated due to possible fraudulent acts by the client in furnishing the main instrument “invoice” to the factor. Invoicing against non-existent goods, pre-invoicing, duplicate-invoicing are some commonly found frauds in such operations, which had put many factors into difficulty in late 50’s all over the world.
3. Lack of professionalism and competence, underdeveloped expertise, resistance to change etc. are some of the problems which have made factoring services unpopular.
4. Rights of the factor resulting from purchase of trade debts are uncertain, not as strong as that in bills of exchange and are subject to settlement of discounts, returns and allowances.
5. Small companies with lesser turnover, companies having high concentration on a few debtors, companies with speculative business, companies selling a large number of products of various types to general public or companies having large number of debtors for small amounts etc. may not be suitable for entering into factoring contracts.

14.12 Factoring in India

Banks do provide non-banking financial services such as housing finance, leasing ans hire-purchase, factoring and Forfeiting. An amendment was made in the Banking Regulation Act in 1983, whereby banks were permitted to provide these services either though their own departments or divisions or through their subsidiaries. Direct and indirect lending services were provided by setting up merchant banking and mutual funds subsidiaries. Factoring and forfeiting service were of recent origin following the recommendation of the Kalyansundarm Committee, set up by the RBI in 1988.

The committee was constituted to examine the feasibility of factoring services in India, their constitution, organizational setup and scope of activities. The group recommended setting up of specialized agencies or subsidiaries for providing the factoring services in India.

The first factoring company was started by the SBI in 1991 namely Factors and Commercial Ltd. (SBI FACS) followed by Canara Bank and PNB, setting the subsidiaries for the purpose. While the SBI would provide such services in the Western region, the RBI has permitted the Canara Bank and PNB to concentrate on the Southern and Northern regions of the country, for providing such services for the customers. The major players since 1991 are Canbank Factors, SBI Factors and later Foremost Factors. The new entrants in the market include ICICI, HSBC and Global Trade Finance. Canbank Factors lead in the domestic market with about 65%-70% of the market share. The first service in the private sector was started in 1992 with the inception of Fiar Growth Factor Ltd. This service was started in April 1991 by them. The following legal implications should be considered:

- **Approval:** The business of factoring can be started in India by RBI's approval. Banks can undertake indirect participants of factoring services with the approval of RBI by investing in shares of other factoring companies. Banks can open subsidiaries for carrying out factoring business individually or jointly with other banks if they get approval from RBI for this business.
- **Genuine transaction:** The factoring contract can arise only out og genuine business transactions between the buyer and the seller.
- **Compensation:** The factor receives a commission as compensation for his services. He also has the right to receive all expenses in connection with the factoring work that he undertakes.
- **Agreement:** It is sale purchase agreement governed by the law of contracts. The time framework and mode of termination are provided in the agreement.
- **Purchase:** The buyer has obligation of making the payment to the factor. The factor has legal status of an assignee. He has to receive the payment and then remit the same to his client. The factoring agreement has to give in detail the mode and date of payment.

The Vaghul Committee Report on Money Market reforms has stressed on the need for factoring services to be developed in India as part of the money market instruments. Many new instruments had already been introduced like Commercial Paper (CP), Participation Certificates (PC), Certificates of Deposits etc. but the factoring service has not developed to may significant extent in India.

14.13 The RBI Guidelines for Factoring

The Reserve Bank of India (RBI), in the light of the recommendations of the expert group headed by C.S. Kalyansunderam, issued the following guidelines in 1988 for banking companies o start factoring services:

1. Banks shall not undertake directly the factoring business. While banks may invest in shares of other factoring companies, they shall not act as promoters of such companies. Banks may set up separate subsidiaries or invest in factoring companies jointly with other banks with the approval of RBI.
2. A factoring company may undertake factoring business and such other activities as are incidental thereto.
3. Investment of a bank in the shares of factoring companies inclusive of its subsidiaries carrying factoring business should not in aggregate exceed 10 percent of te paid-up capital and reserves of the bank.
4. Banks or their subsidiaries undertaking factoring business are required to furnish the required information to RBI periodically.

14.14 Forfeiting

The forfeiting owes its origin to a French term a ‘forfait’ which means to forfeit (or surrender) one’s right on something to someone else. Forfeiting is a mechanism of financing exports:

(a) By discounting export receivables.

(b) Evidence by bills of exchanges or promissory notes

(c) Without recourse to the seller (viz., exporter)

(d) Carrying medium to long-term maturities

(e) On a fixed rate basis upto 100% of the contract value.

In other words, it is trade finance extended by a forfeiter to an exporter/seller for an export/sale transaction involving deferred payment over a long term at a firm rate of discount. Forfeiting is generally extended for export of capital goods, commodities and services where the importer insists on supplies on credit terms. Recourse to forfeiting usually takes place where the credit if for long date maturities and there is no probation for extending the facility where the credits are maturing in period less than one year.

14.15 Mechanism of Forfeiting

1. The exporter and importer negotiate proposed export sale contract. Then the exporter approaches the forfeiter to ascertain the terms of forfeiting.
2. The forfeiter collects details about the importer, supply and credit terms, documentation etc.
3. Forfeiter ascertains the country risk and credit risk involved.
4. The forfeiter quotes the discount rate.

5. The exporter then quotes a contract price to the overseas buyer by loading the discount rate, commitment fee etc. on the sale price of the goods to be exported.
6. The exporter and forfeiter sign a contract.
7. Export takes place against documents guaranteed by the importer's bank.
8. The exporter discounts the bill with the forfeiter and the latter presents the same to the importer for payment on due date or even sell it in secondary market.

14.16 Documentation

1. Forfeiting transaction is usually either by a promissory note or bills of exchange.
2. Transactions are guaranteed by a bank.
3. Bills of exchange may be 'availed by' the importer's bank. 'Aval' is an endorsement made on bills of exchange or promissory note by the guaranteeing bank by writing 'per aval' on these documents under proper authentication.

14.17 Costs of Forfeiting

The forfeiting transaction has typically three cost elements:

(a) Commitment fee, payable by the exporter to the forfeiter 'for latter's' commitment to execute a specific forfeiting transaction at a firm discount rate with in a specified time.

(b) Discount fee, interest payable by the exporter for the entire period of credit involved and deducted by the forfeiter from the amount paid to the exporter against the promissory notes or bills of exchange.

(c) Documentation fee.

14.18 Benefits of Forfeiting

Forfeiting helps the exporter in the following ways:

(1) It frees the exporter from political or commercial risks from abroad.

(2) Forfeiting offers 'without recourse' finance to an exporter. It does not affect the exporter's borrowing limits/capacity.

(3) Forfeiting relives the exporter from botheration of credit administration and collection problems.

(4) Forfeiting is specific to a transaction. It does not require long term banking relationship with forfeiter.

(5) Exporter saves money on insurance costs because forfeiting eliminates the need for export credit insurance.

(6) There is no international risk to the exporter due to foreign exchange fluctuations during the period between the date of insurance and the maturity date of the paper.

(7) Exporters are able to overcome any problem due to financial requirements.

14.19 Forfeiting Contract

The following terms and conditions are required for making a forfeiting contract:

- **Agreement:** A forfeiting agreement is between the exporter and importer. They have to draw up the terms and conditions in the form of a commercial contract. The agreement is without recourse.
- **Finance:** A forfeiter provides 100% financing arrangement of the receivables.
- **Time Period:** A forfeiter finances through promissory notes and bills for a deferred credit period of 3-5 years.
- **Risk:** The forfeiter charges of premium for covering the entire risk of international contract.
- **Premium:** The forfeiter charges of premium for covering the entire risk of international contract.
- **Contract:** The forfeiter and the exporter enter into a contract. Usually the forfeiter is a bank.
- **Payment:** the forfeiter receives the payment from the exporter on the face value of the promissory note of bill of exchange after deducting the discount. The forfeiter can hold the bills or promissory notes till the maturity of the amount and receive the payment from the importer banks. He can also securitize the bills and sell them in the secondary market as short term unsecured loan with a high yield.

In India, exporters have been allowed to enter into forfeiting contracts since 1992. The contract is without recourse. It is used as post shipment finance for export deals.

14.20 Forfeiting v/s. Factoring

Similarities:

Forfeiting is similar to the export/international/cross border factoring to the extent both have common features of:

1. Non-recourse dealing
2. Advance payment

Dissimilarities:

But the two differ from each other in the following aspects:

Factoring	Forfeiting
1. Factoring refers to domestic bill-purchase and discount.	1. Forfeiting refers to discounting of foreign bill in respect of international trade.
2. For ongoing open account sales, no letter of credit or exchange is required.	2. Letter of credit or bank guarantee is required even for a single transaction.
3. A factor finances 75-80% of the account receivables and retains the balance as a reserve till the actual payment is made on the date of maturity.	3. A forfeiter discounts the entire value of the bills. The implication is that 100% finance is made available to the exporter.
4. Factoring may be with or without recourse. Services for credit collection and administration may be provided without financing.	4. Forfeiting is a pure financing arrangement and is always without recourse.
5. Short term transactions involving credit period up to 180 days are handled.	5. Financing for medium to long-term credit periods (180 days up to 7 years) is provided but short-term credit (30-180 days) facilities are also made available.
6. It is a continuous arrangement. All sales are routed by client through factor.	6. Deals are concluded transaction-wise.
7. Responsibility for collection is accepted by factor, which helps the client to reduce his own overheads.	7. Collection of forfeited debt only.
8. Charges are applied for financing, collection, sales administration, credit protection provision of information.	8. Single discount charge is made depending on: Guaranteeing bank and country risk, credit period involved, current of debt and additional charges made during delivery period (if any)
9. Application to both domestic and export receivables.	9. Available usually for export receivables in any freely convertible currency.
10. No restriction on minimum size of transaction.	10. Minimum value of US$ 250.00 per transaction.
11. Factor assists in completing import formalities and provides consultancy services.	11. Forfeiter will accept only clean documentation to conform to all regulations in the importer's country.

14.21 Problem Areas in Forfeiting and Factoring

Some of the problems faced by the factoring and Forfeiting where legal legislation is required are as follows:

1. There is, presently, no legal framework to protect the banker or forfeiter except the existing covers for the risk involved in foreign transactions.
2. Data available on credit rating agencies or importer or foreign country is not sufficient. Even EXIM bank does not cover high risk countries like Nigeria.
3. High country and political risk dissuade the services of factoring and banking to many clients.
4. Government agencies and public sector undertakings (PSUs) neither promptly make payments not pay interest on delayed payments.
5. The assignment of book debts attracts heavy stamp duty and this has to be waived.
6. Legislation is required to make assignment under factoring have priority over other assignment.
7. There should be some provisions in law to exempt factoring organization from the provisions of money lending legislations.
8. The order 37 of the Civil procedure code should be amended to clarify that factor debts can be recovered by restoring o summary procedures.

Thus, the legal framework governing the transactions of factoring business is not adequate to make the functioning simple, inexpensive and attractive in the market. In order to ensure that the functioning of a factor is with ease and confidence the legal framework should:

(a) Define the rights, liabilities, duties and obligations of the parties involved, in a clear and comprehensive manner, so that the parties can plan their affairs with certainty, and

(b) Be supportive of the transactions and procedures involved, so that they may be undertaken and completed simply and inexpensively.

In short, areas like ‘assignment’, ‘stamp duty’, ‘priorities of factoring assignment’, ‘liabilities of the debtor’, ‘obligations of banks’, ‘realization of debts through simple legal process’ etc. require focused attention. A draft bill on the factoring of debts due to industrial and commercial undertakings has been prepared which awaits clearance by the Government of India. Once this bill is passed majority of the constraints will be eliminated.

14.22 Summary

Factoring refers to credit sales sold by a firm to a specialized agency called a factor. The factor is responsible for financing, maintenance of accounts and collection of receivables within a country. When the financing of receivables arise out of international trade, it is called factoring. In factoring three parties are involved ─ the seller, the buyer and the intermediary. Whereas in Forfeiting, four parties are involved ─ the exporter, the exporter's factor, the importer and the importer's factor. The factoring can be with recourse or without recourse, but Forfeiting is a service without recourse, but still this service is not very popular as the factor has to bear all the losses of the seller. Hence, to develop and flourish this financial service a strong base of financial institutions and network has to be established.

14.23 Self Assessment Questions

1. Define the term 'Factoring'. What are the different types of factoring arrangement? Explain in default.
2. What is the impact of factoring transaction on Balance Sheet? Discuss with the help of an example.
3. What are the functions performed by a factor? Also state the benefits of factoring to different parties.
4. Distinguish between Factoring and Forfeiting also discuss the problem areas in factoring and Forfeiting.
5. State the mechanism involved in a factoring transaction. What steps are taken by the buyer, the seller and the factor to complete a factoring transaction?

14.25 Reference Books

- C.S. Kalyansundaram Committee Report (1988), RBI.
- Chandra, Prasanna (2004), Financial Management: Theory and Practice, Tata McGraw Hill, New Delhi.
- Shekhar, K.C. (1986), Banks, Theory and Practice, Vikas Publishing House, New Delhi.
- Rajesh Kothari (2010), Financial Services in India, Sage Publications, New Delhi.
- Preeti Singh (2009), Dynamics of Indian Financial System, Ane Books Pvt. Limited, New Delhi.
- Brealy, R.A. and S.C. Myers (2002), Principles of Corporate Finance, Tata McGraw Hill, New York.

Unit – 15 : Leasing and Hire-Purchase

Structure of Unit

15.0 Objectives

After Completing this unit you would be able to:

- Understand the concept and nature of leasing
- Know about the elements of leasing
- Know about the various types of leasing
- Differentiate between financial & operating Leasing
- Learn the Advantages of leasing
- Point out the risk involved in leasing
- Differentiate between Leasing & Hire-Purchase

15.1 Concept of Leasing

To initiate every business one needs assets. Investment in capital assets needs huge funds. There are different ways to avoid the heavy investment in capital assets, one way is to get it on lease and other is through hire purchase system. Leasing may be defined as "a method of attaining right to use any asset as per the leasing agreement". A contract of lease is entered for this purpose. Lease can be defined as "a contract between owner of an asset (lessor) and the user of the asset (lessee), under which the lessor give the right to lessee to use the asset for the agreed period of time and consideration called "lease rental".

The transfer of property act defines "a lease as a transaction in which a party owing the asset provides the asset for use, over a certain period of time, to another for consideration in the form of periodic rent". International Accounting Standard 17 (IAS-17), on lease defines, "a lease as an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time".

The Institute of Chartered Accountants of India issued AS 19, dealing with accounting for leases. The standard is mandatory in respect of all assets leased during the accounting periods commencing on or after 1.4.2001. The objective of this accounting standard is to provide, for lessee and lessor, the appropriate accounting policies and disclosures in relation to finance leases. Leasing is suitable for financing most of the capital or fixed asset such as agricultural equipments, construction equipments, machinery, aircraft, High value software etc. As per sale of goods act, "a sale means transfer of property in goods." A lease, on the other hand, is merely a transfer of the right to use the goods and is therefore not a sale.

15.2 Nature of Leasing

1. **The long term financial source: -** Leasing is an important source of long term finance of corporate entities. It is an arrangement under which the company acquires the right to use the property as per the agreement without holding the title of the property.
2. **A written agreement: -** A lease is an agreement allowing the economic use of the asset in a stipulated period of time. This agreement is signed by both the owner of the property known as the lessor and the user of the property known as the lessee.
3. **Title of goods: -**The lessor permits the lessee to use the asset for the specific payment under specified duration. However, the tile remains with the lessor or the owner of the property.
4. **Specific duration: -**The lessee agreement always contains an option of the Lease duration and need to be filled mandatorily by both the parties. It also contains a provision of the renewal of the lease or the purchase of the asset at the expiration of the lease period.
5. **Analogous nature: -**A lease is always analogous in nature because it is always different to any other financial claim issued by the company. Under lease the payment are fixed and contractual and is functional equivalent to the financial debt taken by any organization.
6. **Financial decision: -**In exchange for the use of any asset the company can issue a claim against its future cash flows, long term debt equity or any other lease obligations. In this way, we can say that lease is strictly a financial decision.
7. **Right to use property: -**Leasing always represents as an alternative to the ownership. It always transfers the right to use the property but not the title of the ownership.

15.3 Elements of Leasing

1. **Lessor:-**The owner of the asset or the equipment to be used for consideration is known as lessor.

2. **Lessee:-**The party who gets the exclusive rights to use the asset usually for an agreed period of time in return for the payment of rent is known as Lessee.

3. **Manufacturer or supplier:-**Manufacturer or the suppliers are usually the producer of the asset or equipments.

15.4 Lease Structure

This chart explains the lease structure in simple way:-

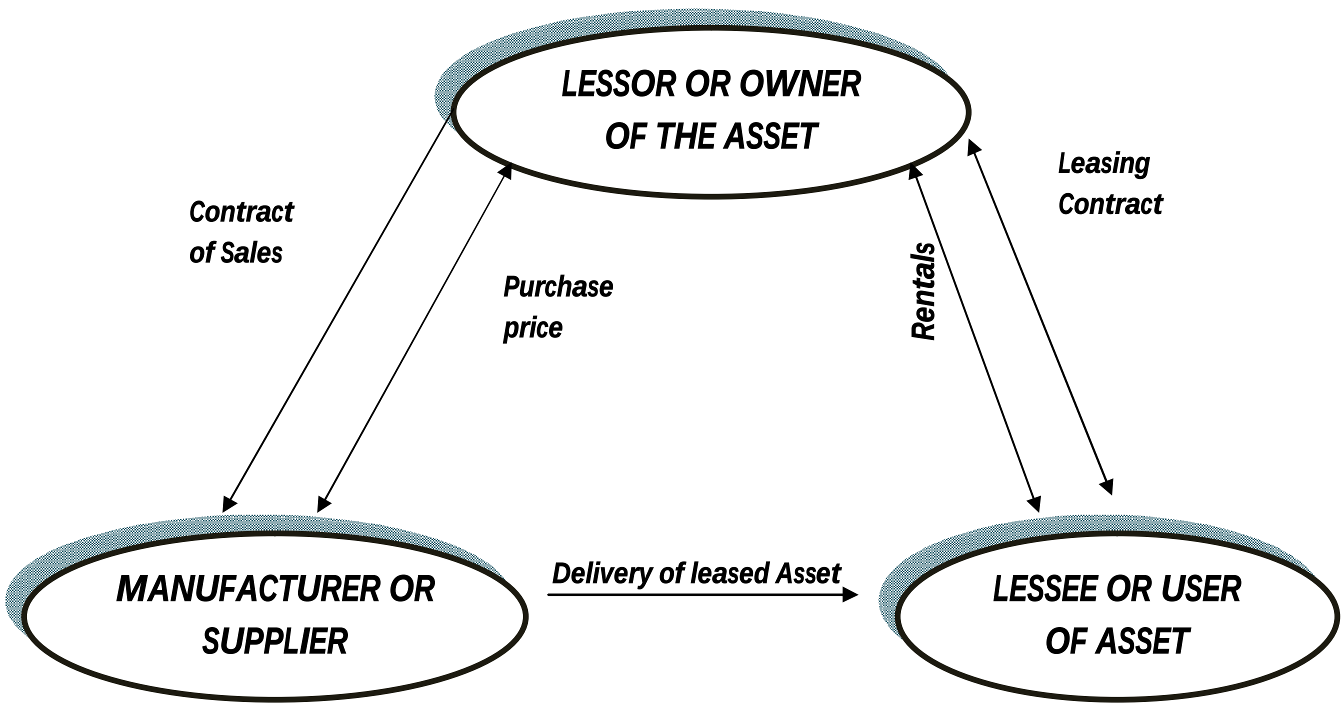


Figure 15.1 The Leasing Process.

The most important steps involved in any leasing transaction are as follow:-

- Initially, the lessee has to tale decision about the asset required by him and the lessor of that equipment or asset in the market.
- Secondly, the lessee then enters into a lease agreement with lessor. He specifies to him his requirements. The leasing agreement determines the obligation of lessee as well as of lessor in the following way:-

❖ The basic period of lease during which lease is binding.
❖ The time and amount of periodical rental to be paid.
❖ Renewal option details need to be mentioned.
❖ Details regarding maintenance, taxes, repairs and insurance charges, to be made during the lease period. If the Lessee pays all the cost, it is called as “net lease agreement”. However, if it is paid by lessor then it is known as “Maintenance lease agreement”.

- As the lease agreement is signed, the lessor contacts the manufacturer to supply the asset to the lessee and makes the payment to the manufacturer as it has been delivered and accepted by the lessee.

15.5 Types of Leasing

A chart showing the classification of types of leasing is as follow:-

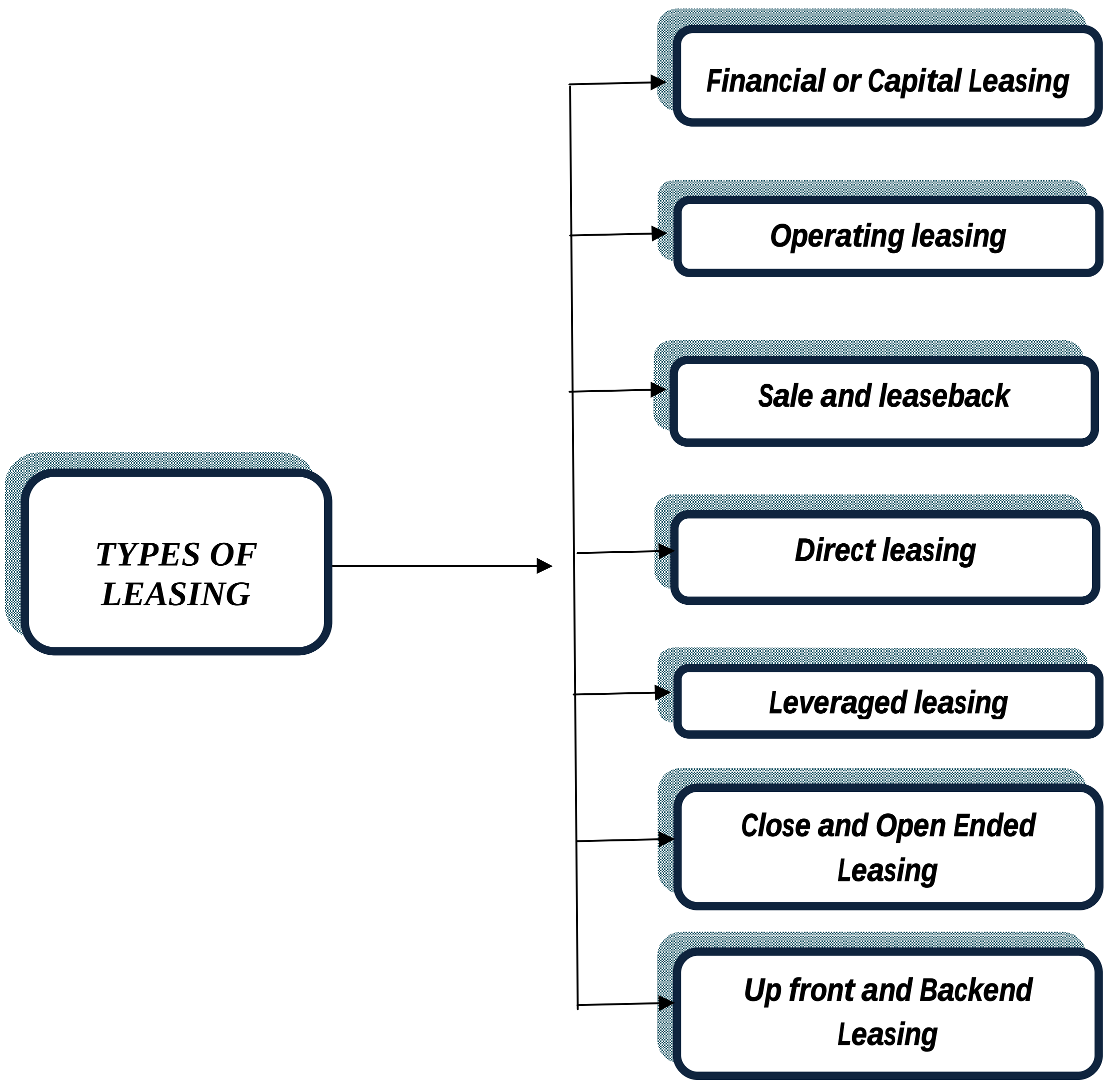


Figure 15.2 Types of Leasing

According to Indian Accounting Standard (AS-19), a lease can be broadly classified into only two groups: - Financial Leasing or capital leasing and Operating Leasing. However, it has various other types in modern era, Such as-Sales and leaseback, Leveraged leasing, direct leasing, Closed and Open ended lease and upfront and back-end lease. As discussed already there is two more type of leasing as per modern terminology (i.e. net leasing and Maintenance leasing). If the Lessee pays all the cost, it is called as “net leasing”. However, if it is paid by lessor then it is known as “Maintenance leasing”.

15.6 Financial Leasing

A long term and irrevocable lease is known as financial lease. It is also known as capital lease because of its long durational capital nature. The time duration of this lease is equals to the economic life of the equipment or the asset. The basic condition of this lease is that it contains a condition to transfer the property or the title of the asset at the end of the lease agreement at very nominal rate. Under this lease the lessor retrieves the 90% of the value of the asset from its rental value and as the lessee bears all the maintenances and insurance charges, so, he gets all the benefits arising from the equipment. The lease period is approximately the 80% of the economic life of the asset. Therefore, we can say that only the title remains with the lessor.

The basic features of the financial leasing are as following:-

- The entire risk and the benefits arising from the asset are transferred to lessee except the title of the asset.
- Lessor transfers the ownership at the end of the lease duration.
- Lessee carries the right to purchase the asset at very nominal rates at the end of the lease duration.
- Lease term covers the major part of the assets economic life.
- The lessee can renew the lease for the secondary period at a rent which is lower than market rent.

15.7 Operating Leasing

A lease can be classified as the operating lease if it does not transfer substantially all the risk and rewards related to the ownership. As per AS-19 and IAS-17 operating lease is defined as a lease other than the financial lease. A lease will be treated as an operating lease if it does not transfer particularly all the risk and reward incident to ownership. An operating lease stands in contrast to the financial lease in almost all aspects. This lease agreement gives to the lessee only a limited right to use the asset. The lessor is responsible for the upkeep, insurance and maintenance of the asset. The lessee is not given any uplift to purchase the asset at the end of the lease period. Normally the lease is for a short period and even otherwise is revocable at a short notice.

Another characteristic of operating lease is that the cost of the asset is not fully amortized. The lease period is short; the lessor will recover the cost of asset from multiple leases.

Mines, Computers hardware, trucks and automobiles are found suitable for operating lease because the rate of obsolescence is very high in this kind of assets.

Now, these are the two basic and the most common type of the leasing running into the market. The difference between the financial and the operating lease are as following:-

Table 15.1 Difference between Financial and Operating Leasing .

Point of Difference	Financial Leasing	Operating leasing
Example	**Leasing a machine**	**Renting an auto**
Time Period	Financial lease is generally for whole useful life of the asset.	Operating lease is for shorter duration only.
Nature	Financial lease is irrevocable in nature.	Operating lease is revocable in nature.
Cost Bearer	Under financial lease, all the cost related to the maintenance and insure or taxes are borne by the lessee.	Under Operating lease, the entire cost bearer is the Leaser.
Buy option	The financial lease provides the option to purchase the asset at the end of the lease contract.	An operating lease doesn't provide any such option to buy the asset.
Original Cost	Original Cost of asset is fully amortized.	Original Cost of asset is not fully amortized.
Risk Bearer	Lessee is the risk bearer in case of obsolescence.	Leaser is the risk bearer in case of obsolescence.
Cancellation	Financial lease is non-cancellable contract.	In Operating lease, the agreement is cancellable at the option of either owner or user of asset gives a notice.

15.8 Sales and Lease Back

Under this, the owner of an asset sells the asset to a party (the buyer), who in turn leases back the same asset to the owner in consideration of lease rentals. However, under this arrangement, the assets are not physically exchanged but it all happens in records only. This is nothing but a paper transaction.

Sale and lease back transaction is suitable for those assets, which are not subjected to depreciation but appreciation, say land. The advantage of this method is that the lessee can satisfy himself completely regarding the quality of the asset and after back transaction can be expressed with the help of the following figure:-

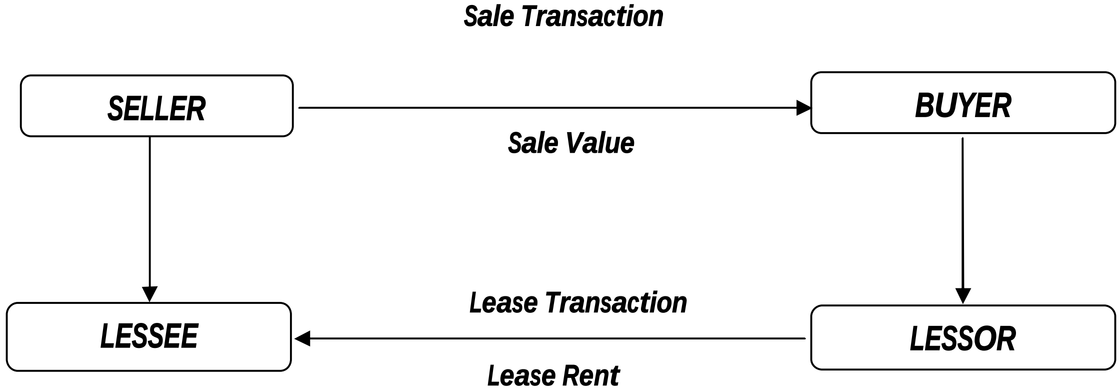


Figure15.3 : - Sales and Lease Back Transaction.

Real estate sector commonly practices the sale and lease back transaction. Insurance companies and financial companies usually purchases the property from a business concern and then plays the role of the lessor for leasing it back to the company (lessee).

Direct Leasing: Under direct leasing, a firm acquires the right to use an asset from the manufacturer directly. The ownership of the asset leased out remains with the manufacturer itself. The finance companies and independent lease companies usually enters into the business of acquiring property for their clients who are in need of certain assets for their business purposes. The major types of direct lessor include manufacturers, finance companies, independent lease companies, special purpose leasing companies etc.

Leveraged Leasing: Under leveraged leasing agreement, a third party is involved beside lessor and lessee. The lessor borrows a part of the purchase price (say 70%) of the asset from the third party i.e., lender and the asset so purchased is held as security against the loan. The lender is paid off from the lease rentals directly by the lessee and the surplus after meeting the claims of the lender goes to the lessor. The lessor, the owner of the asset is entitled to depreciation allowance associated with the asset.

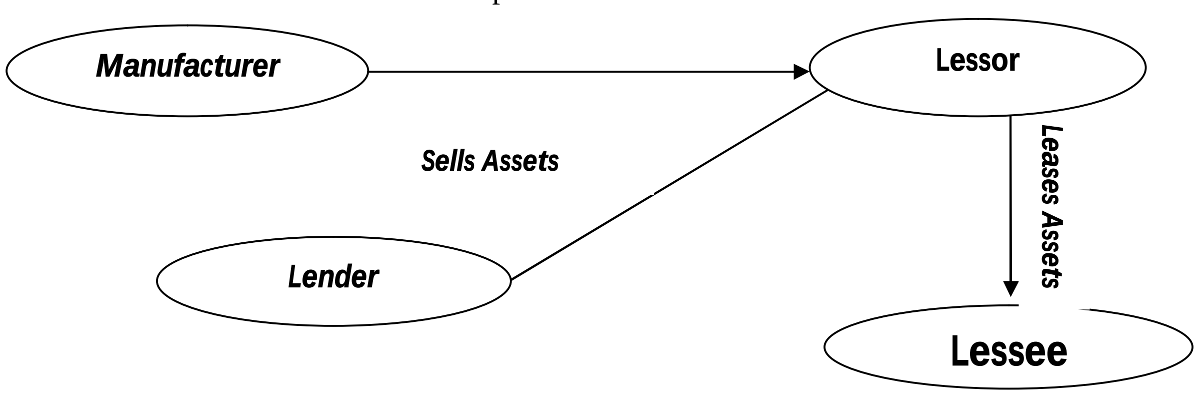


Figure 15.4:- Leveraged Leasing

Close and Open Ended Leasing: In close ended lease, the asset gets transferred to the lessor, at the end of the agreement. However, in open ended lease, the lessee has the option of purchase the title of the asset.

Upfront and Backend Leasing: In upfront leasing, higher rentals are charged in the initial years and lower in the later year of the contract. Whereas in the back-end leasing, in the initial years the rentals are lower than the later years.

15.9 Advantages of Leasing

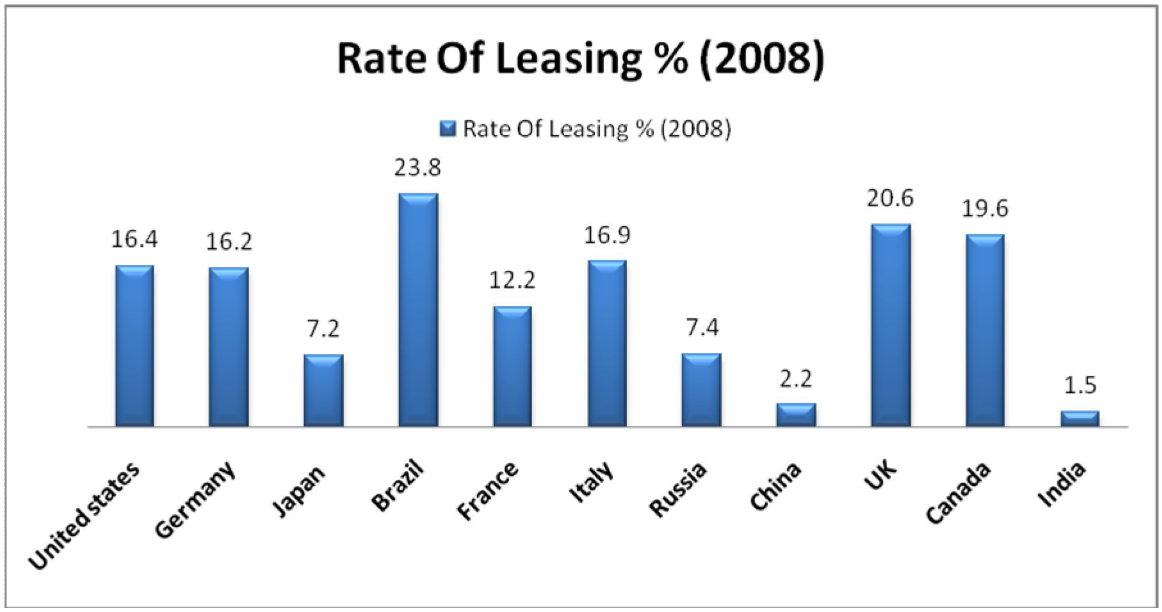
Now-a-days leasing is considered as a major source of corporate financing. The tendency of acquiring assets on lease is very common practice among the business concerns. Leasing is one of the most popular financing options due to the following advantages: -

1. **Avoidance to the risk of the ownership: -** One of the main reasons to acquire asset on lease is that the lease offers the advantage of placing the risk of ownership to the shoulders of the owner or the lessor itself.
2. **Aversion of the investment outlay: -**Leasing enables the lessee to make full use of the asset without making the immediate payment of that asset. Firms experiencing the scarcity of the funds can gain asset more quickly under leasing than in buying.
3. **Tax Saving option: -** Under lease financing, the lessor gets the benefits of tax depreciation. Lease rentals are considered as the operating cost, which means that it is possible to deduct them from taxable profit. As lease rental are fully tax deductable, the cost of the asset is written off in the lessee's book over the lease duration. Leasing always permits a more rapid amortization of any asset or equipment.
4. **No financial restrictions: -**Leasing agreement rarely includes any provision that restricts the usage of the leased equipment due to the future financial obligations. However, in loan agreement it is very common to include financial restriction on the usage of the equipment or for the additional funds borrowings without the lender's permission.
5. **Safety against the risk of obsolescence: -** In the rapid technologically changing era, its necessary to be updated with the new equipments. In this view, if the lessee is acquiring the existing equipments under the short term lease or under the substitution provision of leasing then he may save himself against the risk of obsolescence.
6. **Convenience: -** Lease agreement is always treated as one of the most convenient form of financing than debt financing as it saves the firms from a number of restrictive terms and conditions which are mentioned in the debt financing.
7. **Strong financial position: -**Leasing is said to be useful to the lessee firm in so far as it strengthen its borrowing capacity and thereby permits the firm to raise the debt capital than direct borrowings, given the firm's existing equity base. Since the obligations created under the leasing agreement does not appear as debt on the balance sheet, the firms borrowing power remains same and the lender may extend more credit to such firm even after lease is signed.
8. **Easy to test and compare: -** In case if the lessee is not sure that whether he requires any particular equipment or not then, he may lease it on very short term

basis. It will provide him opportunity to evaluate the items utility to his business concern without doing any specific investment. In this way, the lease provides him the better chance to test and compare different brands and models of any equipment taken on lease.

15.10 Leasing in India

The market for simple finance leases may slow down further with the impending introduction of new Direct Tax Code and would get limited to special situations where the lessor has a need to resort to leasing as a structure to better secure his ownership rights on the equipment as compared to debt financing or hire-purchase transactions. However, we firmly believe that strong customer demand drivers for operating leases are falling in place in several business segments, which are likely to result in high annual growth rates of 25-30% over the next five years.



Source: Global Leasing Yearbook, 2008.

Leasing of construction equipment is expected to rise with introduction of large ticket size sophisticated equipments from International markets and significant demand for capital investments across all infrastructure sectors. Leasing of information technology and office equipment are expected to be driven by high pace of technological obsolescence, trend towards outsourcing of non-core assets and rise in MNC culture of operating on an asset light model. Medical Equipments is another segment where leasing is expected to pick up significantly, driven by introduction of equipments with rapidly changing technology from international manufacturers and emergence of corporate hospital chains. As the changes in the taxation laws and regulations kick in over the next 12-24 months, we may even witness a higher growth rate for the leasing industry which has already found a strong business case in the emerging economic scenario.

Leasing has grown by leaps and bounds in the eighties but it is estimated that hardly 1.5% of the industrial investment in India is covered by the lease finance, as against

16.40% in USA and 20.60% in UK and 7.20% in Japan (Excluding Real estate and consumer asset financing) in 2008. The prospects of leasing in India are good due to growing investment needs and scarcity of funds with public financial institutions. This type of lease finances is particularly suitable in India where a large number of small companies have emerged more recently. Leasing in the sphere of land and building has been in existence in India for a long time, while equipment leasing has become very common in the recent times.

15.11 Risk Involved in Leasing

The risk of default over the long duration is the major risk in lease financing. The lessor is responsible for defects in the goods even though the goods were bought at the insistence of the lessee (Please see decided Case A below).

Other Risks:

1. For leases structured with high residual value such that at the end of the lease period, the asset may not be able to realise the full residual value and the lessee may not have the financial means to honour the residual value to the lessor.

2. Quality of the asset (including the risk of obsolescence) which can affect its cash-flow generating ability and realisation of the residual value at the end of the lease period.

3. Failure of the asset to generate the cash-flow originally expected due to lack of demand for output produced by the asset.

15.12 Concept of Hire-Purchase

Hire-purchase is a system of acquiring goods on credit whereby the seller of the goods is regarded as the dealer; the purchaser is regarded as the hirer and the financier as the owner. The ownership of the goods bought on hire-purchase does not pass to the hirer at the time of the hire-purchase agreement or upon delivery of the goods. The ownership of the goods remains in the financier until the hirer has fully settled the price agreed upon in the hire-purchase agreement.

Hire-purchase is commonly carried out in the form of a triangular transaction. The dealer/seller/vendor sells the goods to the financier (usually finance or credit company), which becomes the owner, in return for an immediate payment, which is the cash price less deposit paid by the buyer/consumer, known as the hirer. The owner then hires the goods to the hirer under a hire-purchase agreement.

Hire purchase is a type of instalment credit under which the hire purchaser, called the hirer, agrees to take the goods on hire at a stated rental, which is inclusive of the repayment of principal as well as interest, with an option to purchase. Under this transaction, the hire purchaser acquires the property (goods) immediately on signing the hire purchase agreement but the ownership or title of the same is transferred only when the last instalment is paid. The hire purchase system is regulated by the Hire Purchase Act 1972. This Act defines a hire purchase as "an agreement under which goods are let on hire and under which the hirer has an option to purchase them in accordance with the terms of the agreement and includes an agreement under which:

1) The owner delivers possession of goods thereof to a person on condition that such person pays the agreed amount in periodic instalments.

2) The property in the goods is to pass to such person on the payment of the last of such instalments, and

3) Such person has a right to terminate the agreement at any time before the property so passes".

Hire purchase should be distinguished from instalment sale wherein property passes to the purchaser with the payment of the first instalment. But in case of Hire Purchase (ownership remains with the seller until the last instalment is paid) buyer gets ownership after paying the last instalment.

15.13 Difference between Leasing & Hire Purchase

BASIS	LEASE FINANCING	HIRE PURCHASE
Meaning	A lease transaction is a commercial arrangement, whereby an equipment owner or manufacturer conveys to the equipment user the right to use the equipment in return for a rental.	Hire purchase is a type of instalment credit under which the hire purchaser agrees to take the goods on hire at a stated rental, which is inclusive of the repayment of principal as well as interest, with an option to purchase.
Option to user	No option is provided to the lessee (user) to purchase the goods.	Option is provided to the hirer (user).
Nature of expenditure	Lease rentals paid by the lessee are entirely revenue expenditure of the lessee.	Only interest element included in the HP instalments is revenue expenditure by nature.
Components	Lease rentals comprise of 2 elements (1) finance charge and (2) capital recovery.	HP instalments comprise of 3 elements (1) normal trading profit (2) finance charge and (3) recovery of cost of goods/assets.

15.14 Role of Government Enterprises in Hire-Purchasing

Small scale firms can acquire industrial machinery, office equipment, vehicles, etc., without making full payment through hire purchase. With the help of assets acquired through hire purchase they can produce and sell. From the earning payments can easily be made in instalments. Ultimately the ownership of assets can be acquired. Now several agencies like National Small Industries Corporation (NSIC) provide machinery and equipment to small scale units on hire purchase basis and on lease basis. NSIC follows the following Hire Purchase procedure and Hire Purchase Scheme for financing plant and machinery to small scale units.

Case A

LIABILITY OF THE LESSOR ON A DEFECTIVE BOOK PRINTING MACHINE HAVING BEEN LEASED OUT:

This case is significant as it holds the lessor responsible for defects in goods, even where it is apparent that the goods were bought at the instance of the lessee. In this case, at the request of the respondents (LESSEE), the appellant (LESSOR) purchased a book printing machine and leased it to them for a term of 40 months for the total rental of Rs 80000/- payable in the sum of Rs 2000/- per month. At the expiration or sooner determination of the lease the appellant as the owner was entitled to take back the machine and dispose of it. Two days after installation in the respondents' premises the machine broke down. It became defective thereafter in spite of constant servicing, repairs and replacement of parts by the supplier at the request of the respondents and with the knowledge of the appellant. As a result, the respondents' business was adversely affected, resulting in losses. The respondents stopped paying the monthly instalments. The appellant exercised its right under the agreement and took custody of the machine. The appellant brought an action and claimed the total rental as specified in the agreement less that already paid. The Judge of the District Court gave judgment for two months' arrears of rental and the appeal of the appellant was dismissed in the High Court. The appellant appealed to the High Court.

Held, dismissing the appeal:

(1) in the circumstances, there was more than sufficient ground for the appellant to have taken action against the suppliers for damages and the respondents were not obliged to continue paying the total specified rental;

(2) the appellant had also committed a breach of the agreement in failing to dispose of the machine by means of a bona fide sale according to the stipulation therein.

15.15 Summary

Leasing may be defined as “a method of attaining right to use any asset as per the leasing agreement”. A contract of lease is entered for this purpose. Lease can be defined as “a contract between owner of an asset (lessor) and the user of the asset (lessee), under which the lessor give the right to lessee to use the asset for the agreed period of time and consideration called “lease rental”. Lease can be broadly classified into only two groups: - Financial Leasing or capital leasing and Operating Leasing. However, it has various other types in modern era, Such as-Sales and leaseback, Leveraged leasing, direct leasing, Closed and Open ended lease and upfront and back-end lease. Hire-purchase is a system of acquiring goods on credit whereby the seller of the goods is regarded as the dealer; the purchaser is regarded as the hirer and the financier as the owner. The ownership of the goods bought on hire-purchase does not pass to the hirer at the time of the hire-purchase agreement or upon delivery of the goods. The ownership of the goods remains in the financier until the hirer has fully settled the price agreed upon in the hire-purchase agreement.

15.16 Self Assessment Questions

1. Define the Conceptual aspect of Leasing? Describe leasing in India?
2. What are the types of Leasing?
3. Explain the different benefits of Leasing.
4. Distinguish between Financial & Operating Leasing and Risk involved in Leasing.
5. Distinguish between Leasing and Hire-Purchasing.

15.17 Reference Books

- Myers, S, Dill, DA & Bautista, AJ 1976 ‘Valuation of Financial Lease Contracts’, *Journal of Finance*, June:799–819.
- Ross, SA, Westerfield, RW & Jordan, BD 2003 *Corporate Finance*, 6th edn. Irwin/McGraw-Hill, New York, Chapter 26.
- Smith, CW Jr & Wakeman, LM 1985 ‘Determinations of Corporate Leasing Policy’, *Journal of Finance*, July:895–908.
- Bazley, M, Brown, P & Izan, HY 1985 ‘An Analysis of Lease Disclosures by Australian Companies’, *Abacus*, 21(1):44–62.
- Mukherjee, TK 1991 ‘A Survey of Corporate Leasing Analysis’, *Financial Management*, Autumn.

Unit - 16 : Credit Rating

Structure of Unit:

16.0 Objectives

After completing this unit, you would be able to:

- Understand the origin and concept of credit rating in India;
- Know about the importance, functions and objectives of credit rating in India;
- Point out the various factors that affect the rating of debt instruments in India;
- Learn about the instruments and ratings other than debt instruments by the various credit agencies in India;
- Understand the advantages and disadvantages offered by the credit rating agencies in India;
- Know about the process involved in rating the various instruments by the rating agencies in India;
- Learn about the various credit rating agencies in India and the rating symbols assigned by them.

16.1 Introduction

With the increasing market orientation of the Indian economy, investors value a systematic assessment of two types of risks, namely “business risk” and “payment risk”. With a view to protect small investors, who are the main target for unlisted corporate debt in the form of fixd deposits with companies, credit rating has been made mandatory. India was perhaps the first amongst developing countries to set up au credit rating agency in 1988. The function of credit rating was institutionalized when RBI made it mandatory for the issue of Commercial Paper (CP) and subsequently by SEBI, when it made compulsory for certain categories of debentures, debt instruments, non-banking financial companies (NBFCs) and fixed deposits. non-convertible debentures.

16.2 Origin of Credit Rating

The origins of credit rating can be traced to the 1840s when Loise Tappen established the first mercantile credit agency in New York n 1841. The agency rated the ability of merchants to pay their financial obligations. It was subsequently acquired by Robert Dun and its first ratings guide was published in 1859. Another similar agency was set up by John Bradstreet in 1849 which published a rating book in 1857. These two agencies were merged together to form Dun & Bradstreet in 1933. In 1900 John Moody founded Moody’s Investors Service. In 1916, Poor’s Publishing Company Published its first ratings,, followed bybthe Standard Statistics Company and the Poor’s Publishing Company merged in 1941 to form Standard and Poor’s which was subsequently taken over the McGraw-Hill in 1996. In the 1970s, a number of credit rating agencies commenced operations all over the world. These include the Canadian Boand Rating Service (1972), Thomson Bankwatch (1974), Japanese Bond Rating Institute (1975), McCarthy Crisanti and Maffei (1975), acquired by Duff and Phelps (1991), Dominican Bond Rating Service (1977), IBCA Limited (1978), and Duff and Phelps Credit Rating Co. (1980).

In India, the Credit Rating and Information Services India Ltd (CRISIL) was set up as the first credit rating agency in 1987, followed by ICRA Ltd (previously known as Investment Information and Credit Rating Agency of India Ltd.) in 1991, and Credit Analysis and Research Ltd. (CARE) in 1994.

16.3 What is Credit Rating?

Credit Rating is the opinion of the rating agency on the relative ability and willingness of the issuer of a debt instrument to meet the debt service obligations as and when they arise. Rating is usually expressed in alphabetical or alphanumeric symbols. Symbols are simple and easily understood tool which help the investor to differentiate between debt instruments on the basis of their underlying credit quality. Rating companies also publish explanations for their symbols used as well as the rationale for the ratings assigned by them, to facilitate deeper understanding.

In other words, the rating is an opinion on the future ability and legal obligation of the issuer to make timely payments of principal and interest on a specific fixed income security. The rating measures the probability that the issuer will default on the security over its life, which depending on the instrument, may be a matter of days to thirty years or more.

In fact, the credit rating is a symbolic indicator of the current opinion of the relative capability of the issuer to service its debt obligation in a timely fashion, with specific reference to the instrument being rated. It can also be defined as an expression, through use of symbols, of the opinion about credit quality of the issuer of security/instrument.

Credit rating does not amount to a recommendation to buy, hold, or sell an instrument as it does not take into consideration factors such as market prices, personal risk preferences and other considerations which may influence an investment decision. Rating does not create and fiduciary relationship between a rating agency and the user of a rating as there is no legal basis for such a relationship. A credit rating agency does not perform an audit. It has to rely on information provided by the issuer and collected by the analysts from different sources, including interactions with different entities during the rating process. The primary objective of rating is to provide guidance to investors and creditors in determination a credit risk associated with a debt instrument and credit obligation.

16.4 Importance of Credit Rating

Credit ratings establish a link between risk and return. They thus provide a yardstick against which to measure the risk inherent in any instrument. An investor uses the ratings to access the risk level and compares the offered rate of return with his expected rate of return (for the particular level of risk) to optimize his risk-return trade off. The importance of credit rating is three-fold. It is useful for investors, companies issuing securities and intermediaries which are providing funds to corporate organization.

- ***Investors:*** it is useful for the investors as data is presented to them to take decisions on investment.
- ***Companies:*** it helps the companies as they are ranked according to the security and safety of their instruments. It provides them with credibility. They are issuers of security and they offer the instrument to public. To get a good rating from the credit rating agency will enhance their credibility.
- ***Intermediaries:*** Merchant bankers, Market traders, brokers and financial institutions and other market players use the information for pricing placement and marketing of issues.

16.5 Objectives of Credit Rating

The objectives of credit rating are to analyze and give an opinion on the type of instrument. The following are some of the objectives:

- To provide credence to financial commitments made by a company.
- To provide information to the investor in selecting debt securities.

- To help the company by providing it with the service of marketability thorough grading of debt securities with technical expertise of rating securities.

16.6 Functions of Credit Rating

A credit rating agency serves following functions:

(1) Provides unbiased opinion. An independent credit rating agency is likely to provide an unbiased opinion as to relative capability of the company to service debt obligations because of the following reasons:

(i) It has no vested interest in an issue unlike brokers, financial intermediaries.

(ii) Its own reputation is at stake.

(2) Provides quality and dependable information. A credit rating agency is in a position to provide quality information on credit risk which is more authenticate and reliable because:

(i) It has highly trained and professional staff who has better ability to access risk.

(ii) It has access to a lot of information which may not be publicity available.

(3) Provides information at low cost. More of the investors rely on the ratings assigned by the ratings agencies while taking investment decisions. These ratings are published in the form of reports and are available easily on the payment of negligible price. It is not possible for the investors to access the creditworthiness of the companies on their own.

(4) Provide easy to understand information. Rating agencies first of all gather information, then analyze the same. At last three interpret and summarize complex information in a simple and readily understood formal manner. Thus in other words, information supplied by rating agencies can be easily understood by the investors. They need not go into details of the financial statements.

(5) Provide basis for investment. An investment rated by a credit rating enjoys higher confidence from investors. Investors can make an estimate of the risk and return associated with a particular rated issue while investing money in them.

(6) Healthy discipline on corporate borrowers. Higher credit rating to any credit investment enhances corporate image and builds up goodwill and hence it induces a healthy discipline on corporate.

(7) Formation of public policy. Once the debt securities are rated professionally, it would be easier to formulate public guidelines as to the eligible of securities to be include in different kinds of institutional portfolio.

16.7 Factors Affecting Assigned Ratings

The following factors generally influence the ratings to be assigned by a credit rating agency:

(1) The security issuers' ability to service its debt. In order, they calculate the past and likely future cash flows and compare with fixed interest obligations of the issuer.

(2) The volume and composition of outstanding debt.

(3) The stability of the future cash flows and earning capacity of company.

(4) The interest coverage ratio i.e. how many number of times the issuer is able to meet its fixed interest obligations.

(5) Ratio of current assets to current liabilities (i.e. current ratio is calculated to access the liquidity position of the issuing firm.

(6) The value of assets pledged as collateral security and the security's priority of claim against the issuing firm's assets.

(7) Market position of the company products is judged by the demand for the products, competitors' market share, distribution channels etc.

(8) Operational efficiency is judged by capacity utilization, prospects of expansion, modernization and diversification, availability of raw material etc.

(9) Track record of promoters, directors and expertise of staff also affect the rating of a company.

16.8 Nature of Credit Rating

The credit rating process posses the following nature:

1. **Rating is based on information :** Any rating based entirely on published information has serious limitations and the success of a rating agency will depend, to a great extent, on its ability to access privileged information. Cooperation from the issuers as well as their willingness to share even confidential information are important pre-requisites. The rating agency must keep information of confidential nature possessed during the rating process, a secret.
2. **Many factors affect rating :** Rating does not come out of a pre-determined mathematical formula. Final rating is given taking into account the quality of management, corporate strategy, economic outlook and international environment. To ensure consistency and reliability a number of qualified professionals are involved in the rating process. The Rating Committee, which assigns the final rating, consists of specialized financial and credit analysts.

Rating agencies also ensure that the rating process is free from any possible clash of interest.

3. **Rating by more than one agency :** In the well developed capital markets, debt issues are, more often than not, rated by more than one agency. And it is only natural that ratings given by two or more agencies differ from each other e.g., a debt issue, may be rated ‘AA+’ by one agency and ‘AA’ or ‘AA-’ by another. It will indeed be unusual if one agency assigns a rating of AA while another gives a ‘BBB’.
4. **Monitoring the already rated issues :** A rating is an option given on the basis of information available at particular point of time. Many factors may affect the debt servicing capabilities of the issuer. It is, therefore, essential that rating agencies monitor all outstanding debt issues rated by them as part of their investor service. The rating agencies should put issued under close credit watch and upgrade or downgrade the ratings as per the circumstances after intensive interaction with the issuers.
5. **Publication of ratings :** In India, ratings are undertaken only at the request of the issuers and only those ratings which are accepted by the issuers are published. Thus, once a rating is accepted it is published and subsequent changes emerging out of the monitoring by the agency will be published even if such changes are not found acceptable by the issuers.
6. **Right of appeal against assigned rating :** Where an issuer is not satisfied with the rating assigned, he may request for a review, furnishing additional information, if any, considered relevant. The rating agency will undertake a review and thereafter give its final decision. Unless the rating agency had over looked critical information at the first stage chances of the rating being changed on appeal are rare.
7. **Rating of rating agencies :** Informed public opinion will be the touchstone on which the rating companies have to be assessed and the success of a rating agency is measured by the quality of the services offered, consistency and integrity.
8. **Rating is for instrument and not for the issuer company :** The important thing to note is that rating is done always for a particular issue and not for a company or the Issuer. It is quite possible that two instruments issued by the same company carry different ratings, particularly is maturities are substantially different or one of the instruments is backed by additional credit reinforcements like guarantees. In many cases, short-term obligations, like commercial paper (CP) carry the highest rating even as he risk profile changes for longer maturities.
9. **Rating not applicable to equity shares :** By definition, credit rating is an opinion on the issuers’ capacity to service debt. In the case of equity there is no pre-determined servicing obligation, as equity is in the nature of venture capital. So, credit rating does not apply to equity shares.
10. **Credit vs. financial analysis :** Credit rating is much broader concept than financial analysis. One important factor which needs consideration is that the

rating is normally don at the request of and with the active co-operation of the issuer. The rating agency has access of unpublished information and the discussions with the senior management of issuers give meaningful insights into corporate plans and strategies. Necessary adjustments are made to the published accounts for the purpose of analysis. Rating is carried out by specialized professionals who are highly qualified and experienced. The final rating is assigned keeping in view the number of factors.

11. **Time taken in rating process :** The rating process is a fairly detailed exercise. It involves, among other things analysis of published financial information, visits to the issuers offices and works, intensive discussion with the senior executives of issuers, discussions and auditors, bankers, creditors etc. It also involves an in-depth study of the industry itself and a degree of environment scanning. All this takes time, a rating agency may take 6 to 8 weeks or more to arrive at a decision. For rating short-term instruments like commercial paper (CP), the time taken may vary from 3 to 4 weeks, as the focus will be more on short-term liquidity rather than on long-term fundamentals. Rating agencies do not compromise on the quality of their analysis or work under pressure from issuers for quick results. Issuers are always advised to approach the rating agencies sufficiently in advance so that issue schedules can be adhered to.

16.9 Instruments for Credit Rating

Rating may be carried out by the rating agencies in respect of the following:

(i) Equity shares issued by a company;

(ii) Preference shares issued by a company;

(iii) Bonds/debentures issued by corporate, government etc.

(iv) Commercial papers issued by manufacturing companies, finance companies, banks and financial institutions for raising short-term loans.

(v) Fixed deposits raised for medium-term ranking as unsecured borrowing;

(vi) Borrowers who have borrowed money.

(vii) Individuals;

(viii) Asset backed securities are accessed to determine the risk associated with them. The objective is to determine quantum of cash flows emerging from the asset that would be sufficient to meet committed payments.

16.10 Rating Other than Debt Instruments

Credit rating has been extended to all those activities where uncertainty and risk is involved. Now-a-days credit rating is not just limited to debts instruments but also over the following:

I. **Country Rating :** A country may be rated whenever a loan is to be extended or some major investment is to be made in it by international investors to determine the safety and security of their investments. A number of factors such as growth rate, industrial and agricultural production, government policies, inflation, fiscal deficit etc. are taken into consideration to arrive at such rating. Any upgrade movement in such ratings has a positive impact on the stock markets. Morgan Stanlay, Moodys etc. give country ratings.

II. **Rating of Real Estate Builders and Developers :** CRISIL has started assigning rating to the builders and developers with the objective of helping and guiding prospective real estate buyers. CRISIL thoroughly scrutinizes the sale deed papers, sanctioned plan, lawyers' report, government clearance certificates before assigning rating to the builder or developer. Past experience of the builder, number of properties built by the builder, financial strength, time taken for completion are some of the factors taken into consideration by the CRISIL before giving a final rating to the real estate builder/developer.

III. **Chit Funds :** Chit funds registered as a company are sometimes rated on their ability to make timely payment of prize money to subscribers. The rating helps the chit funds in better marketing of their fund and in widening of the subscribers base. This service is provided by CRISIL.

IV. **Rating of States :** States of India have also approached rating agencies for rating. Rating helps the State to attract investors both from India and abroad to make investments. Investors find safety of their funds while investing in a state with good rating. Foreign companies also come forward and set up projects in such states with positive rating. Rating agencies take into account various economic parameters such as industrial and agricultural growth of the State, availability of raw material, labour etc. and political parties agenda with respect to industry, labour etc., relation between Centre and State and freedom enjoyed by the states in taking decisions while assigning final rating to the states. States like Maharashtra, Madhya Pradesh, Tamil Nadu, Andhra Pradesh and Kerela have already been rated by CRISIL.

V. **Rating of Banks :** CRISIL and ICRA both are engaged in rating of banks based on the following six parameters also called CAMELS.

C – C stands for capital adequacy of banks. A bank need to maintain at least 10% capital against risky assets of the bank.

A – A stands for asset quality. The loan is examined to determined non-performing assets. An asset/loan is considered non-performing asset where either interest or principal is unpaid for two quarters or more. Ratios like NPA to Net Advances, Adequate of Provision & Debt Service Coverage Ratio are also calculated to know exact picture of quality of asset of a bank.

M – M stands for management evaluation. Here, the efficiency and effectiveness of management in framing plans and policies is examined. Ratios like ROI, Return on Capital Employed (ROCE), Return on Assets (ROA) are calculated to comment upon bank's efficiency to utilize the assets.

L – L indicates liquidity position. Liquid and current ratios are determined to find out banks ability to meet its short-term claims.

S – S stands for Systems and Control. Existing systems are studied in detail to determine their adequacy and efficacy.

Thus, the above six parameters are analyzed in detail by the rating agency and then final rating is given to a particular bank. Ratings vary from A to D. Where A denotes financial, managerial and operational soundness of a bank and D denotes that bank is in financial crisis and lacks managerial expertise and is facing operational problems.

VI. **Rating (Recommendation) for Equities :** These days analysts specialized in equity ratings make a forecast of the stock prices of a company. They study thoroughly the trend of sales, operating profits and other variables and make a forecast of the earning capacity and profitability position of a company. They use financial statement analysis tools like ratio analysis, trend analysis, fund flow analysis and cash flow analysis to comment upon company's liquidity, solvency, profitability and overall efficiency position. Analysts suggest a target price of the stock giving signal to the investor to swing into action whenever the stock hits that particular price. The following are some of the recommendations made by the equity analysts for its investors:

(i) **Buy:** It shows the stock is worth buying at its current price.

(ii) **Buy on Declines:** This recommendation indicates stock is basically good but over priced now. The investor should go for buying whenever the price declines.

(iii) **Long-term Buy:** This recommendation suggests that a stock should be bought and held for a longer period at least a year in order to realize gains.

(iv) **Strong Buy:** This buy recommendation strongly favors the purchase of a stock because analysts except a steep rise in the price of stock from its current price.

(v) **Outperformer:** This recommendation shows that whatever may be the mood of the stock market the stock will perform better than the market.

(vi) **Overweight:** This refers to that investor can increase the quantum or weight of that stock in his portfolio. This recommendation is applicable to those investors who keep number of stocks in their portfolio.

(vii) Hold: This recommendation is a suggestion to the investor to exist because stock prices are not likely to be appreciated significantly from the current price level.

(viii) Sell/Dispose/Sub-Standard/Under-weight: It indicates to the investor to sell/dispose off or decrease the weight of stock from its portfolio because stock is fundamentally overvalued at its current level and the investor should exit from it immediately.

16.11 Advantages of Credit Rating

Different benefits accrue from use of rated instruments to different class of investors or the company. These are explained as under:

A. Benefits to Investors

(1) Safety of investments. Credit rating gives an idea in advance to the investors about the degree of financial strength of the issuer company. Based on rating he decides about the investment. Highly rated issues give an assurance to the investors of safety of investments and minimizes his risk.

(2) Recognition of risk and returns. Credit rating symbols indicate both the returns expected and the risk attached to a particular issue. It becomes easier for the investor to understand the worth of the issuer company just by looking at the symbol because the issue is backed by the financial strength of the company.

(3) Freedom of investment decision. Investors need for seek advise from the stock brokers, merchant bankers or the portfolio managers before making investments. Investors today are free and independent to take investment decisions themselves. They base their decisions or rating symbols attached to a particular security. Each rating symbol assigned to a particular investment suggests the creditworthiness of the investment and indicates the degree of risk involved in it.

(4) Wider choice of investments. As it is mandatory to rate debt obligations for every easier company, at any particular time, wide range of credit rated instruments are available for making investment. Depending upon his own ability to bear risk, the investor can make choice of the securities in which investment is to be made.

(5) Dependable credibility of issuer. Absence of any link between the rater and rated firm ensures dependable credibility of issuer and attracts investors. An rating agency has no vested interest in issue to be rated and has no business connections or links with the Board of Directors. In other words, it operates independent of the issuer company, the rating given by it is always accepted by the investors.

(6) Easy understanding of investment proposals. Investors require no analytical knowledge on their part about the issuer company. Depending upon rating symbols assigned by the rating agencies they can proceed with decisions to make investment in any particular rate security of a company.

(7) **Relief from botheration to know company.** Credit agencies relieve investors from the botheration of kowing the details of the company, its history, nature of business, financial position, liquidity and profitability position, composition of management staff and Board of Directors etc. credit rating by professional and specialized analysts reposes confidence in investors to rely upon the credit symbols for taking investment decisions.

(8) **Advantages of continuous monitoring.** Credit rating agencies not only assign rating symbols but also continuously monitor them. The Rating agency downgrades or upgrades the rating symbols following the decline or improvement in the financial position respectively.

B. Benefits of Rating to the Company

A company who has got its credit instrument or security rated is benefited in the following ways:

(1) **Easy to raise resources.** A company with highly rated instrument finds it easy to raise resources from the public. Even though investors in different sections of the society understand the degree of risk and uncertainty attached to a particular security but they still get attracted towards the highly rated instruments.

(2) **Reduced cost of borrowing.** Investors always like to make investments in such instrument which ensure safety and easy liquidity rather than high rate of return. A company can reduce the cost of borrowings by quoting lesser interest on those fixed deposits or debentures or bonds which are highly rated.

(3) **Reduced cost of public issues.** A company with highly rated instruments has to make least efforts in raising funds through public. It can reduce its expebditure on press and publicity. Rating facilities best pricing and timing of issues.

(4) **Rating builds up image.** Companies with highly rated instruments enjoy better goodwill and corporate image in the eyes of customers, shareholders, investors and creditors. Customers feel confident of the quality of goods manufactured, shareholders are sure of high returns, investors feel secured of their investments and creditors are assured of timely payments of interest and principal.

(5) **Rating facilitates growth.** Rating motivates the promoters to undertake expansion of their operations or diversify their production activities thus leading to the growth of the company in future. Moreover highly rated companies find it easy to raise funds from public through new issues or through credit from banks and financial institutions to finance their expansion activities.

(6) **Recognition to unknown companies.** Credit rating provides recognition to relatively unknown companies going for public issues through wide investor base. While entering into market, investors rely more on the rating grades than on 'name recognition'.

C. Benefits to Intermediaries

Stock brokers have to make less effort in persuading their clients to select an investment proposal of making investment in highly rated instruments. Thus rating enables brokers and other financial intermediaries to save time, ebergy costs and manpower in convincing their clients.

16.12 Disadvantages of Credit Rating

(1) **Non-disclosure of significant information.** Firm being rated may not provide significant or material information, which is likely to affect the investor's decision as to investment, to the investigation team of the credit rating company. Thus any decisions taken in the absence of such significant information may put investors at a loss.

(2) **Static study.** Rating is static study of present and past historic data of the company at one particular point of time. Number of factors including economic, political, environment, and government policies have direct bearing on the working of a company. Any changes after the assignment of rating symbols may defeat the very purpose of risk indicativeness of rating.

(3) **Rating is no certificate of soundness.** Rating grades by the rating agencies are only an opinion about the capability of the company to meet its interest obligations. Rating symbols do not pinpoint towards quality of products or management or staff etc. in other words, rating does not give a certificate of the complete soundness of the company. Users should form an independent view of the rating symbol.

(4) **Rating may be biased.** Personal bias of the investigating team affect the quality of the rating. The companies have lower grade rating do not advertise or use the rating while raising funds from the public. In such a case the investors cannot get the true information about the risk involved in the instrument.

(5) **Rating under unfavourable conditions.** Rating grades are not always representative of the true image of a company. A company might be given low grade because it was passing through unfavourable conditions when rated. Thus misleading conclusions may be drawn by the investors which hamper the company's interest.

(6) **Difference in rating grades.** Same instrument may be rated differently by the two rating agencies of the personal judgment of the investigating staff on qualitative aspects. This may further confuse the investors.

16.13 Credit Rating Process

The process/procedure followed by all the major credit rating agencies in the country is almost similar and usually comprises of the following steps:

(1) Receipt of the request. The rating process begins with the receipt of formal request for rating from a company desirous of having its issue obligations under proposed instrument rated by credit rating agencies. An agreement is entered into between the rating agency and the issuer company.

The agreement spells out the terms of the rating assignment and covers the following aspects:

(i) It requires the CRA (Credit Rating Agency) to keep the information confidential.

(ii) It gives right to the issuer company to accept or not to accept the rating.

(iii) It requires the issuer company to provide all material information to the CRA for rating and subsequent surveillance.

(2) Assignment to analytical team. On receipt of the above request, the CRA assigns the job to an analytical team. The team usually comprises of the members/analysts who have expertise in the relevant business area and are responsible for carrying out the rating assignments.

(3) Obtaining information. The analytical team obtains the requisite information from the client company. Issuers are usually provided a list of information requirements and broad framework for discussions. These requirements are derived from the experience of the issuers business and broadly confirms to all the aspects which have a bearing on the rating. The analytical team analyses the information relating to its financial statements, cash flow projections and other relevant information.

(4) Plant visits and meeting with management. To obtain classification and better understanding of the client's operations, the team visits and interacts with the company's executives. Plant visits facilitate understanding of the production process, assess the state of equipment and main facilities, evaluate the quality of technical personnel and form an opinion on the key variables that influence level, quality and cost of production.

A direct dialogue is maintained with the issuer company as this enables the CRAs to incorporate non-public information in a rating decision and also enables the rating to be forward looking. The topics discussed during the management meeting are wide ranging including competitive position, strategies, financial policies, historical performance, risk profile and strategies in addition to reviewing financial data.

(5) Presentation of findings. After completing the analysis, the findings are discussed at length in the Internal Committee, comprising senior analysts of the credit rating agency. All the issue having a bearing on rating are identified.

An opinion on the rating is also formed. The findings of the team are finally presented to Rating Committee.

(6) **Rating Committee meeting.** This is the final authority for assigning ratings. The rating committee meeting is the only aspect of the process in which the issuer does not participate directly. The rating is arrived at after composite assessment of all the factors concerning the issuer, with the key issues getting greater attention.

(7) **Communication of decision.** The assigned rating grade is communicated finally to the issuer along with reasons or rationale supporting the rating. The ratings which are not accepted are either rejected or reviewed in the light of additional facts provided by the issuer. The rejected ratings are not disclosed and complete confidentiality is maintained.

(8) **Dissemination to the public.** Once the issuer accepts the rating, the credit rating agencies disseminate it through printed reports to the public.

(9) **Monitoring for possible change.** Once the company has decided to use the rating, CRAs are obliged to monitor the accepted ratings over the life of the instrument. The CRA constantly monitors all ratings with reference to new political, economic and financial developments of industry trends. All this information is reviewed regularly to find companies for major rating changes. Any changes in the rating are made public through published reports by CRAs.

16.14 Credit Rating Agencies in India

In India, there are four rating agencies, namely

(a) Credit Rating and Information Services of India Ltd. (CRISIL),

(b) Investment Information and Credit Rating Agency of India Ltd. (ICRA)

(c) Credit Analysis & Research (CARE), and

(d) Duff & Phelps Credit Rating India (DCR), now known as FITCH.

1. Credit Rating and Information Services of India Ltd. (CRISIL)

CRISIL was jointly promoted, in 1988, by India's leading financial institutions, ICICI and Unit Trust of India (UTI). Its other shareholders including LIC, SBI, HDFC, GIC, Standard Chartered Bank, Bank of Tokyo, Banque Indo Shez, Sakura Bank, UCO Bank, Canara Bank, Central Bank of India, Indian Overseas Bank (IOB), Vysya Bank Ltd., and Bank of Madura Ltd. CRISIL went public in 1992 and to date is India's only listed credit rating agency. In 1995, CRISIL entered into a strategic alliance with Standard & Poor's to extend its credit rating services to borrowers from the overseas market. The services offered are broadly classified as rating, information services, infrastructure services, and consultancy. CRISIL provides:

1. Rating services for ratings of debt instruments, long, medium and short term, securitized assets, and builders.
2. Information services offering corporate research report and the CRISIL 500

Index.

3. The infrastructure and consultancy division assisting specific sectors such as power, telecom, and infrastructure financing.

Different rating symbols by Credit Rating Agencies for debentures indicate different meanings. The table below explains the CRISIL's rating symbols more elaborately:

Different rating symbols by Credit Rating Agencies for debentures indicate different meanings. The table below explains the CRISIL's rating symbols more elaborately:

Table 1: CRISIL Rating Symbol ── Debenture Rating Symbols High Investment Grades

AAA (Triple A) Highest Safety	Debentures rated "AAA" are judged to offer highest safety of timely payment of interest and principal. Though the circumstances providing thi degree of safety are likely to change, such changes can be envisaged and are most unlikely to affect adversely the fundamentally strong position of such issues.
AA (Double A) High Safety Investment Grades	Debentures rated "AA" are judged to offer adequate safety of timely payment of interest and principal. They differ in safety from "AAA" issues only marginally. Debentures rated "A" are judged to offer adequate safety of timely payment of interest and principal. However, changes in circumstances can adversely affect such issues.
A Adequate Safety	Debentures rated "A" are judged to offer adequate safety of timely payment of interest and principal. However, changes in circumstances can adversely affect such issues.
BBB (Triple B) Moderate Safety	Debentures rated "BBB" are judged to offer sufficient safety of timely payment of interest and principal for the present. However, changing circumstances are more likely to lead to a weakend capacity to pay interest and principal than for debentures in higher rated categories.
BB (Double B) Inadequate Safety	Debentures rated "BB" are judged to carry inadequate safety of timely payment of interest and principal.
B High Risk	Debentures rated "B" are judged to have greater susceptibility to default; while currently interested and principal payments are met, adverse business

	or economic conditions would lead to lack of ability or willingness to pay interest or principal.
C Substantial Risk	Debentures rated “C” are judged to have factors present that make them vulnerable to default. Timely payment of interest and principal is possible only if favorable circumstances continue.
D Default	Debentures rated “D” are in default and in arrears of interest or principal payments or are expected to default on maturity. Such debentures are extremely speculative on maturity. Such debentures may be realized only on reorganization or liquidation.

The Table below discusses the rating symbol of CRISIL for fixed deposits.

Table 2: CRISIL Fixed Deposit Rating Symbols Investment Grades

FAAA (Triple A) Highest Safety	This rating indicates that the degree of safety regarding timely payment of interest and principal is very strong.
FAA (Double A) High Safety	This rating indicates that the degree of safety regarding timely payment of interest and principal is strong.
FA Inadequate Safety	This rating indicates that the degree of safety regarding timely payment of interest and principal is satisfactory.
Speculative Grade	
FB Inadequate Safety	This rating indicates inadequate safety of timely payment of interest and principal.
FC High Risk	This rating indicates that the degree of safety regarding timely payment of interest and principal is doubtful.
FD	This rating indicates that the issue is either in default or is expected to be in default upon maturity.

Default	

The Table 3 below shows the rating symbols for short-term instruments.

Table 3: CRISIL Ratings for Short-term Instruments

F-1	This rating indicates that the degree of safety regarding timely payment on the instrument is very strong.
F-2	This rating indicates that the degree of safety regarding timely payment on the instrument is strong.
F-3	This rating indicates that the degree of safety regarding timely payment on the instrument is adequate.
F-4	This rating indicates that the degree of safety regarding timely payment on the instrument is minimal and it is likely to be adversely affected by short-term adversity or less favorable conditions.
F-5	This rating indicates that the instrument is expected to be in default on maturity or is less in default.

2. Investment Information and Credit Rating Agency of India Ltd. (ICRA)

ICRA, set up in 1991, has been promoted by IFCI and 21 other shareholders comprising foreign and nationalized banks and Indian insurance companies. It is the second rating agency in India. Services offered by ICRA can be broadly classified as analytical services, advisory services, an investment services.

1. The analytical services comprise rating of debt instruments and creit assessment.
2. Advisory services include strategic counseling general assessment such as restructuring exercise and sector-specific services such as for power, telecom, ports and municipal ratings.
3. The information or the research desk provides research reports on specific industry, sector and corporate.
4. The information services also include equity-related services, namely, equity grading and equity assessment.

In 1996, ICRA entered into a strategic alliance with Financial Proforma Inc., a Moody's subsidiary to offer services on risk management training and software. Moody's and ICRA have entered into a memorandum of understanding to support these efforts.

Like CRISIL, another rating agency called ICRA also provides different rating symbols. The table below will explain the following in detail:

ICRA Rating Scale

Table 4: Long-term instruments ─ including Debentures, Bonds, Preference Share

LAAA	Highest safety. Indicates fundamentally strong position. Risk factors are negligible.
LAA+ LAA LAA-	High safety. Risk factors are modest and may vary slightly. The protective factors are strong and the prospect of timely payment of principal and interest as per terms under adverse circumstances, as may be visualized, differs from LAAA only marginally.
LA+ LA LA-	Adequate safety. The risk factors are more variable and greater in periods of economic stress. The protective factors are average and any adverse change in circumstances, as may be visualized, may alter the fundamental strength and affect the timely payment of principal and interest as per terms.
LBBB+ LBBB LBBB-	Moderate safety. Considerable variability in risk factors. The protective factors are below average.
LBB+ LBB LBB-	Inadequate safety. The timely payment of interest and principal are more likely to be affected by present or prospective changes in business/economic circumstances.
LB+ LB LB-	Risk prone. Risk factors indicate that obligations may not be met when due.
LC+ LC LC-	Substantial risk. There are inherent elements of risk and timely servicing of debts/obligations could be possible only in case of continued existence of favorable circumstances.
LD	Default. Extremely speculative. Either already in default in payment or interest and/or principal as per terms or expected to default. Recovery is likely only on liquidation or re-organization.

3. Credit Analysis & Research (CARE)

CARE has been promoted, in 1992, by IDBI jointly with Canara Bank, UTI, private sector banks, and insurance company. The services offered by CARE include credit rating of debt instruments, credit assessment of companies, advisory services, credit reports, and performance ratings.

1. CARE undertakes ratings of all types of debt instruments of all maturities,

including short-term instruments like commercial paper and certificates of deposits not exceeding 12 months; and medium and long term instruments like term deposits, floating rate notes, bonds and debentures.

2. CARE also undertakes rating of securitized paper and structured obligations.
3. CARE undertakes credit assessment of companies for use of banks and financial institutions. It is without reference to any particular instrument. CARE analyzes the overall debt; management of the company and its capacity to service its obligations.
4. CARE also undertakes "performance rating" of parallel marketers of liquefied petroleum gas (LPG) and superior kerosene oil (SKO), as per the scheme notified by Ministry of Petroleum and Natural Gas, Government of India.

CARE rating agency has also given its own rating symbols for long-term and medium term instruments. The table below explains the same:

Table 5: CARE Rating Symbols Long-term and Medium-term instruments

CAREAAAC CAREAAA (FD)/(CD)/(SO)	Instruments carrying this rating are considered to be of the best quality, carrying negligible investment risk. Debt service payments are protected by stable cash flows. While the underlying assumptions may change, such changes can (FD)/(CD)/(SO) be visualized and are most unlikely to impair the strong position of such instruments.
CAREAA CAREAA (FD)/(CD)/(SO)	Instruments carrying this rating are judged to be of high quality by all standards. They are also classified as high investment grade. CARE AA securities are rated lower than CARE AAA because of somewhat lower margins of protection. Changes in assumptions may have a greater impact or the long-term risks may be somewhat larger. Overall, the difference from CARE AAA rated securities is marginal.
CAREA CAREA (FD)/(CD)/(SO)	Instruments with this ratings are considered upper medium grade instrument and have many favorable investment attributes. Safety for principal and interest are considered adequate in CARE A. Assumptions that do no materialize may have a greater impact as compared to the instruments rated higher.
CAREBBB CAREBBB (FD)/(CD)/(SO)	Such instruments are considered to be of investment grade. They indicate sufficient safety for payment of interest and principal, at the time of rating. However, adverse CARE BBB changes in assumptions are more likely to weaken the debt servicing capability compared to the higher rated instruments.

CAREBB CAREBB (FD)/(CD)/(SO)	Such instruments are considered to be speculative, with inadequate protection for interest and principal payments.
CAREB CAREB (FD)/(CD)/(SO)	Instruments with such rating are generally classified susceptible to default. While interest and principal payments are being met, adverse changes in business conditions are likely to lead to default.
CAREC CAREC (FD)/(CD)/(SO)	Such instruments carry high investment risk with likelihood of default in the payment of interest and principal.

Table 6: Table Short-term Instruments

Grades	*Commercial Paper*
High Investment Grade	PR-1
Medium Investment Grade	PR-2
Investment Grade	PR-3
Speculative Grade	PR-3
Speculative Grade	PR-4
Poor Grade	PR-5

4. Duff & Phelps Credit Rating India (DCR)

DCR is a joint venture between Duff & Phelps, USA and Alliance Capital Ltd., Calcutta. Its expertise is in the rating of structured obligations with international standards. It offers rating of all other short-term, medium-term and long-term debt instruments.

Activity C:

The table given above had only provided few of the credit symbols assigned by the various credit rating agencies in India. Find out the ratings of the other debt instruments given by the aforesaid four important agencies in India.

16.15 Credit Rating Methodology

Rating methodology used by the major Indian credit rating agencies is more or less the same. The rating methodology involves an analysis of all the factors affecting the creditworthiness of an issuer company e.g. business, financial and industry characteristics, operational efficiency, management quality, competitive position of the issuer and commitment to new projects etc. A detailed analysis of the past financial statements is made to access the performance and to estimate the future earnings. The company's ability to service the debt obligations over the tenure of the instrument being rated is also evaluated. In fact, it is the relative comfort level of the issuer to service obligations that determine the rating. While assessing the instrument the following are the main factors that are analysed into detail by the credit rating agencies:

Business Analysis

1. Industry risk including analysis of the structure of the industry, the demand-supply position, a study of the key success factors, the nature and basis of competition, the impact of government policies, cyclicality and seasonality of the industry.
2. Market position of the company within the industry including market shares, product and customer diversity, competitive advantages, and selling and distribution arrangements.
3. Operating efficiency of the company; this would locational advantages, labour relationships, technology, manufacturing efficiency as compared to competitiors, etc.
4. Legal position including the terms of the prospectus, trustees and their responsibilities and systems for timely payment.

Financial Analysis

1. ***Accounting Quality:*** This is of particular importance in India where till recently reporting practices of companies varied substantially. Here the credit rating agency would look at any overstatement/understatement of profits, auditors' qualifications in their report, methods of valuation of inventory, depreciation policy, etc.
2. ***Earning Protection:*** This would include sources of future earnings growth for the company, and future profitability.
3. ***Adequacy of Cash Flows:*** Under this, the agency would take note of whether cash flows would be sufficient to meet debt servicing requirements in addition to fixed and working capital needs. An opinion would be formed regarding the substanability of the cash flows in future and the working capital management of the company.
4. ***Financial flexibility:*** This is a very important area which would be examined minutely by any rating agency. A company's ability to source funds from other sources (e.g., group companies), ability to defer capital expenditure, and alternative financing plans in times of stress are some of the main considerations here.

Management Evaluation

A rating exercise would obviously not be an analysis of the numbers. The quality and ability of the management would be judged on the basis of past track record, their goals, philosophies and strategies, and their ability to overcome difficult situations would be analyzed. In addition to ability to repay an assessment would be made of the management's willingness to repay debt. This would involve an opinion of the integrity of the management.

Regulatory and Competitive Environment

Structure and regulatory framework of the financial system would be examined. Trends in regulation/deregulation would also be examined keeping in view their likely impact on the company.

Fundamental Analysis

Fundamental analysis is undertaken for rating debt instruments of financial institutions, banks and non-banking finance companies.

1. ***Capital Adequacy:*** An assessment of the true net worth, including its adequacy as compared to the volume of business and the risk profile of assets.
2. ***Asset Quality:*** This would encompass the company's credit risk management, systems for monitoring credit, exposure to individual borrowers, management of problem credits, etc.
3. ***Liquidity Management:*** Capital structure, term matching of assets and liabilities, and policy on liquid assets in relation to financing commitments would be some of the assets examined.
4. ***Profitability and Financial Position:*** A great deal of weightage would be paid by the agency on past historical profits, the spreads on funds deployed, accretions to reserves, etc.
5. ***Interest and Tax Sensitivity:*** Exposure to interest rate changes, tax law changes, etc., would be examined.

16.16 Summary

Credit rating agencies offer a service to the public by finding out the basic value of the instruments based on the time value of money. It is a service which helps to identify rated companies. Credit rating agencies offer their own opinion through fundamental and technical analysis. However, in recent years the credit worthiness of the credit rating agencies is being questioned in India. Since the credit rating is an opinion, but often these opinion have gone wrong and buyers are well aware of this fact. Although credit rating agency express an opinion to an issue, they do not claim responsibilities for incorrect judgment on the basis of which people apply for issues of securities. These are not offered as guarantees or protection against defaults and frauds. Rating is made specifically for an instrument and not a business house. In India, the investors are of the opinion that there should be a law to enforce the responsibilities of a credit rating agency.

16.17 Self Assessment Questions

1. What do you understand by credit rating? What are the advantages and disadvantages of credit rating?
2. Explain the credit rating process and methodology adopted by the various credit rating agencies in India to rate various securities?
3. What are the factors affecting the rating to be assigned by the credit rating agencies?
4. Write a detailed note on the importance of credit rating and discuss its nature.

16.18 Reference Books

- Brealy, R.A. and S.C. Myers (2002), Principles of Corporate Finance, Tata McGraw Hill, New York.
- CARE research team (2008), “Indian Banking Sector: Edgy but Resilient”, Available online at www.careratings.com
- CMIE (2008), Monthly Bulletin, Bombay: Centre for Monitoring Indian Economy.
- CRISIL research team (2009), “CRISIL India Budget Analysis for Years 2008-09: Detailed Economic Analysis”. Available online at www.crisil.com

Unit – 17 : Bills Discounting

Structure of Unit

17.0 Objectives

After completing this unit, you would be able to:

- Know the meaning of Bill of Exchange.
- Understand characteristics and specimen of Bill of Exchange.
- Know about different parties in a Bill of Exchange.
- Understand the meaning of Bill discounting.
- Know the advantages of Bills discounting.

17.1 Introduction

In modern business scenario, there are lot of credit transactions take place. In the situation of credit sales, the seller wants a written commitment from the purchaser to pay the amount of goods on a particular date. As a written commitment Bill of Exchange and Promissory Notes are issued. These are properly written and stamped documents. Under this situation, seller of the goods draw a bill of exchange on the buyer and buyer accepts the bill and returns the same to the seller. On the particular date, the purchaser makes the payment to seller. But these bills can be discounted by banks before maturity date. On the basis of the bills of exchange Banks make payment to the party and on maturity date collects payment from the buyer. For this banks charges some amount of discount and this facility is known as bills discounting. It is a fund based activity, emerged as a profitable business in the early nineties for finance companies and represented a diversification in their activities in tune with the emerging financial trend in India.

17.2 Characteristics of Bills of Exchange

1. The Bill of Exchange must an order to a certain sum of money.

2. It must always be in writing.

3. It must be unconditional.

4. It has an acceptance of the debtor / purchaser.

Specimen of a Bill of Exchange

Rs. 20,000	Shri Nathpuram C, Kota
Stamp	10^{th} March, 2014

Two months after date, pay to us or our order the sum of Rupees twenty thousand only, for value received.

To,	For Gupta & Co.
M/s Sharms & Company	Anshuman
102/74, Mansarovar	Proprietor
Jaipur.	

5. It must be payable on demand or after a certain period of time.

6. It must contain a particular and definite maturity date.

7. It must be written by the seller of the goods and accepted by the purchaser.

8. A certain money must be payable after a definite period of time.

9. It must be duly stamped.

17.3 Different Parties in a Bill of Exchange

(a) **Drawer :-** The person who draws or makes the Bill. He receives the bill amount on the maturity date of the bill. He is seller of the goods.

(b) **Drawee :-** He is also known as acceptor of the bill. He is buyer of the goods and is the person to whom the order is made to make payment i.e. a debtor.

(c) **Payee :-** Payee is the person to whom the amount specified in the bill is payable. It drawer himself receives the payment on due date, then he will be the payee also. But when bill is endorsed or discounted by the Banks, then endorsee or Bank would be the payee.

17.4 Discounting of a Bill of Exchange

In cash sell, the seller receives the amount immediately but in situation of credit sell, the purchaser like to pay after some time and seller would like to be paid immediately. To solve this problem seller writes a bill of exchange on the buyer. The buyer, who is the debtor, is known as drawee acknowledge his responsibility for the payment of the amount after a specified time by writing his acceptance on the bill.

Now, the seller, who is holding the bill of exchange has two options :

(a) Upto maturity hold the bill and then take the payment on due date.

(b) Discount the bill of exchange by bank or other discounting agency.

If he chooses to discounting the B/E, he obtain cash from the discounting agency and that agency charges some discount. Actually discount is the margin between the ready money paid and the face value of the bill and normally calculated at a rate percentage per annum on the maturity value.

17.5 Types of Bill of Exchange

1. **Demand Bill :-** Demand Bill is the bill which is payable immediately 'on presentation' or 'at sight' to the drawee. For this type of bill no due date is specified for payment.

2. **Usance Bill :-** This is also known as time bill. 'Usance' means the time period recognised by custom or usage for payment of bills.

3. **Documentary Bills :-** These are bills which are supported by the documents such as lorry receipt, railway receipt, transport operator receipt, bill of lading etc. This type of bill confirms that trade has taken place. Documentary Bills on be classified into two categories :

   a. Documents against Acceptance of Bills (D/A Bills)

   b. Documents against Payment of Bills (D/P Bills)

   D/A Bills :- In D/A Bills, the documentary evidence is deliverable against the acceptance by the drawee.

   D/P Bills :- In D/P Bills, the documents of title will be held by the finance company or bank till the maturity date of the Bill of exchange.

5. **Clean Bill :-** These are the bills which are not attached by any type of documents that shows that a trade has taken place between the buyer and the seller. Interest rate are changed on such type of bills is higher than documentary bills.

17.6 Advantages of Bills Discounting

Bills discounting is beneficial both for investors as well as to Banks. Following are the advantage explained below :-

Advantages to Investors

1. These are the cheaper form of the loan. Banks usually charges discount rates below the cash credit rate.
2. This is a easy short term source of finance.
3. Because it is not a lending, so no tax at source is deducted.
4. It is very much flexible scheme not only for amount of investment but also for duration of the bill of exchange.

Advantages to Banks

1. Bill of exchange has a fix maturity date and Bank knows the maturity amount on a specified date. So there is no need by banks to maintain large, unutilised ideal cash balance with them.
2. Bill is a negatiable instrument with the signature two parties. If the acceptor not paid the amount on due date, the bank can claim the whole amount from the drawer of the bill.
3. In the situation of bill discounting, the bank charges discount which is normally higher than other loan interest.
4. The seller feels more relaxed because as a security, the bill amount is fix. There is no problem of fluctuations of value as in case of other goods or securities.

17.7 Precautions for Bills Discounting

Banks should follow the given points before approving a bill for discounting -

1. The signature of the borrower should be verified.
2. Credit limit of the borrower for bill discounting must be sanctioned.
3. If discounting facility is availing on bill, the original tenure for bill does not exceed 120 days.
4. Maturity date must be clearly mentioned on the bill.
5. The transaction details including all invoice must be mentioned on the bill.
6. It must be verified that bill is drawn only for sale of goods transactions.
7. Notice of dishonour and presentment have been waived.

17.8 Bill Market Schemes

In order to make commercial bill an active instrument in the secondary market, the Reserve Bank of India has constantly endeavouring for this. Many committces set up to examine the system of bank financing and money market some of them under -

(i) Dehejia Committee, 1969 (ii) Tondon Committee, 1974

(iii) Chore Committee, 1980 (iv) Vaghul Committee, 1985

This section outline the efforts made by the RBI in the direction of the development of a full-fledged bill market.

Bill Market Scheme 1952

M.Y. Khan Quotes in his book 'Financial Services' -

The salient features of the scheme were as follows :-

(i) The scheme was announced under section 17(4)(c) of RBI Act which enables it to make advances to scheduled banks against the security of issuance of promissory notes or bills drawn on and payable in India and arising out of bona fide commercial or trade transaction bearing two or more good signatures one of which should be that of scheduled bank and maturing within 90 days from the date of advances.

(ii) The scheduled banks were required to convert a portion of the demand promissory notes obtained by them from their constituents in respect of loans / overdrafts and cash credits granted to them into usance promissory notes maturing within 90 days to be able to avail of refinance under the scheme.

(iii) The existing loan, cash credit or overdraft accounts were, therefore, required to be split upto into two parts, that is :

(a) one part was to remain covered by the demand promissory notes, in this account further withdraws or repayments were as usual being permitted.

(b) the other part, which would represent the minimum requirement of the borrower during the next three months would be converted into usance promissory notes maturing within ninety days.

(iv) This procedure did not bring any change in offering same facilities as before by banks to their constituents. Banks could lodge the usance promissory notes maturing within ninety days.

(v) The amount advanced by the RBI was not the exceed the amount rent by the scheduled banks to the respective borrowers.

(vi) The RBI could also make such appropriate enquiries as it demmed fit, in connection with eligibility of bills and call for any further information from the scheduled banks concerned.

(vii) The scheduled bank applying for accommodation had to certify that the paper presented by it as collateral arose out of bonafide commercial transactions and that the party was creditworthy.

(viii) Advances to banks under the scheme, in the initial stages, were made at one-half of one percent below the bank rate. The concessional rate of interest was withdrawn in two stages of one quarter of one percent each and ceased to be operative from November 1956.

(ix) As a further inducement to banks, the RBI agreed to bear half the cost of the stamp duty incurred in converting demand bills into time bills.

(x) In the initial stages the minimum limit for an advanced which could be availed of from the RBI at any time was fixed at Rs. 25 lakh and the individual bills tendered for the purpose were not to be less than rupee one lakh. subsequently, however the scheme was liberalised and the minimum amount were reduced from Rs. 25 lakh to Rs. 10 lakh (reduced further to Rs. 5 lakh in Feb. 1967) and from Rs. 1 lakh to Rs. 50,000. The scheme, which was initially restricted to licensed scheduled commercial banks having deposits (including deposits outside India) of Rs. 10 crore or more was later extended to all licensed scheduled commercial banks, irrespective of the size of their deposits.

The scheme virtually ceased to function in 1970. The main reasons being :

(i) Lack of specialised institutions for discharging the functions of acceptance and discount houses,

(ii) Paucity of usance bills-both domestic and foreign.

(iii) Traders found cash credit facility conveniently available from banks and avoided usance bills asan instrument of credit.

(iv) Export bills were negotiated by banks under letters of credit opened by foreign importers and foreign correspondent banks.

(v) Banks got refinance against declaration of export bills from RBI / Exim-Bank when needed.

(vi) Lack of practice of discounting the bills with other banks having excess liquidity.

(vii) Criteria for creditworthiness of the traders was not evolved to avoid risk of defaults of redemption on maturity of the bills.

Bill Market Scheme, 1970

M.Y. Khan quotes in his book "Financial Services"

In pursuance of the recommendations of the Dehejia Committee, the RBI constituted a working group (Narsimham Study Group) to evolve a scheme to enlarge the use of bills. Based on the scheme suggested by the study group, the RBI introduced with effect from November 1, 1970, the new bill market scheme in order to facilitate the re-discounting of eligible bills of exchange by banks with it. To popularise the use of bills, the scope of the scheme was enlarged, the number of participants was increased, and the procedure was simplified over the years. The salient features of the schemes are as follows :

Eligible Institutions

All licenced scheduled banks and those which do not require a licence (i.e. the State Bank of India, its associate banks and nationalised banks) are eligible to offer bills of exchange to the RBI for rediscount. There is not objection to a bill accepted by such banks being purchased by other banks and financial institutions but the RBI rediscounts only such of those bills as are offered to it by an eligible bank.

Eligibility of Bills

The eligibility of bills offered under the scheme to the RBI is determined by the statutory provisions embodied in section 17(2)(a) of the Reserve Bank of India Act, which authorise the purchase, sale and rediscount of bills of exchange and promissory notes, drawn on and payable in India and arising out of bonafide commercial or trade transaction, bearing two or more good signatures, one of which should be that of a scheduled bank or a state cooperative bank and maturing.

(a) In the case of bills of exchange and promisary notes arising out any such transaction relating to the export of goods from India, within on rundred and eighty days.

(b) In any other case, within ninety days from the date of purchase or rediscount exclusive of days of grace.

(c) The scheme is confined to genuine trade bills arising out of genuine sale of goods. The bill should normally have a maturity of not more than 90 days. A bill having a maturity of 90 to 120 days is also eligible for rediscount provided at the time of offering to the RBI for rediscount it has a usance not exceeding 90 days. The bills presented for rediscount should bear at least two good signatures. The signature of a licensed scheduled bank is treated at a good signature.

(d) Bill of exchange arising out of the sale of commodities covered by the selective credit control directives of the RBI have been excluded from the scope of the scheme to facilitate the selective credit controls and to keep a watch on the level of outstanding credit against the affected commodities and

(e) The following types of bills are acceptable to RBI for the purpose of re-discount :

(i)Bills drawn on and accepted by the buyer's bank.

(ii)Bills drawn on buyer and his banker jointly and accepted by them jointly.

(iii)Bills drawn on and accepted by the buyer under an irrevocable letter of credit and certified by the buyer's bank which has opened the letter of credit in the manner specified by RBI, that is, that the terms and conditions of the letter of credit have been duly complied with by the seller.

(iv)Bills drawn on and accepted by the buyer and endorsed by the seller in favour of his bank and bearing a legend signed by a licensed scheduled bank which should endorse the bill, confirming that the bill will be paid by bank three days before the date of maturity,

(v)Bills drawn and accepted in the prescribed manner and discounted by a bank at the instance of the drawee.

Where the buyer's bank is not a licensed scheduled bank, the bill should additionally bear signature of a licensed scheduled bank.

17.9 Reasons for Non-development of Bill Market in India

Although RBI has taken various steps to activate bill market but there are some reasons due to which it has not been developed fully. Some of reasons are being enlisted here :

(1) If a bill is dishonoured, then it is expected to get prompt legal remedy. It has been noticed that procedural delay creates problem in this regard.

(2) Bill market requires strict commitment to honour financial obligations on the agreed date but it has been observed that government and industries are not ready and serious in this regard.

(3) Cost of credit facility is comparatively low in comparison to cost of credit through bill discounting.

(4) There is no uniformity in the documents to avail bill discounting facility.

(5) Absence of reliable credit information causes delay in the approval of new customers.

(6) Bills are not accepted within a reasonable time frame which causes delay on the part of drawee.

(7) Delay in remittance of proceeds by the bank.

(8) Buyer's are scattered in various part of the country.

17.10 Measures to Encourage Bill Market

The RBI has introduced several measures to encourage bill market. Some of these measures are being explained here under :

1. RBI in 1981 allowed mutual funds to participate in Bill-rediscounting market.
2. Rediscounting procedure in respect of bills below the face value of Rs. 10 lakhs has been simplified by dispensing with the actual lodgement of bills.
3. If bills of exchange is payable in not more than three months and drawn in favour of a co-operative bank or a commercial banks, the Govt. of India has provided the facility of remission of stamp duty.
4. The commercial banks which are licensed scheduled have been permitted to rediscount bills with some financial institutions approved by RBI. Unit trust of India (UIT), general Insurance Corporation of India (LIC) are the examples of such financial institutions.
5. The RBI set up the discount and Finance House of India Ltd. (DFHI) to develop secondary market for commercial bill. It has been set up jointly will All India Financial Institutions and Public sector banks.
6. Commercial banks are free to charge market determined interest rate on bills. Interest rates applicable on discounting of bills have been delinked from the prime lending rates of banks for this purpose.

17.11 Summary

In modern business scenario, there are lot of credit transactions take place. In the situation of credit sales the seller wants a written commitment from the purchaser to pay the amount of goods on particular date. As a written commitment Bills of Exchange is issued. These are properly written and stamped documents. On the basis of the Bill of Exchange, Banks make payment to the party and maturity date collects payment from the buyer. For this, Banks charges some amount of discount and this facility is known as bills discounting Bills of exchange may be of different types i.e. Demand Bill, Usance Bill, Documentary Bill, Clean Bill etc. Bill discounting facility is beneficial both for investors as will as to Banks. For investor it is a cheaper easy flexible short term source of finance and for banks it is a safe, and higher discounting charges scheme.

But for safe bill discounting banks should follow some points like signature should be verified, credit limits must be sanctioned etc.

For the development of commercial bill an active instrument in the secondary maket, the Reserve Bank of India has set up several committees and schemes i.e. Dehejia Committee, Tondon Committee, Chore Committee, Vagul Committee, Bill Market Scheme 1952, Bill Market Scheme 1970.

17.12 Self Assessment Questions

1. What is Bill of Exchange ?
2. Who are the parties to a Bill of Exchange ?
3. Who is Drawer ?
4. What is Demand Bill ?
5. Define Usance Bill.
6. Name the parties of a Bill of exchange.
7. What is Documentary Bill ?
8. What is meant by clean Bill ?
9. Explain about the different types of Bills.
10. What is Bill of Exchange ? Explain different types of Bills.
11. What is Bill Discounting ? Explain the advantages of Bill Discounting.
12. Explain the reasons for non-development of Bill Market in India.

17.13 Reference Books

- M.Y. Khan : Financial Services.
- Jain, Rathi, Thakur, Salanki : Marketing of Financial Services.
- Sharma, Bhardwaj, Jain : Book-keeping and Accountancy.