MANAGEMENT OF FINANCIAL SERVICES

(DBUS32)

(MBA 3Years)

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Lesson - 1

FINANCIAL SERVICES AND FINANCIAL MARKETS

1.0 Objective:

After studying this lesson, you shall be able:

* to understand the concept of Financial System.
* to know about the objectives of Financial System.
* to understand about Financial Market and its participants.
* to know about the concept of Financial Services and examine various types of Financial Services.

Structure:

1.1 Financial System

1.2 Objectives of Financial System

1.3 Financial Markets

1.4 Participants in Financial Markets

1.5 Nature and Scope of Financial Services

1.5.1 Mutual Funds

1.5.2 Merchant Banking

1.5.3 Hire Purchase Financing

1.5.4 Housing Finance

1.5.5 Venture Capital

1.5.6 Portfolio Services

1.6 Leasing Finance

1.6.1 Factoring

1.6.2 Forfaiting

1.7 Credit Rating Services

1.8 Summary

1.9 Self Assessment Questions

1.10 Reference Books

1.1 Financial System:

The financial system is the most important institutional and functional vehicle for economic transformation. It is a set of interrelated activities and services working together to achieve some predetermined purpose or goal. It includes different markets, the institutions, instruments, services and mechanisms which influence the generation of savings, investment of capital and growth. Van Horne defines the financial system as the purpose of financial markets to allocate savings efficiently in an economy to ultimate users either for investment in real assets or for consumption. Robinson defines financial system as "a link between savings and investment for the creation of new wealth and to permit portfolio adjustment in the composition of the issuing wealth'. From the above definitions, it may be said that the primary function of the financial system is the mobilisation of savings, their distribution for industrial investment and stimulating capital formation to accelerate the process of economic growth.

A financial system provides services that are essential in a modern economy. Financial assets with attractive held, liquidity and risk characteristics encourage savings. By evaluating alternative investments and monitoring the activities of borrowers, financial intermediaries increase the efficiency of resource use. Access to a variety of financial instruments enables an economic agent to pool, price and exchange risks in the markets. Trade, the efficient use of resources, saving and risk taking are the cornerstones of a growing economy. The financial system has been identified as the most catalysing agent for growth of the economy, making it one of the key inputs of development.

Structure of the Finance System: The Indian Financial System is broadly classified into two broad groups i.e., (1) Organised sector, (2) Unorganised Sector. The financial system is also divided into users of financial services and providers. Financial institutions sell their services to households, businesses and government. They are users of the financial services. The providers of financial services are central bank, commercial banks, financial institutions, Money and capital markets, non-banking institutions etc.,

Organised Financial System: The organised financial system comprises of an impressive network of banks, other financial and investment institutions and a range of financial instruments which together function in fairly developed capital and money markets. Short term funds are mainly provided by the commercial and cooperative banking structure. About 85 percent of such banking business is managed by twenty seven public sector banks. In addition to commercial banks, there is the network of comparative banks and land development banks at state, district and block levels. With around two third share in the total assets in the financial system, banks play an important role. Of late, Indian banks have also diversified into areas of such as merchant banking, mutual funds, leasing factoring and insurance etc.,

The organised financial system consists of the following sub systems:

* Banking System

* Cooperative System

* Development Banking

    (i) Public Sector

    (ii) Private Sector

* Money Markets

* Financial Companies/Institutions

Over the years, the structure of financial institutions in India has developed and become broad based with diversification.

Unorganised Financial System: The unorganised financial system comprises money lenders, indigenous bankers, lending pawn brokers, landlords, traders etc., This part of the financial system is not directly under the control of the Reserve Bank of India. There are a host of financial companies, investment companies, chit funds etc., which are not regulated by the RBI or the government in a systematic manner.

Organised Financial System:

Banking System: The structure the banking system is determined by two basic factors - economic and legal. The development of the economy and the spread of banking habit calls for increasing banking services. The RBI, the central bank of the country is at the top of the financial system. The commercial banking system can be divided into four as given hereunder.

I. Public Sector Banks:

* State Bank of India } State Bank group
  Associate Banks } 1 + 7

* 14 Nationalised Banks (1969)

* 6 Nationalised Banks (1980) 6-1 = 5

  1 Bank merged with another bank.

* Regional Rural Banks (196) (Sponsored by Public Sector Banks)

II. Private Sector Banks:

* Old Private Banks

* Newly set up Private Banks

III. Foreign Banks & their Representative Offices:

IV. Cooperative Banks:

* State Cooperative Banks

* Central Cooperative Banks

* Primary Agricultural Credit Societies

* Urban Cooperative Banks

* Land Development Banks

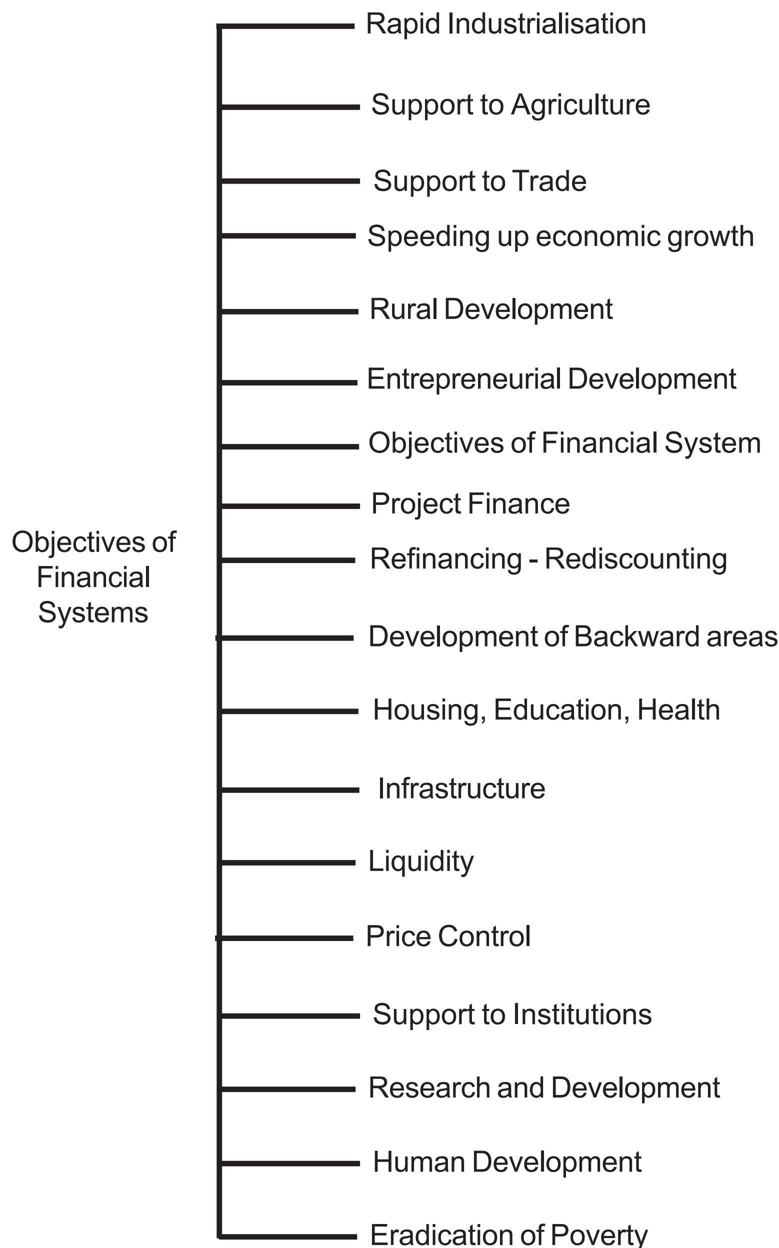
Financial Systems and Development:

A financial system provides services that are essential in a modern economy. The Indian financial system comprises of an impressive network of banks, other financial and investment institutions offering wide range of products and services which together function in fairly developed capital and money markets. As such, financial system has come to occupy an important role in the process of economic development. The economic development of a country depends on its financial structure. Investment is a precondition of economic growth. This is essential to sustain growth of the economy. The more efficient composition of real wealth is obtained by the provision of financial

assets which provide incentives to savers to hold a large part of their wealth in financial form. The increasing rate of savings is correlated with the increase in the proportion of savings held in the form of financial assets relative to tangible assets.

1.2 Objectives of Financial System:

The Indian financial system has been undergoing rapid changes particularly in relation to the emerging financial liberalisation. In the process, it has undergone a radical transformation in its structure and organisation. The main objectives of the financial system is to serve as an agent of socio-economic development in various sectors viz., industry, agriculture and international trade.



The foremost task of any financial system is to accelerate the growth of the economy. Rapid industrialisation even in the private sector has been referred to as providing additional employment opportunity as well as higher production. Liquidity and Price Control motivate people to save and invest in development and thereby develop various segments of the economy and create vast employment opportunities, generate income, improve standard of living, eradicate poverty, ill health, illiteracy and sustain economic development.

Role of the Financial System:

Financial systems provide payment services. They mobilise, savings and allocate credit. The diverse services used in the financial system are by households, business and government through an array of instruments like cheques, DDs, credit cards, bonds, stock, certificates, commercial papers, Billing Exchange etc;. A financial system's contribution to the economy depends on the quantity and quality of its services and the efficiency with which it provides them. Financial services make it cheaper and less risky to trade goods and services and to borrow and lend.

Finance is the key to investment and growth. Providing saved resources to others with more productive uses for them raises the income of saver and borrower alike. Without an efficient financial system, lending can be both costly and risky. Self financed investment is one way to overcome these difficulties but profitable investment opportunities may exceed the resources of the individual enterprise. Investment by the public sector is another answer and the government mobilises additional savings through tax system. When the economy is growing, financial arrangements need to be augmented by commercial banks, financial institutions. In a diversified market based system, the government retains a key role as prudential regulator to ensure sound development of financial system through effective, functioning of financial institutions.

Financial Intermediaries:

Financial intermediaries are the institutions which collect savings from others, issuing in return claims against themselves and use the funds thus acquired to purchase ownership or debt claims. They play a very important role in the saving investment process by raising the level of saving and investment and allocating more efficiently scare savings among most productive investments. Financial institutions are grouped under five different categories as given hereunder.

(1) Banking System (Central Bank, Commercial Banks, Cooperative Banks, Regional Rural Ranks)

(2) Depository Organisations (Mutual funds, Credit Unions etc.)

(3) Insurance Organisations (LIC, GIC, Postal Insurance, Pension Funds, Provident Funds etc.)

(4) Development Banks and

(5) Other Institutions (Investment and Finance Companies, Stock Exchanges etc.)

The financial system in India has undergone rapid changes. The financial system should facilitate the speedy growth of the economy. In recent years, the financial institutions are concentrating more on the management of fund based resources as an effective means of development. The changing environment of competition amongst different segments of the financial system should call for more professionalism and good performance levels.

1.3 Financial Markets:

Money, debt instruments and equities are called financial assets and they are claims against present and future income. These claims are traded in financial markets. Although some securities are traded directly between buyers and sellers after private negotiation, the major places for trading securities are called financial markets. Financial markets perform a vital function of allocating the wealth of the economy. Financial markets are the centres or arrangements that 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 interlinked by the laws, contracts and communication network.

Classification of Financial Markets:

The financial market comprises all banking and non banking financial institutions, procedures, practices followed in these markets and financial instruments for facilitating the flow of funds. The financial markets in an economy can be classified into:

(a) Primary and Secondary Markets and

(b) Money and Capital Markets.

a) Primary and Secondary Markets:

Primary market deals with the new issues of securities, while the market for existing claims (financial assets) is known secondary market. In other/words, primary market deals with new securities issued for the first time to the public and the secondary market deals in those securities which have already been issued to the public. In the primary market, the brokers act as under writers, managers, registrars and even merchant bankers to the new issues. In the secondary market, the claims of long term nature of one year and above are traded both on spot and forward basis. This trading imparts liquidity to investments and thus promotes saving and investment. These claims can be converted into money at any time although at a loss of capital in various degrees.

In the primary market, the government and corporate sector issue securities and raise additional funds for investment purposes. In the secondary market, the existing securities change hands from one owner to another owner and there is no additional flow of funds for further investment. An active secondary market stimulates activity in the primary market. Thus, the level of development in the secondary market determines the efficiency and growth of the primary market.

b) Money and Capital Markets:

Money Market is the place where short term claims (with a maturity period of one year or less) are traded. The money market facilitates short term financing and assures liquidity of short term financial assets. The money market is the central place for banking activities and is significant in indicating changes in short term interest rates, monetary policy and availability of short term credit. Money market assures borrowers that they can obtain short term funds quickly and it also assures the lenders that they can convert their short term financial assets into cash. A well developed money market is the basis for an effective monetary policy.

Capital market is a wider term and includes all operations in the new issues market (NIM) and stock market. It is the market in which lenders and investors provide long term funds in exchange for financial assets offered by borrowers or holders. The primary purpose of capital market

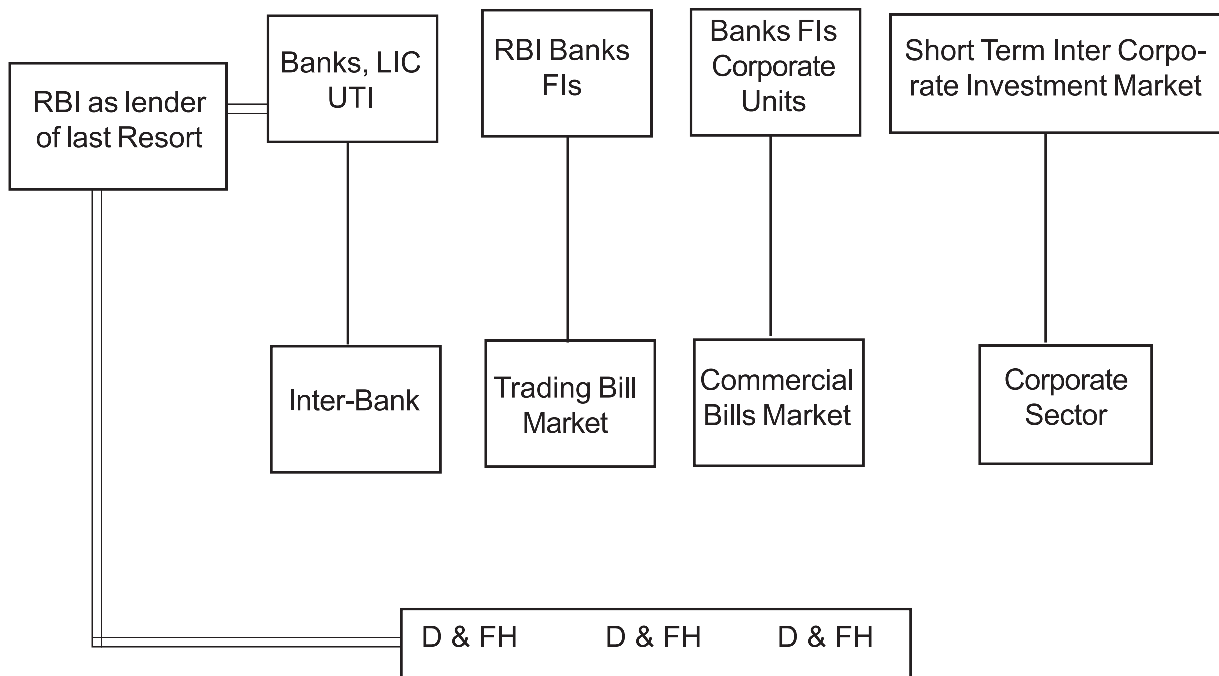
is to direct the flow of savings into long term investments by development banks and other financial institutions. There are two important aspects of capital market, namely, the raising of new capital in the form of shares and debentures and trading in the securities already issued by companies. While the first aspect is much more important from the point of view of economic growth, the second aspect is also of considerable significance. However, the financial deregulation, development of new instruments of money market and setting up of new subsidiaries of banks for undertaking financial services have all aided in the deepening and widening of the capital market in India.

1.4 Participants in Financial Markets:

Financial Markets include money and capital markets. Money market an important segment of the financial market has no geographical constraints and relates to all dealings in money and monetary assets. The Indian money market is divided into organised and unorganised markets. The unorganised money market consists of indigenous bankers and money lenders. The organised money market in India consists of Reserve Bank of India, State Bank of India and its subsidiaries, commercial banks, foreign banks, cooperative banks, regional rural banks, financial corporations, bill market etc; The banking system is the most dominant force in the Indian money market and the RBI being the central bank occupies the pivotal position in the money market as it has wide powers to control money and credit through various credit instruments.

Participants in Money Market:

The participants and interconnecting participants in money market are presented in the charts given hereunder.

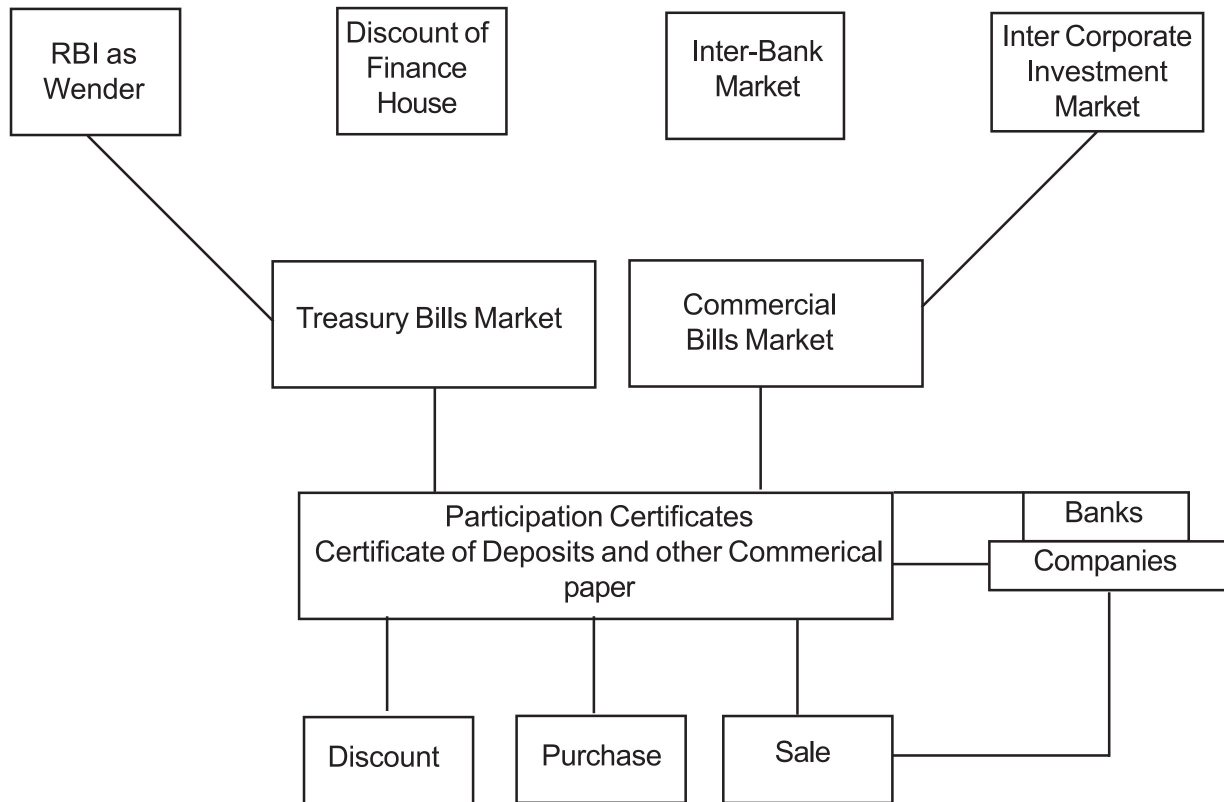


D & FH - Discount and Finance Houses

Source: VA Avadhani, Marketing of Financial Services, Himalaya Publishing House, New Delhi, 2004, P-42.

Inter Connecting

Participants in Money market



Source: V,.A, Avadhani, Marketing of Financial Services, Himalaya Publishing House, New Delhi, 2004, P- 42

The money market consists of a number of interrelated sub markets such as call marker, bill market, treasury bill market, commercial paper market, certificates of deposit market etc.

Participants in the Capital Market:

Following are the participants in the capital market.

* Industrial Development Bank of India (IDBI) as Apex body

* Industrial Finance Corporation of India (IFCI)

* Industrial Credit & Instrument Corporation of India (ICICI)

* Small Industries Development Bank of India (SIDBI)

* Industrial Reconstruction Bank of India

* State Financial Corporations.

* State Industrial Development Corporations

* Life Insurance Corporation of India (LIC)
* General Insurance Corporation (GIC)
* Unit Trust of India (UTI)
* Discount and Finance House of India (DFHI)
* Securities and Exchange Board of India (SEBI)
* Stock Holding Corporation of India (SHCI)
* National Stock Exchange of India (NSE)
* Over the counter Exchange of India (OTCEI)
* Credit Rating Institutions.

The Indian capital market has developed to a large extent due to various measures taken over the years. Various institutions like SEBI, Stock Holding Corporation of India, over the Counter Exchange of India and credit rating agencies have been set up to strengthen and expand the securities market in the country and to provide various services to the investors and companies and also to regulate stock exchanges so as to promote a healthy and orderly securities market. A depository system has been introduced and dematerialised trading is picking up and computerised one line trading between different markets is gathering momentum. All these steps are aimed to achieve greater autonomy to corporates and better transparency for investors.

Financial Services:

Concept: Financial Services Sector refers to that sector which provides are facilities for the people to put their money in various investment portfolios. There has been phenomenal growth in the financial services sector during the last one decade. The growth of capital and money markets and the fast pace of industrialisation have contributed to the development of financial services sector to a greater extent. Financial services sector comprises financial institutions, commercial banks, merchant bankers, brokerage houses and stock advisers. The expansion of financial services at a very fast pace has left its impact on the financial services scenario in the country. In the last fifteen years, coordinated efforts were being made to reorganise and restructure the financial services industry. Such efforts were made by various committees set up by the government to look into specific area of the financial sector. Prominent among these have been the Narasimham Committee on financial sector reforms, the Pherwani Committee on reorganisation of stock exchanges, the Dave Committee on mutual funds etc.

Elements of Financial Services Sector:

The financial services sector consists of three major elements:

(a) Instruments: which include issue of company shares, debentures, fixed deposit certificates, Commercial papers etc.

(b) Market Players: Which include Banks, financial institutions, mutual funds, stock brokers etc.

(c) Regulatory Bodies and Specialised agencies : Which include the SEBI, Stock exchanges, credit rating services, DFHI, SHCI, OTCE of India, Venture Capital companies etc;

Constituents of Financial Services Sector: Following are the various constituents of financial services sector in India.

1) Government: The central government is one of the most important constituents of the financial services sector because of its regulating powers. It has extensive powers under the companies Act 1956, Capital Issues (control) Act and securities contract (Regulation) Act 1956.

2) Regulatory Agencies:

* SEBI - Securities Exchange Board of India
* CCI - Controller of Capital Issues
* RBI - Reserve Bank of India.

3) Financial Institutions:

* Commercial Banks
* Mutual Funds
* Stock Exchanges
* Merchant Bankers
* Portfolio Managers
* Stock Brokers
* Non Banking Financial Institutions (NBFI)
* Financial Consultants

4) Specialised Institutions:

* Discount and Finance House of India (DFHI)
* Stock Holding Corporation of India (SHCI)
* Over the Counter Exchange of India (OTCEI)
* Credit Rating Information Services of India Ltd. (CRISIL)
* Information and Investment Credit Rating Associates (IICRA)

1.5 Nature and Scope of Financial Services:

The nature and scope of financial services are very broad which cover not only the fund based activities are: Mutual funds, Merchant Banking etc; Financial Services industry includes all kinds of organisations which intermediate and facilitate financial transactions of both individuals and corporate customers. In view of the development of industry and trade in the country, the financial services sector had to introduce numerous services in recent years to cater to the requirements of the industry. Following are different types of financial activities/services provided by various financial agencies to suit different financial needs of the country.

1.5.1 Mutual Funds:

Mutual Fund is an institution which pools the savings of the community and invests in various types of securities. Mutual fund units are investment vehicles that provide a means of

participation in the stock market for people who have neither the time, nor the money, nor perhaps the expertise to undertake direct investment in equities successfully. It offers the individual saver the advantages of reasonable dividend and capital appreciation coupled with safety and liquidity. The first mutual fund institution i.e., Unit Trust of India was set up in 1964. Later in nineties, many public sector banks like SBI, Indian Bank, Bank of India, PNB, Canara Bank etc; and LIC GIC have launched mutual funds. Subsequently, foreign mutual funds like ANG Grindlays, Standard chartered and Private Sector mutual funds like Reliance, HDFC, ING Vysya, Tata Birla, Escorts etc; companies have started their mutual fund agencies to mobilise resources in the country.

1.5.2 Merchant Banking:

Merchant Bank is defined as a kind of financial institution that provides variety of services including investments, portfolio management, Corporate Counselling, under writing of the issue etc;. Merchant banking in India is of recent origin. It has its beginning in India in 1967 when Grindlays Bank established a division followed by Citi Bank in 1970. State bank of India started its Merchant Banking Division in 1972. Later on ICICI set up their merchant banking division followed by many nationalised banks and financial institutions. Some private companies have also launched Merchant banking Consultancy Services in a big way. For example, J.M. Financial Consultants Champaklal Investments and Financial consultancy, V.B. Desai Consultancy etc;. Following are the merchant banking services.

* Project Counselling or Reinvestment Studies for investors
* Syndication of Loans and Project Finance.
* Issue Management
* Provision of Working Capital
* Foreign Currency Loans
* Portfolio Management for Non Residents

1.5.3 Hire Purchase Financing:

Hire purchase is a form of credit where goods are supplied after payment of a deposit with an agreement to pay regular installments over a period of time. At the end of the hiring period, legal title passes to the hirer on payment of a nominal sum. The hire purchase Act was enacted in 1972 which provides for regulating various, rights and obligations of the owner (financier) and the hirer under a hire purchase transaction. Commercial banks entered in the field of hire purchase later than the private hire purchase financiers. Ever since nationalisation of bank, commercial banks have been playing a dominant role in providing finance to road transport sector, which is a priority sector for the purpose of their advances, while at the same time, hire purchase companies in the private sector continued to grow because of the fast efficient and personalised services.

1.5.4 Housing Finance:

Housing in India has been one of the important economic activities which serves to fulfil many of the plan objectives, providing shelter to the needy, raising the quality of life, creating additional employment. Further, housing could lead to the generation of additional savings at all levels. Easy access to institutional finance at affordable rates is an essential pre-requisite for accelerating the tempo of housing activity. In the recent past, several private housing finance

companies were set up. The national Housing Bank (NHB) has been set up by the government of India as an apex housing finance body to make funds available to provide refinance the commercial banks, housing finance companies, cooperative housing housing finance companies etc; The NHB has recognised 10 housing finance companies as being eligible for refinance facilities. The Housing and Urban Development Corporation (HUDCO), Housing Development Finance Corporation (HDFC), LIC and GIC have been very active in providing finance for housing facilities.

1.5.5 Venture Capital:

Venture capital is a new financial service, the emergence of which went towards developing strategies to help a new class of new entrepreneurs to translate their business ideas into realities. The capital provided to start a venture is known as venture capital. In particular, for a small entrepreneur with zeal and dynamism but inadequate or lack of finance, venture capital of seed capital is a boom making it a launching pad for financial growth. Venture capital is “equity support to fund new concepts that involve a higher risk and at the same time have high growth and profit potential”. Venture capital carries a high degree of risk, but the potential to generate a substantial rate of return is high, if the project is viable.

The venture capital was originated in USA during the nineteenth and early twentieth centuries. In 1987, the government of India announced guidelines for venture capital companies. In 1988, the first venture capital Company Technology Development and Information Company of India (TDICI) was jointly set up by UTI and ICICI. The Technology Development Fund (TDF) set up by IDBI, the Equity Development Scheme (EDS) set up by SBI Capital Markets Ltd and Canfina which have been joined by India Investment Fund (IIF) Promoted by Grindlays Bank are some of the venture capital institutions set up in India. In the Private Sector, Credit Capital Corporation (CCC) started a venture capital company. Andhra Pradesh Industrial Development Corporation (APIDC) and Gujarat Industrial Development Corporation (GIDC) too have started venture capital subsidiaries.

1.5.6 Portfolio Services:

A new area in which financial services are rendered is portfolio services i.e., managing the portfolios of individuals clients. SBI Personal Banking centres and Vysya Bank’s investors clubs are the two good examples. These are also a few private investment advisers, who guide and help individual investors and manage their portfolios. Portfolio Management service include:

* Guidance on purchase and sale of securities
* Handling of such transactions
* Advise on market conditions
* Safe custody of Documents
* Collection of earnings and dividends etc;

1.6 Leasing Finance:

A Lease is defined as a contract between lessor and a lessee for the hire of a specific asset for a specified period of payment and for a specified rentals. It is an arrangement between two parties, the leasing company and the user, whereby the former arranges to buy capital equipment for the use of latter in accordance with the latter’s requirements and specifications. The

consideration for the transaction is in the form of rentals paid by the lesser to the lessor, who, however, remains the owner of the equipment over the agreed period. The rentals are predetermined and payable at fixed intervals of time, according to the mutual convenience of both the parties. A lese is a finance lease if it transfers substantially all the risks and rewards incident to ownership. Lease rentals refer the payments in the form of interest on the lessor's investment, charges born by the lessor - repairs, insurance, maintenance etc; depreciation and servicing charges.

Types of Leases: Following are the different types of leases:

* Financial Lease
* Operating Lease
* Sale and Lease Back Leasing
* Cross Border Lease
* Leveraged Lease
* Specialised Service Lease
* Foreign to Foreign Lease

Leasing finance business was grown in countries like South Korea, Malaysia and Indonesia and leasing is successful in these countries in mobilising and allocating scare financial resources, while fulfilling the medium term and long term needs of their rapidly growing industry. In India, the first leasing company was promoted by chidambaram group in 1973 at Madras. This was followed by the 20th century leasing company in 1980 at Mumbai. Four other finance companies ie; Shetly Investment and Finance, Motor and General Finance, Jayabharati Credit and Finance and Sundaram Finance joined the stream in 1982. The number of leasing firms in India is about 4000, Equipment leasing was being carried out by ICICI and IFCI which provide leasing for computerisation, exports, expansion etc.

Leasing finance being helpful for the small and medium sized units has gained importance with the increasing number of entrepreneurs. Leasing is accepted as an alternative source of finance. The new industrial policy and other economic measures of the government, withdrawal of investment allowance etc, have made leasing as a financing option. It plays an important role in the financing of machinery, plant and equipment. Thus, alot of optimism has been brought about in the leasing industry due to liberalisation. The need of the hour is to regulate it properly to maximise its benefits to the stake holders. Development banks' participation would bring respectability and stability in the lease market as a result of which lease finance will be widely accepted as an innovative instrument for the growth of entrepreneurship.

1.6.1 Factoring:

Factoring is defined as an out right purchase of credit approved accounts receivable with the factor assuming bad debt losses. With the increase in the volume of production and sales, timely collection and efficient management of receivables has assumed greater importance. Factoring Companies specialise in financing inventories and receivables. Factoring offers a clear solution to the problems created by working capital setting locked up in trade debts. It basically means purchase of book debts of clients. In order to be an economically viable proposition, a factoring agency has to build up a suitable infrastructure so as to ensure optimum efficiency in the working of credit and collection departments so that the fixed costs are absorbed at low unit costs.

Factoring is thus an asset based method of financing as well as a specialised service being the purchase of book debts of a company by the factor, thus releasing the capital tied up in accounts receivables and providing financial accommodation to the company. The factor is an intermediary between the supplier and customers who performs financing and debt collection services. Factoring in one form or other is extended on a large scale in USA, UK and many European countries. The varied services provided by the factors could benefit the large number of suppliers in India. The need for factoring in India arises due to the limitations of the banking industry in the provision of finance, credit protection or collection services. Moreover, an efficient system of receivables management for the manufacturers is the need of the hour.

The RBI has already accepted the recommendations of Kalyana Sundaram Committee and initiated on working out the details. SBI has floated its subsidiary to look after factoring service in five zones of the country. Canara Bank has also floated a subsidiary in the southern region. Private sector is being presently kept out of the factoring services. The establishment of SBI factors and Commercial Services (P) Ltd. is a boom to Indian industries. It was set up by SBI in collaboration with Small Industries Development Bank of India (SIDBI), Union Bank of India and State Bank of Saurashtra in Feb 1991 to service the industry. Since the establishment of SBI Factors and Commercial Services (P) Ltd, the sellers of the industrial products, particularly the manufacturers have improved their cash flows through prepayment facilities, leading to increased sales, continuity of suppliers and reduction in the cost of maintenance.

1.6.2 Forfaiting:

Forfaiting is a financial tool to exporters enabling them to convert their credit sales into cash sales by discounting their receivables with an agency called A Forfaiter. It is also to work as Risk Management tool to exporters because by selling the export receivables to the forfaiter, the exporter is relieved of the political and commercial risks involved in international trade. Forfaiting is a source of finance which enables exporters to get funds from the institution called forfaiter on transferring the right to recover the debts from the importer. The exporter surrenders his right to receive payments in future for immediate cash payments.

Forfaiting is a mechanism of financing exports carried as below:

* by discounting export receivables
* evidenced by bills of exchange or Promissory notes
* without recourse to the seller
* carrying medium to long term maturities
* on a fixed rate basis

Forfaiting is the non recourse discounting of export receivables. The most outstanding benefit of forfaiting is its flexibility and it is gaining popularity because of limitations of the traditional sources of export finance. Finance for exports needs to be fast, cheap and flexible and on all these counts, forfaiting meets the bill. Over a period of time, forfaiting is likely to emerge as an alternative source of trade finance especially for deferred exports.

1.7 Credit Rating Services:

Credit Rating is essentially giving an expert opinion by a rating agency on the relative willingness and ability of the issuer of a debt instrument to meet the debt servicing obligation in time

and in full. It is important to note that the company is not rated but the instrument, issued by the company is rated for its capacity to service that instrument. Credit rating is an assessment of the capacity of an issuer of debt security by an independent agency. A rating agency collects the qualitative as well as quantitative data from a company which has to be rated and it assesses the relative strength and capacity of company to honour its obligations contained in the debt instrument through out the duration of the instrument. The methodology involved is the analysis of past performance of the company and assessment of its prospects. If debt securities are rated professionally and if such ratings enjoy widespread investor acceptance and confidence, a more rational risk return trade off would be established in the capital market.

The ratings are expressed in code numbers which can easily be comprehended even by the lay investors. The ratings are the quickest way of understanding a company's financial standing without going into the complicated financial reports. Credit rating is only a guidance to the investors and not a recommendation to a particular debt instrument. Credit rating is a source of cost information to investors. The collection, processing and analysis of relevant information is done by a specialised agency which a group of investors can trust. A highly rated firm can enter the market with great confidence. It also forewarns the management of the perception of risk in the market. Ratings also encourage discipline among corporate borrowers to improve their financial structure and performance to obtain better rating for their instruments.

The credit rating concept was started in USA in 1860. Subsequently, many countries have evolved the credit rating of corporate firms. The Indian capital market has witnessed a tremendous growth in late 80s and the member of companies borrowings directly from capital market has increased and this has forced the industry for credit rating mechanism of the debt instruments issued. Now, there are four credit rating agencies working in India: (1) Credit Rating Information Services Ltd. (CRISIL-1988), (2) Investment Information and Credit Rating Agency of India (ICRA - 1991), (3) Credit Analysis and Research (CARE - 1993), (4) Duff Phelps Credit Rating Pvt. Ltd. (DCR - India). Credit Rating agencies conduct a rating exercise at the request of a company. In accordance with industry prace allover the world, the methodology involves an analysis of the past performance of the company and assessment of its prospects. Already, more instruments and bonds of banks and corporate companies have been covered under credit rating. The outlook for the credit rating industry is said to be positive.

1.8 Summary:

The financial services sector in India is in a process of rapid transformation particularly after the introduction of reforms in the financial sector. The main objective of the financial sector reforms is to promote an efficient, competitive and diversified financial system in the country. At present, numerous new financial intermediaries have started functioning with a view to extending multifashions services to the investing public in the area of financial services. The emergence of various financial institutions and regulatory bodies have transformed the financial services sector from being a conservative industry to a very dynamic one. Further, the process of globalisation has paved the way for the entry of innovative and sophisticated financial products into our country. Keeping in view of the changed environment, the financial services industry in India has to play a very positive and dynamic role in the years to come by offering many innovative products to suit the varied requirements of the millions of the prospective investors spread throughout the country.

1.9 Self Assessment Questions:

1. What is financial system and explain its structure.
2. Discuss the objectives and role of Financial System.
3. Examine the concept of Financial Markets and explain their participants.
4. What are financial services and describe on the elements of Financial Service Sector.
5. Outline the Nature and Scope of Financial Services and discuss Mutual Funds and Housing Finance.
6. Write short notes on:
   a. Leasing Finance
   b. Factoring
   c. Credit Rating Services.

1.10 Reference Books:

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2. *Marketing of Financial Services* : V.A. Avadhani, Himalaya Publishing House, Mumbai, 2004.
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Lesson - 2

MANAGEMENT OF RISK IN FINANCIAL SERVICES - REGULATORY FRAMEWORK FOR FINANCIAL SERVICES

2.0 Objective:

After studying this lesson, you shall be able:

* to understand the concept of Risk in Financial Services
* to know about various financial risks
* to discuss Risk Measurement and Risk Management under Basel Framework and
* to understand the Role of Regulators of Financial Services

Structure:

2.1 Risk in Financial Services:

2.2 Types of Risks

- **2.2.1 Interest Rate Risk**
- **2.2.2 Credit Risk**
- **2.2.3 Liquidity Risk**
- **2.2.4 Operational Risks**
  - **2.2.4.1 Operational Risk : Types & Sources**

2.3 Risk Measurement

2.4 Risk Management under Basel Framework

2.5 Improving Risk Management Systems

2.6 Role of RBI of Financial Services

2.7 Role of SEBI as Regulator

2.8 Strengthening of SEBI Powers

2.9 Powers of SEBI in regulating Financial Markets

2.10 Summary

2.11 Self Assessment Questions

2.12 Reference Books

2.1 Risk in Financial Services:

Risk is intrinsic to banking and financial services. Banks and financial institutions are

engaged in various financial services. They manage portfolios of assets and liabilities and the accompanying information flows. The key portfolio risks of banking are credit risk, interest rate risk and liquidity risk. These specific risks generate variability in bank's cash flows. Exessive risk taking and adverse economic conditions are the ingredients of bank failure. Risk management continues to be the corner stone of banking today and the ability to gauge risks and take appropriate action would be the key to success. The financial sector failures and banking sector weakness, have induced policy makers to devise prudent risk management mechanism. Market orientation of banking and rapid increase in the cross border movements of international capital have further increased the susceptability of the financial system of the world to a greater degree of risk.

2.2 Types of Risks:

As financial intermediaries, banks are confronted with various types of financial and non financial risks. These relate to interest rate, credit, liquidity, market, forex, equity price, legal, regulatory, reputational and operational risks. These risks are highly inter dependent and events that affect one area risk can have ramifications for a range of other risk categories. Banks therefore, are progressively becoming active to improve their ability to identify, measure, monitor and control the over all risk.

2.2.1 Interest Rate Risk: Interest rate risk management forms one of the most critical components of market risk management in banks. As opposed to a completely regulated regime earlier, almost complete deregulation of interest rates has exposed banks to adverse impact of volatility in interest rates. Generally, the net interest margin (NIM) of banks is a direct function of interest rate movements as such they have a bearing on the earning ability of assets and the costs of liabilities. The objective of interest rate risk management is to ensure a cash flow mechanism that is devoid of major mismatches in both assets and liabilities segments.

The primary form of interest rate risk arises from timing differences in the maturity (for fixed rate) and repricing (for floating rate) of assets, liabilities. The risk that the interest rate for different assets and liabilities may change in different magnitudes is called basis risk. Such risk arises due to imperfect correlation in the adjustment of the rates earned and paid on different instruments. When interest rates change, there differences can give rise to unexpected changes in the cash flows and earnings spread between assets and liabilities.

2.2.2 Credit Risk: Credit risk or default risk refers to the uncertainty associated with loan repayment. The most of the bank's earning assets being in the form of loans, and the problem with loan quality have been the major cause of bank failure. Symptoms of poor loan quality include high level of non performing loans.

2.2.3 Liquidity Risk: This refers to a type of risk which arises when adequate liquidity is not properly maintained by a bank to meet the demands of the public. Banks need liquidity for two reasons - to meet deposit withdrawals and to fund customers loan demand. Bank liquidity can be stored in the balance sheet by holding liquid assets such as treasury bills or short term instruments or through certificates of deposits.

2.2.4 Operational Risks: Operational risks may arise due to careless applied automation and integration of systems and by decreasing organisational ability to perceive, detect and comprehend fully the risk and its magnitude. Operational risk is not just internal and it can result from any component of the value chain. It is the risk of loss resulting from inadequate or failed internal processes, people and systems or external events.

Operational Risk: Types & Sources: Operational risk in a bank or financial institution would result due to following reasons.

* wrong/delayed decisions
* lack of accountability, control and proper auditing
* inadequate management information system (MIS)
* incompetency of staff and lack of proper training and job rotation.
* lack of succession planning and development of second line
* lack of contingency planning
* Non compliance with circulars, policies and regulatory requirements
* obsolete policies
* involvement of staff in frauds and forgeries
* failure of electronic instruments, like computers systems, software and telecommunication equipment
* legal flaws in execution of security documents for advances
* natural calamities and unanticipated changes
* deterioration of bank image due to poor services, staff behaviour and high NPAS etc;.

2.3 Risk Management:

For effective risk management, it is necessary to identify and quantity the risk. Various tools have been evolved to measure interest rate risk and hedge them so as to reduce their adverse impact on bank balance sheet. Risk measurement process involves assessment of the risk and evaluates it based on its criticality. Acceptance of core risks that are inherent to the business as a necessary part of being in business is an important preamble to managing risk. Risk management does not mean risk elimination and it comprises a host of activities like identification, prediction, measurement, mitigation or prevention and allocation of capital to cover operational risk.

Bank activities may be broadly divided into eight business lines, against each of which a broad indicator is specified to reflect the size or volume of bank's activities in that area. The business lines are: Corporate financing, Trading and Sales, Retail banking, Commercial banking, Payment and settlement, agency services and custody, asset management and Retail Brokerage. Banks have to appropriate manage these business lines profitably with proper checks and balances and with a structured management information system (MIS). There is a method called internal measurement approach (IMA) to measure the financial risk. Under this approach, a fixed and stable relationship is established between expected losses and unexpected losses. This relationship may be linear i.e.; the capital charge would be a simple multiple of expected losses or non-linear, i.e., the capital charge would be a more complex function of expected losses. Estimates of operational risk capital are based on measures of expected operational risk losses.

2.4 Risk Management under Basel Framework:

The history of the Basel International codes and standards of Bank for International Settlements (BIS) relating to minimum capital adequacy for banks goes back to the developed countries initiative in 1988 to protect the organisation for economic cooperation and development (OECD) banks from financial crisis during 1980s. According to the norm, the BIS reporting banks were to protect the depositors' money by raising capital form the market up to atleast 8 percent of the risk weighted bank assets. The assets consisting of advances and securities were attributed a three tier credit risk ranging from zero to 100 percent. Generally, government held debt (securities) carried a zero risk while bank borrowings and other loans were respectively at 20 percent and 100 percent.

In 1988, the BIS Committee of Banking regulation and supervisory practices established capital accord for international banks that became effective in 1993. The BIS capital standard called for an 8 percent capital to risk weighted assets and off balance sheet items consisting of two tiers of capital. Such a standard aimed at putting all banks on an equal footing with respect to capital adequacy so as to promote safety and soundness in banking. Basel - I played a significant role in strengthening the soundness and stability of the financial system. It proved the framework for fair and reasonable degree of consistency in the application of capital standards in different countries. Decade of nineties witnessed paradigm shift in supervisory and regulatory environment. Since then many changes have occurred in the structure and practices of banking and functioning of financial markets. Extensive recourse to financial innovations and growing complexity of financial transactions, however necessitated a revision of capital adequacy framework under Basel - I.

The above reasons have led to the evolution of Basel II capital accord. Following are the highlights of Basel II which were given a concrete shape in June 2004.

* It is based on three pillars i.e; minimum capital requirements, supervisory review and market discipline.
* For estimation of minimum capital requirements, credit, market and operational risks have been taken into consideration.
* A flexible approach has been adopted in assigning risk weight for strong and weak borrowers
* Two approaches namely, standardised approach and internal rating approach have been designed for measurement of credit risk.
* The Basel Committee has called for market transparency so that market participants can better understand banks risk profile and adequacy of their capital position.

Basel II and Containing Risk: Banks in India have been advised by RBI in March 2005 to adopt by March 2007, a new, proactive, approach towards risk management as laid down by the Basel Committee on Bank Supervision, an internationally recognised body of bank supervisors. Risk management has been basic to the banking business which is more leveraged than any other comparable business. Banks create a multiplier effect by lending more than what their level of deposits would normally permit. The more risks a bank takes on, the more it has to provide for by way of capital and reserves. Since 1988, banks in India and a hundred other countries have followed what is now referred to as the Basel I standard - a set of regulatory rules designed to cope with the

growing uncertaint in the global financial system. Better regulation and inculcating market discipline among banks have come to recognised as equally important. Basel II proposals would result in significant in crease in the capital change for banks in India.

2.5 Improving Risk Management Systems:

With the increasing degree of deregulation and exposure of banks to various types of risks, efficient risk management systems have become essential. The RBI has issued guidelines on asset liability management and risk management in banks. It should be seen as a medium whereby the risk management systems in India are constantly upgraded to address the changing environment. The current business environment demands a more integrated approach to risk management . The RBI has adopted the risk based approach to supervision since 2003 and about 23 banks were brought under the force of risk based supervision (RBS) on a pilot basis. On the basis of the feedback received from the pilot project, the RBS framework has been reviewed. The risk based approach to supervision is also serving as a catalyst to banks' migration to the integrated risk management systems. In view of the relevance of improved risk management systems under the changing circumstances and the larger emphasis placed on risk management systems in banks under Basel II, It is essential that the RBS stabilises at an early date and serves as important feedback not only to the bank managements but also to the RBI. The financial strength of individual banks which are major participants in the financial system, is the first line of defence against financial risks. Strong capital positions and balance sheets place banks in a better position to deal with and absorb the economic shocks. Banks need to supplement this with sophisticated and robust risk management practices and the resolve to face competition without diluting the operational standards. Banks have to develop technology based risk management tools to create structures for managing and mitigating risk.

Regulatory Framework for Financial Services:

All the banks and financial institutions which are engaged in different financial services were being regulated and monitored for proper growth and effective functioning. Ever since the SEBI Act (1982) was enacted, Merchant Bankers, Stock Brokers, Portfolio Managers, Registrars and Managers of mutual funds etc; are governed by the rules and regulations notified by the SEBI.

2.6 Role of RBI as Regulator of Financial Services:

The Reserve Bank is the apex organisation at the national level which is concerned with the efficient smooth functioning of the Indian financial system. The RBI keeps a watch on the developments and disturbances both of daily and seasonal nature in the financial system. It provides liquidity to the system with a view to facilitate the smooth functioning of the system. The flow of liquidity is controlled through money supply changes, reserve requirements of banks, open market purchases and sale of government securities etc;. The cost and availability of credit is also regulated by suitable monetary policy. The RBI can influence the operation in the financial system through not only the liquidity flows but also through regulation of the banking system of bank loans bank holdings of liquid assets, interest rates, public deposits with banks and non banking financial institutions.

The RBI Act says that the main function of the Bank is to regulate the issue of bank notes and keeping of reserves with a view of securing monetary stability in the country. Thus it is not only a banker to the government but also a banker to the commercial banks, cooperative banks and other

financial institutions in which capacity the RBI provides financial accommodation whenever they need. The Bank has also an important role to play statutorily on the maintenance of the external value of the rupee in view of the close inter dependence of international trade and national economic well being. The RBI has been entrusted with the custody of the country's international reserves and also represents the government at the IMF and operates exchange control and other restrictions on foreign payments and receipts.

As a regulator of the financial system, RBI would need a well developed and well organised financial system in which its actions could percolate from one segment to the other easily and quickly with the result that its control could become effective. RBI also controls and regulates the activities of commercial banks in terms of the Banking Regulation Act, 1949. These regulatory provisions were extended to cooperative banks in 1966 in terms of the Banking Laws (Cooperative Societies) Act 1965. In brief, it can be said that the Reserve bank has three types of functions in relation to the financial system - Financial, Regulatory and developmental.

The Reserve Bank and the financial services sector have gone through farreaching changes in the new millennium. Due to the deregulation measures initiated in the economy after Narasimham Committee (1991) recommendations, the decades of nineties has seen many changes in the financial system which are as follows:

* The Control and Regulatory aspects of RBI were curtailed
* Greater freedom and autonomy to banks with discretionary powers.
* Interest rate policy became more market oriented, less controlled and more flexible.
* The Money Market was reformed to have greater depth and width and number of players and instruments traded were both widened and strengthened.
* RBI became more autonomous and less dependent on the government for policy initiatives
* Financial markets have been kept open to foreign capital inflow and foreign expertise
* Rupee was allowed to freely fluctuate and current account controls were removed and some initiatives were taken towards less capital account controls.
* RBI was strengthened in its control on non banking companies and its regulatory role was extended to the whole financial system.

2.7 Role of SEBI as Regulator:

Securities Exchange Board of India setup in April 1988, became a legal entity in March 1992 and has since acquired larger and sweeping powers early in 1995. The SEBI has first started with issuing guidelines for merchant bankers, mutual funds, portfolio managers and then extended its regulations to all intermediaries in the market like brokers, sub brokers, under writers, registrars, custodians, collecting bankers, debenture trustees etc; SEBI has issued regulations for controlling Insider Trading, frauds and malpractices, for Takeovers and Acquisitions, Central Depositories and Practices of brokers in particular of all stock exchanges. SEBI also laid down a code of conduct to be followed by all registered intermediaries in the market.

Regulations of underwriters of capital issues ad capital adequacy norms for the stock brokers in the recognised stock exchanges were announced in October 1993. At the same time, the SEBI issued guidelines of disclosures in prospectus for investor protection. It has also issued guidelines for takeovers and substantial acquisitions to supplement the provisions of the listing agreement in this regard in the year 1994. It contains separate provisions for bail out takeovers and negotiated acquisition of shares. SEBI has the power to investigate any violations of these regulations. In March 1995, SEBI permitted listing of investment and finance companies, leasing and hire purchase companies on Over The Counter Exchange of India (OTCEI). Those were prohibited to be listed on the OTCEI.

Recent changes in New Issue Market:

In January 1996, the SEBI has dispensed with the requirement of a minimum promoters' contribution and lock in for listed companies with a three year dividend track record in the past five years. Since July 1995, the letters of offer for pure rights issue, unaccompanied by public issue are required to be filed with SEBI but no getting of the same is done by the SEBI and no acknowledgment card is necessary for rights issue. In January 1996, the SEBI has announced that it has stopped vetting all pure debt issues also, if unaccompanied by conversion facility into equity and if such issues are credit rated for adequate safety. The regulations for custodians were finalised by the SEBI in Jan. 1996 containing all the details about registration, annual fee, code of conduct, segregation of activities of each client, annual system of books of accounts, records etc; to be kept for inspection. The custodians would not be allowed to delegate work except to other registered custodians. Book building process was encouraged and initial public offer through book building has been picking up.

2.8 Strengthening of SEBI Powers:

The powers of the government under the securities contracts (Regulation) Act 1956 to control the stock exchanges and their members were delegated to the SEBI, with the final appellate power however resting with the Ministry of Finance. In 1995, the SEBI has been entrusted with more extensive penal powers and more extensive coverage of their jurisdiction. Options and futures which were earlier illegal are permitted to be introduced subject to the SEBI's approval. Even companies are brought under SEBI powers in respect of their capital market operations. Powers to grant recognition to stock exchanges, inspection and audit of stock exchanges and stock brokers' membership and other matters relating to stock exchanges including the recognition to new exchanges have been given to the SEBI.

Venture capital funds are brought under the control of SEBI and similar to guidelines given by SEBI for mutual funds, guidelines are also given for venture capital funds in Feb' 1996. Under the amendment to SEBI Act 1995, many more powers on controlling the intermediaries, investors and all players in the stock and capital markets including penal powers both civil and criminal are now vested in SEBI. In 2000, SEBI was declared by the government as the single controlling agency for the capital market. Nidhis, credit rating agencies. Money Market Mutual Funds (MMMFs) were all brought under the SEBI regulation during 2000.

2.9 Powers of SEBI in Regulating Financial Markets:

SEBI as a regulatory and development board has wide and varied powers to control and monitor the capital market for its smooth functioning. They are given below:

* Power to control stock exchanges
* Power to make and amend bye laws of recognised stock exchanges
* Power to grant registration to market intermediaries
* Power to prohibit insider trading
* Power to prohibit fraudulent and unfair trade practices relating to securities
* Power to promote investor's education end training of intermediaries in capital market.
* Power to levy fees
* Power to conduct research and market surveys
* Power to regulate depositories, custodian of securities, foreign institutional investors
* Company directors to be nominated by SEBI board making it more broad based
* Power to change regulations without prior got approval
* Powers to specify matters to be disclosed by listed companies etc;

Using the above mentioned powers to a great extent, SEBI has initiated several steps and measures to promote, develop and regulate the capital market in the country. These have taken place in the primary and secondary markets. SEBI has built its edifice on investor support and attracted public attention. SEBI has been attempting to professionalise the stock market by fixing up responsibilities and making the small investor a smart investor. Capital market scenario is certainly better than the past and it is poised for a healthy growth with speculative overdoses being kept under control with the sweeping powers being exercised by SEBI.

2.10 Summary:

The Indian financial sector has been well supported by suitable legislative measures taken by the government through various regulatory bodies like RBI, SEBI, IDBI and IRDA etc;. In order to improve efficiency in the banking and financial system, the RBI initiated a host of measures for the creation of healthy and competitive environment. The RBI has also taken sufficient measures to enhance the need for the usefulness of good corporate governance in the financial services sector. Money market is regulated by RBI through its monetary and credit policies keeping in view of the objectives of stable value of currency, promotion of economic growth and providing credit to the growing needs of different sector. Further, SEBI, another important regulator in the financial system, is playing a significant role in the development of securities market on healthy lines and in strengthening the institutions engaged in financial services. It is carefully monitoring the capital market by issuing various guidelines covering both primary and secondary markets from time to time in the changing business environment. Regulators have the most crucial role in improving the services of financial sector agencies in the country. It is significant to note that the road to efficiency lies in minimising regulatory prescriptions and maximising voluntary codes to ensure excellence in corporate governance. Their orderly conduct is an essential pre requisite for a healthy and strong economy.

2.11 Self-Assessment Questions:

1. What do you understand by Risk in Financial Services
2. What are various types of risks in Financial Services and its sources.
3. Examine in detail about Risk Management under Basel Framework.
4. Write briefly on Improving Risk Management Systems.
5. Describe the Role of RBI as Regulator of Financial Services.
6. Discuss the Role of SEBI as Regulator of Financial Markets.
7. Write short notes on:

    (i) Financial Risk
    (ii) Operational Risk
    (iii) Risk Measurement
    (iv) Role of SEBI in Capital Market.

2.12 Reference Books:

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Lesson - 3

STOCK EXCHANGE FUNCTIONS AND ORGANISATION

3.0 Objective:

After going through this lesson, you will get a Bird's Eye view of Stock Exchanges, its functions a importance and organisations and about broking and trading the Equity and Debt.

Structure:

3.1 Introduction

3.2 History and Development of Stock Exchanges

3.3 Functions of the Stock Exchanges

3.4 Organisation of Stock Exchanges

3.5 Securities Control (Regulation) Act 1956

3.6 Powers of the Central Government

3.7 Bye-Laws

3.8 Recognition by the Government

3.9 Securities Contracts (Regulation) Rules 1957

3.10 Membership Rules under SCR Act

3.11 Various Stock Exchanges

- **3.11.1 National Stock Exchange (NSE)**
- **3.11.2 Promoters**
- **3.11.3 Market Segments of NSE**
- **3.11.4 Salient Features of Trading at the NSE**
- **3.11.5 Listing**
- **3.11.6 Trading Mechanism at the NSE.**
- **3.11.7 NSE Membership**
- **3.11.8 NSE - Benefits to Members**
- **3.11.9 Bombay Stock Exchange (BSE)**
- **3.11.10 Trading System**
- **3.11.11 Inter Connected Stock Exchange (ICSE)**
- **3.11.12 Over the Counter Exchange of India.**

3.11.13 National Securities Depository Ltd., (NSDL)

3.11.14 Dematerialisation

3.11.15 Rematerialisation

3.12 Broking and Trading in Equity

3.12.1 Order Routine System (ORS)

3.12.2 Procedure in On line Trading in Equity

3.12.3 Advantages of On line Trading in Equity

3.12.4 Control By SEBI

3.12.5 Prospects of Broking and Trading in India.

3.13 Broking and Trading in Debt.

3.14 List of Stock Exchanges

3.15 Key Words

3.16 Self-Assessment Questions

3.17 Reference Books

3.1 Introduction:

The market for long term securities like Bonds, Equity Stocks and Preferred Stocks is divided into Primary Market and Secondary Market. The primary market deals with the new issues of securities. Outstanding securities are traded in the secondary market which is commonly known as "Stock Market" or Stock Exchange. In the Secondary Market, the investors can sell and buy securities. Stock Markets predominantly deal in the Equity shares. Debt instruments like Bonds and Debentures are also traded in the Stock Exchanges. Well regulated and active stock market, promotes capital formation growth of the Primary Market depends on the Secondary Market. The health of the Economy is reflected by the growth of the Stock Market.

3.2 History and Development of Stock Exchanges:

The credit of starting the earliest transactions in securities goes to East India Company in the 18th Century end. However, the actual stock market transactions were started by the Legislation of Companies Act in 1856. The Stock Market witnessed many booms and depressions before the organised stock exchanges came into being.

Calcutta Stock Exchange was established in 1830 and Stock Exchanges at Bombay and Ahmedabad were set up in 1875 and 1894 respectively. These were organised as voluntary non-profit making associations of brokers to regulate and protect their interests. A need for organised body was felt for the mutual protection and safety of the brokers and the trade which gave birth to CALCUTTA STOCK EXCHANGE ASSOCIATION, in June 1908. Till 1950, Control and Regulation of stock market was a state subject and the BOMBAY SECURITIES CONTRACTS (CONTROL) ACT 1925 used to regulate trading in securities. Under this Act, the Mumbai Stock Exchange was recognised in 1927 and AHMEDABAD in 1937. Under the new constitution in 1950 it became a central subject and a committee headed by A.D. GORWALA went into the bill for securities

regulation. On the basis of the committee's recommendations the Securities Contracts (Regulation) Act because Law in 1956.

Due to out break of First World War, the Indian Stock Market almost became defunct and non-existent and the number of members reduced from hundred to three in 1923.

The Stock Market activity was later received in 1935 with the increases in Textiles Mills and many new plantation companies that have come up in South India. A need arose to cater to the growing trade in plantation and Mill shares and this has lead to the formation of 'MADRAS STOCK EXCHANGE ASSOCIATION (PVT.) LTD.. on 4th September, 1937.

Four more stock exchanges were set up in AHMEDABAD during the Second World War period. Calcutta and Delhi had two stock exchanges besides the existing ones. On 1940 two stock exchanges namely the U.P. Stock Exchange Limited and the NAGPUR STOCK EXCHANGE Ltd. were established in KANPUR AND NAGPUR respectively. In 1944 the HYDERABAD STOCK EXCHANGE Limited was incorporated in Hyderabad as a Company Limited by Guarantee and recognised under the Hyderabad Securities Contracts Control Act modeled on the lines of the Bombay Securities Control Act of 1925. A small stock exchange also sprang up in Bangalore city.

But this proliferation did not last long as many stock exchanges withered away by 1957. Though all the stock exchanges applied for recognition to the Central Government, Under Securities Contracts (Regulation) Act 1956. Only the old Established Stock Exchanges in Bombay, Calcutta, madras, Ahmadabad, Delhi, Hyderabad and Indore were recognised under this act. The Bangalore Stock Exchange Ltd., were recognised subsequently in 1957 and recognised in 1963. At present we have 24 stock exchanges and 21 of them had hardware and software compliance.

3.3 Functions of the Stock Exchange:

The Stock Exchange is defined as "an Association of member brokers for the purpose of facilitating and regulating the trading in securities. A major part of the trading takes place in Equity shares of Public Limited Companies whose transferability by endorsement is ensured under the Indian Companies Act 1956 and under the Securities Contract (Regulation) Act. The Stock Exchange provides the service of getting shares of Public Limited Companies listed for trading purposes. Listing means making a quotation available for a company's share to be traded. Under the present regulation system, public limited Companies with a minimum paid up capital of Rs.5 crores of which 25% are issued to the public can list their securities for trading on a Stock Exchange. For Bombay Stock Exchange (BSE) and NATIONAL STOCK EXCHANGE (NSE) the minimum paid up capital for listing purpose is Rs.10 crores. Following are the major functions of Stock Exchanges:

3.3.1. Maintains Active Trading:

Shares are traded on the Stock Exchanges, enabling the investors to buy and sell securities. The prices may change from transaction to transaction. A continuous trading increases the liquidity or marketability of the shares traded on the Stock Exchange.

3.3.2. Fixation of Prices:

Price is determined by the transactions that flow from investors demand and suppliers preferences. Usually the traded prices are made known to the public. This helps the investors to make better decisions.

3.3.3. Ensures Safe and Fair Trading:

The rules, regulations and Byelaws of the Stock Exchange provide a measure of safety to the investors. Transactions are conducted under competitive conditions enabling the investors to get a fair deal.

3.3.4. Stock Exchanges Helps in Financing the Industry:

A continuous market for shares provides a favourable climate for raising capital. The negotiability and transferability of the securities helps the companies to raise long term funds. When it is easy to trade the securities investors and willing to subscribe to the initial public offerings. This stimulate capital formation.

3.3.5. Dissemination of Information:

Stock Exchanges provide information through their various publications. They publish the share prices traded on daily basis along with the volume traded. Directory of Corporate Information is useful for the investors assessment regarding the corporate handouts, hand books and pamphlets provide information regarding the functioning of the Stock Exchanges.

3.3.6. Performance Inducer:

The prices of stocks reflect the performance of the traded companies. This makes the corporate more concerned with its public image and tries to maintain good performance.

3.3.7. Self-Regulating Organisation:

The Stock Exchanges monitor the integrity of the members, Bankers, Listed Companies and clients. Continuous Internal Audit Safeguards the investors against unfair trade practices. It settles the disputes between member brokers, investors and brokers.

3.4 Organisation of Stock Exchanges:

Some of the recognised Stock Exchanges in BOMBAY, AHMADABAD and INDORE are voluntary non-profit organisations whereas those situated in Calcutta, Delhi and Bangalore function as joint stock companies limited by shares and stock exchanges functioning in Madras and Hyderabad are formed as companies limited by guarantee. Uniformity in their organization is ensured through articles of association which define the constitution of the recognised stock exchanges. The Bombay Stock Exchange was the first to get permanent recognition followed by Calcutta, Delhi, Madras, Ahmadabad, Hyderabad, Indore and Bangalore. The other exchanges were given at the first instance official recognition for a period of five years and at the end of each term the recognition has been renewed for another five year period.

At present there are more than 24 Stock Exchanges in India. As per the present guidelines the proposed region in which the Stock Exchange is to be set up must be industrially developed with a sizable number of industrial units and should be able to attract atleast 50 companies independently.

3.5 Securities Control (Regulation) Act - 1956:

The Securities (Regulation) Act is enacted in 1956 with the main objective of controlling and regulating the activities of Stock Exchange in India. The Act sets up a general framework of control which makes Government influence all pervasive. Every Stock Exchange has to be recognised

under this Act before it starts operations. 'Stock Exchange', means any Development of Backward areas body or individuals whether incorporated or not constituted for the purpose of assisting regulating or controlling the business of buying, selling or dealing in securities. It is an association of member brokers for the purpose of self-regulation and protecting the interests of members.

3.6 Powers of the Central Government in Respect of Stock Exchanges:

The Union Government is vested with the following powers:

1. Grant and withdrawal of recognition approval or change of Bye Laws.
2. Call for periodical returns from the Stock Exchange.
3. Direct enquiries on the members or on the Stock Exchange.
4. Liability of the Exchange to submit Annual Reports.
5. Directing the stock exchange to make certain rules.
6. Supersede the Governing Body of the Stock Exchange.
7. Suspend the Governing Board of the Exchange.
8. Impose any other conditions or regulations for trading.

3.7 Bye-Laws:

Besides the Securities Control Regulation Act, the Securities Contracts (Regulations) rules were also made in 1957 to regulate certain matters of Trading on Stock Exchanges. These are also Bye-Laws on the Exchange which are concerned with the following Areas.

1. Opening/closing of the Stock Exchange
2. Tuning of Trading
3. Regulation of Blank Transfers
4. Regulation of Badla or Carry Over Business
5. Control of the Settlement and other activities of the Stock Exchange
6. Fixation of Margins, Fixation of Market Prices or making up prices
7. Regulation of Taravani Business etc.
8. Regulation of Brokers Trading
9. Brokerage Charges, Trading rules on the Exchange
10. Arbitration and Settlement Disputes
11. Settlement and clearing of the Trading.

3.8 Recognition by the Government:

As stated earlier, a Stock Exchange is recognised only after the Government satisfied that its rules and Bye - Laws conform to the conditions prescribed for ensuring the dealings and protection to investors. Government has also to be satisfied that it would be in the interests of the Trade and

Public Interest to grant such recognition. Mumbai, Calcutta, Delhi, Chennai, Ahmedabad, Hyderabad, Bangalore and Indore have so far been granted permanent recognition.

The rules can be amended, varied or rescinded only with the approval of the Government. Like wise, the Bye-laws of the recognised Exchanges in detail for the regulation and control of contracts in securities and for the trading activities of members must also be sanctioned by Governments amendments or modifications must be similarly approved. The Act empowered the government with power to make enquiries into the affairs of a recognized stock exchange members to supersede the Governing Body and take over the property of an Exchange to suspend its Business and finally to withdraw the recognition to an Exchange should such steps be deemed indispensable in the public interest.

3.9 Securities Contracts (Regulation) Rules - 1957:

Under this Act, Government has promulgated the Securities Contracts (Regulation) Rules 1957 for fulfilling the objectives of the legislation. These rules prescribe the procedure to be followed for

1. Recognition of Stock Exchanges.
2. Submission of periodical returns and Annual Reports by the recognised Stock Exchanges.
3. Inquiry into the affairs of recognised Stock Exchanges and their members.
4. Requirements for listing of securities.

The rules are statutory and applied uniformly to all the recognised Stock Exchanges.

3.10 Membership Rules Under SCR Act:

The regulations governing the admission of members of the Recognised Stock Exchanges are uniform in terms of the provisions of the Securities (Regulation) Rules 1957. These statutory rules provide that no person shall be eligible to be elected as a member if he is,

1. Less than 21 years of Age.
2. Not an Indian Citizen.
3. Adjudged Bankrupt or proved to be insolvent and has compounded with his creditors.
4. Convicted of an offence involving fraud or dishonesty.
5. Engaged as Principal or Employee in any Business other than that of securities.
6. Member of any other association in India where dealings in securities are carried on
7. Director or Employee of companies whose principal Business is that of dealing in securities.
8. Firms and companies are not eligible for membership of a recognised stock exchange.
9. Lastly individuals are ordinarily not deemed to be qualified unless they have had atleast two years market experience as an apprentice or as a partner or authorized assistant or authorized clerk.

3.11 Various Stock Exchanges : Following are the Major Stock Exchanges in India:

3.11.1 National Stock Exchange (NSE):

The National Stock Exchange of India Ltd. was set up with the primary idea of facilitating computerised trading in Debt Market Instruments. This was incorporated in November 1992 by Industrial Development Bank of India and other all India Financial Institutions and because recognised Stock Exchange from April 26, 1993 to provide Nation wide Stock Trading facilities. The National Stock Exchange has a fully automated screen based trading system and operates on the principles of an order driven market. National Stock Exchange is the outcome of the recommendations of Shri M.J. Pherwani Committee. It is expected to operate as Model Stock Exchange and to provide a Nationally integrated stock market system facilitating an easy flow of transactions and resources on a cost effective manner.

3.11.2 Promoters: Following are the Leading Financial Institutions that promoted the National Stock Exchange:

a. Industrial Development Bank of India.

b. Industrial Finance Corporation of India.

c. Industrial Credit and Investment Corporation of India.

d. Life Insurance Corporation of India.

e. General Insurance Corporation of India.

f. SBI Capital Markets Limited

g. Stock Holding Corporation of India Ltd.

h. Infrastructural Leasing and Financial Services Ltd.

3.11.3 Market Segments of N.S.E.:

The National Stock Exchange was intended to establish a viable and vibrant debt market which was in an underdeveloped stage. It provides the traditional retail market for securities and also operates a wholesale Debt Market (which may be termed as Money Market Segment). The National Stock Exchange as conceived consists of three naturally exclusive segments.

1. Whole Sale Debt Market Segment

2. Capital Market Segment

3. Futures and Options Trading

3.11.4 Salient Features of Trading System at NSE:

The National Stock Exchange has a fully automated screen based trading system. It operates on the principle of an order driven market providing complete flexibility to the members in the kind of orders that can be placed by them. The total systems solutions adopted by the NSE involves a technology which is the State of Art. The NSE does not have trading floors as in Conventional Stock Exchanges. The trading entirely is screen based with automated order matching. The screen provides entire market information at the press of a button which the existing telephone trade or

trading floor cannot provide instantaneously. At the same time the system provides for concealment of the identity of market operators. The trading system of the NSE is known as National Stock Exchange of Automated Trading. The NSE is connected through a VSAT (Very Small Earth Based Aperture Terminal) or through leased telephone lines.

3.11.5 Listing:

The term listing means admission of securities of a company to deal on a recognised stock exchange. The principal objective of listing is to provide liquidity and marketability to listed securities and ensure effective monitoring of trading for the benefits of all participants in the market.

A company desiring to get listing at the NSE has to enter into listing agreement and is required to pay the specified listing fees. Thereafter the company is required to comply with all clauses of the Listing Agreement and to send details of Book closure, record dates etc. A copy of Annual report, half-yearly reports and cash flow statements.

The securities of any entity may be listed at any of the following stazes.

1. At the time of public issue of Shares/Debentures
2. At the time of right issue of Shares/Debentures
3. At the time of Bonus issue.
4. Share issue on Amalgamations

3.11.6 Trading Mechanism at the NSE:

The NSE is a completely online screen based trading system accessible to all its trading members on equal time basis. The telecommunications link connecting the trading work station on trading member premises to the NSE's mainframe computer in Mumbai is of crucial importance for the exchange to provide online responses with in a few seconds. The permission to applicants selected as trading members to trade on the Exchange acts in groups as Telecom Network expands progressively to cover all eligible trading members. The NSE's VSAT Telelcommunication Network works as a closed user group and is available to its members. For trading on the system, the trading member will also require a work station which he is expected to purchase along with requisite software. The trading system provides enormous flexibility to trading members. While entering the order a trading member can place various conditions on the order.

3.11.7 NSE Membership:

At the NSE, operations are segmented into the Whole Sale Debt and Capital Market. Professional capability of members to provide desired results of services to investors is the benchmark of obtaining membership of NSE. The Admission criteria for NSE membership is different for the two segments and takes into account financial adequacy infrastructural ability, back ground, experience and education.

3.11.8 National Stock Exchange Benefits to Trading Members:

1. They can provide efficient service to their clients.
2. Their back office load is reduced considerably.

3. There will be no need to occupy office premises near the exchange unlike at present and thus can load reduced establishment cost.

4. The system will assure best practice to participate in the market.

5. Settlement will be quick and efficient.

To Investors:

1. The investor is assured of best price in the market.

2. Price and brokerage are separately shown on contract notes.

3. Date and Time of trade are indicated.

4. The system is better mentioned and regulated ensuring a fair deal to investors.

5. Safety of securities is enhanced in a depository and there will be no problems, delivery loss, theft or forgery.

To Issuers:

1. By a single listing they can provide nation wide access to their investors.

2. As a result their listing costs are reduced considerably.

3. Issuers will have high visibility.

3.11.9 Bombay Stock Exchange (BSE):

The origin of the Bombay (Mumbai) Stock Exchange dates back to 1875. It was organised under the name of "The Native Stock and Share Brokers Association" as a voluntary and non-profit making Association. It got permanent recognition in the year 1952. This Premier Stock Exchange is the Oldest Stock Exchange in Asia. The objectives of the Stock Exchange are:

1. To safeguard the interest of investing public having dealings on the exchange.

2. To establish and promote honourable and just practices in securities transactions.

3. To promote develop and maintain well regulated market for dealing in securities.

4. To promote industrial development in the country through efficient resource mobilisation by the way of investment in corporate securities.

3.11.10 The Trading System:

In March, 1995, the Bombay (Mumbai) Stock Exchange has introduced screen based trading called BOLT (BSE On line Trading). The BOLT is designed to get best bids and offers from Jobbers Book as well as the best buy and sell orders from the order book. Slowly the network is being extended to other cities too. Now the BOLT has a Nationwide Network. Trading work stations are connected with the main computer at Mumbai through Wide Area Network (WAN). The capacity of the Tandem hardware of BOLT is 5 lakhs trades per day (in 6 hours i.e. from 9.30 AM to 3.30 PM). After getting specific approval from SEBI, BOLT connections have been installed in Ahmedabad, Rajkot, Pune, Vadodara and Calcutta.

The securities traded in the BSE are classified into three groups, namely, specified shares or 'A' Group and non specified securities. Again Non-specified Securities are divided into 'B', and 'B'

Groups. ‘A’ Group contains the companies with large outstanding shares, good track record and large volume of Business in the secondary market. Carry forward transactions for a period of 90 days are permitted in ‘A’ group shares. A group contains 150 companies Liquid Securities come under the B group and it comprises of 746 companies. The remaining shares are placed under the ‘B’ group settlements of all the shares are carried out through the clearing house. The settlement period is reduced from 19 days to 7 days for all scrips.

3.11.11 Inter Connected Stock Exchange (ICSE):

This was started Trail runs from August 29, 1998. This is a diluted version of the National Stock Market System (NSMS) recommended by the M.J. Pherwani Committee. The main objective of ISE is to interlink, the Old Regional Stock Exchanges of the country to ensure liquidity. Because of the poor liquidity at the Regional Exchanges there has been a lot of shift in Business to BSE and NSE. The second objective is to minimise the cost of Regional Exchanges as they were incurring huge costs by supporting a very liquid market.

The ISE has received in principle approval from SEBI. The 15 Exchanges participating in ISE are Bangalore, Bhuvaneshwar, Chennai, Kochi, Coimbatore, Guwahati, Hyderabad, Jaipur, Luduiana, Indore, Mugadh (Patna), Mangalore, Saurashtra, Kutch, Uttar Pradesh (Kanpur) and Vadodara. The exchanges that are not part of ISE are Delhi, Calcutta, Ahmedabad, Pune, Mumbai, OTCEI and the National Stock Exchange. The total cost of the ISE project is about Rs.15 crores that is to be shared equally by all participating exchanges.

Mode of Functions: ISE enables a trading member of one exchange to deal with his counter part in other exchanges from his local trader work station using the ISE established central system. The Central Computer is in Mumbai and all the Regional Stock Exchanges are linked to the Central Computer through VSAT. Once these are linked each broker who has a terminal for the local market will be given additional segment of ISE. The broker will have two trading options i.e. he will be able to trade on the local market and the moment he switches over to ISE segment, he will have access to National Market. Whenever he enters an order in the National Market, it will immediately come to the central order book maintained in Mumbai gets matched and reporting will be done. Trading will be done through the same trader work station. Settlement period will be from Thursday to Wednesday and payout will be seven days from the last date of settlement.

3.11.12 Over the Counter Exchange of India:

This was started in the year 1992 after the role models of NASDAQ (National Association of Dealers Automated Quotation) and JASDAQ (Japanese Association of Securities Dealers Automated Quotation). The OTCEI was started with the objective of providing a market for the smaller companies that could not afford the listing fees of the large exchanges and did not fulfill the minimum capital requirement for listing. It aimed at creating a fully decentralised and Transparent Market. Over the counter means trading across the counter in scrips. The counter reforms to the location of the member or dealer of the OTCEI where the deal or trade takes place. Every counter is treated as a trading floor for the OTCEI where the investor can buy and sell. The members or dealers of OTCEI counters are linked to the central OTCEI computer. The member should have the computer and telecommunication facility.

OTCEI is incorporated as a company under Sec.25 of the Indian Companies Act 1956. As per the Registration Norms OTCEI will be obliged to plough back all its profits and will not be allowed to declare dividends on its share capital. The promoters of OTCEI and UTI, ICICI, IDBI, IFCI, GIC,

SBI Capital Markets, Canbank Financial Services and LIC. The players on the OTCEI exchange are the members and dealers. The activities of the members and dealers are:

1. Act as Brokers, buy and sell securities according to the instructions of the investors.
2. Market makers in securities, they quote the prices at which members are willing to buy and sell the specified number of securities.

Members can be the public financial institutions, Scheduled Banks, Mutual Funds, SEBI approved merchant bankers. Banking subsidiaries, venture capital funds and other non-banking financial companies with minimum net worth of Rs.2.5 crores. Members pay a one time non-refundable admission fee of Rs.10 lakh and Rs.5 lakh after one year. The annual subscription fee is one lakh.

The dealers are individuals, partnership firms and corporate entities with a minimum net work of Rs.5 lakh. They should have adequate office space and telecommunications facilities guidelines are issued for the companies whose scrips are to be traded in the OTCEI by the Government. As per the guidelines.

1. The minimum capital requirement for a company to be listed on the OTCEI is Rs.3 crore and the maximum is Rs.50 crores.
2. For the companies with an issued capital of more than Rs.30 lakhs but less than Rs.300 lakhs, the minimum public offer should be 25 percent of the issued capital or 20 lakhs worth of shares in face value which ever is higher.
3. Companies with an issued capital of more than Rs.30 crores seeking to be listed have to comply with listing requirements and guidelines that are applicable to such companies in other Stock Exchanges.

The Procedure adopted for the Listing of the Scrips:

1. An OTCEI member is appointed as a sponsor for the company's issue. The sponsor appraises the project or company on technical, managerial, commercial, economical and financial aspects. The sponsor certifies the OTCEI regarding its appraisal.
2. The sponsor determines the price of the company shares offered to the public, members and dealers of the OTCEI.
3. The sponsor gets all statutory consent and compliance with all SEBI guidelines.
4. The sponsor registers the issue with the OTCEI and places equity.
5. The listing application has to be made to the OTCEI as per its rules and regulations.
6. After getting the approval the allotment is made. Once the allotment is over, the equity is listed and the trading commences. In the primary issue the sponsor carries the activities of issue management and he is the sole underwriter for the issue. He can sub-write his liability with the syndicate of members and dealers.

Trading System:

The OTCEI dealers screen has a left and right halt for the sell and buy counters. The sell counter gives the rate, the number of shares offered and the name of the market maker. It is always in an ascending order with the lowest buy quote given at first. The sell quote prices are displayed in

the descending order and the seller can decide to unload at the highest price displayed. Once the deal is struck, it is entered into the computer. To confirm the transaction on line message appears on the screen. The confirmation slip or trading document is generated through the computer in duplicate. One copy is retained and the other is sent to be OTCEI counter. This is known as the counter receipt.

3.11.13 National Securities Depository Limited (NSDL):

To meet the capital requirements companies turn towards the capital market that is more flexible and responsive source of funds. The savers of Indian Economy a decade ago hold simple pass books of the Post Office and Banks. Today they hold plenty of paper or marketable Financial Assets or Securities. The Stock Brokers have to move large number of paper certificates to give delivery on behalf of their clients. Each transfer deed involves different manual checks. Many of the share transfers are rejected because of some technical defect and investors who sell their shares often, wait a couple of months before they receive their money. Because of this tiring procedure, many of the Foreign Institutional Investors restrict their trading with sensex scrips. In order to mitigate these problems National Securities Depository Limited was established.

National Securities Depository Limited was promoted by the Industrial Development Bank of India, the Unit Trust of India and the National Stock Exchange of India Ltd., to provide Electronic Depository facilities for securities traded in the equity and debt market. The Depositories Ordinances Promulgated by the Government of India in September 1995 enabled the setting up of multiple depository system. The Securities and Exchange Board of India (SEBI) issued the guidelines for depositories in May 1996. The Bill was passed by the Parliament in July 1996. National Securities Depository Limited was registered by SEBI on June, 1996.

Functioning of NSDL: NSDL performs the following functions through its various participants:

1. enables surrender and withdrawal of securities to any from the depository.
2. maintains investors holdings in the electronic form.
3. effects settlement of securities traded on exchanges.
4. carries out settlements of trader that have not been done on the stock exchanges.

NSDL Depository Participant (DP) can be a public financial Institution, Bank, Custodian, Registered Stock Broker or NBFC (Non-Banking Financial Company) subject to approval from the Depository Company and the SEBI. Brokers and NBFCs are required to have a minimum Net Worth of Rs.50 lakhs. Depository participant has to pay a Security Deposit of Rs.10 lakhs and an admission fee of Rs.25,000 to NSDL. The Depository participants are likely to pass on these charges to the investors. NSDL makes use of VSAT Network of the NSE (National Stock Exchange) for communications as it is easier for Depository Participants who have leased lines with NSE to join. After ascertaining its requirement on the volume of trade NSDL would set up its own Network. At present NSE only has the clearing corporation, the National Securities clearing corporation and it can participate in the functioning of NSDL. The Securities Exchange Board of India has now made it mandatory for all Stock Exchanges to have clearing corporation. The Stock Exchanges are setting up their own clearing corporation.

Individual Investor and NSDL:

The investor has to open an account with the depository participant that is similar to the

opening of a Bank Account. Investors can get a list of depository participant from NSDL. The depository participants may also advertise the services offered by them once they are registered. The investor can choose any depository participant of his choice and fill up an account opening form. Reasonable charges are received by the depositories for the opening of accounts and every transaction in the accounts. The investor receives a pass book or a statement of holdings. Just like the Bank Pass Book from the Depository Agent. The statement of holdings is despatched to the investors periodically. The investor can contact the depository participant for any disparity in the statement of holding. It the discrepancy cannot be resolved at the depository participant level, he could approach NSDL for clarification. There is absolutely no restriction with the number of depository participants the investor can open accounts.

Advantages to the Investor:

1. Depositing the securities with NSDL would give the freedom from the worry of loss of share certificates through theft mutilation due to careless handling, fire etc.
2. In setting the shares, the paper work required is reduced to a minimum. Investors also prefer to buy shares that are already in the depository mode. The investor would find it easy to sell the shares whenever he wants to do it.
3. The investor can become the owner of shares within a day of the settlement is being completed. It the shares bought are in the depository mode. There is no need to apply to the company for registering the share in the name of investors. There is no possibility of loss or theft when the share certificates are posted to the company. There is no fear of any fake or stolen shares being delivered to the investor. In the physical transfer of shares, it taken nearly 40-60 days to get the shares registered in his name.

3.11.14 Dematerialisation:

This is a process in which the physical certificates of an investor are taken back by the company. The registrar destroys the shares and equivalent number of shares are credited in the electronic holdings of the investor.

1. Surrendering of certificate to the depository participants for dematerialisation.
2. NSDL is informed by the D.P. through electronic connectivity.
3. Original share certificates are submitted to the registrar by the D.P.
4. The request for dematerialisation from NSDL to the Register.
5. The Register credits an equivalent number of shares in the account and informs NSDL.
6. The NSDL updates its own account and the depository participants are informed.
7. The Depository Agent Credit it in the Account of the and the same is informed to the investor.

3.11.15 Rematerialisation:

Sometimes the investor is likely to convert his electronic holdings back into physical share certificate. The process undertaken for this purpose is called REMATERIALISATION. The investor has to make a request to the Depository Participant for rematerialisation. The Depository Participant puts forward the request to NSDL after verifying whether the investor is having necessary security

balances. NSDL in turn will intimate the registrar who prints the certificate and despatch the same to the investor. The certificate has a new range of certificate has a new range of certificate numbers and new folio number.

1. Investor requests the Depository Participant (DP) for rematerialised.
2. The Depository Participant informs it to the NSDL.
3. NSDL intimate the Registar.
4. The Registar of the company prints certificates with new numbers and informs NSDL.
5. NSDL adjust its account and passes on the details to the D.P.
6. The certificates are despatched to the investor.

3.12 Broking and Trading in Equity:

Many Broking Companies and partnership firms are helping the customers in trading equity. Using the net as a medium for communicating client orders to the stock exchanges through broken websites is called Online Stock Trading or Trading in Equity. Value added services like on the line Stock Quoter, Companies Financial Information and Analysis etc; are also provided by such broker sites apart from full trading through the web site. The online Trading in Equity provides an opportunity to leverage an un-paralleled immediacy, flexibility and transparency to reach out the investors spread throughout the country. In western markets like the (SS about 40 percent of transactions are executed through online. In India too, Internet Trading has taken off in a big way by the initiative taken by most of Big Stock Exchanges. The Premier Exchanges. The Premier Exchanges in India viz. Bombay Stock Exchange (BSE) and the National Stock Exchange of India (NSE) are embracing the Internet in an effort to leverage the power of this medium to reach out to the un-tapped masses by Stock Trading to the desktop.

3.12.1 Order Routing System (ORS):

Using the internet as a route for client orders to Stock Exchanges through a registered broker on behalf of clients for execution of trader is called ORDER ROUTING (ORS). In this system, a broker who opened a website, offers Internet Trading Facility through an electronic template. In ORS, a broker offering internet trading facility provides an Electronic Template/Space for the customer to enter the name of the security whether it is to be bought or sold and the quantity and price specifications. Once the Broker’s System receives the information it is checked electronically against the customer’s account and is routed to the appropriate exchange for execution by the broker. After the order is executed the customer receives a message confirming the order. The customer’s portfolio and Ledger Account may also be updated online to reflect the transaction. The main benefit of ORS is that an investor will have control over the information and quotes and will be able to hit the quote on an online basis. This ensures reliability confidence in the capacity or intention of the broker. There is no need re-confirming the ‘tip’ the broker gave no more running over missed chances.

3.12.2 Procedure in Online Trading in Equity:

As a matter of practice, a provision or space is made in the website for the customer to enter the name of the security, whether he would like to buy or sell quantity and price at which securities are intended to be brought or sold. The Information so furnished by the customer would be checked electronically against the customers, account and is routed to the appropriate Stock Exchange for

execution by the broker. After execution of the order, a message is sent to the customer through e-mail at the time specified by the client confirming the order. The customer's portfolio and ledger account would also be updated online to reflect the transaction. The investor would be allowed to specify the time interval on the website itself within which he would like to receive this information through e-mail. The Broken System would be capable of assessing the risk of the client as soon as the order comes in. The client would be informed of acceptance/rejection of the order within a reasonable period. Reports on margin requirements payment and delivery obligations and so on would be informed to the client through the system. As a matter of abundant precaution, Brokers using internet based systems for routing client orders will also be allowed cross trades of their clients with each other, that is they have to go through the exchange for matching.

3.12.3 Advantages of Online Trading in Equity:

1. Independent Decisions:

With online Trading in Equity the basic requirements are P.C. and modem. One can log on to an Online Trading Portal, go through a comprehensive database of information. Use the online analytical tools and pass on the instructions to the broker.

2. Economical:

Online Trading really is the perfect combination of the medium of the Net Catering to a real life concept. All the information with regard to company's performance to the industrial and economic sceneries the net usually is the perfect solution to investor needs.

3. Convenient:

Online Trading in Equity enables one and all to make trades from any one's home. The case of transaction also makes is highly pragmatic.

4. Fast Mobilization of Resources:

Online Trading in Equity also has a role to play in economic factors such as the mobilisation of savings.

5. End to Fraudulent Practices:

The investors are well equipped with the latest information about the changes in the companies financial position and stock quotes and would be able to hit the quote on an online basis. Such a system puts a full stop to the various types of malpractices to which customers were subjected at present. The individual customers can dependent on their wisdom, capacities and take right timely decisions.

3.12.4 Control by SEBI:

SEBI formulated rules and regulations to be adhered to both by customers and brokers in such a way that malpractices on any side are minimised. It made mandatory for the broker web sites to contain arbitration rules, investor protection rules and links to the relevant stock exchanges site displaying all the rules and regulations. To ensure the financial soundness of the brokers setting up online service, SEBI stipulated minimum Network requirements of brokers to support volumes generated through internet orders. A minimum networth of Rs.50 Lakhs is mandatory for an individual broker and for a team of brokers. The minimum networth is decided by the relevant Stock Exchanges.

3.12.5 Prospects of Broking and Trading in Equity in India:

Broking and Trading in Equity essentially provides investors multiple access points through the net and further exponential growth in the numbers of investors and the amounts invested is sure to create and increase in close connection with the increase in net penetration in India. Improvements in infrastructure, reduction in cost of hardware and the consequent proliferation of cyber cafes across the country will enable investors in smaller towns across India to experience the phenomenon of online trade in Equity. With the increased internet penetration in India. On line broking and trading in Equity with multifaceted advantages of convenience, 24 hours availability and case of transaction is poised to grow exponentially.

3.13 Broking and Trading in Debt:

A Broker is a member of a Stock Exchange who buys, sells or deals in securities. A certificate of Registration from the SEBI is a mandatory to act as a Broker. The Securities Exchange Board of India is empowered to impose conditions while granting the certificate. As a member of a Stock Exchange, the Stock Broker will have to abide by its rules, regulations, Bye-laws, pay the prescribed fee and take adequate steps for redressel of investors grievances within one month of the receipt of the complaint and keep the SEBI informed about the number, nature and other particulars of such complaints.

A Broker seeking registration with SEBI has to apply through the Stock Exchange of which he is a member. The application must be forwarded by the Exchange to the SEBI within 30 days from the date of receipt. For granting registration to the Broker, the SEBI checks whether or not he is eligible to be member of a Stock Exchange, has the necessary infrastructure including manpower to effectively discharge his activities has past experience in the business of buying, selling or dealing in debt and is subject to disciplinary proceedings under the rules, regulations and Bye-laws of the stock exchange with respect to his business and is a fit and proper person.

Every Registered Broker has to pay the SEBI a specified Registration fee based on the Annual Turnover, that is the aggregate of the sale and purchase of securities received and receivable by the Broker during any financial year on his own account as well as on account of his clients. Every Registered Broker has to maintain high standards of integrity, promptness and fairness with due skills, care and diligence in the conduct of all his business. He should not indulge in manipulative, fraudulent or deceptive transactions or schemes or spread rumours with a view to disturb the market equilibrium or making personal gains.

Every Broker is required to keep and maintain the following books of accounts, records and documents: (a) Register of Transactions (b) Client Ledger (c) General Ledger (d) Journals (e) Cash Book (f) Bank Pass Book (g) Documents Register containing particulars of securities received and delivered in physical form. The Capital adequacy requirements for brokers consists of three components (1) Base minimum Capital (2) Additional/Optional Capital related to the volume of business.

The debt market segment provides a facility for Institutions/Body Corporates (Institutional Investors) to enter into high volume transactions in instruments such as Government Securities, T-Bills, Public Sector Under taking (PSU) Bonds, Units of Mutual Funds, Certificates of Deposits, Commercial Papers and so on. The players on the Debt Market segment are trading members and participants.

Trading Members are the recognised members of the National Stock Exchange (NSE). Body Corporates, Subsidiaries of Banks and Financial Institutions can become Trading Members. They are selected on the basis of comprehensive selection criteria. Trading Members must possess a Networth of 2 crore. Participants are the organizations directly responsible for the settlement of the trade. They are large players in the Debt Market and as such take direct settlement responsibility of their own trades executed through Trading Members.

Trading Debt Market Segment is fully computerised online Trading System. The system has increased trading velocities and cut time frames, it has also managed to incorporate the critical aspect of security in its functioning. The NSE provides a facility for screen based trading with order matching facility. The Debt Market Trading System recognises three types of users: (1) Trader, Privileged and Enquiry. Trading Members can have all the three user types whereas participants are allowed as privileged and enquiry users only. The user of a trader gives access for entering orders or traders on the Trading System. The privileged user has the exclusive right to setup counter party exposure limits.

Trading on the Debt Market can be executed in the continuous a negotiated market. In the continuous market, orders entered by the Trading members are matched by the Trading System. The Debt Market Trading System provides for Trading in Debt and other instruments either as outright purchase and sale as Non-Repo trades. While entering the order the Trading member has to indicate the trade type and the desired settlement terms if their order is to settle into a trade. At present the NSE permits the settlement term from T+ o (that is same day) to T+5 (Six Days) and Repo term from three to 14 das. Ropo's allowed in certain Government Securities, PSO Bonds and Corporate Debentures that are traded in a Electronic form.

LIST OF RECOGNISED STOCK EXCHANGES IN INDIA

ADDRESSES AND DATE OF RECOGNITION

Sl.No.	Name & Address of the Exchange	Office Telephone Telex/Fax	Date of Recognition	Approx. No. of Members'
1.	The Ahmedabad Stock Exchange Kamadhenu Complex Shahajanand Complex, Panjarapole Ahmedabad-380008	26561856 STD : 079 TLx:0121-6789 ASEX:100 FAX: 079 GRAM: SHARATION	16-9-57	299
2.	The Stock Exchange (BSE) Prioze Jeejee Bhoy Towers, Dalal Street, Mumbai-400001	2270563/2275581 STD: 022 TLx: 0212-8925 FAX: 022-275981 GRAM: SHARATION	31-8-57	533
3.	The Bangalore Stock Exchange Ltd. UNI Building, Miller Tank, Bangalore - 560052	2225687, 2226577 2222637, 2326631 2227338, 2222137 STD: 080 TLx:080-2874 (BSEIN) GRAM: BANGSTOCKS	16-2-63	223

4.	The Bhubaneswar Stock Exchange Association Ltd., 217, Bhudaraja Building Jharpada, Cutpack Road Bhubaneswar - 751006	252340/41, 255140 254140 STD: 0674 TLx: 0675-437 GRAM: STOCK	5-6-89	300
5.	The Culcutta Stock Exchange Association Ltd. 7, Lyons Range Calcutta - 700001	2203335, 2201488 2206977, 2206957 2201489, 2209368 3202514 STD: 033 TLx: 021-74714 FAX: 033-283724 GRAM: CLASTOCK	10-5-59	726
6.	The Cochin Stock Exchange Ltd., Exchange House, Veekshanam Road Ernakulam P.B.No.3529 Cochin - 680035	GRAM: STOCK		
7.	The Coimbatore Stock Exchange Ltd., Chamber of Commerce Building 8/732 Avanashi Road Coimbatore - 641018	2215100, 2215101 STD: 0422 TLx: 0855-503 FAX: 0422-221130 GRAM: CHAMBER	1991	200
8.	The Delhi Stock Exchange Ltd., 344/4B Asaf Ali Road New Delhi - 110002	2515150/25103 23266845/23271038 23270600/23277708 23271302/23265542 STD: OIL TLX: 031-55317 FAX: 011-3267112 GRAM: UPKARI	9-12-59	375
9.	The Gauhati Stock Exchange Ltd., Saraf Building Annex, A.T. Road, Gauhati-781001	233667, 233672 233670 STD:0361 TLX: 0235-2412 GRAM: STOCKS	1-3-84	126

10.	The Hyderabad Stock Exchange Ltd., 3-6-275, Himayat Nagar, Hyderabad - 500029	236707 Tradiary Hall 231985, 236746 STD: 040 TLX: 0425-6053 GRAM: STOCK EXCHANGE	29-9-58	180
11.	The Jaipur Stock Exchange Ltd., Indira Place, Malaviya Nagar Jaipur - 320017	2552779, 27203637 STD: 0141 TLx: 0365-2648 GRAM: JAI STOCK	9-1-89	600
12.	The Mangalore Stock Exchange Ltd. 4th Floor, Ram Bhavan Complex, Kodal Bail Mangalore - 575 003	235853, 235613 235614 STD: 0284 FAX: 0824-34736 GRAM: STOCK ANARA	9-9-58	60
13.	The Ludhiana Stock Exchange Association Ltd., Phiroze, Gawhdi Market Clock Tower, Ludhiyana	239318, 239319 2404748 STD: 0161 GRAM: DEAL WELL	29-4-83	220
14.	The Madras Stock Exchange Building, P.B.No.183 11, Second Lane Beach, Chennai - 600 001	2512237, 2510845 2514897, 2513081 STD: 044-514897 GRAM: MASTEX	15-10-59	166
15.	The Madhya Pradesh Stock Exchange Ltd., Rajani Bhavan 3rd Floor M.G. Road, Opp:High Court Indore - 452 001	237423, 221773 STD: 0731 GRAM: INDSTEX	24-12-58	72
16.	The Magadh Stock Exchange Ltd., Bihar Industries Association Premises, P.B.No.7, PATNA - 800 001.	2262312, 2262320 2223644, 2222852 STD: 0612 GRAM: MAG EXCHANGE	01-12-86	187
17.	The Meerut Stock Exchange Ltd., Functional Kingsway Building, 345, Bombay Bazar, Meerut - 250 001	273633 STD: 0121		

18.	The Pune Stock Exchange Ltd., Shivleela Chambers, 752, Sadashivpath, R.B. Kumthekar Marg, Pune - 411 030.	2421584, 2858585 2441679, STD: 0212-430764 FAX: 0212-430764 GRAM: STOCK	2-9-82	73
19.	The Saurashtra Kutch Stock Exchange Ltd, 21, New Jagnath Dr. Yagnik Road, Rajkot - 360 002	248176, 242145 STD: 0281 TELEX: 0169-352 SKSEIN	July 89	300
20.	The U.P. Stock Exchange Association Ltd., Padam Towers, 14/113, Civil Lines Kanpur - 208 001	2210133 2210882, 2210601 STD: 0512 GRAM: SHARE BAZAAR	3-6-82	445
21.	The Vadodara Stock Exchange Ltd, 101, Paradise Complex, Opp: Commercial College, Tilak Road, Sayaji Ganj, Baroda - 390 005	232434 (p) 2327501 (E.D.) STD: 0285 GRAM: FAIR DEAL	1990	300
22.	Over the Counter Exchange of India (OTCEI) 92-93, Maker Towers, F. Cuffe Parade, Mumbai - 400 005.	22188164/654/66 22188023 STD: 023	23-8-89	1000
23.	National Stock Exchange of India Ltd., (NSE), Mahindra Towers, Near Doordarshan T.V. Tower, 1st Floor, 'A' Wing Kbc WORLI, Mumbai - 400 018	24928405 24932556 24932578 STD: 022 FAX : 24935631	26-4-93	400
24.	The Inter Connected Stock Exchange of India Ltd., (ICSE), Silver Arcade, 3rd Floor, 147, Marol Maroshi Road, Andheri, East, Mumbai - 400 059.	28593671 28593688 STD: 022 FAX: 8591879	21-10-97	

3.15 Key Words:

1. Capital Market	- This is the Barometer of that country's Economy and provides a mechanism for capital formation. Business firms use capital market for raising long-term funds to take up their capital budgeting proposals.
2. Stock Exchange	- Any body of individuals whether incorporated or not constituted for the purpose of regulating or controlling the business of buying, selling or dealing in securities.
3. SCR Act - 1956	- The Securities Contracts (Regulation) Act is formed in 1956 with the main objective of controlling and regulating the activities of Stock Exchange in India.
4. Online Trading	- Using NET as a medium for communicating client orders to the stock exchanges through broker websites.
5. Order Routing System	- Using the internet as a route for client orders to stock exchanges through a registered broker on behalf of clients for execution of trades.
6. BSE	- Bombay Stock Exchange
7. NSE	- National Stock Exchange
8. ICSE	- The Inter Connected Stock Exchange of India Ltd., (ICSE)
9. OTCEI	- Over the Counter Exchange of India.
10. SEBI	- Securities Exchange Board of India
11. Listing	- Means admission of securities of a company to dealing on a recognised stock exchange.

3.16 Self - Assessment Questions:

1. What are the functions of Stock Exchanges.
2. Specify the conditions for a person to become a member of Stock Exchange?
3. Discuss about Securities Control (Regulation Act) 1956.
4. Explain the powers of Central Government in respect of Stock Exchanges?
5. Explain the procedure of recognition of a Stock Exchange by the Government.
6. Discuss about the membership rules under SCR Act.
7. What are the salient features of trading at NSE?
8. Explain about Inter Connected Stock Exchange (ICSE)?
9. What is over the Counter Exchange of India.
10. Discuss about Broking and Trading in Equity.

3.17 Reading Books:

1. *Security Analysis and Portfolio Management* ; Punithavathy Pandian, Vikas Publishing House Pvt. Ltd.

2. *Investment Management;* V.A. Avadhani, Himalaya Publishing House.

3. *Investment and Securities Market in India Management, Investment Management;* V.A. Avadhani, Himalaya Publishing House.

4. *Banking and Financial Systems;* S.N. Maheswari and R.N. Paul, Kalyani Publishers, Ludhiana.

5. *Financial Institutions and Markets*, L.M. Bhole; Tata McGraw Hill Ltd., New Delhi.

6. *Indian Financial System;* M.Y. Khan, Tata McGraw Hill Publishing Co., Ltd., New Delhi.

Dr. A. SATHISH BABU

Lesson - 4

MUTUAL FUNDS - RELEVANT REGULATIONS

4.0 Objective:

After going through this lesson you will be able to understand about the Mutual Fund Industry in India. Its role and relevance in mobilizing small scale savings and Relevant Regulatory Mechanism.

Structure:

4.1 Introduction

4.2 Origin of the Mutual Fund System

4.3 Objectives of Mutual Funds

4.4 Types of Mutual Fund Schemes

4.5 Advantages and Disadvantages of Mutual Funds

4.6 Organization and Management of Mutual Funds

4.7 Mutual Fund Sector in India

4.8 Geographical Classification of Mutual Funds

4.9 Characteristics of Indian Mutual Fund Schemes

4.10 Tax Benefits Available to Investors

4.11 Mutual Fund in Public Sector and Private Sector

4.12 Pricing Method of Mutual Fund

4.13 Regulatory Framework of Mutual Funds and Objectives

4.14 Regulation and Investor Protection in India

4.15 Role of Self Regulatory Organizations (SRO's)

4.16 UTI Restructuring and Committees on Mutual Funds

4.17 Key Words

4.18 Self Assessment Questions

4.19 Reference Books

4.1 Introduction:

The basic aim of Human Life is to be free from burdens about tomorrow. People are earning money and often they are in a dilemma where to invest their hand earned money with safety. Most of the investors prefer to build their portfolio according to their own ability, knowledge and experience. Whether they are right or wrong, infirmative or ignorant - experienced or in experienced they will

continue the same pattern. If the investor wants to manage his financial matters successfully he requires good knowledge in varied subjects such as Finance, Economics, Taxation, Law, Accounting and statistics. It is not necessary to have a basic degree in all these subjects but basically he must have an aptitude in this area and the investors should have reading habit about. financial matters every day and have to possess the ability to analyze the Financial Data.

If the Investors possess the ability, he can make his own decisions on issues like what to buy when to buy, what to sell, when to sell and what to hold. "Experience makes the man perfect" and if an investor is able to manage his portfolio successfully, the results will be fruited. But Investment Management is a complex system and it is impossible for an investor to be acted independently. The investor has to watch the trends in the stock market. In the Modern busy life most of the people do not find time to handle their own investments, the avenue available to them is "MUTUAL FUNDS".

DEFINITIONS:

1. A Mutual Fund is a special type of investment institution that acts as an investment conduct. It pools the savings, particularly of the relatively small investors and invests them in a well diversified portfolio of sound investment. Mutual Funds issue securities (known as units) to the investors (known as unit holders) in accordance with the Quantum of money invested by them. The profits (or losses) are shared by the investors in proposition to their investments.

2. According to **Mr. James Pierce** "The Mutual Fund is an important vehicle for bringing wealth to holders and deficit units together directly".

3. **Franic Relly** defines Mutual Fund as "Financial intermediaries which being a wide variety of securities within the reach of the most modest investors".

4. According to Securities Exchange Board of India (SEBI) Mutual Fund Regulations 1993 "Mutual Fund means a Fund established in the form of a Trust by sponsor to raise moneys 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.

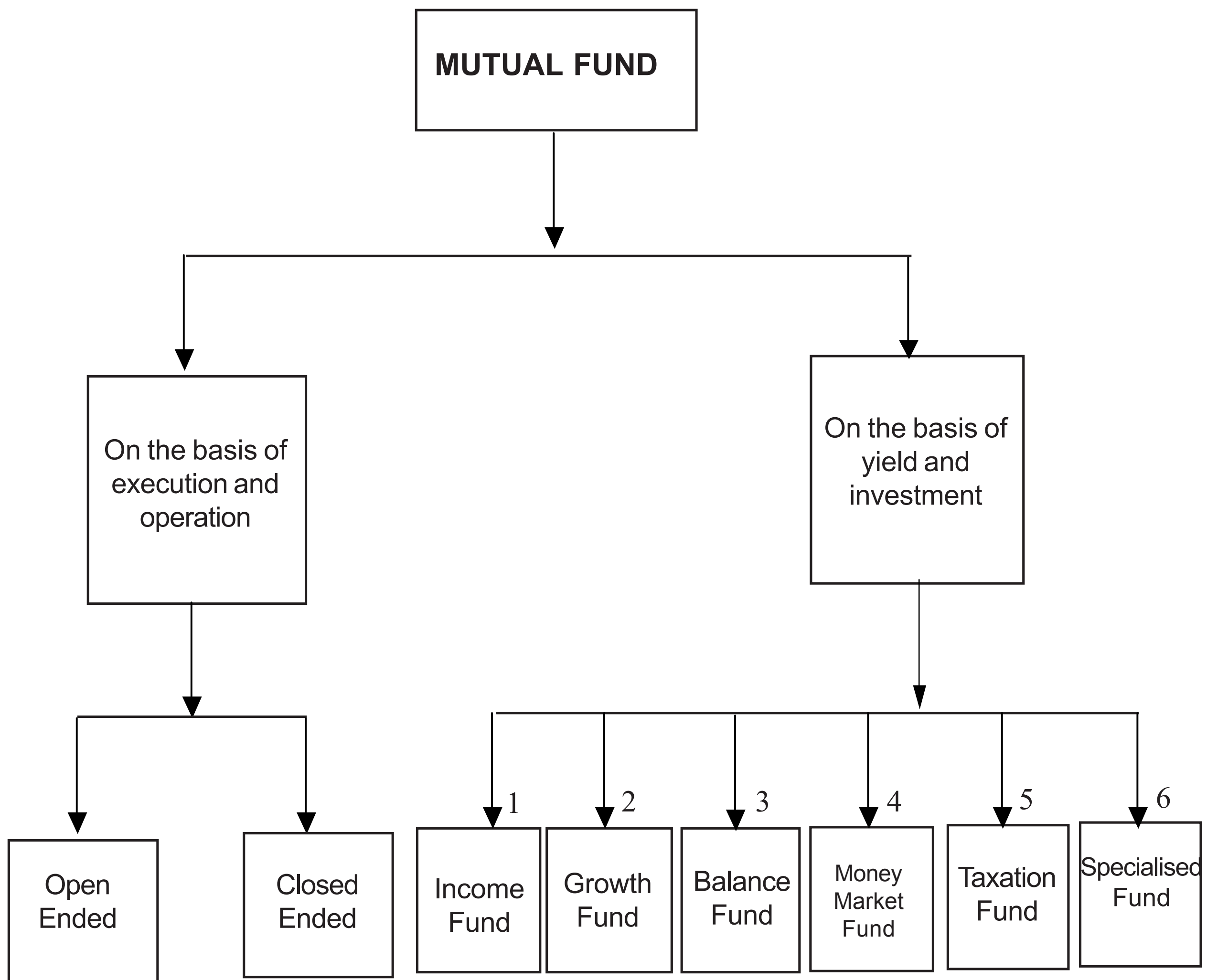
5. According to **J. Fred and Brigham Eugene F**. Unit Trusts are corporations which accept dollars from savers and then use these dollars from savers and then use these dollars to buy stocks. Long Term Bonds, Short term debt instruments issued by business or Government units, These corporations pool funds and thus reduce risk by diversification.

6. In the Indian context, Mutual Fund Trust accepting savings from the investors and invest the same as per the objectives incorporated in the trust deed to manage diversified portfolio which in turn assume reasonable returns to the investors.

4.2 Origin of the Mutual Fund System:

The origin of the concept of Mutual Fund dates back to the very dawn of commercial activity. It is rewarded that Egyptians and PHOENICIANS sold their shares and caravans with a view to spreading the risk attached with the risky ventures. The real credit of introducing the modern concept of Mutual Fund goes to the Foreign and Colonial government Trust, London established in 1986. Thereafter a large number of close ended Mutual Funds were formed in the U.S.A. Twice is followed by many countries in Europe. In all most all the countries both open ended close ended types are popular.

Broadly Mutual Funds can be classified as shown below:



1 **4.3 Objectives of Mutual Funds:**

1. To provide an Investment opportunity to the Investor especially the small income group of people to participate in the growing corporate sector.
2. To mobilize the savings of the public and channel them into productive Investments.
3. To provide a good return on Investment to the unit holders.
4. To cater to the needs of different investors.
5. To strengthen the capital market.

4.4 Types of Mutual Funds:

These funds are of various types and set up for various purposes and objectives. Broadly Mutual Funds can be classified as

A. Open Ended Funds

B. Close Ended Funds

(A). Open Ended Funds and its Features:

In these funds investors can buy and sell units on a daily basis. The scheme has permanent existence and a flexible changing corpus fund. In other words investors are free to buy and sell any number of units at any point of time at prices which are linked to the net asset value.

Features of Open Ended Funds:

1. There is complete flexibility with regard to their investment or disinvestment. The investor can join and come out from the fund as and when he desires.
2. The units are not publicity traded and the fund is ready to repurchase them and resell them at any time.
3. The main objective of this fund is income generation. The Investors get Dividend. Rights or Bonuses as rewards for their investments.
4. The Investor is offered instant liquidity in the scheme that the units can be sold on any working day.
5. Generally the listed prices of the units are very close to their Net Asset Value. The funds fixes a different price for their purchase and sales.

(B). Close Ended Mutual Funds and Features:

This type of scheme has a fixed corpus and operates for a fixed period. At the time of maturity the entire Corpus Fund is invested and the proceeds are distributed to the unit holders in proposition to their holdings after deduction of expenses of the fund by the Trustees. Hence, after final distribution the scheme ends. In close ended scheme, the funds donot, purchase their own shares. Instead, their shares are traded either on an organised exchange or in the over the counter market. If any investor wants to buy or sell shares of a closed ended fund would simply place the order with the broker in his place as if the Investor wanted to buy or sell shares of any company. The contributions from the members are collected during a definite time period of few days to a few months. Listing of close ended scheme on a recognised stock exchange is mandatory.

Features:

1. The period and the target amount of the fund is fixed before hand.
2. Once the period is over and the target is reached the door is closed for the investors and they can not buy any more units.
3. These units are publicly traded through stock exchange.
4. At the time of resumption the entire investment pertaining to a close ended scheme is liquidated and the proceeds are distributed.
5. The Fund ceases to be a fund after find distribution.
6. The main objectives of this fund are capital appreciation.
7. From the investors point of view it may attract more tax since the entire capital appreciation is realized in ToTo.

4.5 Advantages of Mutual Fund Schemes:

1. Safety of investment
2. Stable and fair return
3. Risk reduction and diversified portfolio
4. Investors are relieved of the botheration of managing investments.
5. Helps in expansion of capital markets.
6. Benefit of professional skill of fund managers.
7. Due to Mutual Funds capital formation takes effect.
8. Variety of schemes are available to choose from and some schemes of excellent liquidity.
9. Common Investors are relieved and the problem of managing their portfolio themselves will be eliminated.

Disadvantages of Mutual Funds:

1. The basic problem in Mutual Funds schemes is liquidity. This means capacity or ability to convert into cash.
2. It this being the yardstick most of the schemes are said to be illiquid.
3. Closed ended schemes are to be registered in the recognized stock exchanges and this type of schemes will also setter illiquidity due to the reason that the Net Asset Values may be less than the prices quoted.
4. Mutual Fund Schemes are always subject to market fluctuations.
5. It is felt that mutual funds lack transparency.

4.6 Organisation and Management of Mutual Funds:

A mutual fund can be constituted in the form of a trust and the instrument of trust should be in the form of a Deed duly registered under the Indian Registration Act - 1908 executed by the sponsor in favour of the trustees named in the instrument.

The Trust Deed should contain apart from the rules prescribed by the SEBI, such other clauses that are necessary for sateguarding the interests of the unit holders. However, no trust deed should contain clauses that has the effect of (A) Limiting/Extinguishing the obligations/ Liabilities of the trust in relation to any Mutual Fund/Unit holder or (B) Identifying the Trustees/Asset Management Company for loss/damage caused to the unit holders by their acts of negligence/commissions omission.

The contents of Trust Deed prescribed by the SEBI are as follows:

1. i. A trustee in carrying out his responsibilities as a member of the Board of Trustee/Trustee Company should maintain an arms length relationship with companies/institutions/financial intermediaries and any corporate body with which he may be associated.

   ii. No trustee should participate in the meetings of the Board of Trustees/Trustee company when any decisions for investment in which he may be interested are taken..

iii. All the Trustees must furnish to the Board of Trustees/Trustee Company particulars of Interest that they may have in any other company/Institution/Financial Intermediary/Any Corporate Body by virtue of their position as Director, Partner or with which they may be associated in any other capacity.

2. The minimum number of Trustees would be four.

3. The Trustees must take into their custody/under their control all the property of the schemes of the mutual fund and hold it in trust for the unit holders.

4. Unit holders would have beneficial interest in the trust, property to the extent of individual holding in respective schemes only.

5. It would be the duty of the trustees to act in the interests of the unit holders.

6. It is also the duty of trustees to provide or cause to provide information to unit holders and the SEBI as may be specified by the SEBI.

7. The Trustees should appoint an Asset Management Company (AMC) approved by the SEBI to float schemes for the Mutual Fund after approval by the trustees and the SEBI and manage the funds mobilised under various schemes in accordance with the provisions of the Trust Deed and the SEBI regulations. They should enter into an investment management agreement with the AMC. For this purpose and should enclose the same with the Trust Deed.

8. It is the duty of the trustee to take reasonable care to ensure that the funds under the schemes floated and managed by the AMC are in accordance with the trust deed and the SEBI regulations.

9. The trustees have the power to dismiss the AMC under specific events only with the approved of the SEBI in accordance with these regulations.

10. Appointment of a custodian and responsibility for the supervision of its activities in relation to the Mutual Fund and enter into a custodian agreement for this purpose.

11. The Auditor for Mutual Fund must be different from the Auditor of the AMC.

12. The responsibility of the Trustees to supervise the collection of any income due to be paid to the scheme and for claiming any repayment of tax and holding any income received in trust for the holders in accordance with the Trust Deed and the SEBI regulations.

13. Broad Polices regarding allocation of payments to capital or income.

14. Explicitly for bid the acquisition of any asset out of the Trust Property that involves the assumption of any unlimited liability or should not result in encumbrance of the Trust Property in any way.

15. Forbid the Mutual Fund from making or guaranteeing loans to take up any activity in contravention of the SEBI Regulations.

16. Trusteeship fee if any payable to trustees.

17. No amendment to the Trust Deed can be carried out without the prior approval of the SEBI and unit holders. However in case of subsequently conversion of Board of Trustees into a Trustee Company such conversion would yet require the approval of the unit holders.

18. The removal of the Trustee in all cases would require the prior approval of the SEBI.

19. The procedure for seeking approval of unit holders under such circumstances as are specified in the SEBI regulations.

20. A meeting of the Trustees would be held at least once in every two calender months and atleast six meetings should be held every year.

21. The Quorum for a meeting should be specified with atleast one Independent Trustee/ Director present.

22. The minimum number of Trustees would be four.

The sponsors of Mutual Funds or Trustees would appoint the AMC with the prior approval of the SEBI. Its appointment can be terminated by a majority of trustees or by 75 percent of the unit holders of the scheme. Any change in its appointment also requires prior approval of the SEBI as well as the unit. For grant of approval of the AMC by the SEBI the applicant has to fulfill the following:

(a) An existing AMC should have a sound track record/general reputation and fairness in transactions and should be a fit and proper person.

(b) The Directors of the AMC should have adequate professional experience in Finance and Financial Service related fields and have not found guilty of Moral Turpitude or convicted of any Economic offence or violation of any Securities Laws.

(c) The key personnel of the AMC have not been found guilty of Moral Turpitude or been convicted of Economic offence or violation of Securities Laws or worked for any AMC or Mutual Fund or any intermediary during the period when its registration has been suspended or cancelled at any time by the SEBI.

(d) The Board of Directors of such AMC has atleast fifty percent directors who are not associate of, or associated in any manner with the sponsor or any of its subsidiaries or the Trustees.

(e) The Chairman of the AMC is not a trustee of any Mutual Fund.

(f) The AMC has net worth (paid- up capital and free reserves minus miscellaneous expenditure not written off/adjusted or deferred revenue expenditure intangible assets and accumulated losses of not less than Rs.10 crores.

4.7 Mutual Fund Sector in India:

In our country Unit Trust of India (UTI) started the First Mutual Fund in the year 1964. Subsequently some other leading funds both in public and private sector has entered the arena. These are classified into two categories.

1. Portfolio Classification of Mutual Funds.

2. Functional Classification of Mutual Funds.

1. Portfolio Classification of Mutual Funds:

These are specific funds which are structured for feeding a particular investable purpose. Therefore different Mutual Funds are designed to meet the objective of funds provide fixed returns for those who prefer safety. The savings of investors are invested in various kinds of bonds in which investment is made primarily with different types of savers.

(a) Bond Funds: These are meant for safety. Bond funds specialise in building a portfolio or

corporate or Municipal Bonds. These are conservative in nature and suitable to investors seeking both safety of Principal and Income.

(b) Stock Funds: These funds are established for those who are willing to accept significant risks in the hope of every high return.

(c) Income Funds: A pure income scheme aims at generating and distributing regular income (monthly, quarterly, half-yearly or annually) to the investors. Pure Income Scheme aims at maximization of Regular Income without pursuing for growth objectives. A substantial position of the corpus in invested in high yielding fixed income instruments such as Debenture, Bonds etc., Declaration of Regular Dividends/Interest is the main objective in such schemes. For example SBI Magnum Regular Income Scheme similarly Unit Trust of India has many monthly income schemes. These schemes are very beneficial to the retired and aged investors giving the later an assured level of income with total safety of capital. IND-JYOTI and SWARNA PUSHPA of Indian Bank are purely income oriented.

(d) Money Market Funds: This is very unique concept in India. Investment is made in Treasury Bills and Bonds. Here, the investor has an option to exit from the scheme after a period of more than 30 days.

(e) Specialised Funds: These are to envisage specialising investment in securities of certain Industries or specific income producing securities. Such funds like IT Fund, Pharmacy, Petro Fund carry more risk.

(f) Leveraged Funds: These funds are borrowed funds used in order to increase the size of the portfolio and benefit the share holders.

(g) Balanced Funds: Balanced Funds are those where assets are of an insidious mixture of industrial stocks and Bonds with a view to have modest risks of investment and secure reasonable rate of returns. The funds are employed in high grade common stock with 25% to 40% investments in conservative fixed income securities like debenture/bonds and preference shares.

(h) Growth Funds: A pure growth scheme aims at generating long term capital appreciation for the investor. In this scheme substantial portion of the corpus fund i.e. fund collected is invested in high growth equity shares or other equity related instruments of corporate companies. Growth Funds do not invest in Bonds and Debentures but concentrate wholly on equity investment or in money market operations. Thus, they are able to provide the growth opportunities to their shareholders depending upon their portfolio. They do not guarantee any minimum dividend or give any assurance of Minimum Capital appreciation. Although declaration of dividend is not prohibited but the main objective remains capital appreciation. For example can share and can growth of Canara Bank, Dhan Vika of LIC, Indmoti & Indratna of Indian Bank. Master Growth and Master Gain of Unit Trust of India are growth oriented schemes. Morgan stanley growth fund is a growth fund with a corpus of Rs.981.80 crores from 14,15,611 investors. It is the largest private sector fund and the second largest Mutual Fund Scheme in India. Taurus Mutual Fund and Centurion Quantum Growth Scheme also belongs to this category and also a growth scheme. Major part of the funds is invested in equity whereas in income scheme the major part is invested in fixed returns bearing securities i.e. the investment of certain Mutual Funds.

(i) Dual Purpose Funds: Income and growth are the twin objectives which are achieved by offering halt of the amount of funds to those investors who wish regular income and half to those who wish growth.

(j) Real Estate Funds: These are close ended type. The Fund is named because the collected amount will be invested in Real Estate Ventures.

Functional Classification of Mutual Funds:

This is based on the characteristic of Mutual Fund Scheme opened for subscription. On this aspect the Mutual Funds are classified into open ended and close ended Funds.

4.8 Geographical Classification of Mutual Funds:

National Boundaries provide territories restrictions on the sale and purchase of Mutual Fund Units or shares as in the case of commodity trade or service. In view of this Mutual Fund which operates within the Nation Boundaries are different from those which are meant for subscription of foreigners or the nationals living outside. This classification can be done in two ways.

1. Domestic Mutual Funds
2. Off Shore Mutual Funds

Domestic Mutual Funds are the saving schemes which are open by mobilizing savings from the public within the country. Ex: UTI, GIC, LIC, SBI, CAN BANK, PNB MF, BOIMF, RELIANCE, TATA, DBS CHOLAMANDALAM, FIDELITY, ABN AMRO, BIRLA, SAHARA are the Domestic Funds catering to the needs of public.

The basic objective of opening off shore Mutual Fund Schemes is to attract Foreign Capital for Investment purposes in the country. From Investment point of view, off shore Mutual Fund open up Domestic Capital Market to the International Investor and for Global Portfolio Investments.

The major point of difference between off shore Mutual Funds and Domestic Mutual Funds is the currency and country risk for the global investors as the source of funds from abroad because of high risk and higher return in invested funds can be expected. Like Domestic Mutual Funds, the off shore Mutual Funds can also be functionally classified into close ended or open ended funds.

The major off shore funds opened so far have been close ended schemes providing redemption of the units for individual investors only at the end of the period specified in the scheme. For example UTI's INDIA FUND 1986. INDIA GROWTH FUND, SBI's INDIA MAGNUM, CAN BANK's INDO-SWISS HIMALAYAN FUND, 1990 COMMON WEALTH EQUITY FUND are close ended off shore funds.

4.9 Characteristics of Indian Mutual Fund Scheme:

1. Assurance of Minimum Returns:

Mutual Funds in general do not assure any minimum returns to the investor. Returns are paid to the investors, common separate with the returns earned by the fund on the portfolio as portfolio consists of market risks. Contrary to this, the Indian Mutual Fund Schemes launched during 1987 to 1990 assured specific returns while marketing their schemes. In 1991 (SEBI together with the Union Ministry of Finance ordered that the Mutual Funds do not assure minimum returns. Recently the SEBI (Securities Exchange Board of India) has formulated a policy that mutual funds with a track record of 5 years will be allowed to offer fixed returns. SEBI shall prescribe the returns to be assured from time to time. However, no funds will be allowed to offer fixed returns for more than one year.

2. Multiple Options: Most of the Mutual Fund Schemes are offering different options to the investor under scheme. For example, a Growth Oriented Scheme may offer option of either regular income plan: Dividend shall be distributed to the investors. Second Dividend will be reinvested and the total amount will be paid at the time of redemption. Ex: LIC MF offered DHANA VARSHA with the following options.

1. Immediate Monthly Income
2. Differed Monthly Income
3. Accumulated Income and Benefits Under Section 80(1) of the Income Tax Act 1961.
4. Growth with Capital Gain.

3. Lock in Period: Mutual Fund Scheme offer documents contain a clause of lock-in-period ranging from one year to three years. Until the completion of the minimum period the investors are neither to trade the units on the stock exchange nor to avail repurchased facility.

4. Liquidity:

This means conversion of the asset or security into cash.

(a) Open ended Mutual Funds offer the facility of repurchase and the close ended schemes are also offering repurchase after a minimum period of 2 to 3 years.

(b) Mutual Fund Units can be pledged or mortgaged in favour of Commercial Banks or Financial Institutions and can obtain a loan according to the rules and regulations of the Bank or Financial Institutions.

(c) Mutual Fund units can be transferred in favour of any individuals. However, the Tax Planning Schemes units are not transferable.

5. Incentives to Early Subscribers:

Most of the close ended Mutual Fund Schemes are offering incentives to encourage early subscription by investors. This is more prevalent in Tax Planning Schemes.

4.10 Tax Benefits Available to M.F. Investors:

1. Under Section 80(L) of the Income Tax Act 1961, Income received on units or mutual funds are qualified in a deduction upto Rs.7000 along with other specified securities and deposits.

2. Benefits Under Wealth Tax: Investment in Mutual Funds would be treated on par with investments entitled to exemption with overall limits of Rs.5 lakhs and permitted in Section 5(IA) of the Wealth Tax Act 1957.

3. Benefits Under Gift Tax: No tax shall be changed on gifts of Mutual Fund limits provided the aggregate value of gifts made during the year does not exceed Rs.30,000/-. Further the gift made to a relative who is dependent on the unit holder for support and maintenance on the occasion of the marriage of the relative is exempted provided the value of the gift is upto Rs.1,00,000 each such relative.

4. Tax Benefits for Eligible Institutions: Investment in Mutual Fund units by religious or charitable Trusts is an eligible investment under Section 11(5) of the Income Tax Act. Eligible institutions

such as those covered in the units would qualify the tax exemption in respect of income and corpus under the applicable sections of the Income Tax Act 1961.

5. Tax Benefits for Corporate Sector: A Corporate Sector is entitled to deduction in computing its income in respect of dividend received by it from another Domestic Company under Section 80 M of the Income Tax Act. For this purpose UTI is considered as a domestic company. Due to this reason UTI is having an advantage when compared to other Mutual Funds.

4.11 Mutual Fund in Public & Private Sectors:

In our country there are three categories of players in the Mutual Fund Industry.

1. Unit Trust of India.
2. Mutual Funds floated by Public Sector Banks and Insurance Companies.
3. Private Sector Mutual Funds.

1. Unit Trust of India:

Popularly known as UTI has laid the foundation for Mutual Fund industry. UTI being a public sector company had assumed monopoly in savings mobilisation of house hold sector through its various Mutual Fund Schemes beginning from 1964 to outer to the needs of different investors i.e. Monthly Income Schemes. Capital Gains Schemes, Equity Linked investment plan etc., Recently it has been divided into two UTI -1, AMC-1 which covers only unit 1964 scheme and all other schemes are managed by AMC-2.

2. Public Sector Banks:

The monopoly of UTI in the field of Mutual Fund Industry was broken in 1987 with entry of Public Sector Banks and sponsoring Mutual Fund Trust. Under the Indian Trust Act, presently there are 5 Public Sector Banks having Mutual Funds in operation. They are:

1. State Bank of India.
2. Canara Bank
3. Bank of India
4. Punjab National Bank
5. Indian Bank.

1. State Bank of India : Capital Markets Ltd., a subsidiary of SBI manages Mutual Funds. It has an investor base of more than Ten Lakhs with total investment of Rs.4,300 crores in all the schemes. SBIMF has launched an off-shore fund to tap Foreign Investment known as INDIAN MAGNUM MUTUAL FUND. This is the largest off-shore, country fund with subscriptions in W.S. $200 million.

2. Canara Bank Mutual Fund: It is sponsored by Canara Bank and is the 2nd largest. Mutual Fund aimed to maximize capital appreciation with a provision to distribute earnings.

3. Bank of India Mutual Fund: It was launched in July 1990 at the time when capital market was booming. It has created a trust known as Bank of India Finance Ltd., as its Fund Manager. For the first time this scheme introduced the concept of capital gain benefits for the investor and collected Rs.484 crores.

4. Indian Bank Mutual Fund: It has been set up with main objective to mobilize savings from the Indian Public and to invest them to get a good return on investment and achieve long term capital appreciation and this process assist, capital formation and Industrial Development of the country and to provide investment expertise for the benefit of investors. The main objective of the trust is to pool the funds received from subscription acquisition, holding securities, trading or disposal of securities or any other assets whatever for the purpose of having the effect of providing facilities for participation by the persons as beneficiaries in profits or income arising there form.

5. Punjab National Bank Mutual Fund: It is like the Punjab National Bank as Trust under the Indian Trust Act. It offers regular income and capital appreciation. It offers several schemes for investors.

6. LIC Mutual Fund: It was setup in 1989 as a seperate trust by LIC. The basic objective of LICMF is to collect savings of people especially from Rural and Semi Urban areas and providing good returns. Liquidity and capital appreciation. LIC is the largest Insurance Companies in the world serving more than 8 crore policy holders.

7. GIC Mutual Fund: It has been set up as a trust by GIC and its 4 subsidiaries. The basic objective of GICMF is to mobilize savings from the public and canalize them to the capital market with a view to provide safety, security, returns and liquidity to the investors.

Apart from the Mutual Fund Players in the public sector there are several private players who are mobilizing funds from the public. Mutual were conceived as institutions for providing small investors with avenues of investment in the capital market. Small investors generally do not have adequate time to speed in the capital market. Knowledge, experience and resources for directly accessing the capital market and as such they can rely on investment intermediary which undertakes judicious investment decisions and provides the consequential benefit of professional expertise.

4.12 Pricing Method of Mutual Funds:

(a) Open Ended Scheme: In this scheme the investors can buy and sell units on a daily basis. The scheme has permanent existence and a flexible changing corpous fund. In other words Investors are free to buy and sell any number of units at any point of time at prices which are linked to the Net Asset Value (NAV) of the units. NAV is calculated as follows. For example ‘X’ company has introduced a scheme known as “FORTUNE”. The size of the scheme is 200 crores. Now the NAV is

NAV = 200 crores/100 crores Units x value of each unit x 10 = 2 x 10 = Rs.20.

The value of each unit of Rs.10 is worth of Rs.20. Hence Net Asset Value (NAV) = Rs.20. This NAV is the basis for fixing the repurchase price and fixed price. When the open ended Mutual Fund Investor wants to sell his units, he usually receives an amount equal to the funds NAV times the number of units sold. As the NAV changes with the changes in sharp price, the prices at which the investor can buy or sell the units. There will be a small difference between the buying and selling price because of the transaction cost and stamp duty involved in the buying and selling. As a matter of fact, open ended scheme provides complete fee flexibility to the investors and the investor is at liberty to invest or disinvest scheme. NAV of a Mutual Fund scheme is as important as EPS to a company’s share before and after investment. Hence there is a need for a proper computation of NAV by taking into consideration the accurate value of investments, income earnes on the investment and the related expenditure.

Closed ended scheme units are listed in stock exchanges and are traded like equity shares of

any other industrial company. However in the Indian situation some of the funds extended the facility of repurchase to the closed ended schemes also. The reason for this is that the stock exchanges are located in the metro cities that are not easily accessible to the rural and semi-urban investor prices policies of close ended schemes, the fixation of repurchase price plays a vital role in the close ended schemes also. Theoretically repurchase price should be equal to Net Asset Value (NAV). But the policies of Mutual Funds regarding computation of repurchase price and divergent.

4.13 Regulatory Frame Work of Mutual Funds:

Regulatory Frame Work of Mutual Funds is to give suitable direction to the functioning. The need for regulation is SAFETY of the principal amount and this is very essential for any financial instrument. Where this is not assured there is a possibility of high defaulterise and the investor requires protection. The investors of Mutual Funds/Unit Trust are exposed to high default risk in comparison to investors of other alternative instruments such as Bank Deposits, Debentures and Equity Shares. The Government of India guarantees the savings instruments promoted by the National Savings organisation through post office. Hence the saver/investor is protected various deposits mobilised by commercial banks are protected by the capital adequacy norms laid down by the RBI (Reserve Bank of India) and the credit guarantee corporation gives protection to the bank deposit, holders to some extent. Thus, the investors of Bank Deposits are protected by capital adequacy and Insurance. Various Debenture holders of the corporate sector are protected by the Asset structure of the company capital adequacy.

In contrast, the investors of Mutual Funds/Unit Trust are exposed to both high risk, both default and market risk. Hence there is a need for a strong regulatory frame work.

Objectives of Regulatory Frame Work: The Mutual Fund Regulations should meet the following objectives:

1. Ensure that the Mutual Funds are arranged for the benefit of the investors with fiduciary responsi bilities by charging a rational management fee.

2. Establish confidence among the investors that the funds pooled are invested with clear investment objectives and policies and protect the physical integritty of the assets.

3. Assume that investors receive adequate and accurate information about their investment.

4. Ascertain that funds should not become the investment for the sponsor encouraging the self-dealing and affiliated party transactions by using their privileged positions.

5. Formulate rules for accurate and fair of investment, Net Asset Value, Repurchase price and redemption price.

In the context of the specialised financial intermediaries, the regulations must encourage the operational freedom of the fund managers and creativity in finding out the innovative products. At the same time regulations should provide the utmost protection to the investor. According to **DAVID SILVER**, President Investment Company Institute U.S.A. the following are the principles necessary for Mutual Funds.

1. Prohibition of regulations of various forms of self-dealing or affiliated party transactions.

2. Economic Regulations on Management remuneration.

3. Restriction on unfair or unsound capital structures.

4. Clear disclosure of investment objectives and policies

5. Protection of the physical integrity of the Asset of the pool.

4.14 Regulation and Investor Protection in India:

Securities Market Regulation in India is in process of evolution and cannot be identified either with the UK or the US type of regulation. In India, under the present frame work the regulation of all participants in the securities market is the responsibility of SEBI with the exception of issuers of capital.

SEBI's basic objectives as the Prime Regulator of capital market activities in India are to protect the interest of investors. This objective has been started in the preamble of the Securities and Exchange Board of India Act, 1991, thus to protect the interests of investors in securities and to promote the development and to regulate the securities market and for markets connected therewith or incidental thereto. Accordingly all the capital market activities including that of Mutual Funds are covered under the above objective so far as investor protection is concerned.

The Securities and Exchange Board of India (Mutual Funds) Regulations 1993 was the first attempt to bring Mutual Funds under a regulatory Frame Work and to give direction to their functioning. However it was observed in the course of time that the industry needed a more flexible work environment. Therefore SEBI came out with new regulations in 1996 which eliminated many of the rigidities contained in the 1993 regulations and at the same time introduce new provisions as regards disclosure transparency and obligations on the part of Mutual Funds, AMC's Trustees and key personnel. The Securities and Exchange Board of India (Mutual Funds) Regulations 1996 (Hereafter Regulations) has many similarities with the Investment Company Act, 1940 of the USA so far as Mutual Fund Regulation as investor protection are concerned. The Regulatory and supervisory powers of SEBI also stand strengthened by the Securities Law (Amendment) Ordinance 1995 which empowers SEBI is also allowed to file complaints in the courts without prior approval of the Central Government. SEBI has thus emerged as an autonomous and powerful regulator of Mutual Funds in India. The regulations lay down measures to protect Mutual Fund Investors. Some of the measures are briefly discussed below:

SEBI has incorporated several provisions to check Mutual Funds at the entry level similar to the provisions of "fit and proper" test in the U.K. Every Mutual Fund shall be registered with SEBI and the Registration will be granted on fulfillment of certain conditions laid down in the regulations for efficient and orderly conduct of the affairs of a "Mutual Fund". The regulations further stipulate that the sponsor must have a sound track record and experience in the relevant field of Financial Services for a minimum period of five years professional competence, financial soundness and general reputation of fairness and integrity in all business transactions.

SEBI has laid down conditions of appointment and obligations of trustees and detailed guidelines on trust deed. The Asset Management Company (AMC) to manage the assets of Mutual Funds is to be approved by SEBI also lays down the terms and conditions for approval being that the AMC are to be persons having adequate professional experience in finance and financial service related fields. Mutual Funds must have a custodian to be approved by SEBI and one of the preconditions for approval is the "Sound Track Record, General Reputation and Fairness in Transactions".

SEBI had laid down several provisions for pre-launch and post-launch disclosure to ensure

that investor can take informed decision on the basis of factual information supplied by a Mutual Fund.

No new scheme can be launched by any Mutual Fund unless the same is approved by the trustees and a copy of the document has been filed with the Board. SEBI has also stipulated that the AMC should stipulate the minimum amount it seeks to raise under the scheme and the extent of over subscription to be retained. There are clear regulatory provisions regarding listing of closed ended schemes, refunds, transfer and sending of unit certificate to investors. There is also a provision for disclosing the names of trustees of mutual funds, all Directors of AMC in the prospectus of the funds, as also investment objectives and strategy and approximate percentage share of investment to be made in various instruments. No guarantee of return can be given unless it is fully guaranteed by the sponsor a AMC and a statement indicating the manna of guarantee and the same of the person who will guarantee the returns is made in the offer documents.

SEBI has outlined the advertisement code to be followed by Mutual Fund in making any publicity regarding a scheme and its performance.

All mutual funds are bound to publish a scheme wise Annual report or an abridged summary through an advertisement within six months of the closure of financial year. The trustees of Mutual Fund are bound to convey to investors any information having adverse bearing on investment. A Mutual Fund is also to publish half-yearly un-audited financial results through an advertisement.

SEBI has prescribed norms for investment management with a views to minimize/reduce under investment risk. There are also certain restrictions which are aimed at ensuring transparency and prohibiting Mutual Funds from excessive risk exposure. These restrictions and limitations have strong similarities with such provisions in the U.S.A. and U.K.

SEBI can inspect the Books of Accounts Records and Documents of a Mutual Fund Trustees, AMC and custodian.

In addition Securities Law (Amendment) Ordinance 1995, further empowers SEBI with certain penal actions for violations of Regulations. SEBI can impose monetary penalty under the following situations.

* If any Mutual Fund violates terms and conditions of certificate of Registration, SEBI can impose penalty not exceeding Rs.10 lakhs.
* It a Mutual Fund fails to comply with listing conditions a penalty not exceeding Rs.5000 for each day or Rs.5,00,000 which ever is higher can be imposed.
* It a Mutual Fund fails to dispatch unit certificate in the manner provided it shall be liable for penalty not exceeding Rs.5,000 per day for each day during which such failure continues.
* A Mutual Fund is also liable for penalty, if it fails to refund applications money (specified in the Regulations) not exceeding Rs.1000 per day during which such failure continuous.
* A Mutual Fund can be pevalized if it fails to invest the money collected under a scheme in the manner or within the period prescribed in the regulation such penalty will not exceed Rs.5,00,000 for each failure.
* A penalty of Rs.5,00,000/- for each failure of the AMC can be imposed if it fails to comply with any restrictions provided in the regulations.

As we can see the regulatory frame work as stated above indicates that SEBI is a highly powerful regulator. The Indian Regulatory mechanism is centered on statutory provision. There is a strong emphasis on ex-post investigation and disciplining of Mutual Funds through financial penalty for violation of regulation. The implict tone of regulations is correction through control. There are enough provisions for disclosure. Thus, the Regulator, mechanism and supervisory control are both strong enough for protecting the interests of investors. However the protection can be strengthened further by including a few more elements like investor's protection fund and credit rating.

Indian Mutual Funds have so far never failed to pay reasonably good returns on investments. They have been paying more than guaranteed returns (whenever promised). However keeping in view the emerging scene of competition, the entry of Mutual Funds with unknown track record and growing market volatility, the introductions of investors and protection fund would increase the investor confidence in Mutual Funds and reduce the risk of Mutual Fund investing. Modalities of the Fund can be jointly worked out by SEBI, the Mutual Fund industry and the Government. The Fund can be run on the principle of insurance and managed by a separated body.

Voluntary credit rating can be introduced for Mutual Funds Schemes to help investors to take an informed view of products management and expected performance.

4.15 Role of SRO's:

Self Regulatory Organisations (SRO) should be an integral part of the regulatory mechanism in a financial service industry. The establishment of a strong SRO for Mutual Funds in India becomes imperative, particularly in view of the imperfections of the market system in the current period of Economic transition. Economic transition is often characterized by market volatility. Speculation and frandulent activities which may lead to market failures and exposes investors to great risks. Statutory regulations and ex-post investigation could well fail to prevent market failure unless the explicit and implicit implications of provisions are understood and implemented. An SRO can play an important role in disciplining members and assist the Regulatory Authority in Protecting investor's interest. Further SRO can be effective in the following ways:

* It can help the Mutual Fund Industry to grow on business principles by helping member organisations to overcome environmental, organisational and procedural constraints.

* It can develop an internal code of conduct to be followed by members to prevent them from adopting un-ethical Business Practices.

* It can also conduct periodic checks on the activities of member funds. This will increase the changes of fair business, prevent frauds and increase the confidence of investors.

* It can undertake investor education through publication and seminars.

* An SRO can also develop a code of conduct for associates the Registrars, Custodians, Brokers and Agents.

* SRO's can actively undertake research studies and training for members as well as investors. SRO's can play an active role in promoting the Mutual Fund culture by conducting Research and Producing Literature.

* Business growth and Development require efficient and trained Managers. The Associa-

tion can undertake the training to develop a band of competent Managers for Mutual Funds.

The Association of Mutual Funds in India (AMFI) was formed in August 1995 by the Indian Mutual Funds with a view to promoting and protecting the interest of Mutual Funds and their unit holders, incresing public awareness of Mutual Funds and serving the investors interest by defining and maintaining high ethical and professional standards in the Mutual Funds Industry. To achieve this objective, AMEI has undertaken investor's Awareness programming and is also working to bring out a comprehensive code of ethics for Mutual Funds.

4.16 UTI Restructuring and Committees on Mutual Funds:

UTI, Country's Largest Mutual Fund in an un-precedented move suspended sale and purchase of U.S.-64 in June -01 sending shock waves across the country. The move to suspend U.S.-64 was aimed at achieving the twin objectives to restructure the investment portfolio of the scheme in face of volatile stock market as well as to wait for the market to become stable so that the equity investment of U.S. 64 fetch high returns.

There were more than 20 million investors in U.S. 64 with a total investment of Rs.20,000 crores. Investment in U.S. 64 was little more than 25% of the total fund of Rs.75,000 crores managed by UTI. Unlike other schemes U.S. 64 was not linked to NAV and many times higher rewards were given to unit holders. It is reported that many investment decisions were taken by UTI without sufficient financial prudence and sound analytical basis. It is also reported that individuals took many investment decisions defying the views of evaluation committee.

Things were not good for UTI since the beginning of liberalisation. In 1998 Government sanctioned a bail out package of Rs.3300 crores to restore the health of UTI. DEEPAK PAREKH Committee recommended UTI restructure its investment portfolio to fixed income securities and move to a Net Asset Value (NAV) based system. The committee suggested that UTI should being its operations under the supervision of SEBI.

Being a behemoth in capital market the problem of UTI led to steep fall in prices of many shares and drastic erosion in market capitalization. Since UTI does not have sufficient funds to deploy, the share prices of many corporates are subdued despite better financial results. Following uncertainty so surrounding the fate of UTI, the redemptions were huge and for the first time the total investment in UTI has fallen below Rs.50,000 crores out of Rs.1,00,000 crores investment in the Mutual Fund Industry. Government have decided to bailout UTI once again in order to project the interests of investors and restore their confidence. For this purpose Y.H. MALEGAM Committee was asked to review the recommendations of Deepak Parekh Committee and suggest follow-up action while TARAPORE COMMITTEE was asked to look into UTI's investment over the past 10 years to find it extraneous considerations played a role in the trust's investment decisions. The committee suggested as follows:

Y.H. MALEGAM COMMITTEE:

1. Three tier structure in line with SEBI regulations comprising a sponsor. A trustee company and an Asset Management Company (AMC).
2. W.S. 64 to be Net Asset Value based before UTI restructuring. Before shifting to NAV mode appropriate provisions should be made to meet shortfall arising out of the gap between the available Assets of U.S. 64 and the guaranteed price to individual unit

holders owing upto 3000 units.

3. The UTI Act should be repealed and a new act to be enacted. Government must be completes distanced from UTI.

TARAPORE COMMITTEE:

1. Setting up of Board of Trustees and Three Asset Management Companies one each for income funds growth funds and U.S - 64.
2. UTI could hold 49% of the capital of the three AMC's and this would overtime enable greater private participation in UTI.
3. UTI should empower AMC Committees and take on responsibilities of investment decisions before the move to a NAV basis in January 2002.
4. Only Individual investor should be allowed in U.S.-64.
5. SEBI Act should prevail.

4.17 Key Words:

(A) Mutual Fund : Mobilisation of Funds by Organisations in Public Sector and Private Sector for purposes of investment in stock market securities so as to give adequate returns to the investors who cannot invest directly.

(B) AMC : Asset Management Company.

(C) UTI : Unit Trust of India

(D) LIC : Life Insurance Corporation

(E) SEBI : Securities Exchange Board of India.

(F) FOF : Fund of Funds

(G) MMMF : Money Market Mutual Funds.

(H) NAV : Net Asset Value.

4.18 Self Assessment Questions:

1. Define Mutual Funds and its activities.
2. Explain about various categories of Mutual Funds.
3. What are the objectives of Mutual Funds.
4. What are the advantages and disadvantages of Mutual Funds.
5. What are the features of Open Ended Schemes.
6. What are the features of Close Ended Schemes.
7. Discuss the role of Mutual Funds in India.
8. What are the characteristics of Indian Mutual Fund Schemes.
9. Explain the tax benefit available to Mutual Fund Investors.

10. What is the Pricing Method of Mutual Fund Schemes.

11. Discuss the objectives of Regulatory Frame Work.

12. Explain how the Regulations helps Mutual Funds Investor Protection.

13. Explain about Self Regulatory Organisations (SRO's).

4.19 Reference Books:

Investment Management - V.A. Avabhani, Himalaya Publishing House.

Security Analysis and Portfolio Management - Punithavathy Pandian, Vikas Publishing Pvt. Ltd.

Financial Institutions and Markets - L.M. Bhole; Tata McGraw Hill Ltd.

Investment - An Introduction to Analysis - Fredrick Amling; U.S.A.

Banking and Financial Systems - S.N. Maheswari, R.N. Paul; Kalyani Publishers Ludhiana.

SEBI Guide Lines for Mutual Funds

Indian Mutual Fund Industry - Association of Indian Mutual Funds.

- Dr. A. SATHISH BABU

Lesson - 5

MERCHANT BANKING SERVICES

5.0 Objective:

After studying this lesson, you shall be able:

* to understand the concept of Merchant Banking and its Nature and Role

* to know about the functions of Merchant Banking

* to discuss on Managing an Issue

* to understand about Mergers and Restructuring and

* to know about Project Financing.

Structure:

5.1 Merchant Banking - Concept

5.2 Nature of Merchant Banking

5.3 Role of Merchant Banking

5.4 Functions of Merchant Banking

5.5 Managing An Issue

5.6 Pre-issue Management

5.7 Post-Issue Management

5.8 Mergers

5.9 RBI Guidelines for Mergers

5.10 Restructuring

5.10.1 Restructuring Objectives

5.10.2 Restructuring Options

5.11 Project Financing - Concept

5.12 Estimation of Financial Requirements

5.13 Sources of Finance

5.14 Summary

5.15 Self - Assessment Questions

5.16 Reference Books

5.1 Merchant Banking - Concept:

Merchant Banking is defined as an institution which covers a wide range of activities such as

management of customer services profolio management, credit syndication, acceptance credit, counselling and insurance etc; Merchant banks are issue houses rendering such services to industrial projects or corporate units as floatation of new ventures and new companies, preparation, planning and execution of new projects, consultancy and advice in technical, financial, managerial and organisational fields. The Ministry of Finance of Government of India defines a merchant banker as "any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to the securities as manager, consultant, advisor or rendering corporate advisory service in relation to such issue management".

5.2 Nature of Merchant Banking:

Merchant banking was originated through the entering of London merchants in financing foreign trade through acceptance of bills. Later, the merchants assisted the governments of under developed countries in raising long term funds through flotation of bonds in London money market. Over a period of time, they extended their activities to domestic business of syndication of long term and short term finance, under writing of new issues etc;. The post was period witnessed the rapid growth of merchant banking through the innovative instruments like Euro dollar and growth of various financial centres like Singapore, Hong Kong, Kuwait and Dubai etc;

Rapid innovations in the field of banking have resulted in many activities which were hitherto unknown to Indian Banking. One such innovation is the merchant banking facility. Merchant banking is exclusively a service function. A merchant banker has to seek a client, establish good relations with him, offer him the kind of services he needs and maintain a continuing relationship with him. A client will come for advice only if he is convinced the merchant banker knows more than he does. The merchant banker should therefore not only be knowledgeable and efficient but imbued with the spirit of service so that the client may feel that his interests are safe in his hands.

Merchant banking services are activities i.e. couselling corporate clients, who are in need of money, form of capital to be missed, the terms and conditions of issue, underwriting of the issue, timing of the issue and preparation of the prospectus and publicity of growing the issue for the market. They may also relate to the private placement of capital and the raising of long term loans, either in foreign exchange or in rupee currency from the national/state financial institutions and short term working capital from commercial banks. These activities are mainly stock exchange oriented, relating as they do to the issue of trust capital for a new company setting upon enterprise or for the existing ones which want to finance the expansion and diversification of other businesses. A few proposals of mergers and amalgamations have also been handled. In essence, in India, merchant banking services have been looked upon mainly as those consisting of issue house functions connected with the raising of capital from financial institutions and the market. In the past, many of brokers and same of them have recently setup consultancy organisations which function as managers to the issue of capital in the market. Merchant banking activities have an impact on growth, stability and liquidity of money markets.

5.3 Role of Merchant Banking:

The need for specialised merchant banking service was felt in India with the rapid growth in the number and size of the issues made in the primary market. The merchant banking services were started by foreign banks namely, the National Grindlays Bank in 1967 and the Citi Bank in 1970. The Banking Commission 1972 recommended the setting up of merchant banking institutions by commercial banks and financial institutions. The marked the beginning of specialised merchant

banking in India. The State Bank of India was the first Indian bank to set up Merchant Banking Division in 1972. Later ICICI set up its merchant Banking division followed by Bank of India, Bank of Baroda, Canara Bank, Punjab National Bank and UCO Bank etc;.

To promote the new issue market, there is need for a qualitative improvement in the offer of new issues both in terms of time taken and the cost of floatation. At present the time taken for organising a new issue is between 12 to 18 months and the cost of raising new capital varies from 3 to 8 percent and sometimes even 20 percent. This can be brought down relatively by specialised merchant banking institutions by catering to the requirements of both large and small industrial units. Cost of floatation of equity and preference capital is higher for new companies than for existing companies, indicating thereby the difficulties expressed by new companies, in making a new issue. Merchant banks can help saving in the cost of new companies.

The new issue market has not succeed fully in mobilising savings partly due to the preference of the public to company deposits and partly due to low yields on equities as compared to those on fixed interest securities. There are certain minimum costs to be incurred in respect of fees to brokers, promoter's expenses, underwriting commission etc;, irrespective of the size of the project. While bigger companies are able to manage this, small units find it extremely difficult to meet this minimum cost with uncertain prospects of their own internal resources in order to avoid the high cost of making public issues.

The merchant bank should have an organisation large enough to deal with a number of applications at a time. The issue house which acts as the merchant banker normally pays visits to the company's plant, ware houses and other physical assets if a company goes for a first issue. The merchant bank also requires a report on the history of the company, details of its business, factories, plant, management, labour, competitors, profit margins, taxation etc;. A merchant bank has to suggest an appropriate time of issue and provisional terms. Once these terms are settled, the share certificates, prospectus and other documents are drafted by the merchant bank with the help of lawyers and accountants. They have to satisfy the companies Act and other requirements of law and listing. The merchant banks' would also relate to the advice to the companies on any rights issue or bonus issue. It may as well advise on mergers and takeovers. Merchant banker must be familiar with the administrative procedures, rules and regulations governing the issue of industrial licence, import licence and a host of other issues with which the corporate sector is concerned. The merchant banks have come to occupy an important place on the financial scene of India. Most of the banks and some of the specialised broking firms have entered this field in recent years.

5.4 Functions of Merchant Banking:

With increasing industrialisation of the country and the growing emphasis in the five year plans on industrialisation, merchant banking in India has a very extensive role to play. The financial institutions in India could not meet the demand for long term funds required by the ever expanding industry and trade. The corporate sector enterprises therefore meet their requirements through issue of shares and debentures in the capital market. To raise money from capital market, promoters bank upon merchant bankers who manage the whole show by rendering various services. Following are functions of Merchant bankers. Chart 5.1 depicts various merchant banking functions and they are discussed hereunder.

* Corporate Counselling
  (Project counselling, capital restructuring, Project Management, Lease Financing)

* Project Counselling
  (Preparation of Project reports, deciding upon pattern of finance)

  * Loan syndication
    (Term loans for projects)

  * Issue Management
    (Equity Shares, Preference Shares & debentures, Bonds)

  * Underwriting of Public Issue

  * Managers, Consultants or Advisers to the Issue

  * Portfolio Management

  * Advisory Services relating to Mergers and Takeovers

  * Off shore finance (long term foreign currency loans, financing exports & imports)

  * Preparation of economic, technical and financial feasibility reports

  * Initial Project preparation, Pre investment surveys and market studies

  * Advising on setting up turnkey projects in foreign countries and locating foreign markets.

  * Help in financial management and in designing proper capital structure and debt equity ratio etc. of the company.

  * Management of investment trusts, charitable trusts etc;

  * Management aid and entrepreneurial aid (Management audit providing designs of the complete system operational research and management consultancy)

  * Recruitment (Selection of technical and managerial personnel etc;)

It has been aptly said that a merchant bank is what a merchant does. Some of the important categories of functions that it can perform and is performing is corporate advisory services. A list of corporate advisory services is given below.

Corporate Advisory Services of Merchant Bankers:

* Formation of the Company
* Making of Public Issue and Issue Management
* Project Report Preparation and Appraisal
* Liaison with foreign collaborators and making preparation for joint ventures.
* Making valuation and Revaluation of assets
* Mergers & Acquisitions
* Financial Reengineering
* Entrepreneurial Training and Development
* Quality Control and Product Mix
* Market Survey and Research
* Tax Planning etc;

Corporate sector needs the services of the merchant bankers to tackle the problems in technical, financial, managerial and organisational fields. A study by the RBI showed that insufficient project preparation, defective technical planning, indifferent management and financial bottlenecks faced by promoters were primarily responsible for delay in the implementation of projects. Merchant banks have a role to play to rectify these defects.

5.5 Managing An Issue:

Management of issue involves marketing of corporate securities i.e, equity shares, preference shares and debentures or bonds by offering them to public. Merchant banks act as intermediary whose main job is to transfer capital from those who own it to those who need it. The issue function may be broadly divided into pre issue management and post issue management. In both the stages, legal requirements have to be complied with and several activities connected with the issue have to be coordinated.

5.6 Pre Issued Management:

It consists of the following three aspects discussed here.

(i) Public Issue through prospectus: The most common method of public issue is through prospectus. To bring out a public issue, merchant bankers have to coordinate the activities relating to issue with different government and public bodies, professionals and private agencies. They have to ensure that the information required by the companies Act and SEBI are furnished in the prospectus and get it verified by reputed solicitor. The copies of consent of experts, legal adviser, attorney, solicitor, bankers to the issue, brokers and under writers are to be obtained from the company making the issue, to be filed along with prospectus to the Registrar of companies. After the prospectus is ready, it has to be sent to SEBI for vetting. It is only after clearance by SEBI, the prospectus can be filed with the Registrar of companies.

Brokers to the issue canvass subscription by mailing the literature to the clients and undertaking wide publicity. Members of stock exchange are appointed as brokers to issue. They devise strategy for success of the public issue, keep liaison between merchant bankers and stock exchanges. Sometimes, they also undertake centralised mailing of prospectus, application forms and other publicity material at the instance of merchant bankers. Bankers to the issue accept applications along with subscriptions tendered at their designated branches and forward them to the registrar.

(ii) Marketing and Underwriting: After dispatch of prospectus to SEBI, the merchant bankers arrange a meeting with company representatives and advertising agents to finalise arrangements relating to date of opening and closing of issue, registration of prospectus, launching publicity campaign and fixing data of board meeting to approve and sign prospectus and pass the necessary resolutions. Publicity campaign covers the preparation of all publicity material and brochures, prospectus, announcement, advertisement in the Press, Radio, TV, investors conference etc. The merchant bankers help choosing the media, determining the size and publications in which the advertisement should appear.

The Merchant banker's role is limited to deciding the number of copies to be printed, checking accuracy of statements made and ensure that the size of the application form and prospectus conform to the standard prescribed by the stock exchange. The Merchant banker has to ensure that the material is delivered to the stock exchange atleast 21 days before the issue opens

and to brokers to the issue, branches of brokers to the issue and underwriters on time.

Security issues are underwritten to ensure that in case of under subscription the issues are taken up by the underwriters. SEBI has made underwriting mandatory for issues to the public. The underwriting arrangement should be filed with the stock exchange particulars of underwriting arrangement should be mentioned in the prospectus. The various activities connected with pre issue are a time bound programme which has to be promptly attended to. The execution of the activities with clock work efficiency would lead to a successful issue.

(iii) Pricing of Issues: The SEBI guidelines 1992 for capital issues have opened the capital market to free pricing of issues. Pricing of issues is done by companies themselves in consultation with the merchant bankers. Pricing of issue is part of pre issue management. An existing listed company and a new company set up by an existing company with five year track record and existing private closely held company and existing unlisted company going in for public issues of the first time with two and half years track record of constant profitability can freely price the issue. The premium has to be decided after taking into account net asset value, profit earning capacity and market price. Justification of price has to be stated and included in the prospectus.

5.7 Post Issue Management:

The post issue management consists of collection of application forms and statement of amount received from bankers, screening applications, deciding allotment procedure, mailing of allotment letters, share certificates and refund orders.

Registrars to the issue play a major role in the post management. They receive the applications, verify them and submit the basis of allotment to the stock exchange. After the basis of allotment is approved by the stock exchange and allotted by the board, the auditor/company secretary has to certify that the allotment has been made by the company as per the basis of allotment approved by the exchange. Registrars have to ensure that the applications are processed and allotment/refund orders are sent with in 70 days of the close of the issue. The time limit of 70 days has proved difficult to adhere and applicants have to wait for anytime between 90 to 180 days. Merchant bankers assist the company by coordinating the above activities.

5.8 Mergers:

A merger is a combination of two or more companies into a single company where one survives and others lose their corporate existence. A takeover is the purchase by one company acquiring controlling interest in the share capital of another existing company. Merchant bankers are the middlemen in setting negotiation between the offerce and offeror. Being a professional expert, they are apt to safeguard the interest of the shareholders in both the companies. Once the merger partner is proposed, the merchant banker appraises merger/takeover proposal with respect to financial viability and technical feasibility. He negotiates purchase consideration and mode of payment. He gets approved from the government/RBI, draft scheme of amalgamation and obtains approval from financial institutions.

Mergers and acquisitions are the part of financial services sector and they assume special significance in the context of the changes in the MRTP Act which has made merger of business enterprise substantially simpler. Immediately after the announcement of the MRTP changes there has been some kind of a merger manior. It appears that the mergers that have been done so far did not take into consideration the synergy of operations and they have been doing more for the sake of convenience, except in one or two cases where the merger has resulted in integration of operations.

There would appear good scope to advise those business houses to seriously look at mergers & acquisitions as a possibility. It may be necessary to get some internationally well known companies to offer the basic package with which Indian Companies can start the M & A exercise.

5.9 RBI guidelines for Mergers:

The RBI has laid down certain guidelines in May 2005 for the process of merger proposal, determination of swap ratios, disclosures, the stages at which boards will get involved in the merger process and norms of buying and selling of shares by the promoters before and during the process of mergers. It is also necessary that the decision on merger is approved by two third majority of the total board of directors and not of those present alone. The guidelines cover two situations of mergers and amalgamations, an amalgamation of two banking companies and merger of a non banking finance company (NBFC) with a banking company. When an NBFC is proposed to be merged into a banking company, the banking company should obtain the approval of the RBI after the scheme of merger is approved by its board of directors. The RBI also has decided that the insider trading norms (ITN) stipulated by the Securities and Exchange Board of India (SEBI) will be applicable for bank mergers and acquisitions.

To enable to RBI to determine the value, the amalgamated banking company should submit a report on the valuation of the share of the amalgamated company made for this purpose by the values appointed for the determination of the swap ratio and detailed computation of such valuation. Where the shares of the merged company are quoted on the stock exchange, the RBI needs the details of the monthly high and low of the quotation on the exchange where the shares are most widely traded together with number of shares traded during the six months immediately preceding the date on which the scheme of merger is approved by the boards of directors.

5.10 Restructuring:

An appropriate financial structure is crucial if growth of the business is to be sustained. The financial structure needs to provide for maximum flexibility, need for cash flows and a return on investment. A Company also needs to build in protection against risks such as interest and exchange rate fluctuations, seasonal economic changes, slow paying debtors etc; The financial restructuring of a company or bank refers to the complete reformulating the composition of capital structure.

5.10.1 Restructuring Objectives: Financial restructuring involves restructuring the assets and liabilities of a company/bank, in line with their cash flow needs, in order to promote efficiency, support growth, and maximise the value to shareholders, creditors and other stakeholders. Achieving the optional capital structure in line with the earning capacity of the enterprise i.e; there should exist a proper debt equity mix that is best suited for the company with respect to its cash flows. It is to be ensured that cash flows are sufficient to meet financial obligations with a margin of safety so as to enable the company to focus on the new business plan. Financial restructuring enables the company to achieve an optimal capital structure and help in maintaining its cash flows. It is necessary to restore investors/creditors and other stakeholders faith in the company and its management. A company has to make proper decisions regarding the appropriate financial structure.

5.10.2 Restructuring Options: Financial restructuring involves restructuring the assets and liabilities of a company and refinancing at every level of capital structure as given below:

* Securing asset based loans (accounts receivables, inventories and equipment)

* Securing institutional private placement of equity

* Achieving strategic arrangements or merger

* Sale of Non Core assets

* Obligation assets on lease

* Equity infusion

* Dilusion of equity

* Tax incentives by central/state govt.

* Concession/freezing of power rates by State Electricity Boards

* Soft loans from State Development Institutions/Central/State govt.

While assessing the restructuring options available for the company, short term and long term goals are to be taken into consideration. One needs to prioritise restructuring options by analysing impact on share holders, company and creditors. Therefore, arranging finance in appropriate mix of debt and equity at flexible terms is essential to make the financial restructuring exercise a viable and profitable proposition for the company.

5.11 Project Financing:

Concept: Project financing refers to deciding upon the financing pattern to meet the cost of the project and appraising the project report with the financial institutions or banks. The financing mix for a project has to be decided keeping in view of the rules, regulations and norms prescribed by the government and the Reserve Bank of India. Corporate management has not only to conceive the project in realistic and comprehensive terms but also to ensure that the project will have the continuous ability to serve the providers of funds with satisfactory returns and generate internal resources to support growth. The sourcing and the composition of funds and their cost have a significant bearing on the earning power of the enterprise. Enterprises can obtain funds for the project from a wide range of sources at varying costs. They have to evolve an appropriate capital structure or combination of sources of finance in order to minimise the risk perception and the cost of capital thereby enhancing the profits.

5.12 Estimation of Financial Requirements:

The capital cost of a large project has diverse components. The purchase cost of plant and equipment and the cost of buildings and facilities are part of the capital cost. In addition, the project office expenses and the cost of investigation studies etc. get capitalised and absorbed in the project capital cost before the commencement of commercial operations. Detailed information has to be obtained on current end expected cost of equipment and materials.

Plant outlay, structural requirements; building sizes, roads, railway sidings, parking areas, drainage, fencing, pumping stations, cooling towers, power sub stations etc; will have to be estimated taking note of the site conditions. Current quotations can be secured for principle equipment items to guide price estimation. Note also has to be taken on freight costs, import duties and impact of exchange rate variations on foreign exchange commitments. Labour costs will be influenced by the location and the categories of the skills required. Construction equipment allowances for rental, fuel, maintenance etc; of major items such as cranes, bulldozers can be substantial and have to estimated carefully. Manpower for project administration and implementation at the managerial and

operational levels is a critical cost factor that has to be worked out in detail using best judgement. Associated costs such as design engineering, procurement and field construction costs can also be sizable and require special attention.

In the post construction phase of the project, the emphasis shifts to forecasting and control of project operating costs and revenues. Raw materials, utilities, emoluments, suppliers, royalties, rentals, contingencies, fixed costs including taxes, insurance etc, loading packing and shipping expenses will all require to be carefully considered and estimated. Depreciation depletion as may be relevant, will have to be calculated and reckoned. Administration, sales, corporate office and general expenses will have to be estimated in detail.

Funds requirements for working capital with reference to inventories of raw materials and supplies, work in process and inventories of finished goods, trade credits to customers etc; have to be assessed in detail and provided for in the estimates. Having determined the expected capital costs of the project and its operating costs at the operational phases, the expected return on investment needs to be computed and reviewed. The financial analysis of the project involves the examination of its cash flows. It is a process of review of costs and benefits, where cost constitutes cash outflows and benefits are measured in terms of cash inflows. The cash outflows on fixed assets and working capital requirements are then compared with the cash inflows less the expense outflows over the economic life of the project.

5.13 Sources of Finance:

In project financing, long term sources of finance would become primary sources which are as follows:

* Equity Capital
* Preference Capital
* Convertible debentures
* Non convertible debentures
* Term loans in Rupees
* Term loans in foreign currencies
* Euro Issues
* Bill Rediscounting Scheme
* Supplier's line of Credit
* Seed capital Assistance.
* Unsecured loans and deposits and
* Lease and Hire Purchase Finance

Project finance can flow from the two categories of financial institutions. (1) All India financial Institutions i.e; Industrial Finance Corporation of India (IFCI), Industrial Credit and Investment Corporation of India (ICICI), Industrial Development Bank of India (IDBI), Industrial Reconstruction Bank of India (IRBI), Unit Trust of India (UTI), General Insurance Corporation (GIC), Life Insurance

Corporation (LIC), National Small Industries Corporation (NSIC), Small Industries Development Bank of India (SIDBI) and (2) State Level Institutions i.e.; State Financial Corporation (SFCS) and State Industrial and Investment Corporations (SIICS).

5.14 Summary:

Merchant Banking essentially involves selling an issue for a company and handling related work. Merchant banking industry which remained almost stagnant for over two decades, witnessed an astonishing growth after the process of economic reforms and deregulation of Indian economy in 1991. In addition to Indian merchant bankers, a large number of reputed international merchant bankers like Merrill Lynch, Morgan Stanley, Goldman Sachs, Jardie Fleming etc; are operating in India under SEBI regulations. As a result of proliferation, Indian merchant bankers are faced with severe competition not only among themselves but also with the well developed global players. The mushroom growth of merchant banks has given rise to unethical means, to sell shares. For a healthy growth of the market operation, the SEBI should enforce strict control on merchant banks for their effective functioning and delivering transparent services. Stipulation of proper checks and regulation will raise the confidence of investing public in the dynamic and vibrant market mechanism which will be in the larger interests of the society as well as of the economy.

5.15 Self - Assessment Questions:

1. Define Merchant Banking and Explain the Nature and Role of Merchant Banking.
2. Examine the Functions and other Advisory Services of Merchant Banking.
3. Briefly write on Managing an Issue.
4. What do you understand by Mergers and Explain the guidelines of RBI with regard to Mergers.
5. What are the objectives of Restructuring and discuss on various restructuring options.
6. Define Project Financing? Discuss the procedure for the estimation of financial requirements of a project.
7. Write short notes on:
    (i) Merchant Banking
    (ii) Mergers
    (iii) Project Financing
    (iv) Underwriting an Issue.

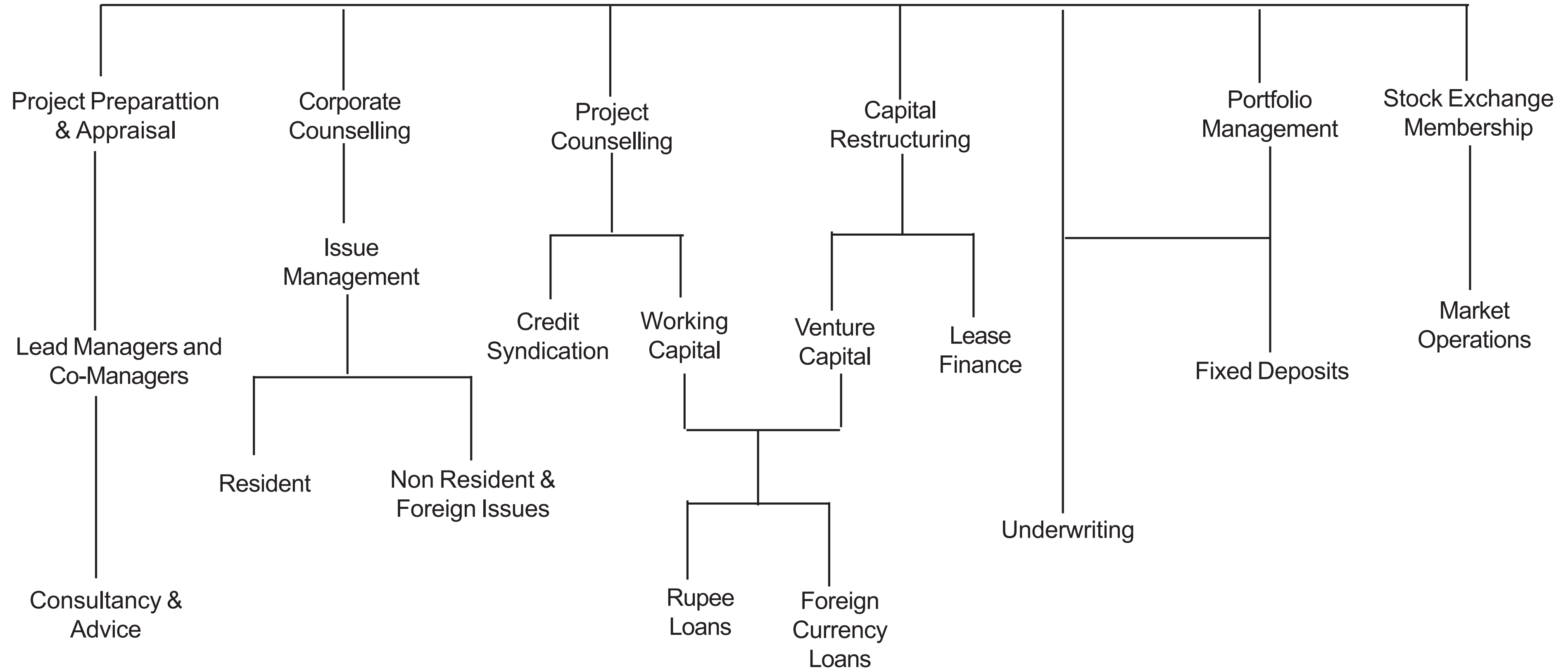
5.16 Reference Books:

1. *Marketing of Financial Services* : V.A. Avadhani, Himalaya Publishing House, Mumbai, 2004.
2. *Financial Markets and Services* : Gordon. E & Natarajan. K, Himalaya Publishing House, Mumbai, 2000.

- Dr. V.K. Bhaskara Rao

Chart : 5.1

Merchant Banking Functions



New Issue Market Players for Issues: Collecting Bankers, Registrars, Brokers, Underwriters, Advertising, Printers, Solicitors, Sub Brokers, Sub-Underwriters, Mailing Agents

Source: Avadhani. V.A, *Marketing Financial Services*, Himalaya Publishing House, 2004, P-197.

LESSON 6A:

LEASING AND HIRE PURCHASE

6A.0 Objective:

After reading this lesson, you will be able to understand

- Concepts of leasing and hire purchase
- Differences between leasing and hire purchase
- Types of leasing
- Evaluation of leasing

Structure:

6a.1 Introduction

6a.2 Meaning

6a.2.1 Leasing

6a.2.2 Hire Purchase

6a.3 Leasing V. Hire Purchase

6a.4 Types of Leasing

6a.4.1 Financial Lease

6a.4.2 Operating Lease

6a.4.3 Sale and Lease back

6a.4.4 Structured Lease

6a.4.5 Other types

6a.5 Essential Futures of Leasing

6a.6 Advantages of Leasing

6a.7 Disadvantages of Leasing

6a.8 Evaluation of Lease

6a.9 Hire Purchase

6a.10 Summary

6a.11 Self Assessment Questions

6a.12 Further Readings

6a.1 Introduction :

Business enterprises mobilise funds from various sources for the purpose of financing assets. A company issues equity shares and debentures for mobilising equity and debt capital. It borrows funds from financial institutions. Alternative forms of financing assets are also used by availing Asset Finance Services. Asset finance facilitates the acquisition of asset without the financial burden and the use of asset without capital expenditure.

Asset finance provides another line of credit without disturbing debt-equity composition of the company. It provides finance for the entire cost of asset with generally minimum initial cash outlay. Asset can be obtained and paid for from cash flows generated by the asset. Separate capital need not be allocated.

Various asset finance services such as leasing, hire purchase, debt securitisation etc are in vogue. In this lesson leasing and hire purchase methods are discussed.

6a.2 Meaning :

6a.2.1 Leasing :

The Transfer of Property Act defines a lease as "a transaction in which a party owning the asset provides the asset for use over a certain period of time to another for consideration either in the form of periodic rent and / or in the form of down payment".

According to the Institute of Chartered Accountants of India (ICAI), " a lease is an agreement whereby the lessor conveys to the lessee, in return for rent, the right to use an asset for an agreed period of time".

The following are the characteristics of a lease.

(a) Two parties are involved, the lessor being the owner of an asset who transfers the right to use the asset for a consideration (lease rentals) and the leasee being the user of the asset with a right to use the asset.

(b) The consideration is in the form of lease rentals.

(c) The period of lease is agreed upon by both the parties.

6a.2.2 Hire Purchase :

Hire purchase is purchasing of an asset where in the purchaser (the hirer) pays the value of consideration in equal periodic installments over a period of time.

According to the Hire Purchase Act, 1972, hire-purchase is defined 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 agreement, and includes an agreement under which:

(i) Possession of goods is delivered by the owner there of to a person on the condition that such person pays the agreed amount in periodic payments.

(ii) The property of the goods is to pass to such a person on the payment of the last of such installments.

(iii) Such person has a right to terminate the agreement any time before the property so passes.

6a.3 Leasing V. Hire Purchase :

Following section presents the differences between both types of asset finance services.

	LEASING	HIRE PURCHASE
1	Ownership of the asset lies with the lessor	Ownership is transferred to the hirer on the payment of last installment

2	Lessor is entitled to depreciation	Hirer is entitled to claim depreciation
3	After the lease period the asset is returned to lessor	After the expiry of the period the ownership transfers to the hirer
4	Lessor capitalises the asset	Hirer capitalises the asset
5	Lessee has to maintain the leased asset in case of financial lease and lessor has to maintain the leased asset in case of operating lease	Hirer has to maintain the hired asset
6	Leasing is used as a source of finance for acquiring high cost assets such as airplanes, ships, heavy machinery	Hire purchase is used as a source of finance for a acquiring selectivity low cost assets such as office equipment, automobile.
7	Down payment is required in case of financial lease	Down payment (margin money) is required
8	Lease rentals are treated as revenue expenditure and taken into account for tax purpose.	Hire interest is considered as revenue expenditure and taken into account for tax purpose
9	Lease assets are not shown in the Balance Sheet of the lessee.	Assets acquired through hire purchase are shown as assets in the Balance Sheet of the hirer and outstanding installments amount is treated as a liability.
10	Lease is preferred for long periods	Hire purchases are under taken for short periods of time

6a.4 Types Of Lease :

Leasing takes different forms. Most important forms are

1. Financial lease
2. Operating lease
3. Sale and lease back

6a.4.1. Financial Lease:

Financial lease is a lease where in the user can acquire the use of the asset for most of its useful life and pay rentals to the lessee. The wear will be responsible for maintenance of the equipment and the payment of taxes and insurance.

The International Accounting Standard (IAS) No: 17 defines a financial lease as "a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or many not eventually be transferred".

In the case of financial lease, the lessee selects the equipment it wants and the supplier of that equipment. Lessee negotiates terms with a leasing company. When the terms are set the leasing company buys the equipment. The supplier delivers the equipment to the lessee. The supplier is paid by the lessor (Leasing Company) plant, Machinery and equipment are acquired through financial lease arrangements.

Financial lease is some times called capital lease. A lease should be treated as **'Capital Lease'** if it meets any one of the following four conditions, as per the Financial Accounting Standards Board.

- If the lease life exceeds 75% of the life of the asset
- If there is a transfer of ownership to the lessee at the end of the lease term.
- If there is an option to purchase the asset at a "bargain price" at the end of the lease term
- If the present value of the lease payments, discounted at an appropriate discount rate exceeds 90% of the fair market value of the asset.

6a.4.2 Operating Lease :

Operating lease is a contract between the lessor and lessee such that the cost of the asset is not fully recovered from a single lessee. The period of the lease will be shorter since the lessor will recover the cost of the asset from multiple lessees. Repair and maintenance of the asset is the lessor's responsibility.

Operating lease is also known as service lease, which provides for financing and maintenance. Computers, office equipment, automobiles and trucks are acquired through operating lease.

6a.4.3 Sale And Lease Back :

Sale and lease back is a transaction where the lessee already owns the asset he wants to lease. The lessee sells the asset to the lessor who pays for the asset and immediately leases it back to the lessee. This type of lease is an alternative to a mortgage. This method is similar to financial lease. The only difference is that the leased equipment is not new and lessor buys it from the user-lessee. It provides non-fund based finance to the selling company and brings down debt-equity ratio.

6a.4.4 Structure Lease :

In the case of structure lease, lease rentals are not flat or equated over the lease term. Rentals vary over the lease term. The rental structure is scheduled in such a way that it typically fits the lessee's inflows from the asset. Main types of structured lease are

1. Stepped up rentals where rentals are structured so that the lessee will pay smaller rental amounts at the beginning of the lease period and larger rental amounts towards the end of the lease period.
2. Stepped - down rentals are structural so that the lessee will pay larger rental amounts at the beginning of the lease period and lower rental amounts towards the end of the lease period.

6a.4.5 Other Types

6.4.5.a Secondary Lease :

A second lease period during which the lessee will pay nominal peppercorn rentals in order to ensure that the lease period is long enough for the lessee to gain maximum benefit from the lease.

6.4.5.b Sub – Lease :

A transaction in which the lease property is re-leased by the original lessee to another party and the lease agreement between the two original porties remains the same.

6a.5 Essential Features Of Leasing :

The essential features of leasing are as follows:

1. Leasing is a contract between the lessor and lessee and hence should satisfy the requirements of a valid contract as per the Indian Contract Act 1872.
2. The parties to the lease contract are lessor and lessee. Lessor must be competent and must have a clear title to the equipment leased, leasee must be competent to contract.
3. Equipments are bought by lessor at the request or lessee.
4. Lease contract specifies the period of contract.
5. The leasee uses the equipment.
6. The lessee in consideration pays the lease rentals to the lessor.
7. The lessor is the owner of the assets and is entitled to the benefit of depreciation and other benefits under the Income Tax Act 1966a.
8. The lessee can claim the lease rentals as expenses chargeable.

- Lessee selects the supplier and the equipment required
- Lessor enters into a contract with the lessee
- Lessor acquires the title to the equipment to be leased by paying the value of the equipment
- Supplier delivers the equipment to the lessee
- Lease rentals are paid by the lessee to the lessor
- The equipment is returned to the lessor at the end of the lease period

or

- The lessee continues to use it on small annual secondary rental payment

6a.6 Advantages of Leasing :

The following are the important advantages of leasing from the lessee's point of view:

(i) It is an easy method of financing capital assets requiring huge capital outlays
(ii) No margin money is required as in the case of borrowing
(iii) It helps for read the capital cost over a period
(iv) For business with shortage of capital or which cannot access capital market for funds leasing is an ideal source.
(v) Lease rentals are deductible for tax purpose
(vi) It helps conserve scarce capital resources
(vii) Lessee is protected from technological obsolescence when it is under operating lease agreement
(viii) It is an 'off Balance sheet ' method of financing
(ix) It gives the facility to possess and operate the asset without owning the asset

The advantages to the lessor are:
(i) It is a safe method of asset based financing
(ii) Lessor enjoys tax benefit arising out of depreciation on leased asset
(iii) Lease rentals provide better liquidity through regular cash inflows.

6a.7 Disadvantages of Leasing :

The following are the disadvantages of leasing from the lessee's point of view:

(i) When compared other methods, lease financing is costly
(ii) Lessee will have no flexibility once the contract terms are agreed upon

(iii) Lessee can not claim depreciation on leased asset

6a.8 Evaluation of Lease :

Both lessor and lessee should evaluate a prospective lease. Lessee must determine whether (a) taking an asset on lease is beneficial or (b) buying an asset is beneficial. As lease is comparable to borrowing lessee must compare between the following options

(i) buying an assets by borrowing the funds required
(ii) leasing the asset

Lease evaluation from the viewpoint of lessee involves the following steps:

✡ Find after tax cash out flows for each year under the leasing after native. Lease rental payments are deductible for income tax purpose.

After – Tax Cash out flows = Lease rental Payment (1 – Tax rate)

✡ Find after tax cash out flows for each year under the buying alternative. When an asset is bought by borrowing, annual installment payable by the borrower will have two components (i) loan (capital) repayment (ii) interest on borrowed amount (deductible for income tax purpose).

Annual cash outflow = Loan repayment + Interest
After tax cash outflow = Loan repayment + Interest (1 – tax rate)

✡ Find the tax benefit when annual depreciation is charged under buying alternative.
When asset is purchase by borrowing the lessee will be the owner and eligible for depreciation claim which is deductible for income tax purpose. Lessee gets the tax benefit.

Tax benefit = Annual Depreciation **x** Tax rate
✡ Find net after tax cash outflows for each year under buying alternative

Net after tax cash outflows = Loan repayment + Interest (1 - tax rate)
– tax benefit due to depreciation.

✡ Find the present value of the cash outflows under both the alternatives at a discount rate i.e., after-tax cost of capital (K) of the company.
✡ Select the alternative with the lowest present value of cash outflows.

Example:

A company is proposing to acquire a machine for a period of ten Years. The company is evaluating two alternatives.
The cost of the machine is Rs. 1,00,000.

Alternative 1 :

If the asset is taken on lease the company would be required to pay lease rentals at the rate of Rs. 34,000 per annum for the first five years and Rs. 600 per annum for the next five years.

Alternative 2 :

If the asset is to be owned / purchased by the company to finance the asset a loan of Rs. 75,000 can be raised at 9% per annum interest. Interest is payable annually and principal is repayable in year ten.

Rate of depreciation is to be charged at 15% per annum under written down value method. Tax rate is 33%.
Advise the company as to which alternative it should adopt.

Solution :

6a. After tax cash outflows under leasing alternative

Year	(Lease Rental X 1 – Tax rate)
1 – 5	(34,000 X (1 – 33%) = 22,780
1 – 6	(600 X (1 – 33%) X 5 = 402

2. After tax cash outflows under buying alternative

			Rs.	Rs.
Year	0	Own Investment	-	25,000
	1 – 10	Interest	6,750	4,523
	10	Repayment of Loan	-	75,000

3. Tax benefit due to depreciation

Year	Depreciation	Tax Benefit
1	15,000	4,950
2	12,750	4,208
3	10,838	3,577
4	9,212	3,040
5	7,830	2,584
6	6,656	2,196
7	5,657	1,867
8	4,809	1,587
9	4,087	1,349
10	3,474	1,146

4. Net after tax cash outflows under buying alternative

Year	After Tax Cash outflow	Tax Benefit	Net after Tax Cash flow
	25,000	-	25,000
1	4,523	4,950	- 427
2	4,523	4,208	315
3	4,523	3,577	946
4	4,523	3,040	1,483
5	4,523	2,584	1,939
6	4,523	2,196	2,327
7	4,523	1,867	2,656
8	4,523	1,587	2,936
9	4,523	1,349	3,174
10	4,523 + 75,000	1,146	3,377 + 75,000

5. PV of Cash on flows

Year	PV factor at 10%	After Tax cash out flows		PV of cash out flow	
		Leasing	Buying	Leasing	Buying
0	6a.0	----	25000	----	25000
1	0.909	20780	-427	20707	-388
2	0.826	22786	315	18816	260
3	0.751	22780	946	17108	710
4	683	22780	1483	15559	1013
5	0.621	22780	1939	14146	1204
6	0.564	402	2327	227	1312
7	0.513	402	2656	206	1363
8	0.467	402	2936	188	1371
9	0.424	402	3174	170	1346
10	0.386	402	78377	155	30254
				87282	**63833**

Conclusion :

Purchase of plant out of borrowed funds is the best alternative rather than taking it on lease.
From the lessor's point of view leasing agreement would be beneficial if the asset earns return that exceeds the cost of capital (K). The cash inflows (lease rentals) must be adjusted to the tax payable and the tax savings accruing due to the claim of depreciation. The lessor is entitled to depreciation, as he is the owner of the asset. Following are the steps in the lease evaluation from the lessor's point of view.

1. **Find the Cash Outflows:** Cost of the asset proposed to be leased is the cash outflow (Co)

2. **Find out Cash Inflows after Tax (CIAT):**

	Rs.	
Annual Lease Rentals	xxxx	[Cash Flows Before Depreciation and Tax]
Less: Annual Depreciation	xxx	
Earnings Before Tax	xxxx	
Less: Tax	xxx	
Earnings After Tax	xxxx	
Add: Annual Depreciation	xxx	
Annual Cash flows After Tax	xxx	

3. Find the present value of the Annual CFAT:

PV of annual CFAT = CFAT x PV of annuity of Rs. 1 at Cost of Capital(K) for n Years.

4. Net Cash flow = PV of ACFAT - Cost of the asset
= PV of ACFAT - Co

5. The lessor should go for leasing the asset if the net cash flow is positive i.e., PV of ACFAT exceeds cost of the asset (Co).

6a.9 Hire Purchase:

The features of hire purchase and the differences between hire purchase and leasing have been discussed in 6.2.2 and 6.3 respectively. In this part of the lessor let us see how the hire purchase installments can be split in to interest and principal repayment.

Hire Purchase instalments cover interest as well as principal repayment. The hiree charges interest on a flat basis. This means that a certain rate of interest is charged on the initial investment made by the hiree and not on the diminishing balance.

Assume that the cost of equipment is Rs. 1 crore, the flat interest rate is 15% and hire purchase period is 36 months.

Total Interest = Rs. 1,00,00,000 x 15% x 3 Years
= Rs. 45,00,000

Hire Purchase Installment per annum = $\frac{\text{Rs. } 1,00,00,000 + \text{Rs. } 45,00,000}{3 \text{ years}}$
= Rs. 48,33,333

Hire purchase Installment per month = $\frac{\text{Rs. } 48,33,333}{12 \text{ months}}$
= Rs. 4,02,777.

As per the sum of the years digit method the proportions of interest allocated to the three years are as follows:

$$\text{Year 1} = \frac{36+35+34+\ldots\ldots\ldots\ldots..+25}{36+35+34+\ldots\ldots\ldots\ldots..+1} = \frac{366}{666}$$

$$\text{Year 2} = \frac{24+23+22+\ldots\ldots\ldots\ldots..+13}{36+35+34+\ldots\ldots\ldots\ldots..+1} = \frac{222}{666}$$

$$\text{Year 3} = \frac{12+11+10+\ldots\ldots\ldots\ldots..+11}{36+35+34+\ldots\ldots\ldots\ldots..+1} = \frac{78}{666}$$

Based on these proportions, the interest allocations are:

$$\text{Year 1} = \frac{366}{666} \times \text{Rs. } 45,00,000 = \text{Rs. } 24,72,972$$

$$\text{Year 2} = \frac{222}{666} \times \text{Rs. } 45,00,000 = \text{Rs. } 15,00,000$$

$$\text{Year 2} = \frac{78}{666} \times \text{Rs. } 45,00,000 = \text{Rs. } 5,27,027$$

Year	Hire Purchase Installment Rs.	Interest Component Rs.	Principal Component Rs.
1	48,33,334	24,72,972	23,60,361
2	48,33,333	15,00,000	33,33,333
3	48,33,333	15,27,027	43,06,306
Total	**1,45,00,000**	**45,00,000**	**1,00,00,000**

6a.10 Summary:

In this unit major types of asset financing services are discussed. Lease is an agreement whereby the lessor conveys to the lessee, in return for rent, the right to use an asset for an agreed period of time. Hire purchase is purchasing of an asset where is the hirer pays the value of consideration in equal periodical installments over a period of time. Under leasing the lessor will be the owner of the asset while in hire purchase the hirer will be considered as the owner Hire purchase is extended for transport vehicles where as leasing is granted for industrial equipments.

6a.11 Self Examination Questions:

1. Discuss the meaning and features of leasing.
2. Distinguish between leasing and hire purchase.
3. What are the various types of leasing? Discuss.
4. Explain advantages and disadvantages of leasing.
5. What steps are involved in the evaluation of leasing V. Purchase.

6a.12 Further Readings:

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LESSON 8:

CREDIT CARDS

8.0 Objective:

After reading this lesson, you will be able to understand .

- Concept of credit cards
- Types of credit cards
- Benefits, limitations of credit cards

Structure:

8.1 Introduction

8.2. Origin and History

8.3 Features

8.4 Types of Credit Cards

8.5 Benefits and Limitations

8.6 Conclusion

8.7. Self Examination Questions

8.8. Reference Books

8.1 Introduction: -

Economic, social, cultural and technological development of society led to the growth of the service industry. Society exhibited increasing affluence combined with growing complexity of life. All these factors have contributed to the phenomenon of credit cards. Credit cards enable the individuals to purchase certain products / services without paying immediately. The buyer only needs to present the credit card at the cash counter and to sign on the bill. Credit cards can therefore be considered as a good substitute for cash and cheques. However these credit cards are accepted only by those establishments, which have consented to entertain them, these establishments are known as merchant establishments.

During the past decade, plastic cards have become increasing popular in India. The reason for their popularity has now shifted focus from being a status symbol to offering convenience and security with worldwide acceptance of late, banker have been permitted into the credit card business with out every the prior approval of the RBI. Banks have been given the freedom to start the card division either by them selves or in association with other card issuing banks. As a result, many Indian banks including state Bank of India have entered the credit card business in a big way during the last few years.

8.2 Origin and History:-

Credit cards were introduced as viable means of selling goods on credit with maximum of expanding sales and building a strong customer base.

8.2.1 Non Bank Cards:-

The use of credit cards originated in USA in the 1920's, when individual firms, such as oil companies, hotel chains, began issuing them to customers for purchase made at their outlets.

Mobil oil issued the world's first credit card in the year 1940. Initially, the company in order to give specialised services to its regular customers issued the card. This helped boost sales and increase customer base following the success of the Mobil card, various organizations such as the Diners club, American Express and carte blanche standard issuing cards, for different purposes like travel, leisure, etc.

8.2.2 Visa and Master Card:-

Fraklin National Bank, USA issued the first ever-general purpose credit card in the year 1952, and it was widely accepted by local merchants. The sales ship which was generated using the card, was presented to the bank, which would then credit the merchants account. The limitation of these cards was the card-holders could shop only in their geographical area and only with those merchants who had agreements with their banks.

In 1960, Bank of America developed the present credit card operating system. This system was subsequently licensed to some other banks, which led to the establishment of an international bankcard system called Visa international. Competition amongst the U.S. banks resulted in mother international bankcard system being introduced, known by Master card.

8.2.3 Electronic Cards:-

Most banks became members of the two organizations and started to issue both super of cards. The seventies witnessed the evolution of electronic card authorization systems, electronic clearing and settlement systems and electronic data capture (EDC) at the point of sale (POS) terminals. This virtue6 eliminated paper work and significantly speeded up the process. The card industry is presently witnessing a technological, revolution and is fast moving towards the introduction of "Smart" cards, which user computer ships, biometrics etc.

8.3 Features of Modern Credit Card:-

Any card that is used as a payment device to access customers financial resources is referred to as a credit card. The card. The card may be used during travel, at home, for purchaser or at the Automatic Teller Machines (ATM's) for credit or debit transactions. It is also known as plastic money and it can be used for the purchase of all kinds of goods and services. Following all the salient features of the modern credit card.

8.3.1 Owner identification:-
A Credit card identifies its owners at one who is entitled to purchase goods and services with out physical money and is eligible for credit from establishments. For this purpose, the card issuer enters into tie-up with various merchant establishments.

8.3.2 Wide usage:-

Bank credit is the most widely used payment device issued by bank of. It is based on the system of revolving credit where by a credit limit if sectioned to the customer and can be availed impart or in full. The credit card holders can use the credit cards at merchant locations to buy goods and services.

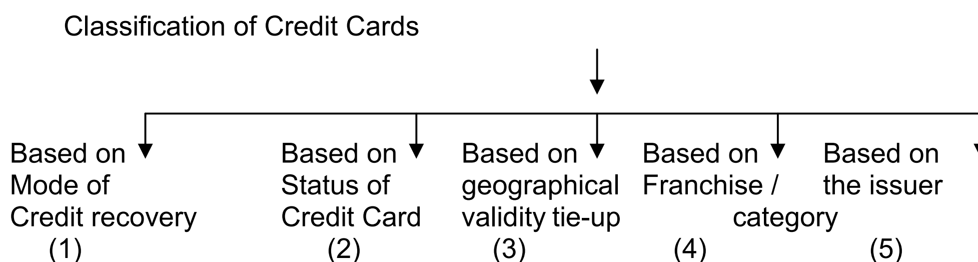
8.3.3 Credit Limit:-

The issues for the purpose of convenience and scrutinising set up a credit card limit for its card holders and a floor limit for its merchant establishments. The convenience and safety factors add value to these cards.

The credit card business is typically a high volume low value business, with the potential to break-even only beyond a certain volume of cards issued. The dependence on technology is inevitable to keep the operating costs to the minimum.

8.4 Types of Credit Cards (or) Classification of Credit Cards:-

The credit cards system can provide a wide range of products and services to the user. Depending on the necessity of the customer and trade competition, banks issue different types of credit cards.



8.4.1 Based on mode of credit recovery:-

This classification includes two types.

8.4.8.1 Revolving Credit Card:-

This type of credit card follows revolving credit principle. A limit is set on the amount of money one can spend on the card for a particular period. The card holder has to pay a minimum percentage of outstanding credit which may vary from 5 to 10 percent at the end of a particular period. Interest varying from 30 to 36 percent per annum is changed on the outstanding amount.

8.4.8.2 Charge Card:-
A change card is not a credit instrument. This facility given a consolidated bill for a specific period and bills are payable in full on presentation. There is no interest liability and no pre-set spending limits either.

8.4.2 Based on the status of Credit Card:-

Based on the status of credit card the credit cards can be classified into three types as under.

8.4.2.1 Standard Card:-

Credit cards that are regularly issued by all card-issuing banks an called standard cards, with these cards it is possible for a card holder to make purchases with out having to pay cash immediately. Some banks issue standard cards under the fraud name "Classic" cards.

8.4.2.2 Business Card:-

It is also known as "Executive" cards are issued to small partnership firms, firms of chartered accountants, tax consultants and others for use by executives on their business trips.

8.4.2.3 Gold Card:-

The gold card offers high value credit for the elite. It offers many additional benefits and facilities such as higher credit limits more cash advance limits etc., that are not available with standard or executive cards.

8.4.3 Based on Geographical Validity:-

Based on geographical validity the cards can be classified into two categories.

8.4.3.1 Domestic Card:-

Cards that are valid only in India and Nepal are called "Domestic Cards". All transactions will be in rupees. These cards are issued by most of the banks in India.

8.4.3.2 International Card:-

Credit cards that have international validity are called "international cards". These cards are honored in every part of the world except India and Nepal. The card holder can make purchaser in foreign currencies subject to RBI sanction and FEMA rules and regulations.

8.4.4 Based on Franchise Tie-up:-

According to this category, the cards can be classified into four categories. Those are.

8.4.4.1 Proprietary Card:-

Cards that are issued by banks themselves, with out any tie-up are called proprietary cards. A bank issuer such cards under its own fraud.

8.4.4.2 Master Card:-

This is a type of credit card issued under the umbrella of "Master Card International". The issuing bank has to obtain a franchise from the Mater Card Corporation of USA.

8.4.4.3 Visa Card:-

This is a type of credit card, which can be issued by bank having tie-up with VISA international corporation, USA. The banks that issue VISA cards are said to have a franchise of VISA international.

8.4.4.4 Domestic tie-up card:-

These are cards issued by a bank having tie-up with domestic credit card brands such as Can-card and Ind-card etc.

8.4.5 Based on the issuer category:-

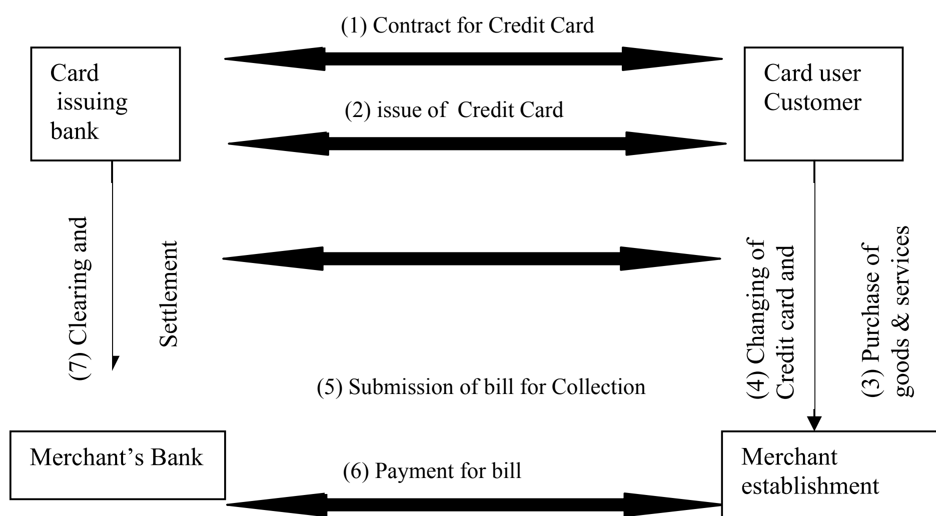
According to this category the credit cards can be divided into 2 types.

8.4.5.1 Individual Cards:-

These are the non-corporate credit cards that are issued to individuals.

8.4.5.2 Corporate Cards:-

These are the credit cards that are issued to corporate and business firms. The executives and top officials of the firms use these cards. The card bears the name of the firm and the bills are paid by them.
Mechanics Of Credit Card Operation (or Process of Credit Card):-



8.5 Benefits of Credit Cards:-

The benefits of credit cards can be classified into three types as under.
(a) Benefits to card holders
(b) Benefits to Merchants and

(c) Benefits to issuer banks.

8.5.1 Benefits to card holders:-
8.5.8.1 Shopping convenience:

Credit cards are convenient to use. Shopping is made more comfortable and joy us and purchasing poses no difficulty, since cards have wide acceptance.

8.5.8.2 Credit facility:-

The credit card enables the card holders avail the credit facility sanctioned by the card issuing company. The customer can either repay the amount of credit in full, or can up to for repaying it in flexible monthly installments. Card holders usually get a period of 30 to 45 days to clear the dues.

8.5.8.3 Safety:-

Credit cards allow for a safe means of conducting transactions. Credit card holders need not carry large amount of cash, they avoiding the risk of theft.

8.5.8.4 Acceptability:-

Merchant establishments widely accept VISA and Master card. This makes it vary convenient for holding a credit card.

8.5.8.5 Cash withdrawals:-

In times of need, card holders are also given the facility of withdrawing cash up to the sanctioned limits, from the banks or other tie-up ATMs.

8.5.8.6 Offers:-

Card issuing institutions, service organizations like Railways and Airlines, Merchant establishments are giving attractive bargains and offers to encourage purchase transactions by credit cards.

8.5.2 Benefits to Merchants: -

8.5.2.1 Guaranteed Payment: -
The merchant has guarantee of payment and in his account if created immediately on the submitting the charge slip into his bank. No bad debt arises in credit card transaction.

8.5.2.2. Proper Cash Flows: -

A good cash flow is established because of the speedy settlement of bills by banks.

(i) Reduction in Security Risk: -

The acceptance of credit card in lieu of cash reduces security risk.

(ii) Availability Credit Facility: -

The member establishments are able to offer credit facility to their customers without setting up their own credit arrangement.

(iii) Increase in volume of business: -

More and more people accept the practical advantage of credit cards and turn to suppliers who accept the cards in settlement. This helps in increasing the volume of business to member establishments.

8.5.3 Benefits to issuer banks: -
(i) High Profit: -

Credit card holders offer high profit for the banks. They commission or discount usually @ 2.5% on sale through credit cards. As more and more take advantage of credit facility the credit card service becomes more profitable.

(ii) New Customers: -

If the card is issued to non-account holders it may help to generation of new customers.

(iii) Cost control: -

The credit card system helps to control the bank cost as it reduces the number of cheques issued by the cumtomers

Credit Card limitations: -

The rapid growth of the payment card industry has lead to a dramatic rise in credit card frauds. A significant amount of money is lost because of frauds. The credit card is not risk free and all payers associated with it have to face an element of risk associated with it.

1. The card holders are burdened with service charge, annual fee, membership fee, etc. A high rate interest is charged for delayed payment. Credit card tempt the holders for more purchases beyond their repayment capacity.
2. The cost involved in the credit card business is high which includes the cost of plastic card to be imported, cost of information and the cost on staff to monitor processing of applications, etc. Unless the number of cards are high and the volume of business is more, the credit card business will not be profitable one.
3. The frauds perpetuated by the holders of bogus cards and some times in collusion with the member establishments is the major problem for the issuers.
4. The average utilisation of credit card is only 20% to 30% in India. The under utilisation this facility erodes the profitability of the banks.
5. More commission is to be paid to the issuing bank or credit card organisation. Due to the lack of effective system and prominent personnel some banks make delay in payment, which affect the cash flow of the member establishment.

Drawbacks of Credit Cards:-
Credit have many drawbacks for the user, issuer and the merchant establishments alike. Some of these are.

1. Waste of Money:-
It would be a waste of money to subscribe to a credit card if the card was not utilised.

2. Thought less buying:-
Credit cards invariably encourage impulsive purchases. Since the user need not pay instantly it may tempt the purchase of product / services that are not genuinely required.

3. Financial problem:-
Use of credit cards may drag the user into financial problems including overdraft. This happen where repayment on the credit card account is not done promptly.

4. Mental agony:-
The pressure tactics used by recovery agents appointed by some card issuers to collect outstanding dues may cause mental agony to the user.

8.6 Conclusion: -

According to top banking professionals the credit card business will grow over 100% every year for the next 5 years. To realise the potential in the credit card market the following suggestions are made.

- Reduce the membership and annual subscription fees.
- Encourage member establishments to accept credit cards for routine items also.
- Make the features of cards convenient to middle class people.
- Enhance the cash withdrawal limits.
- Workout the strategies to popularise the credit card among people in semi urban and rural areas.

8.7 Self Examination Questions: -

1. Explain the features of credit cards issued by various banks?
2. Explain various types of credit cards?
3. Describe the facilities offered to the credit card holders?
4. Discuss the advantages and disadvantages of credit cards?

8.8 Reference Books: -

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LESSON 9:

BANKING & INSURANCE (INCLUDING PENSION FUNDS)

9.0 Objective:

After reading this lesson, you will be able to understand .

- Concept of Banking & Insurance
- Merchant Banking Services
- Leasing Services
- Factoring Services etc. of Banks
- Principles of Insurance
- Life & Non-Life Insurances and
- Functioning of IRDA

Structure:

9.1 Banking

9.1.1. Introduction

9.1.2.Financial Services on offer

9.1.2.1.Merchant Banking

9.1.2.2.Leasing

9.1.2.3.Mutual Funds

9.1.2.4.Factoring

9.1.2.5. Credit Cards

9.1.2.6. Credit Rating

9.1.2.7. Commercial Paper

9.1.2.8. Housing Finance

9.1.2.9. Venture Capital

9.1.3. New Vistas in Financial Services

9.2. Insurance

9.2.1. Definition

9.2.2. Basic Principles of Insurance

9.2.2.1 Good Faith

9.2.2.2. Insurable Interest

9.2.2.3. Compensation

9.2.2.4. Subrogation

9.2.2.5. Contribution

9.2.2.6. Loss Mitigation

9.2.2.7. Cause Proxima

9.2.3. Life Insurance

9.2.3.1. Definition

9.2.3.2. Polices

9.2.4. General Insurance

9.2.4.1. Meaning

9.2.4.2. Types

9.2.4.3. Concept of Insurance Services

9.2.5. Profile of Insurance Service Providers

9.2.5.1. General Insurers

9.2.5.2. Life Insurers

9.2.6. Insurance Regulatory and Development Authority (IRDA)

9.2.6.1. Composition

9.2.6.2. Duties

9.2.6.3. Powers and Functions

9.3. Self Examination Questions

9.4. Reference Books

9.1 Banking

9.1.1 Introduction

Financial services are an essential segment of financial system. Financial system facilitates the transformation of savings of individuals, government as well as business into investment and consumption. It consists of financial intermediaries, financial markets and financial assets. A vibrant and competitive financial system is necessary to sustain reforms in the structural aspects of any economy financial system in India has made commendable progress in extending it's geographical spread and functional reach. Nationalization of commercial banks in 1969 gave a new direction to timely and adequate credit support for viable productive endeavour especially in agriculture and small sector.

In the changing economic scenario, with increase in financial deregulation and industrial liberalisation, the role of the financial sector is increasing manifold. The financial service sector has thus emerged as the fastest growing sunrise industry. With the one set of liberalisation process, several new institutions have appeared on the financial scene. These institutions like merchant banks, leasing companies, venture capital companies, factoring companies and mutual funds etc., have expanded the range of financial services available.

9.1.2 Financial Services on offer: -

Banks, investment companies, accounting firms, and financial institutions offer numerous financial services to business concerns. A few financial innovations / services which

are emerging as potent instruments at the disposal of commercial banks and investment financing institutions in India are:

1. Merchant Banking
2. Leasing
3. Mutual Funds
4. Factoring
5. Credit Cards
6. Credit Rating
7. Commercial Paper
8. Housing Finance
9. Venture Capital

The banks and insurance companies are rendering all the above service either on their own or through subsidiaries and making very significant contributions. Let us now know about role of these institutions in these services in detail.

9.1.2.1 Merchant Banking Services: -

Merchant Bankers are financial intermediaries. They act as intermediaries in the process of transfer of capital from those who own it to those who use it. But they do this with a difference. The main strength of merchant bankers is not provision of finance but providing the whole range of inputs of innovative financial services, technical and managerial knowledge and competence and expert advice on legal and industrial matters needed by the user of funds for establishing a new industrial unit or for diversifying / modernizing a running industrial unit or for merger / acquiring another industrial unit or for merger / acquiring another industrial unit or for entering into a foreign collaboration / launching of a joint venture abroad.

Merchant banking business in India developed on the traditional European pattern and remained till recently as an adjunct to the main business of loan operations of Commercial / Development banks. Grindlays Bank was the first to open a Merchant Banking Division in 1967. After that many other institutions joined, notably the State Bank of India, Bank of Baroda and Canara Bank, ICICI and some of leading broking firms and financial consultants.

Merchant banking divisions of commercial banks have been active in a narrow range of traditional merchant banking activities akin to or arising out of their major commercial banking business. The availability of funds temporarily at lower cost attracts banks to act as manager to the new issues. The commercial banks are also engaged in underwriting business. They are also actively involved in arranging underwriting business. They are also actively involved in arranging Euro-currency loans and export finance. Some of them (notably the SBI) act as advisers to major borrowers during major foreign loan negotiations.

With a view to strengthening the organizational and managerial capabilities; broad base the resources position, enlarge the scope of operations and activities and to offer more specialised services with professional expertise, the erstwhile Merchant Banking Divisions of the nationalized banks have started forming independent subsidiary companies. The first of such subsidiary company was formed by State Bank of India known as SBI Capital Markets Ltd. followed by Bank of India (BOI) finance, Indian Bank-Ind Bank Finance; Canara Bank-Canfin; Punjab National Bank-PNB, CAPS: etc.

9.1.2.2 Leasing: -

Recently the tendency of the commercial banks and other financial institutions to act as leasing intermediaries and to dominate the lessors market is increasing dramatically. The important reason, perhaps is the ability of the financial institutions (because of their high profitability and relatively high tax brackets) to exploit the attractive tax concessions.

The modern concept of financial leasing was pioneered in India during the year 1973 by setting up of “First Leasing Company of India Limited” in Madras “Monopoly” for a period of six years. During the first six years the company had a business of Rs. 26 crores and gross profit of the company formed 93 percent of it’s total income.

With the entry of “Sundaram Finance Limited” into leasing business man other companies like MGF limited, Goodwill India limited, The New Indian Industries Ltd., etc., diversified their finance and hire purchase business by starting leasing activities. Several financial institutions also started taking keen interest in leasing operations.

Apart from the private leasing companies, the banks and financial institutions also started participating in the leasing business. With a view to encourage healthy growth of lease financing activity in India, RBI has issued policy guidelines in respect of the role of commercial banks in this regard.

The industrial Development Bank of India (IDBI) also entered the leasing venture in the year 1987-88. It sanctioned a sum of Rs. 14 crores towards the leasing business during that very particular year. This amount reached to Rs. 86 crores in the year 1988-89.

On November 1, 1987 the Industrial Finance corporation of India (IFCI) launched a new scheme for leasing and hire purchase concerns in the corporate and cooperative sectors.

On April 1, 1988 the commercial banks were also permitted to transact leasing business through their subsidiaries. Several commercial banks have decided to enter the field of leasing by promoting leasing subsidiaries or by making portfolio investment in existing or newly set up private leasing companies. The banks are in an advantageous position to recover lease rentals in time, which is not so in case of other leasing companies. The SBI, CANFIN and PNB CAPS have done a business of Rs.5564 lakh during the first year of their operations, (PNB Rs. 3703 lakhs, SBI Rs. 427 lakhs and CAN Rs. 1434 lakhs).

9.1.2.3 Mutual Funds: -

Mutual funds originated in the UK during the last century essentially as a means for mobilising household savings for housing finance. Now these are important elements in the development of capital markets world over.

Mutual funds is an ideal alternating for a small saver who is handicapped with inadequate resources for diversified portfolio, lack of time, expertise and market knowledge.

The first Mutual fund in India was established in 1964 by UTI, but the movement gained momentum only in 80's. Now the Indian money market is flooded with mutual funds catering to the needs of varied interests of savers. These includes SBI MF-Can Bank MF-LIC MF(Dhanasri – Dhanaraksha – Dhanarrithi) and Mutual funds of Bank of Baroda, Punjab National Bank and GIC Mutual funds. The Abid Hussain Committee recommended opening of mutual funds to the private sector in tune with the expertise of the Western countries. As a result, various mutual funds have been set up by the private sector which includes 20th Century Mutual Fund, Tata Mutual Fund, Birla Mutual Fund, JM Mutual Fund. Besides these foreign tie-ups for inland schemes like Alliance Capital Mutual Fund of USA and ICICI Mutual Fund with J.P Morgan Investment Management of USA etc. also look place. The enormous growth of mutual funds compelled growth of mutual funds compelled the government to issue guidelines under the set up of SEBI to regulate the same for their healthy growth on prudential norms.

With a view to provide an additional short-term avenue to investors and to bring money market instruments within the reach of individuals and small bodies, the RBI has proposed a scheme for a new type of Mutual funds by scheduled commercial banks and their subsidiaries. The new money market mutual funds are a special type of funds investing only in high quality money market instruments of a shot-term nature. In an increasingly tightening money market, the few existing MFs and nationalized banks-owned MFs are out-doing each other in offering higher discounts to gain the investor's attention towards their tax saving scheme. The Mutual funds are being governed by RBI and SEBI (MF) Regulation,1999. SEBI has revised its guidelines for money market investments by mutual funds to give it more flexibility.

9.1.2.4 Factoring: -

RBI constituted a study group in January 1988 to examine the feasibility of starting factoring organizations in India. RBI accepted its recommendations in principles in 1989. Vaghul Committee and Kalyana Sundaram Committee recommended for the introduction of factoring services in India. Factoring is a business activity where in the factor (a bank) purchases the receivables of the sellers of small scale and medium industries. The first factoring company in India was SBI Commercial & Factoring Services Ltd. (July 1991). Canbank factoring Ltd., was set up in August 1991 followed by PNB factoring ltd., with the introduction of factoring services it is expected that the commercial banks factoring services will be able to meet the requirements of the small scale sector and exports units in the country.

9.1.2.5 Credit Cards: -

Under Credit Card System credit is accommodated to the card-holders for a specific period of time without obtaining any security. The credit card service has been introduced as an integral part of better customer service and the bank is also able to make increased earnings by way of commission from dealers and interest on credit offered.

A credit card organization enters into an agreement with several establishments of the different parts of the country and even of other countries to provide goods and services to the credit card holders. This service also provides emergency cash facilities through banks or Automatic Teller Machine (ATM). The ATM facility is popular with the customers as All-Time Money facility Central Bank of India was the first bank in India to introduce credit card System in August 1980 and was followed by several other banks.

9.1.2.6 Credit Rating: -

Establishment of credit rating agencies forms an important step in the process of financial informs. In India four rating agencies have been set up so far. These are:

1. The Credit Rating Information Services of India Limited (CRISIL).
2. The Investment Information and Credit Rating Agency of India Limited (ICRA) and
3. The Credit Analysis and Research Ltd. (CARE) and Duff & Phelps Credit Rating (P) Ltd. (DPCR).

CRISIL was promoted in 1987 by the Industrial credit and Investment Corporation of India (ICICI) and Unit Trust of India (UTI). Other share holders include The Asian Development Bank (ADB), LIC, SBI, HDFC, GIC and 20 other banks. The ratings provide a guide to the investor. However, it is not a recommendation to invest or not to invest. CRISIL rates debentures, fixed deposit programmes, short term instruments like commercial paper, structural obligation and preference shares.

The ICRA has been promoted in 1991 by the Industrial Finance Corporation of India (IFCI), Life Insurance Corporation of India (LIC), SBI and 17 other banks. The primary objective of ICRA is to provide guidance to the investors/creditors in determining the credit risk associated with a debt instrument/credit obligation.

The ratings are not recommendations to buy or sell securities. The ICRA rates instruments including Debentures, Bonds, Preference Shares, fixed deposits and short term instruments like commercial papers etc.

The other two rating agencies (i.e., CARE and Duff and Phelps) are set up by IDBI and Commercial banks and Alliance Capital Ltd. and Duff and Phelps of U.S. respectively. In case of CRISIL, CARE and ICRA the role and contribution of banks and insurance companies is very significant.

9.1.2.7 Commercial Paper: -

Financial disinter mediation has been gaining momentum in the Indian economy. The Reserve Bank has been giving a definite direction to this trend through its policy initiatives. The introduction of Commercial Paper (CP) from January 1, 1990 has been one of the important policy initiatives of the RBI and it intends to bring the high credit-worthy corporate borrowers and the investors into direct contact through the scheme of Commercial Papers (CP). Commercial Papers are issued by the public utilities, insurance companies, bank holding companies and finance companies, etc. Purchasers of CPs are banks and non-banking financial institutions. The position of banks is quite significant in the market for commercial papers because in addition to being an important buyer, they also act as agents in issuing, holding of commercial papers and provide credit to firms, which issue commercial papers. The non-banking institutional investors like LIC, GIC and UTI are not substantial buyers of commercial papers because their investment requirements and funding strategies are decided by the government with the money market mutual funds opening up, the potential of CP will increase further. Though CP is said to be highly liquid because of its transferability, but in the absence of highly developed secondary markets, its liquidity could be greatly affected.

9.1.2.8 Housing Finance: -

Commercial banks have entered into Housing Finance to facilitate middle and low income groups purchase or construct houses or flats. Setting up of NHB in 1988, an apex body for housing finance has given a boost to banks. Banks like SBI, Canara Bank, PNB have already set up separate subsidiaries for housing finance. Housing Finance while open up a new era for business so far as the banks are concerned, it is also of great significance from the point of view of social justice. The Canara Bank sponsored a Housing Finance Company, Canfin Homes Ltd., in 1988, it has its branches in more than 22 cities and it operates the home loan account scheme of NHB, GIC set up a company in July 1990, GIC Frih Vista Ltd., in joint venture with its subsidiaries, UTI, ICICI, HDFC and SBI Capital Markets. The purpose of setting up these companies is to help people to own their homes. LIC set up a Housing Finance Company namely LIC Housing Finance Limited (LICHFL) in 1991 with its two schemes namely Jeevan Kutir and Jeevan Nivas. The primary business of LICHFL is granting housing loans to individuals. It also provides finances to agencies engaged in construction of houses/flats for residential purposes. It has floated various schemes for group housing loans being targeted towards Development authorities, Builders, Developers, Employer Organisation for construction of employees quarters, etc. presently, LICHFL is the largest housing finance company in terms of market share, next only to HDFC other Commercial Banks have set up their housing finance companies namely PNB Housing Finance Limited and SBI Home Finance Limited.

9.1.2.9 Venture Capital: -

Venture capital is the response of invisible funds to capitalize on an opportunity to earn very high returns as compared to conventional security backed lending by enabling high risk but high promise projects to realize their full potential.

The growth of venture capital is typically the response to the demand created for more risk-bering funds to finance commercialisation of new technologies and innovative market solutions. Venture capital industry in India is of recent origin. In 1986 the Government of India enacted Research and Development Cess Act, Prescribing collection of a cess of 5 percent on all payments for import of technology with the idea that the funds thus collected will be used for venture capital to be operated by the Industrial Development Bank of India (IDBI) Almost around the same time, ICICI set up a venture capital scheme. In 1988, ICICI established the Technology Development and Information Corporation of India ltd., (TDICI). Similarly, the Risk Capital and technology Finance Corporation was established by the Industrial Finance Corporation of India. Later, some of the state-level developmental financial institutions also promoted venture capital units-the Gujarat Venture Finance Ltd., APIDC Venture Capital Ltd., etc (APIDC-VCL, 1991 GVFL, 1988). The Canbank Venture Capital Fund was established by Canfin and Canara Bank. The Credit Capital Venture Fund (CCVF) was the firs private sector venture capital fund to be set up, followed by the Twentieth Century Venture Finance.

Some public sector banks also have undertaken venture capital financing through their subsidiaries. Canbank Financial Service Ltd., (Canfina), a subsidiary of Canara Bank, SBI Capital Markets Ltd., (SBI Caps), a subsidiary of State Bank of India and India Investment Funds and Financing Projects of Grindlays Bank have started operations in this direction.

9.1.3 New Vistas in Financial Services: -

Since the volume of international business and capital flows are increasing hence the commercial banks are likely to be exposed to different types of risks and there is a need to hedge these exposures. The emerging derivatives in foreign countries are increasingly used portfolio. It is the right times that foresee dealers, especially the commercial banks in India, familiarise with the complexity of these instruments and acquire skills to manage these emerging challenges.

Establishment of foreign banks and non-banking companies have played a very key role in introducing the technology cult in the financial sector in India. In the light of the diversified product range the banks and financial institutions are offering to public the various types of financial services in a global perspective. Hence, in the aspiration towards becoming major player in the modern financial service sector, commercial banks and various investment institutions will have to evolve appropriate strategies for technology integration for providing faster and efficient financial services.

9.2. INSURANCE SERVICES

9.2.1 Definition: -

A contract whereby one party, called the insurer or the insurance company, undertakes to compensate the other party called the 'insured', for any loss or damage suffered by the latter in consideration of payment of 'premium' for a certain period of time, is known as 'insurance'.

9.2.2 Basic Principles of Insurance: -

A contract of insurance is required to possess the following essential characteristics:

9.2.2.1 Good Faith: -

A contract of insurance is founded on the principle of 'utmost good faith' Accordingly, both parties to the contract are required to disclose all material facts. The rule of 'caveat emptor' is not applicable in the case of insurance.

9.2.2.2 Insurable Interest: -

The insured party is required to have an insurable interest on the object on which the insurance policy is taken. Insurable interest is required to be present both at the time of the contract, as well as at the time of loss. Insurance interest refers to the pecuniary or financial interest possessed by the beneficiary, which is the insured party on the object being insured for. This implies that loss or damage caused to such an object would cause financial loss to the insured party.

9.2.2.3 Compensation: -

An insurance contract undertakes to indemnify the insured for any loss or damage sustained due to the risk against which it is insured. This is applicable only to the general insurance business, where it is possible to calculate the loss or the damage in terms of money the amount of compensation depends on the value of the insurance policy and not on the value of the object insured.

9.2.2.4 Subrogation: -The term 'subrogation' refers to stepping into the shoes of others. Accordingly an insurer can step into all the rights and privileges of the insured in relation to the insured object, after making payment to the insured. Under this doctrine, the property in the object will pass on to the insurance company after the payment of insurance claims.

9.2.2.5 Contribution: -

According to this principle, the amount of compensation forthcoming from an insurance company would depend proportionately on the amount for which the insurance policy has undertaken to compensate for the loss. This is applicable in the case of 'double insurance', whereby the insured insures the object with more them one insurance company.

9.2.2.6 Loss Mitigation: -

In order that the insurance company makes a reasonable payment of claims, it is necessary that the insured party takes all the necessary steps to mitigate the risk of loss in the event that the contingency insured against occurs. The insured must act as a person of ordinary prudence, and should make all reasonable efforts to minimize the loss.

9.2.2.7 Cause Proxima: -

According to this principle, risk coverage is available to the insured party, provided the loss has occurred directly from such events as specified in the insurance policy.

Reinsurance:

The insurance business done between insurance companies is known as 'reinsurance'. It is an arrangement through which it is possible for one insurance company to transfer a portion of its insurance business to other insurance company. Such an arrangement helps an insurance company to minimize its share of claims. There are two types of reinsurance. When one insurance company off-loads a portion of its insurance business to other insurance companies, it is a case of 'reinsurance ceded'. On the other hand, when one insurance company accepts a portion of insurance business of other insurance companies, it is a case of 'reinsurance accepted'.

9.2.3 Life Insurance:

9.2.3.1 Definition:

A contract in which the insurer undertakes to pay a certain sum of money to the insured, either on the expiry of a specified period, or on the death of the insured in consideration of payment of 'premium' for a certain period of time, is known as 'life insurance'. It is typically called 'life assurance' Life insurance serves the purpose of protection as well as an investment contract. It is a protection contract because it gives protection to the assured in the event of death, by making payment of the entire amount of the 'sum assured'. It is an investment contract too, as it gives the assured/investor the advantage of regaining the money with interest and bonus at the end of the policy.

9.2.3.2 Policies:

Some of the popular types of life assurance policies are as follows.

1. Whole life policy: An ordinary policy which runs throughout the life of the assured is known as 'whole life policy' the sum assured under this policy is payable only after the death of the assured. The premium payable is low, and is meant to protect the family. This policy offers the advantage of an investment for a life term.
2. Endowment policy: The policy runs for a period as specified in the policy document. The sum assured, along with the bonuses, are payable either on the date of maturity of the policy, or on the death of the assured, whichever occurs earlier. This policy offers the advantage of both protection and investment.
3. Annuity policy: Under this policy, the amount of the policy is paid in the form of annuities for a specified number of years, or till the death of the assured.
4. Joint life policy: When the insurance policy covers the lives of two or more persons, it is called 'Joint life policy'.
5. Group insurance policy: when an insurance policy is taken out on the lives of the members of the family, or the employees of a business concern, it is called 'group insurance policy'.

9.2.4 General Insurance:

9.2.4.1 Introduction:

A contract whereby, upon periodic payment of a sum of money called premium, the insurer undertakes to compensate the insured in the event of any specified loss or damage suffered by the latter, is known as 'general insurance'. A typical characteristic of general insurance is that it serves only as a protection contract and not as an investment contract. This means that the money paid as premium will come back to the insured by way of claims only on the occurrence of some specified events resulting in loss or damage to the insured.

9.2.4.2 Types: -

The various types of general insurance are fire insurance, marine insurance, personal accident insurance etc.

Fire insurance:

Under fire insurance, the insurance company under takes to indemnify the loss sustained by the insured party on account of fire accidents. In order that fire claims are admitted by the

insurance company, there must be an actual fire that is accidental and not international. The cause of the fire is immaterial for the fire claim to be admitted. However, in the event of a fire breaking out, the insured party must have taken all the precautions that a person of ordinary prudence would take to salvage the subject matter insured.

1. Valued policy: It is a policy wherein the value of the property is agreed upon, and the insurance company undertakes to pay the agreed value in the event of destruction of the property.
2. Average policy: A policy wherin, fire claims are paid to the insured in proportion to the actual value of the property at the time of loss, is called 'average policy'. Such a clause aims at preventing under-insurance.
3. Specific policy: This is a policy wherin risk on account of fire is insured for a specific sum. The maximum coverage under this policy shall be upto the amount of the insurance policy.
4. Floating policy: When an insurance policy covers risk pertaining to one or several kinds of goods in different places for a single sum and for a single premium, it is called a 'floating policy'.
5. Excess policy: In a policy where the risk coverage is to the extent of the maximum additional amount by which stocks may sometimes increase, it is called 'excess policy'.
6. Blanket policy: Where the risk pertaining to all types of assets, fixed as well as current is covered under one single insurance policy, it is a case of 'blanket policy'.
7. Comprehensive policy: A policy which covers all types of risks arising from explosion, lightning, thunderbolt, riot, civil commotion, strikes, burglary, etc. is called a 'Comprehensive policy'.
8. Consequential loss policy: Where a fire policy covers the risks arising from loss of profit owing to interruption of business by fire, it is called a 'Consequential loss policy'.

Marine Insurance: -

An insurance contract, which covers the risks of loss arising from and incidental to marine adventure, is known as 'Marine Insurance'. The kinds of risks that are covered in this type of insurance are cargo, hull, freight, etc. The different types of marine insurance includes cargo insurance, hull insurance and freight insurance. Cargo insurance covers the risks arising from an act of god, enemy, fire, gales, etc. Hull insurance covers the risk caused to the ship during the voyage. Freight insurance covers risks arising from the non-payment of freight charges to the owner of the ship on account of the perils of the sea voyage.

Other Insurances: -

In addition to fire and marine insurance other popular types of general insurance includes motor insurance, burglary, theft and robbery insurance.

Liability insurance: A type of insurance contract that provides insurance protection to a person in the event of damage caused to someone's heath or property, if found to be at fault is called 'Liability insurance'.

9.2.4.3 Concept of Insurance Services: -

Services relating to life and non-life insurance, offered by banks and financial institutions to trade and non-trade customers, on the basis of premium payments, may be referred to as 'Insurance services'.

9.2.5 Profile of Insurance Service Providers: -

With the liberalization of the Indian economy, the insurance industry is has a large number of players, especially the private players in the recent past. The Life Insurance Corporation of India (LIC) remains the single largest service provider in the realm of life insurance, while United India Insurance dominates general insurance business. A profile of the various service providers in the insurance industry is presented below:

9.2.5.1 General Insurers: -

The General Insurance Corporation of India (GIC) had four subsidiary companies, namely.

1. Oriental Insurance Company Limited.
2. New India Assurance Company Limited.
3. National Insurance Company Limited.
4. United India Insurance Company Limited.

(With effect from December 2000, these subsidiaries have been de-linked from parent company and made independent insurance companies)

In addition, the following were also registered with the IRDA for carrying out general insurance business:

1. Royal Sundaram Alliance Insurance Company Limited, on 23-10-2000.
2. Reliance General Insurance Company Limited on 23-10-2000.
3. IFFCO Tokio General Insurance Company Limited, on 04-12-2000.
4. TATA AIG General Insurance Company Limited, on 22-01-2001.
5. Bajaj Allianz General Insurance Company Limited, on 02-05-2001.
6. ICICI Lombard General Insurance Company Limited, on 03-07-2002.
7. Cholamandalem General Insurance Company Limited, on 15-07-2002.

9.2.5.2 Life Insurers: -

In addition to the LIC of India, the following companies have been registered with the IRDA for providing life insurance services:

1. HDFC Standard Life Insurance Company Limited, on 23-10-2000.
2. Max New York Insurance Company Limited, on 15-11-2000.
3. ICICI Prudential Life Insurance Company Limited, on 24-11-2000.
4. Om Kotak Mahindra Life Insurance Company Limited, on 10-01-2001.
5. Birla Sun Life Insurance Company Limited, on 12-01-2001.
6. TATA AIG Life Insurance Company Limited, on 12-02-2001.
7. SBI Life Insurance Company Limited, on 30-03-2001.
8. ING Vysya Life Insurance Company Limited, on 02-08-2001.
9. Allianz Bajaj Life Insurance Company Limited, on 03-08-2002.

10. Metlife India Insurance Company Private Limited, on 06-08-2001.
11. AMP SANMAR Assurance Company Limited, on 03-01-2002.
12. Dabur CGU Life Insurance Company Private Limited, on 14-05-2002.

9.2.6 Insurance Regulatory and Development Authority (IRDA): -

9.2.6.1 Composition: -

The Insurance Regulatory and Development Authority (IRDA), was constituted by an act of Parliament (Under Section 4 of IRDA Act 1999). The authority is a ten member team consisting of a chairman, five whole-time members and four part-time members, all appointed by the Government of India.

9.2.6.2 Duties: -

Under Section 14 of the IRDA Act, the authority's duty is to regulate, promote and to ensure an orderly growth of the insurance and the re-insurance business.

9.2.6.3 Powers and Functions:

Under subsection 1 of Section 14 of the IRDA Act, the authority has the following powers and function:

1. Registration: Insurance of certificate of registration, or to renew, modigy, withdraw, suspend or cancel such registration.
2. Protection: Protection of the interests of policy holders in matters concerning assigning of policy, nomination by policy holders, insurable interest, settlement of insurance claim, surrender value of policy and other. Terms and conditions in contracts of insurance.
3. Qualification: Specifying the requisite qualifications, code of conduct and practical training for insurance intermediaries and agents.
4. Code of conduct: Specifying the code of conduct for surveyors and loss assessors.
5. Efficiency: Promoting efficiency in the conduct of the insurance business.
6. Professionalism: Promoting and regulating professional organizations connected with the insurance and re insurance business.
7. Fees etc: Levying fees and other charges for carrying out the objectives of this Act.
8. Information: Calling for information from, undertaking inspection of and conducting enquiries and investigations, including audit of the insurers, intermediaries including audit of the insurers, intermediaries and other organizations connected with the insurance business.
9. Terms of business: Control and regulation of the rates terms and conditions that may be offered by insurers for general insurance, business not so controlled and regulated by the Tariff Advisory Committee under section 64U of the Insurance Act, 1938 (4 of 1938).
10. Book of accounts: Specifying the form and the manner is which books of account shall be maintained, and statement of accounts shall be rendered by insurers and other insurance intermediaries.
11. Funds investment: Regulating investment of funds by insurance companies.
12. Margin of solvency: Regulating the maintenance of margin of solvency.
13. Adjudication: Adjudication of disputes between insurers and intermediaries or insurance.
14. Supervising: Supervising the functioning of the Tariff Advisory Committee.
15. Premium income: Specifying the percentage of the premium income going into finance scheme for promoting and regulating professional organizations pursuing assurance business.

16. Rural Insurance etc: Specifying the percentage of life insurance business and general insurance business to be undertaken by the insurer in the rural or social sector.

9.3 Self Examination Questions:

1. Explain various financial services offered by banking sector?
2. Explain the roll of commercial banks in housing finance?
3. Give a brief note on recent changes in financial services offered by banking sector?
4. What are the basic principles of insurance?
5. What are various types of Life Insurance Policies?
6. What are various types General Insurance?
7. Give brief note on the functioning of IRDA?

9.4 Reference Books:

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LESSON 10

VENTURE CAPITAL

10.0 Objective:

After reading this lesson, you will be able to understand .

- Concept of Venture Capital
- Features
- Stages in Venture Capital Financing & Importance of Venture Capital.

Structure:

10.1. Introduction

10.2. Origin of Venture Capital

10.3. Initiative in India

10.4. Meaning of venture capital

10.5. Features of Venture Capital

10.6. Venture Capital Financing – Stages

10.6.1. Development of an Idea – seed finance

10.6.2. Implementation stage-startup finance

10.6.3. Fledging stage-Additional finance

10.6.4. Establishment stage-Establishment Finance

10.7. Importance of Venture Capital

10.7.1.Advantages to investing public

10.7.2. Advantages to the promoters

10.7.3. General advantages

10.8. Methods of venture financing

10.8.1. Equity participation

10.8.2. Conventional loan

10.8.3. Conditional loan

10.8.4. Income Notes

10.9. Conclusion

10.10. Self Assessment Questions

10.11. Reference Books

10.1 Introduction:

Venture Capital is risk money, which is used in risky enterprises either as equity or debt capital. It may be in new sunshine industries or older risk enterprises. The funds, which finance such risky ventures, are called venture capital funds.

10.2 Origin of Venture Capital:

Venture Capital was originated and popularised in the USA in the sixties. American Research and Development Corporation, founded by Gen. Doriot soon after the Second World War. The real development of VC took place in 1958 when the business administration was passed by US congress.

UK occupies a second place after US in terms of investment in VC. The concept became popular in the late sixties in UK.

10.3 Initiative in India:

Indian tradition of VC for industry goes back more than 150 years when many of the managing agency houses acted as venture capitalists providing both finance and management skill to risky to risky projects. The Tatas also initiated a managing agency system, named investment corporation of India in 1937 which by acting as venture capitalist. Venture capital's growth in India passed through various stages. In 1973, R.S. Bhatt committee recommended formation of Rs 100 crore venture capital fund. United Nations Development Programme in 1987 on behalf of Government examined the possibility of developing venture capital in private sector.

10.4 Meaning of venture capital:

Venture Capital is long-term risk capital to finance high technology projects, which involve risk, but at the same time has strong potential for growth. Venture capitalist pools their resources including managerial abilities to assist new enterprises in the early years of project. Once the project reaches the stage of profitability they back their equity holdings at high premium.

10.5 Features of Venture Capital:

Some of the features of venture capital financing are as under.

1. Venture Capital is usually in the form of equity participation. It may also take the form of convertible debtor long-term loan.
2. Investment is made not only in high risk but also in high growth potential projects.
3. Venture capital is available only for commercialisation of new ideas or new technologies and not for enterprises, which are engaged in trading, booking, financial services, agency liaison work or research and development.
4. There is continuous investment in business after making an investment by the investor.
5. Investment is usually made in small and medium scale enterprises.
6. Venture Capital is not just injection of money but also an input needed to setup the firm, design its marketing strategy and organise and manage it.

10.6 Venture Capital Financing – Stages:

The various stages in the financing of venture capital are described bellow.

10.6.1 Development of an Idea – seed finance: -

In the initial stages venture capitalists provide seed capital for translating an idea into business preposition. At this stage investigation is made indepth, which normally takes a year or more.

10.6.2 Implementation stage-startup finance: -

When the firm is setup to manufacture product or provide a service, startup fiancé is provided by venture capitalists. The first and second stage capital is used for full manufacturing and further business growth.

10.6.3 Fledging stage-Additional finance: -

In the third stage the firm has made some headway and entered the stage of manufacturing a product but faces farthing problems. It may not be able to generate adequate funds and so additional round of financing is provided to develop the marketing infrastructure.

10.6.4 Establishment stage-Establishment Finance: -

At this stage, the firm is established in the market and expected to expand at a rapid pace. It needs further financing for expansion and diversification so that it can reap economics of scale and attain stability. At the end of the establishment stage the firm is listed on the stock exchange and at this point the nature capitalist disinvests their share holdings through available exit routes.

10.7 Importance of Venture Capital:

10.7.1. Advantages to investing public: -

Venture capital is of great practical value to every corporate enterprise in modern times.

(a) The investing public will be able to reduce risk significantly against unscrupulous management, if the public invests in venture fund that in turn will invest in equity of new business.
(b) The venture funds equipped with necessary skills will be able to analyse the prospects of the business. So the investor has no means to vouch for the profitability of the business.

10.7.2 Advantages to the promoters: -

1. Public issue of equity shares has to be preceded by lot efforts, viz., necessary statutory sanctions, under writing and brokerage arrangement the new entrepreneurs find it very difficult to meet all these arrangements and requires a great deal of effort. Venture fund assistance would eliminate those efforts by leaving the entrepreneur to concentrate upon bread and butter activities of business.
2. For the success of public issue the entrepreneur is required to convince the under writers, brothers and no.of investors but to obtain venture capital assistance he will be required to sell his ideas to justify the officials of the venture fund.

10.7.3 General advantages: -

1. A developed venture capital institutional setup reduces the time lag between a technological innovation and its commercial exploitation.
2. It helps in developing new processes/ products in conceder atmosphere, free from the dead weight of corporate bureaucracy, which helps in exploiting full potential.
3. Venture capital acts as a cushion to support business borrowings as bankers and investors will not lend money with inadequate managing of equity capital
4. A venture capital firm serves as an intermediary between investors looking for high return for their money and entrepreneurs in search of needed capital for their startups.
5. It also pares the way for private sector to share the responsibility with public sector.

10.8 Methods of venture financing: - (the Indian scenario)

10.8.1 Equity participation: -

Venture capital firms participate in equity through direct purchase of shares but their stake does not a need 49%. These sharer are sold either to the promoter at negotiated price under by back agreement or to the public in the secondary market at a profit.

10.8.2 Conventional loan: -

Under this form of assistance, a lower fixed rate of interest is changed till the assisted units become commercially operational after which the lean carrier normal or higher rate of interests.

10.8.3 Conditional loan: -

Under this form of finance an interest free loan is provided during the implementation period but it has to pay royalty on sales. The loan has to be repaid according to a predetermined schedule as soon as the company is able to generate sales and income.

10.8.4 Income Notes: -

It is a combination of conventional and royalty are payable at much lower rates than in case of conditional loans.

10.9 Conclusion:

At present there are several venture capital firms are incorporated in India and they are promoted by all India FIs like IDBI, ICICI, IFCI, State level FIs, Public sector banks or promoted by foreign banks.

10.10 Self Assessment Questions:

1. Define the term Venture Capital and write the features of Venture Capital Financing?
2. Discuss the various types of Venture Capital Financing?
3. Discuss the various stages involved in Venture Capital Financing?
4. Trace the origin and growth of Venture Capital Financing?

10.11 Reference Books:

1. M.Y. Khan, Financial Services, TMH, 2001.
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LESSON 11:

FACTORING

11.0 Objective:

After reading this lesson, you will be able to understand.

- Concept of Factoring
- Types of Factoring
- Meaning of Forfaiting
- Meaning of Bill Discounting
- Bill Market in India

Structure:

11.1. Factoring

- **11.1.1. Meaning**
- **11.1.2. Parties to Factoring Contract**
- **11.1.3. Types of Factoring**
- **11.1.4. Advantages & Disadvantages of factoring**
- **11.1.5. Mechanism of factoring**
- **11.1.6. Factoring in India**

11.2. Forfaiting

- **11.2.1. Meaning**
- **11.2.2. Differences between factoring and forfaiting**
- **11.2.3. Forfaiting in India**
- **11.2.4. Advantages of forfaiting**

11.3. Bill Discounting

- **11.3.1. Meaning**
- **11.3.2. Evolution of Bill Discounting scheme in India**
- **11.3.3. Procedure for Rediscounting**
- **11.3.4. Revitalising the bill market in India**

11.4. Self Examination Questions

11.5. Reference Books

11.1. Factoring

11.1.1 Meaning: -

Factoring is a financial service which is rendered by the specialised persons known as "Factors", who deal in realising the book debits, bills receivable, managing sundry debtors and sales registers of the commercial and trading firms in the capacity of agent for a commission. Such commission is known as "Commercial charge". Factoring helps in realization of credit sales of trading firms.

The nature of the obligation of the factor is of bailment contract. Factor stands in a fiduciary relationship with the client firm and the main responsibility arises out of the terms of the contract or agreement between the parties. Factoring firms are professionally competent with skilled persons to handle credit sales realisations for different clients in different trades for better credit management.

Need for factor-services is felt by traders to concentrate on sales and realization of credit sales be left in specialised hands to minimise the risk of bad debt arising on account of non-realisation of credit sales. If sales are realised with in reasonable time, the traders need not depend much for bank finance towards working capital.

11.1.2 Parties to Factoring Contract: -

There are three parties involved generally a factoring contract, Viz.,

1. Buyer of goods who has to pay for goods bought on credit terms.
2. Seller of goods who has to realise credit sales from buyer.
3. "Factor" who acts as agent in realising credit sales from buyer and passes on the realised sum to seller after deducing.

11.1.3 Types of Factoring: -

The factor could be of three broad types

1. Domestic factoring
2. Export factoring
3. Cross border factoring

11.1.3.1 Domestic Factoring: -

Domestic factoring could be again sub-divided into three main principal types viz:

a. Disclosed factoring
b. Undisclosed factoring and
c. Invoice discounting

11.1.3.1.1 Disclosed factoring: -

In disclosed factoring the name of the factor is disclosed in the invoice by the supplier or manufacturer of the goods asking the buyer to make payment to the factor so named there in. The supplier may continue to bear the risk of non-payment by the buyer without passing in on to the factor. In such cases the factor is said to have "recourse" to the principle. Generally, the factors assume this risk under "non-recourse" arrangements. The limit within which the dealings are done on recourse basis.

11.1.3.1.2 Undisclosed factoring: -

The name of the factor is not disclosed in the invoice although factor maintains the sales ledger of the supplier or manufacturer. The entire realisation of the business transaction is done in the name of the supplier company but control of all moneys remains with the factor. This type of factoring is much in vogue in UK.

11.1.3.1.3 Invoice discounting: -

The factor could be a bank or the supplier of funds which discounts the invoices of the supplier at a pre-agreed credit limit providing finance to the supplier against the security in the form of a charge on the book debts of the supplier on a specific cash receivables.

11.1.3.2 Export factoring: -

In export factoring, banks play an important part. The export company obtains finance from the banks by virtually selling the export document to it on a reasonable basis i.e. if the claims are not honoured by the importer's bank, the exporter shall repay the bank the amount so received. The factor bank usually advances 75% - 50% of the export claims of the supplier exporter. This advantage is on both recourse as well on non-recourse basis. If the factoring covers risk of non-payment on non-recourse basis, it creates more attractive proposition.

11.1.3.3 Cross border factoring: -

Export factoring is also known as cross border factoring when import factor at the debtor's place is engaged by export factor. Import factor has knowledge of local conditions and provides help in realisation as well as reduction of commercial risk. Export factor takes over the commercial risk from the exporter on the assurances given by import factor. This may also be of 'recourse' and 'non-recourse' type. In non-recourse type factoring, disputed claims even if taken over by factor are suspended till settlement is arrived at between the exporter and importer. After final settlement, the factor takes back the claims the question and render factoring services.

11.1.4 Advantages of factoring: -

Following are the advantages resulting from the factoring:

1. Elimination of trade discounts.
2. Prompt payments and credits.
3. Improves scope for operating leverage.
4. Reduction of administrative cost and burden.
5. Increase in return to the client.
6. Improvement in liquidity
7. Provides insurance against bad debts
8. It is neither a loan nor a deposit but facilitates liquidity
9. It avoids increased debts
10. Current assets are efficiently managed thus reducing working capital requirements.
11. Better credit discipline amongst customers by regular realisation of dues, effective control of sales journal, reduced credit risk, better working capital management etc.

Disadvantages of factoring: -

1. Image of the client may suffer as engaging a factoring agency is not considered a good sign of efficient management.
2. Factoring may not be of much use where companies have nation-wide network of branches.
3. Financial evaluation may not be accurate.
4. If the client has cheaper means of finance and credit (where goods are sold against advance payment) factoring may not be useful.

11.1.5 Mechanism of factoring: -

Various activities undertaken by the three parties (the buyer, the seller and the factor) in a factoring transaction are listed here under:

1. The Buyer

(a) Buyer negotiates terms of purchasing plant and machinery or other material with the seller;

(b) Buyer receives delivery of goods with invoice and instructions by the seller to make payment to the factor on due dates;

(c) Buyer makes payment to the factor in time or gets extension of time or in the case of default is subject to legal process at the hands of factor.

2. The Seller

(a) Enters into a Memorandum of Under standing (MSU) with the buyer in the form of letter exchanged between them or agreement entered into between tem;

(b) Sells goods to the buyer as per MOU.

(c) Delivers copies of invoice, delivery challan; MOU, instructions to make payment to factor given by buyer;

(d) Seller receives 80% or more payment in advance from factor on selling the receivables from the buyer to him;

e)Seller receives balance payment from factor after deduction of factor's service charges, etc.

3. The Factor

(a) The factor enters into agreement with seller for rendering factor services to it;

(b) On receipt on copies of sales documents as referred to above makes payment to the seller of the 80% of the price of the debt;

(c) The factor receives payment from the buyer on due dates and remits the money to seller after usual deductions;

(d) The factor also ensures that the following conditions should be met to give full effect to the factoring arrangements;

(i) The invoice, bills or other documents drawn by seller should contain a clause that these payments arising out of the transaction as referred to or mentioned there in might be factored;

(ii) The seller should confirm in writing to factor that all the payments arising out of these bills are free from any encumbrances, charge, lien, pledge, hypothecation or mortgage or right of set-off or counter-claim from another etc.

(iii) The seller should execute a dead of assignment in favour of factor to enable the latter to recover the payment at the time of after default;

(iv) The seller should confirm by a letter of confirmation that all conditions sell-buy contract between the buyer and him have been compiled with and transaction is complete;

(v) The seller should procure a letter of waiver from the bank in favour of the factor in case the bank has a charge over the assets sold out to buyer and the sale proceeds are to be deposited in the account of bank.

11.1.6 Factoring in India: -

Reserve Bank of India had constituted in January, 1988 a study group under the chairmanship of Shri C.S. Kalyansundram to examine the feasibility and mechanism of starting factoring organisation in India. The group submitted the report in January 1989.

The study group had gone into its various functional formalities, implication and importance for promoting factoring in the country with involvement of commercial banks and non-banking financial intermediaries like merchant banks, etc. The report of the study group on factoring and the recommendations made therein were accepted by RBI. Some of major factoring firs in India are;

11.1.6.1 SBI Factors & Commercial Services Ltd,: -

SBI has floated its subsidiary in March, 1991 as SBI factors and commercial services ltd. (SBI FACS), which commenced operations in April, 1991 starting with bill-discounting and other services. SBI FACS contemplated to undertake collection and credit services designed to improve cash flow of business concerns, by timely realization of debts or receivables. A seller can have his invoice converted into instant cash upto 80% without having to wait for 30,60 or 90 days or even longer for payment by the purchaser. SBI FACS takes the responsibility of collection of debts due from customers of the clients. It will also undertake the maintenance of clients sales ledger by using the computerised system, monthly sales analysis, overdue invoice analysis and customers payment reports will be provided to clients. Once a line of credit is established, availability of cash to the client will get directly gareared to sales. These services would be provided against recoverable service charges without guarantee or security being insisted upon.

SBI FACS has designed its services having studied models prevalent in countries like Singapore and Indonesia and adopted them with suitable changes to domestic business environment. Small Industries Development Bank of India (SIDBI) would be teaming up with SBI to discount bills.

SBI FACS would be programming its services to all forms of business organisations engaged in manufacturing and trading.

SBI FACS has paid up capital of Rs.25 crores and had factored debt of Rs.30 crores with gross profit of Rs.2 crores during the year 1991-911.

11.1.6.2 Canara Banks Factors Ltd.: -

Canara Bank Factor Ltd., got RBI approval and was simultaneously incorporated as subsidiary of Canara Bank in August, 1991 and has been operating in south zone. It has paid up capital of Rs.10 crores contributed by Canara Bank, Andhra Bank and Small Industries Development Bank of India in the proportion of 60:20:20 and rendering same services as SBI FACS. Till 1991-92, it had done business worth factoring Rs.26 crores and earned gross profit of Rs.69 lakhs.

2.1.6.2.1 Fair growth factors Ltd.: -

It is the first company in private sector allowed to operate as factors. It has started its functions in April, 1992 and has paid up capital of Rs. 5 Crores.

Domestic factoring in USA amount to US $ 33 billion Europe, UK, Sweden, Italy, Norway, Germany, Belgium and Netherlands make maximum use of domestic factoring. In other nations like Japan, Hong Kong, Malaysia, Singapore, Australia and Philippines its use is getting momentum.

11.2 FORFAITING

11.2.1 Meaning: -

Forfaiting denotes the purchase of trade bills or promissory notes by a bank or financial institution without recourse to seller. This purchase is in the form of discounting the bills or notes covering the entire risk of non-payments in collection. Thus all risks and collection problems are fully the responsibility of purchaser (forfaiter's) who pays cash to seller after discounting the notes or bills. Forfaiting is backed by bank guarantee. The salient features of forfaiting are noted below:

1. Commercial contract between the exporter and importer.
2. Delivery of goods from exporter to importer.
3. Acceptance and delivery of bills of exchange drawn on importer by exporter back exporter.
4. Forfaiting contract between the forfeiter and the exporter. The agreement should provide the basic terms like coverage of cost to forfaiting, margin to cover risk, commitment charges, days of grace, fee to compensate forfeiter for loss of interest due to transfer and payment usually bi-annual installments, rate of interest which is generally fixed rate, etc.
5. Delivery of bills of exchange by exporter to importer.
6. Cash payment by forfeiter to exporter of the face value of bills less discount.
7. Presentation of bills of exchange on maturity for payment by forfeiter to importers bank.
8. Payment of bills by importers bank to forfeiter

From the above features it is concluded that forfaiting is a modification of bill discounting and involves non-recourse discounting of bills. It ensures the exporter from any default risks. It involves endorsement without recourse by the exporter of bills of exchange or promissory notes

accepted by the importer and co-accepted by a bank in favour of forfaiting agency for exchange of discounted cash proceeds. The discount rates are charged as a percentage over the Euro-market interest rates.

11.2.2 Differences between factoring and forfaiting: -

1. Factoring is usually for trade credit transaction of short term maturities not exceeding six months, where as forfaiting is usually for credit transactions of long-term maturity periods.
2. Factoring can be with recourse or without recourse depending upon the terms of transactions between the seller and factor. Forfaiting is without recourse to the exporter. All risks are taken over by the forfeiter.
3. Cost of factoring is usually borne by the seller while cost of forfaiting is borne by the overseas buyer (importer).
4. Under factoring, the business can avail of services for a whole set of jobs at a predetermined price but in forfaiting structuring and costing is on case to case basis

Conditions for the success: -

For forfaiting to be successful, existence of secondary market is an essential condition. A forfeiter may not be interested to hold the discounted bills or notes upto maturity because of his own liquidity considerations. In the secondary market, forfeiters can buy or sell these bills first like other securities. Reputation of the forfaiting agency and credit period of are important in deciding the cost of forfaiting.

11.2.3 Forfaiting in India: -

Forfaiting has been permitted to exporters in India since 1992, as a method of post shipment export finance. Forfaiting is a without recourse finance which converts a credit sale into a cash sale. It does not lock up any bank limits. In case of Export Bill Rediscounting (EBR), bank limits are blocked and it is a with recourse finance and as such, forfaiting is better than EBR. Forfaiting is a viable method of post shipment finance in medium to long-term credit for large size export of goods.

11.2.4 Advantages of forfaiting: -

Use of forfaiting provides a number of advantages viz.;(a) forfaiting enable a broad range of instrument in use like promissory notes, bills of exchange, acceptances, letter of guarantee, documented receivables in balance sheet as pending and can use own credit lines; (c) export risk for non-settlement of claims, etc. is averted as it provides a non-recourse facility, (d) it does not involve any risk on account of foreign exchange fluctuations to exporter between the insurance date and maturity of paper; (e) exporter faces no credit administration and collection problems; (f) it provides finance for counter trade, etc.

11.3 BILLS DISCOUNTING

11.3.1 Meaning: -

Bill discounting is a source of short-term trade finance. It is also known as acceptance credit where one party accepts the liability of trade towards third party. Bill discounting is used as a medium of financing the current trade and is not used for financing capital purposes.

Trade Bills are negotiable money market instruments and these are bought by the intermediaries at a discount before their maturity. Discount houses act as intermediaries between the central bank and the banking system, providing liquidity and ensuring efficient operations of money market. Discount houses play important role throughout the universe in the whole system of banking.

11.3.2 Evolution of Bill Discounting Scheme in India: -

In 1931, the Indian Central Banking Enquiry Committee had recommended for the establishment of a market in commercial bills for effecting improvement in the monetary system.

On January 16, 1952 Reserve Bank of India introduced the first bills market scheme. The main features of the scheme are:

(i) The scheme was announced under section 17(4)(c) of Reserve Bank of India 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 bonafide commercial or trade transaction bearing two or more good signature, one of which shall be that of a 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 above scheme.

(iii) The then existing loan, cash credit or overdraft accounts were, therefore, required to be split up into two parts, viz.

(a) One part was to remain covered by the demand promissory notes, in this account further withdrawals 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 90 days.

(iv) The procedure did not bring any change in offering same facilities as before by banks to their constituents. Bank could lodge the usance promissory notes with Reserve Bank of India for advances as eligible security for borrowing so as to replenish their loanable funds.

(v) The amount advanced by the Reserve Bank was not exceeding the amount lent by the scheduled banks to the respective borrowers.

(vi) 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.

(vii) The Reserve Bank could also make such appropriate enquiries as it deemed fit, in connection with eligibility of bills and call for any further information from the scheduled banks concerned.

(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 further inducement of banks, the Reserve Bank agreed to bear half the cost of the stamp duty incurred in converting demand bills into time bills.

11.3.3 Procedure for rediscounting: -

Eligible banks are required to apply to the Reserve Bank in the prescribed form giving their estimated requirements for ht e12 months ending October of each year and limits are sanctioned renewed for a period of one year running from 1st November to 31st October of the following year. The Reserve Bank will not present for payment bills of exchange rediscounted by it and such bills have to be taken delivery off by the rediscounting banks against payment not less than three working days before the dates of maturity of the bills concerned. In case bills are retired before due dates pro rata refund of discount is allowed by the Reserve Bank.

Banks to hold bills rediscounted: -

In the first year of the operation of the scheme the banks were require to lodge all eligible bills with the Reserve Bank for availing themselves of the rediscounting facilities. In November 1971, actual lodgment of bills of the face value of Rs. 2 lakhs and below with the Reserve Bank was dispensed with and the banks were authorised to hold such bills with themselves. This limit was increased to Rs. 10 lakhs in November 1973. The banks are required to make declarations to the effect that they hold eligible bills of a particular aggregate value on behalf of the Reserve Bank as its agents and on this basis the Reserve Bank pays to them the discounted value of such bills. The discounting banks are also required to endorse such bills in favour of the Reserve Bank before including them in the declarations and also re-endorse the bills in their own favour when they are retired.

11.3.4 Revitalising the bill markets in India: -

1. The Reserve Bank of India has taken some decisions on the Vaghul Committee report submitted to it on January 13, 1987 as under.

(a) Call money interest rates and participants.:

For the time being the structure of the call money market in terms of the administered interest rates and the participants in the market will remain unchanged.

(b) Lowering of the bill discount rate:

Effective April 1, 1987 the maximum lending rate was reduced from 17.5% to 16.5% and the interest rate on bills for such category of borrowers was prescribed at a rate one percent below the new maximum lending rate. Thus effective April 1, 1987 banks were required to fix the bill discounting rate for such borrowers at a level equivalent to an effective interest rate of 15.5%

(c) Raising of the rediscount rate:

With effect from April 1, 1987 the ceiling on the rediscount rate was raised from 11.5% per annum to 111.5% per annum.

(d) Participants in the rediscount market:

The Reserve Bank would for the present, continue to control entry to the rediscount market for institutions on a case by case basis though access to the rediscount market would be less restrictive than hitherto.

(e) Measures to promote bill financing:

The following measures have been taken;

(i) Proportion of receivable financed under the cash credit facilities. In the case of all parties subject to the Credit Authorisation Scheme (both in the private sector and public sector), while calculating the drawing power on cash credit / overdraft facilities against receivables,

effective April 1, 1988 only 75% of the receivables would be eligible for financing subject to the normal margins prescribed by the banks.

(ii) Discretion to banks to sanction adhoc bill;

As an incentive to use the bill facility on the event of an increase in the scale of operations, in addition to the present powers to sanction additional limits temporarily a separate additional inland bill limit could be provided by banks for a period not exceeding three months upto an amount equivalent to 10% of the existing bill limit subject to a ceiling of Rs. 1 crore.

(iii) Stipulation of bill acceptances to credit purchases:

All parties subject to the credit Authorisation Scheme (both in the private and the public sector), would be required to attain a ratio of bill acceptances to credit purchase of 25% by April 1, 19811.

2. Interest rate on bill finance:

On 31st March, 1987, RBI announced specific measures to promote bill financing which included reduction in discount rate on usance bills. The effective interest rate for bill discounting in respect of borrowers subject to maximum lending rate for bank finance at 16.5% was brought down to 15.5% and for other borrowers the effective interest rate for bill finance was to be the same as applicable to cash credit / overdraft accounts. The discount rate of 15.5% is recovered in advance at the time when a bill is negotiated, the discount rate and interest rate are to be treated differently as interest is arrived at taking into account the maturity period of usance bills. It may be recalled that effective rate of interest on cash credit was 16.5% in April 1987 which was reduced by 1% from 17.5% and 1% point reduction in favour of bill financing was done as a fair inducement to trade and industry to opt for bill financing.

3. Stamp Duty:

The Central Government has notified the remission of stamp duty on bills of exchange drawn on or made by or in favour of commercial bank or a co-operative bank. With this a major hurdle as seen by the mercantile community has been removed. The derivate promissory note as described below has bee exempted from stamp duty.

4. Simplification of procedure:

The procedure requiring the bill to be endorsed and delivered to the rediscounter at every time of rediscounting has been done away with. A derivate usance promissory note is issued by the discounter on the strength of underlying bills which have tenor corresponding to or lesser than tenor of the derivatives usance promissory note and in any case not more than ninety days.

5. Discounting, rediscounting of bills by banks:

Merchant Bankers and financial services companies had been doing marvelous services to the business community by acting as bill-brokers for sellers and buyers of bills arising out of genuine business transactions. They were acting as a link pin between banks and the commercial houses. At time, they used to take up bills on their own account using own funds or taking short-term accommodation from banks working as acceptance and discount houses on lines run in U.K. by merchant bankers. They had been handling the business of the order of the nearly Rs. 5,000 crore in metro cities of Bombay, Delhi, Calcutta, Madras, Bangalore, Hyderabad and Ahmedabad. Bill discounting is fund based activity rendering availability of funds cheaper by 1% than cash credit finance. Bill finance forms about 25% of the bank finance.

11.4 Self Examination Questions: -

1. Distinguish between discounting and factoring?
2. Discuss in detail the various services rendered by factoring intermediaries?
3. Define forfeiting & Critically assess the role of forfeiting as a source of financing?
4. Distinguish between factoring and forfeiting and state the scope for the introduction of such service in India?
5. What is bill discounting? How is it superior to the other conventional system of cash credit?

11.5 Reference Books: -

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LESSON 6B:

DEBT SECURITISATION

6B.0 : Objective:

After reading this lesson, you will be able to understand

- Meaning of securitision
- Process of securitisation
- Benefits of securitisation
- Provisions of securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.

Structure:

6b.1 Introduction
6b.2 Meaning
6b.3 Process of securitisation
6b.4 Parties to a securitisation transaction
6b.5 Instruments of securitisation
6b.5.1 Pass through certificates
6b.5.2 Pay through certificates
6b.5.3 Stripped Securities
6b.5 Advantages of securitisation
6b.7 Demerits of Securitisation
6b.8 Securitisation in India
6b.9 Summary
6b.10 Self Assessment Questions
6b.11 Further Readings

6b.1 Introduction :

Ever expanding economic activity require continuous supply of capital resources. Accessing funds from the capital market is the crux of the problem. As alternative to traditional modes of fund raising like issue of equity, debentures, deposits, etc new methods like leasing, hire purchase, asset securitisation etc are gaining popularity. Developments in the financial sector led to the use of new and innovative financial techniques and financial instruments.

Securitisation is conversion of existing or future cash inflows of any person into tradable security, which can be sold in the market. The cash inflows from financial assets such as mortgage loans, automobile loans, trade receivables, credit card receivables, fare collections become the security against which borrowings are raised.
Banks and financial institutions make loans and advances for the purchase of assets such as cars, houses, tracks, machinery etc. They hold a pool of individual loans and receivables that generate cash flows. Securities are created against them, which are rated and sold to investors.

6b.2 Meaning :

Securitisation in “a process by which the future cash inflows of an entity are converted and sold as debt instruments with a fixed rate of return to the holders of beneficial interest”.

Securitisation is “the process of conversion of existing assets or future cash flows into marketable securities. Securitisation deals with the conversion of assets, which are not marketable into marketable ones.

Conversion of existing assets into marketable securities is known as asset – backed securitisation and conversion of future cash flows into marketable securities is known as future flows securitisation. Assets that can be secuiritised are loans like car loans, housing loans etc. Future cash flows that can be securitised are credit card payments, ticket sales, car rentals or any other form of future receivables.

According to the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, securitisation means “acquisition of financial assets by any securitisation company or reconstruction company from any originator, whether by raising of funds by such securitisation company or reconstruction company from qualified institutional buyers by issue of security receipts representing undivided interest in such financial asstes or other wise”.
The last part of this lesson deals with legal framework of the Act.

6b.3 Process of Securitisation :

The process of securitisation starts which recreation of loans into homogeneous pools. The pools are formatted according to type of credit, maturity pattern and interest rate risk. These asset pools are transferred to a trustee or an issuer. The issuer issues securities, which are sold to the prospective investors. The issuer is given legal protection in the form of an undertaking that these securities are being placed in the market without recourse to the seller. Each issue of securities has a servicer responsible for collecting interest and principal payments on the loans in the underlying pool of assets and for transferring funds to the investors. The issues are rated by rating agency on the basis of structure of issue, underling pool of assets, expected cash flows, extent of loss protection provided to investors, degree of credit enhancement, etc. The rating normally improves the sale ability of an issue.

A typical securitisation deal has the following stages:-

i) The originator (owner of a financial asset) determines which assets he wants to securitise for raising funds.
ii) A trust or special purpose vehicle (SPV) formed for the securitisation purpose acquires the financial assets from the originator under an agreement at their discounted value.

iii) The SPV issues securities to the investors and SPV in funded by the investors
iv) The servicer to the transaction is appointed by the originator.
v) The servicer collects the receivables and pays off the collection to the SPV
vi) The SPV passes the collections to the investors or reinvests the collections to pay off to investors.
vii) In case of default, the servicer takes action against the debtors as the SPV's agent.
viii) When a small amount of outstanding receivables are left to be collected, the originator may clean up the transaction by buying back the outstanding receivables.
ix) At the end of the transaction, the originator's profit, to the extent agreed by the originator, in the transaction is paid off by the SPV.

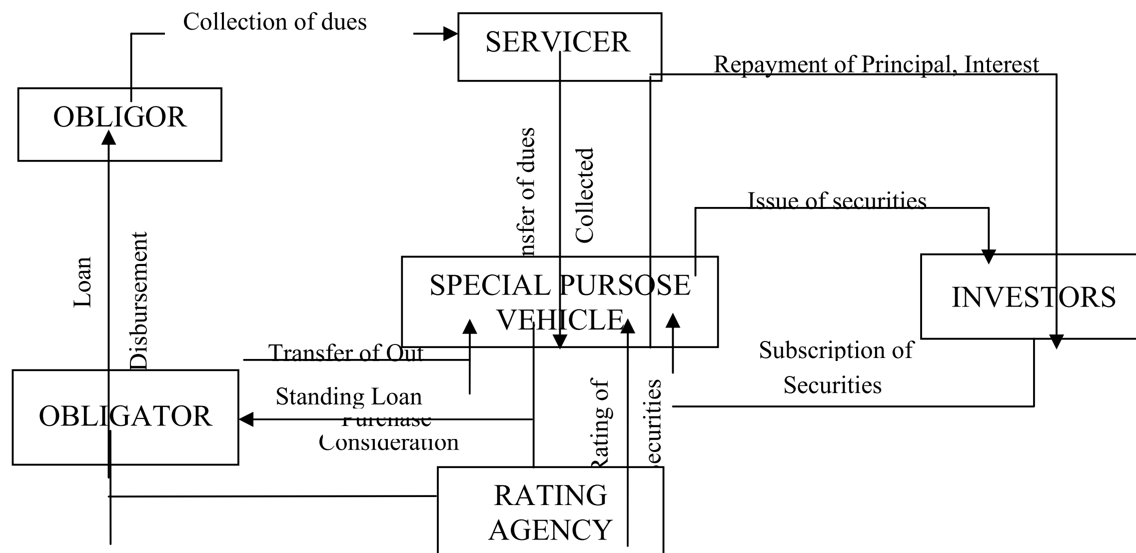

Fig 6b.Securitisation Process.

6b.4 Parties to a Securitisation Transaction :

Primarily originators, special purpose Vehicle (SPV) and investors are the parties to a securitisation transaction. The obligors, rating agency, servicer are other agencies involved in the transaction.

(a) **ORIGINATOR:**

Originator is the entity on whose bocks the assets to be securitised exist. Originator sets up the required structure-originator is the entity whose future cash inflows are sold.

(b) **SPECIAL PURPOSE VEHICLE (SPV):**

An SPV is an entity specially created for doing the securitisation deed. It invests investment from investors, uses the invested funds to acquire the assets or receivables of the originator and then uses the realisations from the receivables transferred to it to pay the investors, there by giving them a reasonable return. An SPV may be a trust, corporation or any other legal entity. Its activities are

- Holding title to transferred financial assets.
- Issuing beneficial interest.
- Collecting cash proceeds from assets held.
- Reinvesting proceeds in financial instruments

- Distributing proceeds to the holders of beneficial interest.

(c) **Investors:**
The investors may be institutional investors or individual investors. Financial institution, mutual funds, banks, insurance companies and provident funds constitute institutional investors.

(d) **Obligor(s):**
The obligors are the original borrowers. They are the debtors of the originators. The amount outstanding from the obligor is a financial asset that is transferred to a special purpose vehicle (SPV).

(e) **Rating Agency:**
The rating agency assesses the strength of the cash flow, mechanism for the timely payment, credit quality, extent of liquidity support, strength of the legal framework etc. Based on the rating, investors take on the risk of investing.

(f) **Servicer:**
Servicer collects the payments due from the obligors and passes it to the SPV. It pursues legal remedies available against the defaulting borrowers.

6b.5 Instruments of Securitisation:

The instruments of recuritisation are
i) Pass through Certificates
ii) Pay through Certificates
iii) Stripped Securities

6b.5.1 Pass through Certificates:

It is an instrument, which signifies transfer of interest in the financial asset in favour of the holder of the pass through certificate. The investors in a pass through transaction acquires the receivables subject to all these fluctuation, prepayment etc. The material risks and rewards in the asset portfolio, such as the risk of interest rate variations, risk of prepayments etc are transferred to the investors. The features of pass trough certificates are
i) Investors get a proportional interest in pool of receivables
ii) Collections are divided proportionally
iii) All investors receive proportional payments
iv) There will be no reinvestment of cash collected by the SPV

6.5.2 Pay through Certificates:

In case of pay through certificates the SPV issues debt securities like bonds repayable on fixed dates instead of transferring undivided interest on receivables. The bonds would he backed by the mortgages transferred by the Originator to the SPV. The SPV may make temporary reinvestment of cash flows to the extent required for bridging the gap between the date of payments on the mortgages along with the income out of reinvestment to retire the bonds.

6b.5.3 Stripped Securities:

Securities are Classified as “Interest Only” (IO) or “Principal Only” (PO) under this category. IO securities are paid back out of interest income only while PO securities are paid out of principal repayments only. There securities are highly volatile in nature and are least preferred by the investors. PO securities increase involve when interest rates go up. These

securities are traded by speculators who make money by speculating about interest rate charges.

6b.6 Advantages of Securitisation:

i) Securitisation helps in raising funds at a rating higher than what is the actual rating of the originator
ii) Securitised assets go off the balance sheet of the originator
iii) If is especially helpful in the banking industry to satisfy the capital adequacy norms
iv) The asset portfolio is liquidated releasing cash which in term reduces the need for demand and time liabilities that are subject to statutory reserves in case of banks
v) Small investors con profit from such deals since they can invest small sums in the SPV and acquire beneficial interest.
vi) Securitisation keeps the other traditional lines of credit undisturbed.

6b.7 Demerits of Securitisation:

i) True picture of the originator's financial position as can not be known as Securitisation is off-balance sheet funding.
ii) If the lest assets of the company may be left with sub-standard assets on its books.
iii) Huge liabilities taken by a company may net appear on the balance sheet leading to lack of transparency.
iv) The SPV has the right to recover the dues from the originator if assets securitised become bad.
v) The originator may have a lot of contingent liabilities without any one being aware of it.

6b.8 Securitisation in India:

Based on the recommendations of Narasimham Committee I and II and Andhyarujina Committee a new legislation for securitisation and empowering banks and financial institutions to take possession of the securities and to sell them without the intervention of the court has been enacted. The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 came into force on 21st June 2002. Its purpose is to promote the retting up of asset reconstruction / securitisation companies to take over the Non performing Assets (NPAs) accumulated with the banks and public financial institutions.

In a conventional lending process a bank disburses a loan, maintains it as an asset on its balance sheet, collects principal and interest and monitors whether there is any determination in the borrower's credit worthiness.

This process requires a bank to hold assets (loans) till their maturity resulting in blocking of funds. Securitisation releases these funds so that they will be available for further lending.
The lending bank is known as originator an the borrower is the obligor.

One type of asset (e.g. auto loans) of similar maturity are bundled together and transferred to the SPV (asset reconstruction / securitisation company) for the purpose of creating the securitised instrument. The SPV divides the assets in to marketable securities. Qualified Institutional buyers (QIBs) who possess the expertise and the financial strength to invest in securities market are allowed to invest in these securities. Mutual funds, financial institutions, scheduled commercial banks, insurance companies, provident funds, pension funds, state industrial development corporations fall under the category of QIBs.

The rating agency rates the securities based on the asset quality securities rated high offer low risk and high yield and vice versa.

A servicer is appointed to collect payments from the obligors. The servicer follows with the defaulters and uses legal remedies against them. Normally the originator carries out this activity.

The securitised assets will be removed from the books and funds generated will be used for giving new loans.

Features of the Act:

I. Securitisation and Reconstruction of Financial Assets of banks and Financial Institution

1 Securitisation Company or Reconstruction Company should obtain certificate of registration.

2 The company should have own funds of not less Two Crore rupees

3 Securitisation Company or Reconstruction Company may acquire financial assts of any bank or financial institution by issuing a debenture or bond for consideration agreed upon.

4 Securitisation Company or Reconstruction Company will be deemed to be the lender and all rights of such banks or financial institutions will be vested in Securitisation Company or Reconstruction Company in relation to the financial asset acquired.

5 All contracts, deeds, bonds, agreements, power-of-attorney, grant of legal representation, permissions, approvals, consents or no objections relating to the financial asset are deemed to have been issued in favour of the Securitisation Company or Reconstruction Company.

6 Securitisation Company or Reconstruction Company may apply to the Appellate Tribunal for transfer of all pending application to any one of the Debts Recovery Tribunals if any financial asset comprises of second debts of more than one bank or financial institution. If the bank or financial institution has filed applications before two or more Debts Recovery Tribunals.

7. The Securitisation Company or Reconstruction Company may offer security receipts to qualified institutional buyers (Q1Bs) for subscription.

8. A Securitisation Company or Reconstruction Company may raise funds from the Q1Bs by formulations schemes for acquiring financial assets. Realisations of such financial asset should be used for redemption of investment under the scheme.

9. A Securitisation Company or Reconstruction Company may provide for the following measures for the purpose of asset Reconstruction

- Proper management or change in or takeover of the management of the borrower’s business.
- Sub or lease of a part or whole of the borrower’s business
- Rescheduling of payment debts payable
- Enforcement of security interest
- Settlement of dues payable by the borrower
- Taking possession of secured asset.

Enforcement of Security Interest:

1. Any secured interest created in favour of any secured creditor may be enforced, without the intervention of Court Tribunal, by such creditor.
2. Secured creditor can classify a secured debt as non-performing asset (NPA) in case of default in repayment.

3. If the borrower fails to discharge his liability in full with in the specified period, the secured creditor may take the following measures to recover the secured debt.

- Take possession of the secured asset
- Take over the management of the business of the borrower including the right to transfer the secured asset
- Appoint manager to manage the secured assets whose possession has been take over by the secured creditor
- Require any person who has acquired the secured asset from the borrower and from whom money is due to pay the secured creditor

4. If the sale proceeds are not sufficient to recover the dues, the secured credit may file on application with the Debt Recovery Tribunal for recovery of the balance amount from the borrower.

6b.9 Summary:

Asset securitisation is the process of bundling similar type of financial assets like loans receivables, transferring them to special purpose vehicle, issuing of securities by SPV and there by raise funds for business purpose. In India securitisation is permitted only in the case of banks and financial institutions. Banks are able to transfer Non performing assets to the securitisation company and reconstruction company.

6b.10 Self Assessment Questions:

1. Explain the process of securitisation ?
2. What are the various instruments of securitisation ?
3. What is a SPV? How does it operate?
4. Bring out the merits and demerits of securitisation?
5. What are the salient features of the Securitisation and Reconstruction of financial assets and Enforcement of Security Interest Act, 2002?

6b.11 Further Readings:

1. S. Gurusamy, “Financial Services & Systems”, Vijay Nicole imprints Pvt. Ltd., Chennai, 2004.

2. The Securitisation and Reconstruction of Financial ssets and Enforcement of Security Interest Act, 2002, Gogia Law Agency, Hyderabad.

3.M.Y. Khan, “Financial Services”, Tata Mc Graw Hill Publishing Company ltd., New Delhi, 2006b.

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LESSON – 7A

HOUSING FINANCE

7A.0 Objective:

After going through this lesson, you will be able to understand

- Emergence of housing finance
- Role being played by institutional players

Structure:

7a.1 Introduction
7a.2 Role of Institutional Players
7a.3 Tenure of a Housing Loan
7a.4 Repayment Schedule of Loans
7a.5 Role of National Housing Bank (NHB)
7a.6 Borrowing and Acceptance of Deposits by NHB
7a.7 Housing finance System
7a.8 Housing and Urban Development Corporation (HUDCO)
7a.9 Insurance Corporations
7a.10 Commercial Banks
7a.11 Co-operative Banks
7a.12 Specialised Housing finance Institutions
7a.13 Securitisation Process
7a.14 Competition in Housing finance
7a. 15 Future Scenerio
7a.16 Summary
7a. 17 Self Assessment Questions
7a. 18 Further Readings

7a.1 Introduction :

From the time immoral shelter is considered to be the basic necessity of a Humans being To the Homoc Sepian no other problem is as worrying and mind boggling as the housing problem. To construct a house is a distant dream in the lives of many people. Conservatively in our country most of the people used to dependent on their Provident Fund and gratuity amounts received after retirement for the purchase or construction of a house. Loan is considered to be the last resort for many a people in yesteryears. Employees who are in transferable Jobs also give

importance to construct a house at the fag end of their career or they will decide where to settle just before the retirement. Hence this is a major burning problem for many people.

In a populated country like India many people are below the poverty line and to construct a house is a big dream for them. People below the poverty line have been living in slum areas. Even after attainment of Independence there is no considerable momentum in this sector.

However with the emergence of housing finance as a major business in the country an increasingly large member of people are going for housing loans. As a result the housing and real estate sector in our country is undergoing unprecedented change. There is another reason for this also. In search of Employment villagers are migrating to towns and cities. Due to this phenomenon there is a need to develop urban infrastructure. Consequent to the introduction of economic reforms internationally reputes industrial houses are feeling that Indian market is very attractive and they are of the opinion that “IF YOU ARE NOT IN INDIA TODAY, YOU MAY AS WELL NOT BE IN BUSINESS”.

The sustained demand from the international Technology Sector certainly changed the Urban Land Scape of our country. Bangalore has positioned it self as the IT Capital of India and there is intensive competition in the area among Bangalore, Hyderabad and Chennai. Several multinational companies are evincing keen interest to start their operations in India to take advantage of low costs. Since human resource being the chief element in the Industry, the hiring and houses of people both at their work place and home assume great-importance and hence the need to create space for people to work and live, which is turn triggers the development of other related Infrastructure. Young I.T employees are being paid good salaries and on an average before attainment of 30 years they are planning to acquire a house property. Just married I.T couples are also preferring to possess the house in order to avail the Income Tax Concessions. Indians are migrating to other countries and their savings at work places are being sent to their parents and the parents are purchasing / constructing beautiful homes, apartments etc.

The predominant trend has been to setup world class business centers often camups style establishments. Some of these locations are being formed as the “TEMPLES OF MODERN INDIA”. Just an indication of the extent of Real Estate Development taking place. The Housing Industry today has been transformed into a Buyer’s market with service standards having to keep pace with the ever rising customers expectations.

The emergence of Housing finance as a major Business in the country, an increasingly large number of people are going for Housing Loans. Incomes of families are rising and their purchasing capacity as well as loan re-paying capacities are also going up. At present both public sector banks, private sector banks and foreign banks are liberally coming forward to extend loan facilities to prospective buyers. The Government of India has been giving substantial encouragement to the Housing Sector. The social structure of the Indian families is going through a sea change as the joint family is fast giving way to the nuclear family concept. The pressure to have one’s Home is high among these families.

7a.2 Role of Institutional Players:

Many Institutions such as State Bank of India, Canara Bank, Indian Overseas Bank, Syndicate Bank, in fact all Public Sector Banks are Proving Housing finance at attractive and affordable rates. A part from these banks, HDFC, LIC, PNBHF, ICICI, are very active in this area. All these institutions offer number of Home Loan Products to its clientele that include plot purchase

loan, house construction loans, home / flat purchase loan, house improvement loan and extension loan. Royal Sundaram Home Loans is very Popular in southern India.

7a.3 Tenure of Loan:

The tenure of loan depends upon age, need of the customer, purpose of loan, pepayment capacity, tenure of service etc. On an average house owners are taking the loan for 15 years on Equated Monthly Installments (EMI) Cost of Loan: All the housing finance Institutions charge processing and administration fee which is linked to the amount of loan from customers. The quantum of charges affects the cost of loan to be borne by the customer.

7a.4 Repayment Schedule of Loan:

The Loan is repaid in the form of installments. Mostly the installments are to be paid monthly. The repayment of loan in the case of most of the Housing finance Institution are in the form of Equated Monthly (EMI). Some Institutions permit the customers to repay the amount at any time but normally it is paid in Equated Monthly Installments and has a provision of Bi-annual system of repayment in case of agriculturists. Some other loan options available are Front Loaded, Ballon Type or Back Loaded. In case of Front Loaded system the Installments will be very high. In case of Ballon type the total loan period will be divided into Three parts and in the initial years the installment will be low and in the middle period the installment will be high and again at the fag end period the installment amount will bellow. Some Private Housing finance Companies are charging at 'FLAT RATE'. The interest will be spread for the entire loan period. For prompt payment there will be some concession of 1 or 2 percent keeping in mind the competition level among Housing finance Institutions. Almost all the Institutions are offering fixed or floating rate of Interest to their customers.

7a.5 Role of National Housing Bank (NHB):

This Institution was established as a fully owned subsidiary of the Reserve Bank of India (RBI) in the year 1988 under the NHB Act 1987 to operate as a Principal Agency to promote Housing finance Institution (HFIs) at both local and Regional Levels and to Provide financial and other support to the. The NHB is a body corporate. It can establish offices / agencies at any place with the prior approval of the Reserve Bank of India. It was incepted with an authorised paid up capital of Rs. 350 crores and it is fully subscribed by the RBI. The authorised capital can be increased up to Rs. 2000 crores by the Union Government in consultation with the Reserve Bank of India. The Board of Directors of the National Housing Bank may issue the increased authorised capital on terms and conditions determined from time to time. At the minimum 51% of its issued capital would be held by the RBI / Government / Public Sector Banks and other Institutions owned / controlled by the Government.

The supervision, direction and management of the affairs and business of the NHB is vested in its Board of Directors which exercises all powers and executes all acts and things on its behalf. Subject to the provisions of the NHB Act, the Board while discharging its functions has to act on Business Principles with due regard to Public Interest. The NHB is allowed to the following kinds of Business.

a) Promoting, establishing, supporting / Aiding in the promotion establishment / support of Housing Financing Institutions.

b) Making of loans and Advances or rendering any other form of financial assistance, what so ever for housing activities to HFI's, Banks, State Co-operative, Agricultural and Rural Development Banks or any other Institutions / class of Institutions notified by the Government.

c) Subscribing to / purchasing stocks, shares, bonds, debentures and securities of every other description.
d) Guaranteeing the Financial Obligations of HFI's and Under writing the issue of stocks / shares / Bonds / Debentures / Other Securities of HFI's.
e) Drawing, accepting, discounting / rediscounting, buying / selling and dealing in Bills of Exchange / Promissory Notes, bonds / debentures, hundies, coupons / other instruments.
ea) Buying / selling or otherwise dealing in any loans / advances secured by mortgage / charge of immovable property relating to banks / HFI's.
eb) Creating Trust (s) and Transferring loans / advances together with / without securities to HFIs for a consideration.
ec) Setting aside loans / advances held by NHB and issuing / selling securities based upon them in the form of debt obligations / trust certificates of beneficial interest / other instruments and to act as trustee for the holders of such securities.
ed) setting up of Mutual Funds for undertaking housing finance activities.
ee) Undertaking / participating in housing mortgage insurance.
f) Promoting / forming / conduction or associating in promotion / formation conduct of companion / mortgage banks / subsidiaries societies / Trusts / other associations of persons it may deem fit for carrying out all / any of its functions under NHB Act.
g) Undertaking research and surveys on construction techniques and other studies relating to shelter / Housing and Human settlement.
h) Formulating schemes for purposes of mobilization of resources and extension of credit for Housing.
i) Formulating scheme (s) for purposes of mobilization of resources and extension of credit for Housing for the economically weaker sections of society, which may be subsidised by the Government or any other source.
j) Organising Training Programmes / Seminars / Symposia on matters relating to Housing.
k) Providing guidelines to HFIs to ensure their growth on sound lines.
l) Providing Technical / Administrative assistance to HFIs.
m) Co-ordinating with Life Insurance Corporation of India the unit trusts of India. The General Insurance Corporation of India and other Financial Institutions in the discharge of its overall functions.
n) Exercising all powers and functions in the performance of duties entrusted to it under the NHB Act or under any other law in force for the time being.
o) Acting as a Agent of the Central / State Government / RBI or of any authority as may be authorised by the RBI.
p) Any other kind of Business which the Government may on the recommendations of the RBI authorize.
q) Generally, doing of all such matters and things as may be incidental to or consequential upon the exercise of its powers or the discharge of its duties under the NHB Act.

7a.6. Borrowing and Acceptance of Deposits:

For purposes of carrying out its functions the NHB may
a) Issue and sell Bonds and Debentures with or without the guarantee of the Central Government in such manner and on such terms on may be prescribed.
b) Borrow money from the Central Government, Banks, Financial Institutions, Mutual Funds and from any other authority or organization or Institution approved by the Government on such terms and conditions as may be agreed upon.
c) Accepting Deposits repayable after such period and on such forms as may generally or specially be approved by the RBI.

d) Borrow money from the RBI (i) By way of loans and advances and generally obtain financial assistance in a manner specified by the RBI (ii) out of the National Housing Credit (Long Term operation) Fund established under sec. 46 – D of the RBI Act.
e) Receive for services rendered, remuneration, commission, commitment charges, consultancy charges, service charges royalties, premium, license fee and other considerations of any description.
f) Receive gifts, grants, donations or benefactions from the Government or any other source.

7a.7. Housing finance System:

The implementation of Housing finance Policies presupposes efficient institutional arrangements. Although there were a large number of agencies providing direct finance to individuals for house construction, there was no well established finance system till the mid eighties in as much as it had not been integrated with the main financial system of the country. The establishment of the National Housing Bank (NHB), a fully owned subsidiary of the Reserve Bank of India as an apex Institution was the end of the fulfillment of a long overdue need of the Housing finance Industry in India. The system has also been characterised by the emergence of several specialised financial institutions that have considerably strengthened the organization of the Housing finance system in the country. At present, there are about 320 Housing finance companies of which 26 are registered with the NHB and which account 98 percent of the Total Housing Loan disbursed. Following are the main agencies operating in our country.

a) **Central and State Governments:** Till the mid eighties the responsibility to provide Housing finance rested by and large with the Government. The Central and State Governments indirectly support the housing building effort. The Union Government has introduced from time to time various social housing schemes. The role of the Central Government against these schemes is confined to laying down broad principles providing necessary advice and rendering financial assistance in the shape of loans and subsidies to the State Governments and Union Territories. The Central Government has set up the Housing and Urban Development Corporation (HUDCO) to finance and undertake housing and Urban development Programmes Development of land for satellite towns besides setting up of a building materials industry.

The Central Government provides necessary fulcrum to the HUDCO and guarantees the Bonds issued by it. Apart from this the Central Government and respective State Governments provide house building advances to their employees. The responsibility of the Central Government is to evolve the policies and the respective State Governments are the real implementers.

7a.8. Housing and Urban Development Corporation (HUDCO):

HUDCO was established on 25th April 1970 as a fully owned Government of India enterprise with the following objectives.
a) To provide long-term finance for construction of houses for the residential purposes or finance or undertake housing and urban development programmes in the country.
b) To finance or undertake the establishment of New Satellite Towns.
c) To finance or undertake the establishment of the building materials industries.
d) Administer the monies received from the government of India and other such grants for purposes of financing or undertaking housing and urban development programmes.
e) To subscribe to the debentures and bonds to be issued by the State Housing Boards, Improvement Trusts, Development Authorities and so on specially for the purpose of financing housing and urban development programmes.

7a.9. Insurance Organizations / Corporations:

The Life Insurance Corporation of India and General Insurance Corporation support housing activity both directly and indirectly. Besides subscribing to bonds of the HUDCO and State Housing Boards, LIC grants loans to the states for their Rural Housing Programmes and to Public Sector Companies for construction of Staff Quarters. Though LIC has been granting loans directly to individuals the impetus to housing finance was provided In June 1989, the LIC promoted a subsidiary for the purpose namely LIC Home Finance Ltd.

7a.10. Commercial Banks:

The trend of commercial banks lending to individuals for housing emerged in the wake of the report of the working group on the role of banking system in providing finance to housing schemes. (R.C SHAH Working Group the RBI 1978). They have been lending to the Housing sector based on Annual Credit allocations made by the RBI. In terms of the RBI guidelines, scheduled commercial banks are required to allocate 1.5 percent of their incremental deposits for disbursing on housing finance every year. Of this allocation 20 per cent has to be by way of direct housing loans which again at least half, that is 10 per cent of the allocation, has to be rural and semi – urban areas. Another 30 per cent could be for indirect lending by way of term loans to housing institutions, housing finance companies and public housing agencies for the acquisition and development of land and to private builders for construction. The balance 50 per cent is for subscription to the HUDCO and the NHB Bonds.

7a.11. Co-operative Banks:

The Co-operative Banking Sector consists of state co-operative banks (SCBS). District control co-operative banks (DCBs) and primary urban co-oerative Banks (PUCBs). The First set of comprehensive guidelines for these co-operative banks were issued in 1984 by the RBI. Co-operative Banks, Finance Individuals, Co-operative group Housing Societies, Housing Boards and others who under take housing projects for the Economically weaker sections, Low Income groups and Middle Income groups.

7a.12. Specialised Housing finance Institutions (HFIS):

There are some Institutions termed as “Specialised HFIs that cater only to the needs of the housing sector. They can be further classified as housing finance companies (HFIs) promoted in the Public / Joint / Private Sectors and Co-operative Housing finance Societies. A major and leading company is Housing Development Finance Corporation (HDFC). It lends mainly for new residential housing to individuals, group of individuals and individual members of co-operative societies. Apart from the HDFC a member of Housing finance Corporations have been sponsored by banks such as the SBI Home Finance Ltd., Canfin Homes Ltd., Ind Bank Housing finance Ltd. And Citi Bank Ltd.,

SECURITISATION: This is a process of Pooling and repackaging of homogeneous illiquid financial assets into marketable securities that can be sold to investors. The process leads to the creation of financial instruments that represent ownership interest in or one secured by segregated income producing asset or pool of Assets. The pool of assets collateralises securities. These assets are generally secured by personal or real property such as automobiles, real estate or equipment loans but in some cases are unsecured credit card debt and consumer loans.

7a.13. Securitisation Process:

1. Assets are originated through receivables, leases, housing loans or any other form of debt by a company and funded on its balance sheet. The company is normally referred to as the 'Originator'.
2. Once a large portfolio of assets has been originated, the assets are analysed as a portfolio and then sold or assigned to a third party, which is normally a special purpose vehicle company (SPV) formed for the specific purpose of funding the assets. It issues debt and purchases receivables from the originator. The SPV is owned by a trust the originator.
3. The administration of the asset is then subcontracted back to the originator by the SPV. It is responsible for collecting interest and principal payments on the loans in the underlying pool of assets and transfer to the SPV.
4. The SPV issues tradable securities to fund the purchase of assets. The performance of these securities is directly linked to the performance of the assets and there is no recourse back to the originator.
5. The investors purchase securities because they are satisfied that securities would be paid in full and on time from the cash flows available in the asset pool. The proceeds from the sale of securities are used to pay the originator.
6. The special purpose vehicle (SPV) agrees to pay any surplus which may arise during its funding of the assets back to the originator. Thus the originator for all practical purposes retains its existing relationships with the borrowers and all of the economies of funding the assets.
7. As cash flow arise on the assets, these are used by the SPV to repay funds to the investors in the securities.

7a.14. Competition in Housing finance:

Towards the end of 1990s against the back drop of lower interest rates, Industrial slow down, sluggish credit off-take and ample liquidity, commercial banks reorganised that if they had to maintain profit margin they need to shift their focus from the wholesale segment and build up their retail portfolios. Some commercial banks devised aggressive marketing campaign to increase the size of their housing segment. This includes intensive advertising campaigns. Waivers of processing and administrative fee, gift offers and other incentives on the spot loan approvals without margin money i.e. cent per cent. Due to these reasons Housing finance Industry to-day has been transformed into 'Buyers Market. Service standards keep pace with ever rising customers satisfaction.

7a.15. Future Scenario:

As such there is great demand for housing finance in India. In order to give impetus to this sector there is a need to completely change the legal system governing various aspects of real estate. There are several procedures to be followed in different states due to the reason that land is a state subject. Every year Government is increasing Stamp Duty which is a State Subject. This aspect is to be rationalised. Similarly more avenues have to be opened up facilitating long-term finance for the Housing sector. The noteworthy feature is that Securities Exchange Board of India has permitted the mutual fund asset management companies to enter into real estate Arena. At the same time, the introduction of mortgage guarantee or insurance will help a large segment of the society to access Housing finance.

7a.16. Summary:

Housing finance has grown into a major business. Several private and public institutions have entered this field of business. National Housing Bank established as a subsidiary of Reserve

Bank of India is operating as a principal agency to promote Housing finance Institutions. HUDCO established as a fully owned Government of India enterprise provide long term finance for construction of houses for residential purpose.

7a.17. Self Assessment Questions:

1. Discuss the role of National Housing Bank.
2. Explain the role of HUDCO
3. Explain the system of housing finance prevailing in India.

7a.18. Further Readings:

1. VK Bhalla, *Management of Financial Services* Armed Publications Pvt. Ltd, New Delhi.
2. S. Gurusamy, *Financial Services and Systems* Vijay Niole imprints Pvt. Ltd, Chennai.
3. M Y Khan, *Financial Services*, Tata McGraw Hill, Publishing Co. Ltd., New Delhi.
4. V A Avadhani, *Financial Services*, Himalaya Publishing House, New Delhi.

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LESSON – 7B

CREDIT RATING

7B.0 Objective:

After studying this lesson, you will be able to understand

- Meaning of Credit rating.
- Bases of Credit rating.
- Benefits of Credit rating.
- Problems of Credit rating.

Structure:

7b.1 Introduction to credit rating
7b.2 Bases for credit rating
7b.3 Rating symbols
7b.4 Importance of rating
7b.5 Leading international players in rating
7b.6 Indian credit rating agencies
7b.7 Guidelines for credit rating
7b.8 Benefits of credit rating to investors
7b.9 Benefits to the issuers
7b.10 Benefits to the Intermediaries
7b.11 Instruments rated in India
7b.12 Regulatory frame work
7b.13 Problems in credit rating
7b.14 Problems of investors in debt instruments
7b.15 Summary
7b.16 Self Assessment Questions
7b.17 Further Readings

7b.1 Introduction:

The History of credit ratings can be traced to the beginning of this century when large funds had to be raised by corporate world in the United States of America for construction of rail roads.

Since the amounts required were substantial the rail road companies wanted to mobilise funds from savers. In this process it was felt that credit rating would be an aid for instilling confidence in the investing public. Rating started in 1909. When John Moody, a financial analyst on Wall Street published ratings on bonds issued by Rail Road companies using rating symbols ranging from 'Aaa' to 'C'. A year later Moody extended his ratings to utility and Industrial Bonds.

Subsequently, the business saw the entry of Poor's publishing company, which issued its first rating in 1916 followed in 1922 by Standard Statistics Company in 1922 and in 1924 by the Fitch Publishing Company. The number of bond rating agencies in the United States reverted to three when standard statistics and Poor's Publishing company merged to form Standard and Poor's (S&P) in 1941.

At the outset the opinions offered on credit risk of instruments were more in the form of a right – the right to express an opinion Slowly these got embedded in legislation particularly after the greatest depression in 1929 and by 1933 credit rating took regulatory roots. The major credit

goes to the Rail Road company that provided the real catalyst for the growth of credit rating. In June 1970 the world's largest Transport company U.S. PENN CENTRAL filed for Bankruptcy after defaulting on a $ 82 million outstanding domestic commercial paper (CP). Subsequently the Federal Reserve made it mandatory for commercial paper to be rated. Today in the U.S. ratings are an integral part of corporate and financial culture with nearly 100 percent of the public capital market being rated. In fact, it is mandatory for American Companies to have ratings from two agencies.

Hence, credit rating is essentially the symbolic indicator of the current opinion of a rating agency on the relative ability and willingness of the issuer of a financial (debt) instrument to meet the debt service obligation as and when they arise. It provides a relative ranking of the credit quality of debt instruments or their grading according to investment qualities.

Credit rating is an objective independent assessment of the credit worthiness of a borrower / issuer in terms of business and financial risk. A rating is defined as a current opinion regarding the credit quality of the issuer with reference to the particular instrument rated.

The rating offers an opinion regarding the issuer ability to meet in a timely manner his obligations on payment of interest and principal on the debt instrument to which the rating has been assigned. The important aspect here is that the rating is applicable only for the specific instrument and not the company issuing the debt instrument. Credit rating is only a measure of credit risk of particular debt instrument. It is only an opinion and is not a market rating or a recommendation to purchase, sell or hold that debt instrument. Another factor is that credit rating is not a general-purpose evaluation of the company. A rating is also not a guarantee. The rating of a debt instrument is under constant surveillance over its life and the rating can change either downward or upward depending upon circumstances.

7b.2 Bases of Credit Rating:

The credit ratings are based on the current information provided to the credit rating agencies by the borrowing company or obtained by the credit rating agencies from sources they consider realiable. In determining credit ratings the credit rating agencies will analyse various aspects of the borrowing company VIZ.,

a) Business Analysis: That relates to risk, market position of the company, operating efficiency and legal position of the company.

b) Financial Analysis: That includes accounting quality, earnings protection, adequacy of cash flows and financial flexibility.

c) Management Evaluation: That relates to human resource management, planning, control, business policy and decision making, foresightedness, challenges, threats, opportunities, strength etc.,

d) Geographical Analysis: That includes the location of the company etc.,

e) Regulatory and Competitive Environment Analysis: That relates to the structure and regulatory framework and their impact on the company.

f) Fundamental Analysis: That relates to liquidity and management, profitability and financial position and interest and tax sensitivity of the company.

7b.3 Rating Symbols:

The rating is expressed in symbols (ALPHA / ALPHA NUMERIC) that convey in a summarized manner to an investor the rating agency's current opinion as to the future risks associated with a particular debt obligation. The ratings assigned by all the credit rating Agencies are meant to indicate the likelihood of default or delayed payment of the security. Most of the agencies have

their own systems of symbols. The majority use letters for ranking the risk of default from highly safe to highly speculative. The agencies also attach a plus or minus symbol to ratings in order to provide finer gradation in terms of risk profile.

Agencies also have different sets of symbols for different kinds of instruments. In most of the cases the distinction is made on the basis of the nature of the instrument – The Tenure. Agencies have different sets of symbols for indicating long term ratings (mainly Fixed Deposits) and short term papers (Commercial Paper, Certificate of Deposit).

7b.4 Importance of Rating:

Ratings have gained wide acceptance not only in the United States but also in other countries. Regulatory authorities in most of the countries have been quick to sanction official recognition to ratings.

In certain countries, ratings are required for listing of debt instruments. Thus a higher rated instrument may provide higher liquidity than a lower rated instrument. Over the time the Agencies have increased the range of cover age. Today the Leading American Agencies rate not only long Term Bonds issued by U.S. Corporations but also a wide variety of other debt instruments including Municipal Bonds, Asset backed securities, Medium Term Note Programmes, Commercial Paper Programmes and Bank Certificate of Deposit.

Credit Ratings are today used in the Financial Markets of most of the developed economies and in several emerging market countries as well. The major Rating Agencies S&P. MOODY's and DUFF and PHELPS have expanded their horizons and have setup overseas offices.

7b.5 Leading International Players in Rating:

Till the late sixties credit rating was essentially a U.S. Phenomenon. Rating of emerging market debt instruments by U.S. rating agencies commenced in 1977. When Standard & Poor rated debt instruments of Latin American Countries. Rating agencies came up in the seventies in Canada, the U.K. and Japan with growth in debt Markets. The eighties saw the spread of credit rating to South Asian Countries such as the Philippines, Malaysia, India, Singapore and latin American Countries such as Chile, Argentina and Brazil. Today credit rating has become a Global Phenomenon.

Today the world's largest rating agencies are Standard and Poor's (S&P) followed by Moody's Investor Service. A part from rating Agencies which rate all debt instruments, there are also specialised agencies that rate only specific institutions like THOMSON BACKWATCH which rates only Financial Institutions and A.M Best which only rates Insurance Companies claims paying abilities.

7b.6 Indian Credit Rating Agencies:

The credit rating agencies play an important role in the Indian financial markets in protecting and safeguarding the inverter's interest. Credit Rating Agencies VIZ., Crisil, Care and Duff and Phelps Credit Rating India Pvt. Ltd., are playing a very significant role in rating the debt instruments. These Agencies give opinion on the relative ability and willingness of the issues of a financial (debt) instrument to meet the debt servicing obligations as and when they arise. These agencies rate the debt instruments VIZ., Bond Commercial Paper, Debentures, Company Deposits etc., Credit ratings in India covered only debt instruments and not the equity shares but in developed nations equity shares are also being rated for the benefit of guidance of investors. Presently the equity is also being rated in India by ICRA.

In abroad especially in the U.S. the investors in debt Instruments wholly depend upon the credit ratings given by reliable / dependable credit rating agencies but in India the investors in debt instrument are varied nature. Most of the investors decide about their investment considering many other bases i.e. Hearsay, Advertisement etc., A few of the Investors usually take decisions about their investment wholly based on credit rating. The importance of credit rating system is essentially the consequence of the developments besides increasing levels of defaults resulting from the growing access to the financial markets VIZ the growth of Information Technology, the increased securitisation of borrowing and lending, globalization of financial markets, the increasing role of capital and money markets consequent to disintermediation and withdrawal of Government safety nets and the trends towards privatization.

Developing Nations are short of financial resources. Limited Funds available at their disposal are to be sagaciously to earn better return. Savings of the public in general are to be mobilized for Investment in trade and Industry. Hence, to motivate savers to invest in industry and trade it is necessary that their funds should be invested in safe enterprises where financial risk is least. It is only when savers have develop confidence in the company they would invest their savings. Safety of their investment can be pre-assessed if the companies ability and capacity to pay off the principal and other accruing dues is indicted in advance through a reliable credit rating Agency. A well rated company can get funds from the credit lending institution. Even the lower risk profile company can obtain easily funds at lower rate of interest as low risk profile investors would put their money therein.

7b.7 Guidelines for Credit Rating:

In our country it is mandatory to get the debt instruments rated by the approved credit rating agencies as stated below:

a) It is mandatory to get the debt instruments (Debentures and Bonds) rated in case of public issue when the conversion / redemption period exceeds 18 months.

b) The Non Banking Financial Companies which have net owned funds of more than Rs. 20 million must have got their FD rated within 31st March 1995.

c) In case of commercial paper the issue must have rating not below the A.2 grade of ICRA or its equivalent for other rating agencies in India.

7b.8 Benefits of Credit Rating to Investors:

Credit rating is highly beneficial to the investors in the following ways:

(i) Credit rating gives superior information at low cost.
(ii) It enables the investors to take calculated risk.
(iii) Credit rating encourages to invest in companies to get high returns.
(iv) Credit rating reduces dependence on brokers and merchant bankers.
(v) An alternate method for investment based on name recognition.
(vi) Credit rating encourages disintermediation.
(vii) Credit rating will multiply investor population.
(viii) The investors get the benefit of ongoing surveillance.

7b.9 Benefits to the Issuers:

1. A credit rating serves as a marketing tool for placement of debt obligations and offers an issuer the opportunity to access a wide range of funding alternatives.
2. Institutional investors usually operate under strict investment guidelines that often require the securities in which they invest to carry a credit rating assigned by a recognized

rating agency. Some institutions and banks have specified the minimum credit rating for a company to be eligible for finance.

3. Ratings help the process of disintermediation by helping companies mobilise funds directly from the capital markets. Credit rating is also useful while negotiating leases or long term contracts because it is quicker and easier to establish credibility and standing of the company as a counter party when independent opinion is available.

4. Rating can help companies to lower their cost of borrowing, as companies with high ratings are able to raise funds at lower interest. Cost credit ratings also act as a guide to companies which get a lower rating – the management is forewarned of the perception of its risk in the market enabling it to take corrective steps to change this risk perception.

7b.10. Benefits to the Intermediaries:

For intermediaries such as merchant an bankers and brokers, ratings help in providing advice to their clients as to the risk of a particular investment.

It also helps investment brokers and bankers in pricing debt. As the rate of interest on debt instruments of corporate is linked to ratings companies and intermediaries are facilitated in determining the pricing of debt offerings through ratings.

7b.11. Instruments Rated in India:

Credit rating in India is normally limited to rating of all rupee dominated debt obligations. The debt instruments rated include long term instruments such as bonds and debentures, fixed deposit programmes and short term instruments such as commercial paper programmes and certificates of deposit.

Other instruments rated are preference shares and other new and innovative instruments like structured obligations including asset based securities and Municipal bonds. Performance rating of parallel marketers of Liquefied Petroleum Gas (LPG) as well as of plantation companies is also undertaken.

7b.12. Regulatory Framework:

As in other countries, in India credit rating is mandatory while issuing certain debt instruments. Rating exercises are normally initiated at the request of a company. In evaluating and monitoring ratings the agencies employ both qualitative and quantitative criteria in accordance with the industry practice world wide. The methodology involves an analysis of past performance of the company and an assessment of its future prospects.

The past is not considered as a guide to the future but to understand why the company performed the way it did. More important a rating Agency has to look ahead over the life of the debt instrument.

Rating agencies go into the entire gamut of company's financial and operational strengths. An assessment of the "BUSINESS RISKS" and "FINANCIAL RISKS" associated with the issuer / borrowing entity is undertaken. The business risks analysed include industry risks, market position of the company within the industry (including product profile, competitiveness – external and domestic) and operating efficiency of the borrowing company.

In financial risk analysis the accounting quality of the entity its past financial performance as well as its future financial performance are examined. The funding sources available to the company and the financial flexibility available in case of a short term financial crunch is also analysed. Stress is also laid on the evaluation of the management.

The ratings are based on current information provided to the rating agency by the borrowing company or facts obtained by the agency from sources it considered reliable.

7b.13. Problems in Credit Rating:

1. Possibility of confusion due to existence of various credit rating agencies, which rate the same debt instrument differently.
2. The credit rating agencies do not have common rigid formula to rate a particular debt instrument. Hence subjective bias in the areas i.e., Management Quality, Asset Quality, Auditor's Quality, Accounting Quality, etc., may arise in credit ratings.
3. Credit rating agencies can give only an indication and cannot give any foolproof and cent percent reliability of its assessment.
4. The assigned rating to a debt instrument is supposed to be monitored and revised either upward or downward depends upon the position and reliability of the issue. However, in this aspect credit rating agencies in India are lacking. Rarely the assigned ratings are revised and made publicity.
5. Under the prevailing situation a company in India is free to accept or reject any rating deliberately suppressing the low rating and publishing / accepting high rating. It is rated by more than one credit rating agencies. This practice misleads the potential investors.
6. In western countries the rating agencies under take voluntary rating even if the issuer company does not approach them. This unsolicited rating is primarily intended towards protection of the interest of the common investors. This aspect is lacking in India.
7. The practical difficulties in assessing some of the criteria VIZ. Quality of personnel, Quality of service etc., are not overcome.
8. Some of the credit rating agencies follow qualitative aspects for rating which may not be more realisable and accurate.

7b.14. Problems for Investors in Debt Instruments:

Although the credit ratings establish a link between risk and return they simply provide a yardstick against which one can measure the risk inherent in any instrument. An investor uses the credit ratings to assess the risk level and compares the offered rate of return trade off. The risk perception of a common investor in the absence of a credit rating highly depends on his familiarity with the names of promoters, common sense, advice from friends and relatives, messages in News Papers etc.,

At present a company desirous of credit rating its debt instrument needs to approach a credit rating agency and pay a fee for this service. Hence, there is no compulsion on the corporate sector to obtain or publicise the credit rating. This can lead the company to its rating as another publicity exercise if it is good one and obliterate it from its prospectus and publicity if it is not so good one and obliterate it from its prospectus and publicity if it is not so good. As far the investors in debt instruments are concerned most of them do not give much importance to the credit ratings. They either go for expert opinion from brokers in debt market or get advise from their friends / relatives / neighbours / peer groups etc., Another problem is the existence of more number of credit rating agencies which rate the same debt instrument differently at a time.

7b.15. Summary:

Credit rating is rating of borrower's solvency and ability to repay the borrowed amount when it becomes due. It is evaluation of risk involved in a financial transaction of lending and borrowing. When debt instruments like debentures and bonds are issued by companies rating is mandatory. Number of factors are taken into account. CRISIL, ICRA, CARE etc are some of the rating agencies in India.

7b.16. Self Assessment Questions:

1. Discuss the origin of credit rating.
2. Define credit rating and discuss its importance.
3. Explain the process of rating and discuss various factors taken into account.
4. What are the benefits of credit rating ?

7b.17. Further Readings:

1. VK Bhalla, *Management of Financial Services*, Anmol Publications Pvt. Ltd, New Delhi.
2. S. Gurusamy, *Financial Services and Systems,* Vijay Nicole Imprints Pvt. Ltd, Chennai.
3. M Y Khan, *Financial Services*, Tata McGraw Hill Publishing Co. Ltd., New Delhi.
4. VA Avadhani, *Financial Services,* Himalaya Publishing House, New Delhi.