ALAGAPPA UNIVERSITY

[Accredited with 'A+' Grade by NAAC (CGPA:3.64) in the Third Cycle
and Graded as Category–I University by MHRD-UGC]

KARAIKUDI – 630 003

DIRECTORATE OF DISTANCE EDUCATION

Vallal Dr.RM.Alagappa Chettiar

M.Com.
310 24

FINANCIAL SERVICES

II - Semester

ALAGAPPA UNIVERSITY

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(A State University Established by the Government of Tamil Nadu)

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FINANCIAL SERVICES

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SYLLABI-BOOK MAPPING TABLE

Financial Services

Syllabi	Mapping in Book
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Unit - 2: Money Market in India - Indian Capital Markets - Difference between Money Market and Capital Market - Classification and objectives of Indian Money Markets and Structure of Capital Markets.	**Unit 2:** Money and Capital Market **(Pages 14-24);**
Unit - 3: Financial services and market environment - Development of financial markets - Global integration of financial market - Finance Companies: Functions, strengths and weaknesses.	**Unit 3:** Financial Services and Market Environment **(Pages 25-33);**
Unit - 4: Secondary Markets - Stock Exchange - Role of Secondary Market - Trading in Stock Exchange - Various Speculative Transactions - Role of SEBI - Regulation of Stock Exchange.	**Unit 4:** Secondary Market **(Pages 34-58);**
Unit - 5: Banks as Financial Intermediaries - Commercial Banks Role in Financing - IDBI - IFCI - LIC - GIC - UTI - Investments Companies.	**Unit 5:** Banks as Financial Intermediaries **(Pages 59-77)**
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Unit - 6: Markets for Corporate Securities - New Issue Markets - Functions Issue Mechanism - Under writing.	**Unit 6:** Markets for Corporate Securities **(Pages 78-92);**
Unit - 7: Commercial Banking and their fund based and non-fund based financial services - Leasing - Steps in leasing transactions - Lease finance - Accounting and reporting for lease.	**Unit 7:** Overview of Commercial Banking **(Pages 93-124);**
Unit - 8: Hire purchase financing: Salient features, guidelines, functions - Components of hire purchase contract - Hire purchase agreement - Cost of hire purchase.	**Unit 8:** Overview of Hire Purchase **(Pages 125-136);**
Unit - 9: Mutual Funds: Types of mutual funds - Floatation - Asset Management Company of mutual funds - Regulations.	**Unit 9:** Overview of Mutual Funds **(Pages 137-159)**
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INTRODUCTION

NOTES

The forces of globalization and liberalization have brought about tremendous changes in the Indian economy during the past two decades. These have left no sector untouched. However, financial service sector is the area where such effects are most noticeable. Driven by these forces, capital markets and the Indian financial service industry have almost crossed a whole generational change from the days of broker-run exchanges with dubious service standards and internal governance, floor-based trading of the physical certificates, almost non-existing derivative markets, and the mutual fund markets under the governmental monopoly. These changes have been visibly very rapid. Hence, presently the Indian capital market can be compared with the most advanced ones around the world, e.g., in terms of settlement speed, corporate bonds, etc.

Undoubtedly, financial services have acquired a very significant role in the Indian economy. Financial services comprise the conversion of intangible into tangible. In the past when these services were offered, these were mostly in the form of intangibles, i.e., not to be seen, not to be touched and not to be realized. However, the latest technological changes have forced the service providers to convert them into products. This book, *Financial Services*, attempts to educate the students about the conceptual aspects of the Indian financial services.

This book has been designed keeping in mind the self-instruction mode (SIM) format and follows a simple pattern, wherein each unit of the book begins with the Introduction followed by the Objectives for the topic. The content is then presented in a simple and easy-to-understand manner, and is interspersed with Check Your Progress questions to reinforce the student's understanding of the topic. A list of Self-Assessment Questions and Exercises is also provided at the end of each unit. The Summary and Key Words further act as useful tools for students and are meant for effective recapitulation of the text.

BLOCK - I
PRIMARY AND SECONDARY MARKET

NOTES

UNIT 1 INTRODUCTION TO FINANCIAL SERVICES

Structure

1.0 Introduction
1.1 Objectives
1.2 Nature and Various Facets of Financial Service Industry
1.3 Analysis of Financial Services
1.3.1 Need for Financial Innovation
1.4 Answers to Check Your Progress Questions
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1.0 INTRODUCTION

Services that are financial in nature are known as financial services. They are a part of the financial system consisting of financial institutions, financial markets, financial instruments and services that facilitate the transfer of funds. All four are interrelated. Financial institutions operate in the financial markets and provide financial services. For example, merchant bankers provide services for issuing financial products such as equity shares, bonds and debentures, while stock brokers provide services to the investors in the buying and selling of securities in stock exchanges.

'Financial stability is crucial for sustained economic growth but this cannot be achieved without strong financial systems.' (Financial Stability Institute, Basel)

The financial sector in India is witnessing an era of innovations. Since liberalization, there has been a broadening and deepening of financial markets. Several new instruments and products have been introduced and some sectors have been opened to new private players to operate in. This has given a strong impetus to the development and modernization of the financial sector. The financial sector has acquired greater strength, efficiency and stability by the combined effect of competition, regulatory measures, policy environment and motivation among the market players including banks. The financial markets, especially money market, government securities and forex markets are nurtured and developed because of their role in the transmission mechanism of monetary policy.

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The changes that have taken place in the financial markets are: (a) easing of controls on interest rates and their realignment with market rates, (b) gradual reduction in resource pre-emption by the government, (c) relaxation of stipulations on concessional lending and (d) denial of access to concessional resources for financial institutions. New players have adopted international best practices and modern technology to offer a more sophisticated range of financial services to corporate and retail customers. This process has clearly improved the range of financial services and the number of service providers available to Indian customers. The entry of new players has led even the existing players to upgrade their products and distribution channels. This growth has been backed by the Internet penetration. E-services have changed the entire spectrum of financial service sector. Exposure to global practices has made the Indian investor more discerning and demanding.

Financial services are diverse in nature; they extend from banking to leasing, from housing finance to credit rating, from stock-broking to underwriting, from factoring to venture capital funding, from merchant banking to mutual funds, from depository and custodial services to debt securitization, from credit card to insurance. These services are numerous and span a wide range of financial activities.

This unit explains the concept of financial services and its various types. In the financial services industry, there are as many varieties of pure services as there are of financial instruments. However, financial instruments are not commodities like consumer durables or non-durables; the role of the seller of a financial 'commodity' does not end with designing, quality control, delivery and need-based after-sales service. Such instruments in the financial market, during their entire lifetime, require a continuing connectivity between the customer and the seller. For example, when a bond (a financial instrument) is issued, the investor (customer) continues to be concerned about the debt-servicing ability of the issuer, regularity of interest payment, etc. Thus, the service feature is predominantly the general characteristic of all financial products. Consequently, the marketing of financial products is best understood as services marketing.

Another important aspect of financial services that will be dealt in this unit is merchant banking. A merchant bank is an intermediary in the capital market, i.e., it mediates between the issuer (the company issuing securities like equity shares, preference shares, bonds, etc.) and the investors (the persons with available funds and willing to invest in capital market instruments). In case of public issue of securities, it is mandatory, as per SEBI's guidelines, for the issuer company to appoint merchant bankers. For relatively large issues, it is necessary to appoint more than one merchant banker. This unit describes various aspects related to merchant banking in detail.

1.1 OBJECTIVES

After going through this unit, you will be able to:

- Explain the concept of financial services
- Identify the various types of financial services
- Provide an analysis of financial services
- Discuss the need for financial innovation

NOTES

1.2 NATURE AND VARIOUS FACETS OF FINANCIAL SERVICE INDUSTRY

'Financial services' refer to those services and products, provided by institutions that function in the financial system. Financial services are provided by various organizations, which deal with the management of money. In simple words, financial services refer to any services or products of a financial nature offered by financial institutions to consumers and business firms in the financial services sector. The financial services industry encompasses a broad range of organizations, which participate in diverse kinds of activities. The organizations that predominate in the financial services sector are banks, credit card companies, insurance companies, consumer finance companies, stock brokerage firms, mutual funds and some government-sponsored enterprises. These institutions facilitate various kinds of financial transactions and other related services. Financial services have been significantly transformed over a period of time, with the increasing aspirations and demands of society. In the financial services sector, knowledge is a competitive weapon, which is always challenged and tested, as it is essential to keep abreast of the fast-changing regulatory structure. If an organization has to be on the path of development, it has to be on the lookout to develop new products, to stay ahead of its competitors.

The financial services sector consists of various functions and services, which are provided to individuals and business firms by financial institutions in a financial system.

A financial institution collects funds **from the** public **and invests them in** financial assets**, such as** loans**,** bonds and shares in companies, **rather than** tangible property**. It** acts **as** a **channel between the savers and** borrowers **of** funds**. Broadly speaking, there are two categories of financial services:**

- Fund / asset-based financial services
- Non-fund / fee-based financial services

The institutions that provide the above services fall into three categories:

- Deposit-taking institutions, such as banks, which accept and manage deposits and provide loans and other ancillary services. These could be public/private sector banks and foreign banks.
- Non-banking financial companies, such as insurance companies and pension funds.
- Other financial intermediaries, such as brokers and sub-brokers, portfolio managers, investment advisors, underwriters and mutual funds.

The financial service sector in India has undergone significant liberalization in all the four segments, viz. banking, non-banking finance, securities and insurance. All these sectors have grown substantially over the years. An efficient and regulated financial system is essential for effective and qualitative delivery of financial services.

Nature of Financial Services

The main focus of financial services is the mobilization and allocation of savings. Financial services include all those activities that transform savings into investments. In this context, the role of financial intermediation has been significant and essential. Hence, financial services and financial intermediaries go together.

Financial intermediation is a process by which funds are mobilized as savings and later made available to individuals and corporate entities in need of investments.

The financial services sector is a key area for accelerated development. A well-developed financial services industry is necessary to mobilize funds from numerous savers and allocate them to various investable channels to promote the industrial development of the country. The financial service is an essential segment of the financial system.

Characteristics of Financial Services

Generally, financial services have several important characteristics that distinguish them from physical products. These are as follows:

1. Intangibility

Financial services are intangible in nature, unlike physical commodities. The institutions providing these services should build a good brand image in the public sphere and create confidence amongst their clients. They have to focus on the quality of their services, which will give them credibility in the market. Nowadays, the tendency to use marketing to make gains has become popular with some financial institutions, which affects their long-term prospects.

2. Customer-centricity

Financial services are customer-centric. The financial service industry is a customer-intensive and customer-focused industry. It needs high customer involvement. The financial services industry begins by identifying the needs of its customers. They have to remain in constant contact with their customers to understand their requirements and design products that cater to their specific demands.

A product is manufactured, while a service is not. A financial product is standardized, while a financial service is tailor-made. Financial services cannot be uniform for all the clients. Services vary from customer to customer and cannot be standardized. Some services are targeted at individuals, while some are meant for institutions or companies. For example, housing finance is made available directly to individuals, and also to companies, which pass on the benefits to their employees.

Financial services are tailor-made to woo customers and are based on a customer-centric design as individual requirements are not uniform.

Financial products are services of various kinds offered by institutions, such as banks, to facilitate different financial transactions and other related activities in the world of finance.

3. Inseparability

The production and supply of financial services must be performed, simultaneously. For example, an individual who wants to have a haircut has to depend on the availability of the barber to avail of the service. The service and service provider cannot be separated. Persons engaged in the same industry differ in the quality of service offered.

4. Heterogeneity

Firms engaged in providing financial services must be proactive in anticipating what the market wants and react to the specific needs and wants of their customers. The market is very dynamic in the financial industry and financial firms have to be innovative and adapt, quickly, to the changing needs of their customers to survive and grow.

5. Marketability

The marketing of financial services has become intensive at present. Banks did not have marketing teams in the past. Persons engaged in marketing have to be ethical as customers base their financial decisions, trusting the marketers. They should have the necessary knowledge and be people-friendly and honest.

The concept of a 'relationship manager' has emerged in the banking sector recently, to understand the needs of customers and serve them better.

6. Simultaneous functions

The creation of financial services and their delivery have to be simultaneous. They have to be created and delivered to the target clients immediately. Both the functions, i.e. production and supply of new and innovative financial services, are to be performed, simultaneously. Hence, it is imperative for the providers of financial services to synchronize and ensure a perfect match between the demand and supply.

7. Perishability

Unlike other services, financial services perish, if not used. They cannot be stored and provided, based on the requirements of customers. They have to be supplied as required by the customers. Hence, financial institutions have to ensure a proper synchronization between demand and supply.

8. People-based services

Financial services are subject to the variability of performance or quality of service, depending on the persons who render the services. We feel the services of a particular bank branch have deteriorated, in terms of quality, when the desk officer changes and the concerned person renders service impolitely or impersonally. As a service-oriented industry, the personnel in the financial services sector need to be selected on the basis of their temperament and suitability. The personnel have to be trained, properly and periodically, with suitable job orientation, so that they can perform their role efficiently and effectively.

9. Dynamic nature

Economic and social factors affect consumer habits, which have undergone a radical change. For example, customers were in the habit of going to banks, physically, in the past. Now, most normal transactions, such as cash withdrawal and deposit, as well as several connected services are delivered at ATMs.

It is no longer necessary to go to a bank to conduct routine transactions. Till the end of 2012, customers visited their bank physically to deposit cash. Now, cash deposit machines (CDMs) have been installed at several places. The State Bank of India (SBI), the country's largest public sector lender, introduced the first CDM in Mangalore on 28 January 2013.

The media plays an important role in spreading awareness of financial services.

The range and scope of financial services, as well as the speed and ease with which these can be undertaken, have undergone radical changes; that institution which lacks the vision to perceive this and the energy to act speedily on this perception, ceases to grow.

10. Market dynamics

Market dynamics depend on the disposable incomes of the social segment that is the target; their investment habits, educational standards and socioeconomic transformations in society. Financial services have to be constantly innovative, redefined and refined, taking into account the composition of the clientele and changing market dynamics. The institutions that provide financial services have to visualize what the market needs, while evolving new products and services, even as they stay ahead of the market and responsive to the needs and desires of their customers.

Check Your Progress

1. What do you understand by the term ‘financial services’?
2. List some of the organizations that predominate in the financial services sector.
3. What is the main focus of financial services?

NOTES

1.3 ANALYSIS OF FINANCIAL SERVICES

Though new products and services are developed in the financial services sector, investors do not come to know because banks fail to make a conscious effort to keep them informed. These new products and services are of no use if customers know nothing about them. Lack of sufficient publicity is the real cause of customers’ inadequate awareness. Banks do not use the infrastructure and resources they have to advertise their innovative products. For example, they could use the surroundings and inner space in ATMs to advertise their products. Bank customers frequently visit ATMs, which are common access points for operating accounts with any bank, without extra charges. Banks can utilize the ATM avenue/area to publicize their latest products, to bring about public awareness. Banks can target their own customers, as well as those using other banks.

Customers often queue up before ATMs for their turn to operate their accounts. They have all the time to look around them since they have no other work to do. This could be a golden opportunity for the banks to create customers’ awareness of their products and services, at no additional cost. They could use cartoons and caricature to make it more interesting to read about new products and services, using humour creatively. It is time for commercial banks to change their outlook regarding the advertising of their products and services.

Banks have to be more imaginative and practical in their approach to publicize their products and improve their earnings, at no extra cost.

Banks can generate revenue by showcasing running ads on the window panels of ATMs. Financial services provide a window for innovation, and use of existing resources can do wonders, if one has the vision.

Lack of Transparency

The financial sector lacks transparency. For example, customers using credit cards do not know if the interest rate advertised by the credit card company is the only interest they have to pay. They are often charged hidden costs. There is no openness in the approach while providing this financial service. This short-term approach should be avoided for the healthy growth of financial services.

Lack of Specialization with Financial Intermediaries

On the Indian scene, financial intermediaries have dabbled in several financial products, without developing adequate specialization in any particular area. This is not so in other countries, where financial intermediaries specialize in one or two areas and provide expert service.

Inadequate Market Surveys

Most firms engaged in financial services do not conduct extensive research to build a firm base of data, before embarking on the development of new products or services. As a result, the financial products and services they create do not become successful as they have not fully tested or understood the pulse of the public.

Inclusive Growth

Although growth has been achieved to a certain extent, its fruits have not reached the people living below the poverty line.

Bank lending has benefitted the rich more and inclusive growth, wherein all sectors of society benefit, is yet to be achieved.

Lack of Information Security

The primary objective of commercial banks is to promote their business by any means, making technology more user-friendly, always available anywhere and at any time. They have used social networking sites to share information with their customers. However, white-collar crimes have also been facilitated by the use of sophisticated technology. Criminals use all kinds of tricks to access financial data for their own ulterior motives. Brokers, insurance companies and banks have made it possible for customers to use their products, even on mobile phones. However, the use of online banking and mobile banking is risky, since the security of their financial data is at stake. The massive shift from conventional banking to providing financial services 24/7 is revolutionary but leaves the system unprotected.

The lack of stringent cyber laws, which match modern technology, and swift mechanism for justice and punishment are at present the Achilles heel of the system. Suitable measures to safeguard systems have to be implemented and strengthened, so that the fast strides in banking automation do not expose the financial services to frauds.

Weak Security Laws

Security laws are weak in India, which impedes the growth of outsourcing of financial services to our country. For instance, security laws relate to computer security, data protection and network security in the context of computers and communications. These laws are meant to safeguard against losses, damages, unwanted modifications, or unauthorized access.

India's intellectual property (IP) laws and their enforcement mechanisms are weak compared to western IP laws and practices.

Despite the technological innovation and progress made by our country, gaps in the existing IP regime have prevented the outsourcing of financial services from the US and other European countries.

NOTES

Lack of an Efficient Risk Management System

With the onset of liberalization and globalization, multicurrency transactions have exposed clients to the attendant political, economic and interest risks of those countries with which we do business. A high-level expertise in all those areas is not adequately available, especially in smaller towns and cities, at an affordable cost.

Ethical Issues

The service sector is vast with a large number of people using services provided by diverse financial institutions. Ethical lapses in the financial services industry affect everyone as consumers of these services are numerous. Ethical lapses related to these services are widely publicized in the media, because such lapses touch upon many areas of life. An inability to compensate for such a lapse could lead to bad publicity, if not resolved expeditiously. Ethical problems in the financial services sector get wider adverse publicity.

Failure of Iconic Commercial Banks

The rural sector still suffers from a lack of adequate and timely credit. Micro-finance institutions (MFIs), a new experimental window of lending, are able to ensure timely availability of funds to the under-privileged at an affordable interest rate. They have proved to be successful in an area and market where iconic commercial banks have failed.

The micro-finance sector, where the operators understand social needs, has made progress to set right the history of rural credit and poverty alleviation.

Absence of Advanced Computer and Telecommunications Technology

A lack of appreciation of advanced computer and telecommunication technology has deprived us of its benefits and constrained the growth of this sector in our country. (The reference relates to the growth of advanced computer and telecommunication technology, repetition has been avoided).

1.3.1 Need for Financial Innovation

Financial innovation has come through advances over time in financial instruments and payment systems used in the lending and borrowing of funds. These changes – which encompass updates in technology, risk transfer, and credit and equity generation – have increased available credit for borrowers and given banks new and less costly ways to raise equity capital. Financial innovation is a general term and can be broken down into specific categories, based on updates to different spheres of the financial system.

Check Your Progress

4. What is the real cause of customers' inadequate awareness?
5. What is the primary objective of commercial banks?

1.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. 'Financial services' refer to those services and products, provided by institutions that function in the financial system.
2. The organizations that predominate in the financial services sector are banks, credit card companies, insurance companies, consumer finance companies, stock brokerage firms, mutual funds and some government-sponsored enterprises.
3. The main focus of financial services is the mobilization and allocation of savings.
4. Lack of sufficient publicity is the real cause of customers' inadequate awareness.
5. The primary objective of commercial banks is to promote their business by any means, making technology more user-friendly, always available anywhere and at any time

1.5 SUMMARY

- Services that are financial in nature are known as financial services.
- They are a part of the financial system consisting of financial institutions, financial markets, financial instruments and services that facilitate the transfer of funds.
- 'Financial stability is crucial for sustained economic growth but this cannot be achieved without strong financial systems.'
- Financial services are diverse in nature; they extend from banking to leasing, from housing finance to credit rating, from stock-broking to underwriting, from factoring to venture capital funding, from merchant banking to mutual funds, from depository and custodial services to debt securitization, from credit card to insurance.

- The financial services sector consists of various functions and services, which are provided to individuals and business firms by financial institutions in a financial system.
- The financial service sector in India has undergone significant liberalization in all the four segments, viz. banking, non-banking finance, securities and insurance.
- The main focus of financial services is the mobilization and allocation of savings. Financial services include all those activities that transform savings into investments.
- Financial services are intangible in nature, unlike physical commodities. The institutions providing these services should build a good brand image in the public sphere and create confidence amongst their clients.
- Financial products are services of various kinds offered by institutions, such as banks, to facilitate different financial transactions and other related activities in the world of finance.
- The marketing of financial services has become intensive at present. Banks did not have marketing teams in the past.
- Economic and social factors affect consumer habits, which have undergone a radical change.
- Market dynamics depend on the disposable incomes of the social segment that is the target; their investment habits, educational standards and socioeconomic transformations in society.
- Banks can generate revenue by showcasing running ads on the window panels of ATMs. Financial services provide a window for innovation, and use of existing resources can do wonders, if one has the vision.
- Most firms engaged in financial services do not conduct extensive research to build a firm base of data, before embarking on the development of new products or services.
- The primary objective of commercial banks is to promote their business by any means, making technology more user-friendly, always available anywhere and at any time.
- With the onset of liberalization and globalization, multicurrency transactions have exposed clients to the attendant political, economic and interest risks of those countries with which we do business.
- The rural sector still suffers from a lack of adequate and timely credit. Micro-finance institutions (MFIs), a new experimental window of lending, are able to ensure timely availability of funds to the under-privileged at an affordable interest rate.

- Financial innovation has come through advances over time in financial instruments and payment systems used in the lending and borrowing of funds.
- Financial innovation is a general term and can be broken down into specific categories, based on updates to different spheres of the financial system.

1.6 KEY WORDS

- **Merchant Bank:** A merchant bank is an intermediary in the capital market, i.e., it mediates between the issuer (the company issuing securities like equity shares, preference shares, bonds, etc.) and the investors (the persons with available funds and willing to invest in capital market instruments).
- **ATM:** ATM is a machine that dispenses cash or performs other banking services when an account holder inserts a bank card.
- **MFIs:** Micro Finance Institutions, also known as MFIs, a microfinance institution is an organization that offers financial services to low income populations.

1.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. What are the various types of financial services?
2. Write a short note on the ethical lapses in the financial services industry.
3. Why is there a need for financial innovation?
4. What do you understand by the term ‘financial innovation’?
5. Why is there a need for a well-developed financial services industry?

Long Answer Questions

1. Explain the concept of financial services.
2. Critically analyze the nature of financial services.
3. Financial services have several important characteristics that distinguish them from physical products. Discuss these characteristics.
4. Describe the importance of financial innovation.
5. Financial services are customer-centric. Do you agree? Give reasons for your answer.

1.8 FURTHER READINGS

NOTES

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UNIT 2 MONEY AND CAPITAL MARKET

NOTES

Structure

2.0 Introduction
2.1 Objectives
2.2 Money Market in India: Classification and Objectives
2.3 Indian Capital Markets: Classification, Objectives and Structure
2.3.1 Features
2.3.2 Difference between Money Market and Capital Market
2.4 Answers to Check Your Progress Questions
2.5 Summary
2.6 Key Words
2.7 Self Assessment Questions and Exercises
2.8 Further Readings

2.0 INTRODUCTION

The money market is where money or its equivalent instruments are traded. The main function of the money market is to facilitate the efficient transfer of short-term funds between lenders and borrowers, which offers avenues as well as benefits for both groups. Short-term means a period that ranges from one day to one year. The lender/investor parts with the funds for a short-term loan to secure a reasonable return. The borrower benefits from access to rapid and relatively inexpensive cash in the form of short-term liabilities.

In this unit, you will learn about the money market in India, its classification and objectives. This unit will also discuss the Indian capital markets, its features, objectives and structure. At the end of this unit, you will also study the difference between money market and capital market.

2.1 OBJECTIVES

After going through this unit, you will be able to:

- Explain the money market in India, its classification and objectives
- Discuss the Indian capital markets, its features, objectives and structure
- Differentiate between money market and capital market

2.2 MONEY MARKET IN INDIA: CLASSIFICATION AND OBJECTIVES

The money market consists of many sub-markets, such as the call money market, acceptance market, commercial bills market, etc. Collectively, these constitute the money market.

The money market provides a focal point for the RBI to intervene to influence the liquidity and general levels of interest rates in the economy.

The RBI, which is a major constituent of the money market, aims at ensuring that the liquidity and short-term interest rates are consistent with its monetary policy objectives.

Characteristics of the Money Market

The money market is characterized by the following features:

- **Short-term:** It is a market for short-term loans of a year or less.
- **Liquidity:** It is an extremely liquid market and deals with fixed-income securities.
- **Safety:** It provides a relatively high degree of safety as the issuers of credit instruments have the highest credit ratings.
- **Discount pricing:** It issues credit instruments at a discount to their face value. If the face value of the instrument is ₹ 1,000, it is issued at a discounted price of ₹ 950. The difference constitutes the return for the period of the instrument as no interest would be separately specified.
- **No brokers:** It enables transactions to take place without the intervention of brokers.
- **No physical contact required:** It facilitates transactions over the phone, with relevant documents and written communication being exchanged, subsequently.
- **Heterogeneous market:** It comprises several sub-markets, each specializing in a particular form of financing, such as the call money market, acceptance market, treasury bills market and so on.

Functions of the Money Market

The money market performs the following functions:

1. **It deals in short-term market instruments:** The money market deals in short-term market instruments such as call money, notice money, term-money, repos, treasury bills, commercial paper, certificates of deposit, inter-bank participation certificates and inter-corporate deposits.
2. **It transfers short-term funds with return:** The money markets facilitate the efficient transfer of short-term funds from the surplus financial units to borrowers in the form of cash assets. For the lender/investor, the money market provides a reasonable return on their funds, which would have been idle otherwise.
3. **It enables borrowers to meet sudden short-term requirements:** From the view-point of the borrowers, it enables rapid and relatively inexpensive acquisition of cash to meet the unanticipated sudden short-term needs.

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4. **It influences RBI's monetary policy:** The money market is a focal point for the RBI to intervene and influence the liquidity and general levels of interest rates in the economy. The RBI is a major constituent of the money market. Through the money market, the RBI is able to ensure that liquidity and short-term interest rates are consistent with its monetary policy objectives.
5. **It includes a large network of participants:** A large network of participants exists in the money market, which provides greater depth and transparency. For example, as a primary dealer, SBI DFHI Ltd is an active player in this market and widely deals in short-term money market instruments.
6. **It introduces new instruments and practices:** Innovative new instruments and dealing practices are introduced in the money market to provide healthy competition, which leads to an efficient economy. All money market transactions are to be carried out and reported on an electronic platform, called Negotiated Dealing System (NDS), introduced in the government securities from February 2002.
7. **It is a wholesale trading market:** The volume of funds traded in the money market is in crores of rupees.
8. **It offers high liquidity and low returns:** Money market offers the highest liquidity and safety for the funds, but with low returns.
9. **It features several major participants:** The major participants in the money market are RBI, commercial and cooperative banks, SBI DFHI Ltd, financial and investment institutions (such as LIC, UTI, GIC and development banks), mutual funds, corporates and primary dealers. Commercial banks play a dominant role in this market.

Having discussed the functions of money market, let us discuss the various money market instruments and their relative role in the money market.

Requirements for an Efficient Money Market

An efficient money market should:

- Have diversified instruments
- Include an active secondary market to facilitate trading
- Include a number of sub-markets, inter-related and integrated
- Encourage competition between and within these sub-markets of the money market
- Integrate the unorganized sector with the organized sector
- Include an efficient and strong central bank for direction, regulation and intermediation
- Possess a highly organized banking system
- Enjoy a large demand and supply of liquid funds

Money Market Instruments

Money market instruments are short-term debt securities, which are traded within a money market. These instruments are very liquid and safe. They are considered to be considered extraordinarily safe due to the unlikelihood of default. As these instruments are extremely conservative in nature, they offer significantly lower return than most other securities. They are also called cash investments due to their near-liquid nature and short maturities.

Money market instruments:

- Provide an opportunity to earn a modest return while parking short-term funds
- Meet short-term deficits at a reasonable cost
- Provide a focal point for RBI to influence and regulate the liquidity in the economy through its intervention in the market
- Provide a quick access to the providers and borrowers of short-term funds

Money market instruments traded in India are:

- Call or notice money
- Banker's acceptances
- Certificates of deposit
- Collateralized borrowing and lending obligation (CBLO)
- Treasury bills
- Commercial bills
- Commercial papers
- Repos (repurchase agreements) and reverse repos

Check Your Progress

1. What is the main function of the money market?
2. What is the aim of RBI in the money market?
3. Mention the major participants in the money market.

2.3 INDIAN CAPITAL MARKETS: CLASSIFICATION, OBJECTIVES AND STRUCTURE

In this section, we will study about the Indian capital markets.

2.3.1 Features

The capital market is a part of the financial system. Let us first understand the financial system and then we will try and understand how capital markets are placed in a financial system.

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All financial systems aim at transferring the surplus money of one sector of the economy to the deficit sector of the same or different economy. India is no exception. India, since Independence, has had a well-regulated and structured financial system. The financial market is one of the major constituents of any financial system and consequently, the Indian financial market is also an integral part of India's financial system. The financial market mainly consists of the money market and the capital market. The financial market is a market in which financial assets are bought and sold.

The financial market operation is a very complicated one. However, it is well-planned and well-structured. The operation mainly deals with transactions related to shares, banks, commercial paper, term loan, mutual funds, treasury bills, debentures, call money and so on. The operation of each of these instruments requires that certain procedures be followed by the individual institution and the relevant parties. The parties which are actively associated with the financial market are banks, stock exchanges, corporates, retail investors, post offices and so on. Figure 2.1 shows the position of the capital market in the entire financial system of India.

The primary function of the Indian financial market is to facilitate the flow of surplus money from household savings, corporate savings and institutional surplus (lenders) to government and corporate institutions (borrowers) mainly for economic development. India being the largest 'small savings' nation in the world, definitely needs a strong, well-organized financial market so as to utilize the savings in a manner that ultimately functions as fresh investment-generating capital formation in the economy.

The financial market in India has three primary functions:

(*i*) Determining the price of the financial asset in the open markets

(*ii*) Providing the liquidity option to the investors and savers

(*iii*) Providing low cost and secured transactions in the finance market with perfect and relevant information

The capital market provides long-term funds for corporates, central and state governments. The capital market has sub-markets like debt market, equity market and derivative market.

- Fixed income securities of various types and features are issued and traded in the debt market. Debt markets are therefore markets for fixed income securities issued by Central and state governments, municipal corporations, government bodies and commercial entities like financial institutions, banks, public sector undertakings, public limited companies and structured finance instruments.
- In the equity market, variable income securities like equity shares are issued and traded. Equity shares are issued by the companies and financial institutions.

- In the derivative market, financial products and commodity based derivatives like options and futures are traded. Commodity options and futures on precious metals, oil and agricultural products are traded on the commodity exchanges. Financial product derivatives like stock options and futures, stock index futures and options, and interest rate futures are traded on the stock exchanges.

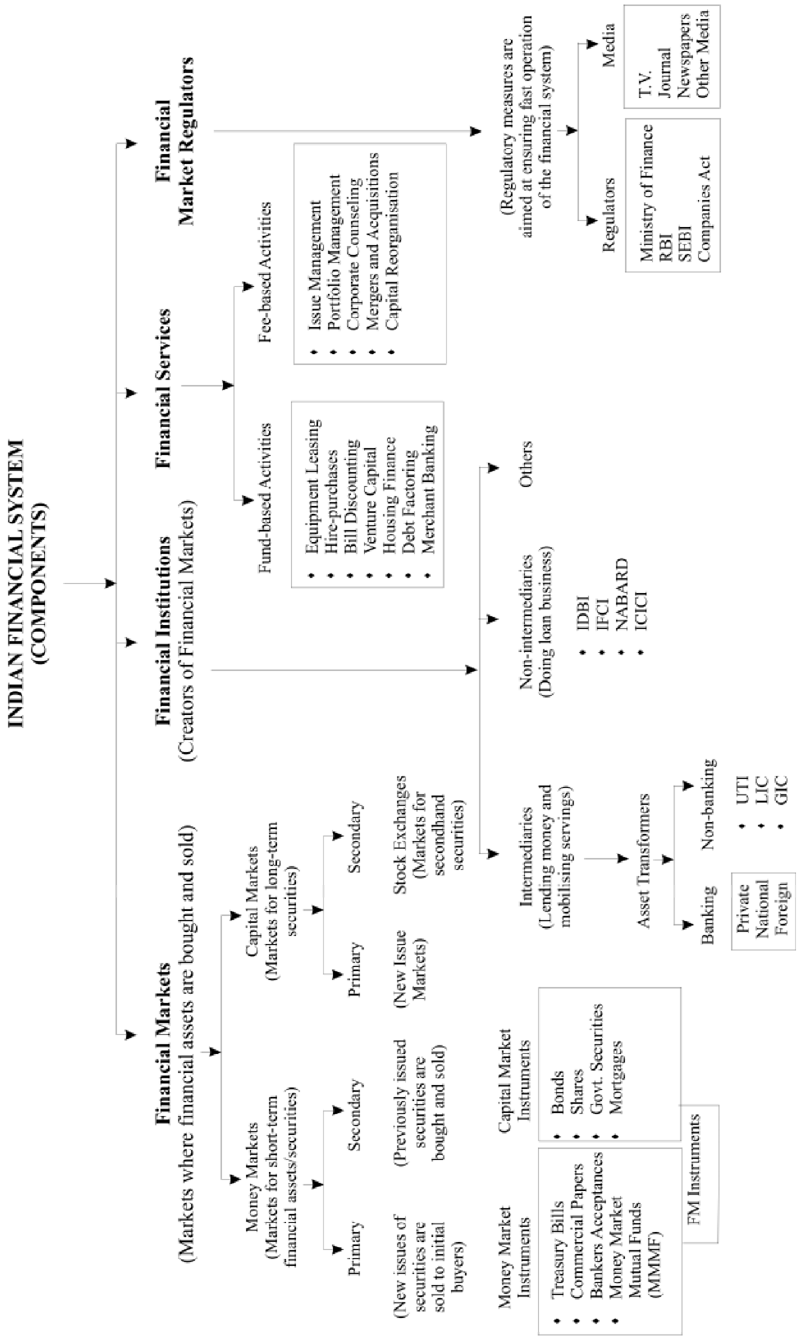
INDIAN FINANCIAL SYSTEM
(COMPONENTS)
Financial Markets
(Markets where financial assets are bought and sold)
Financial Institutions
(Creators of Financial Markets)
Financial Services
Financial
Market Regulators
Money Markets
(Markets for short-term
financial assets/securities)
Capital Markets
(Markets for long-term
securities)
Primary
Secondary
Primary
Secondary
(New issues of
securities are
sold to initial
buyers)
(Previously issued
securities are
bought and sold)
(New Issue
Markets)
Stock Exchanges
(Markets for
secondhand
securities)
Money Market
Instruments
• Treasury Bills
• Commercial Papers
• Bankers Acceptances
• Money Market
Mutual Funds
(MMMF)
Capital Market
Instruments
• Bonds
• Shares
• Govt. Securities
• Mortgages
FM Instruments
Intermediaries
(Lending money and
mobilising servings)
Asset Transformers
Banking
Private
National
Foreign
Non-banking
• UTI
• LIC
• GIC
Non-intermediaries
(Doing loan business)
• IDBI
• IFCI
• NABARD
• ICICI
Others
Fund-based Activities
• Equipment Leasing
• Hire-purchases
• Bill Discounting
• Venture Capital
• Housing Finance
• Debt Factoring
• Merchant Banking
Fee-based Activities
• Issue Management
• Portfolio Management
• Corporate Counseling
• Mergers and Acquisitions
• Capital Reorganisation
(Regulatory measures are
aimed at ensuring fast operation
of the financial system)
Regulators
Ministry of Finance
RBI
SEBI
Companies Act
Media
T.V.
Journal
Newspapers
Other Media

Fig. 2.1 *The Position of the Capital Market in the Indian Financial System–Schematic Diagram*

The Perfect Capital Market

A perfect capital market is a myth. Yet, at the same time, all capital markets always aim at reaching perfection. The characteristics of a perfect capital market are as follows:

(*i*) Free entry and exit in the capital market

(*ii*) No cost associated with any transaction

(*iii*) A large number of finance traders

(*iv*) No individual trader being able to influence the financial market

(*v*) Information being perfect and available free of cost

A capital market is an organized market dealing with financial assets which have a long or indefinite maturity period. In general, it consists of those assets which have a maturity period of over one year.

The classification of the capital market is shown in Figure 2.2.

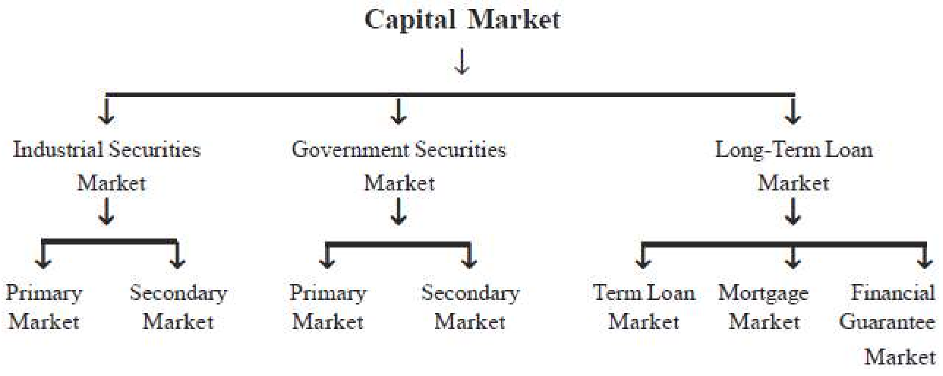
Capital Market
Industrial Securities Market
Government Securities Market
Long-Term Loan Market
Primary Market
Secondary Market
Primary Market
Secondary Market
Term Loan Market
Mortgage Market
Financial Guarantee Market

Fig 2.2 *Classification of Capital Market*

The instrument for the capital markets is mainly stock that is, equity shares, preference shares, debentures, bonds, and so on.

Instruments of a capital market

(*i*) Secured Premium Note with detachable warrants

(*ii*) Equity Shares with detachable warrants

(*iii*) Preference Shares with warrants

(*iv*) Fully convertible cumulative Preference Shares

(*v*) Non-convertible Debentures with detachable Equity Warrant (NCD)

(*vi*) Zero interest fully convertible Debentures

(*vii*) Fully convertible Debentures (FCD)

(*viii*) Zero interest partly convertible Debentures with detachable tradeable warrants (*ix*) Zero interest Bonds

(*x*) Deep discount Bond (DDB)

(*xi*) Other Bonds

(*xii*) Bonds with warrants

The major new instruments, as recommended by the Pharwani Study Group, are as follows:

(*i*) Participating Preference Shares

(*ii*) Participating Debentures

(*iii*) Convertible Debentures with Options

(*iv*) Third party Convertible Debentures

(*v*) Convertible Debentures redeemable at a premium

(*vi*) Debt for Equity Swap

2.3.2 Difference between Money Market and Capital Market

Stock market or securities market or primary market is a market where securities issued by companies in the form of shares, bonds and debentures can be bought and sold freely. The components of stock market are primary market and secondary market. Primary market or new issues market is concerned with the issue of new securities.

The features are as follows:

- It is a market for long-term capital where the securities are sold for the first time. Hence, it is also called New Issue Market (NIM).
- Funds are collected and securities are issued directly by the company to the investors.
- Primary issues are carried out by the companies for the purpose of inception and functioning of business.

Benefits of Primary Market

The benefits are as follows:

- Company need not repay the money raised from the market.
- Money has to be repaid only in the case of winding up or buyback of shares.
- There is no financial burden, because it does not involve interest payment. If the company earns profit, dividend may be paid.
- Better performance of the company enhances the value for the shareholders.
- It enables trading and listing of securities at stock exchanges.
- There is greater transparency in the corporate governance.
- If the company performs well; the image of the company is enhanced.

Disadvantages of the Public Issues

The disadvantages are as follows:

- It is a time consuming process involving the fulfilment of legal formalities.
- It is expensive and many intermediaries are involved in it. It necessitates constant adherence to listing of agreements and legal requirements.
- Cornering of shares and hostile takeover may take place.
- Speculative trading of the company's equity affects the reputation of the company.

Check Your Progress

4. What is the primary function of the Indian financial market?
5. What is a capital market?

2.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. The main function of the money market is to facilitate the efficient transfer of short-term funds between lenders and borrowers, which offers avenues as well as benefits for both groups.
2. The RBI, which is a major constituent of the money market, aims at ensuring that the liquidity and short-term interest rates are consistent with its monetary policy objectives.
3. The major participants in the money market are RBI, commercial and cooperative banks, SBI DFHI Ltd, financial and investment institutions (such as LIC, UTI, GIC and development banks), mutual funds, corporates and primary dealers.
4. The primary function of the Indian financial market is to facilitate the flow of surplus money from household savings, corporate savings and institutional surplus (lenders) to government and corporate institutions (borrowers) mainly for economic development.
5. A capital market is an organized market dealing with financial assets which have a long or indefinite maturity period. In general, it consists of those assets which have a maturity period of over one year.

2.5 SUMMARY

- The money market is where money or its equivalent instruments are traded.
- The main function of the money market is to facilitate the efficient transfer of short-term funds between lenders and borrowers, which offers avenues as well as benefits for both groups.

- The money market consists of many sub-markets, such as the call money market, acceptance market, commercial bills market, etc.
- The RBI, which is a major constituent of the money market, aims at ensuring that the liquidity and short-term interest rates are consistent with its monetary policy objectives.
- The money market deals in short-term market instruments such as call money, notice money, term-money, repos, treasury bills, commercial paper, certificates of deposit, inter-bank participation certificates and inter-corporate deposits.
- Money market instruments are short-term debt securities, which are traded within a money market.
- All financial systems aim at transferring the surplus money of one sector of the economy to the deficit sector of the same or different economy.
- The primary function of the Indian financial market is to facilitate the flow of surplus money from household savings, corporate savings and institutional surplus (lenders) to government and corporate institutions (borrowers) mainly for economic development.
- A capital market is an organized market dealing with financial assets which have a long or indefinite maturity period. In general, it consists of those assets which have a maturity period of over one year.
- Stock market or securities market or primary market is a market where securities issued by companies in the form of shares, bonds and debentures can be bought and sold freely.

2.6 KEY WORDS

- **Commercial Bill:** Commercial bill is a bill of exchange issued by a commercial organization to raise money for short-term needs.
- **RBI:** The Reserve Bank of India (RBI) is India's central banking institution, which controls the issuance and supply of the Indian rupee.
- **Liquidity:** Liquidity is the availability of liquid assets to a market or company.
- **Heterogeneous Market:** It comprises several sub-markets, each specializing in a particular form of financing, such as the call money market, acceptance market, treasury bills market and so on.
- **Stock Market:** Stock market or securities market or primary market is a market where securities issued by companies in the form of shares, bonds and debentures can be bought and sold freely.

2.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

NOTES

Short Answer Questions

1. List the various characteristics of the money market.
2. What are functions of money market?
3. Mention the requirements for an efficient money market.
4. List the characteristics of a perfect capital market.
5. Identify the various instruments of a capital market.

Long Answer Questions

1. Explain the concept of money market in India.
2. Discuss the various money market instruments and their relative role in the money market.
3. Describe the three primary functions of the financial market in India.
4. Differentiate between money market and capital market.
5. Explain the benefits of primary market.

2.8 FURTHER READINGS

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UNIT 3 FINANCIAL SERVICES AND MARKET ENVIRONMENT

NOTES

Structure

3.0 Introduction
3.1 Objectives
3.2 Development of Financial Markets
3.2.1 Global Integration of Financial Market
3.3 Finance Companies
3.3.1 Banks and Non-Banking Financial Companies
3.4 Answers to Check Your Progress Questions
3.5 Summary
3.6 Key Words
3.7 Self Assessment Questions and Exercises
3.8 Further Readings

3.0 INTRODUCTION

Brigham and Eugene defined the financial market as a place where people and organizations wanting to borrow money are brought together with those having surplus funds. Financial market does not refer to a physical location. Formal trading rules and communication networks for originating and trading financial securities link market participants. Transferring of funds from the surplus sector to the deficit sector is the main function of the financial market. The credit requirements of the corporate sector are greater than their savings. The savings of the household sector are channelized into the corporate and public sectors for productive purposes. In this unit, you will deal with the development of financial markets and global integration of financial market. This unit will also discuss banks and non-banking financial companies.

3.1 OBJECTIVES

After going through this unit, you will be able to:

- Explain the development of financial markets
- Describe the global integration of financial market
- Discuss the role of banks and non-banking financial companies

3.2 DEVELOPMENT OF FINANCIAL MARKETS

The market participants in financial markets are investors or buyers of securities, borrowers or sellers of securities, intermediaries and regulatory bodies. Securities are financial instruments that represent the holder's claim on a stream of income or a fixed amount from a corporate or government.

Constituents of Financial Market

The financial market is broadly categorized into money market, capital market and forex market.

Money Market

Monetary assets, which are short term in nature and less than one year are traded in the money market. Money market facilitates RBI's conduct of monetary policy. There was a paucity of instruments in the money market for a long time. After the mid- 1990s the money market in India experienced significant development in terms of refinements of existing money market instruments and introduction of new instruments. The money market instruments in general are close substitutes to money. The various money market instruments have been given next.

- Call/ Notice/ Term Money
- Repos
- Treasury Bills
- Certificate of Deposits (CD)
- Commercial Papers (CP)
- Inter Bank Participation Certificates
- Inter Bank Term Money
- Interest Rate Swaps/Forward Rate Agreements and
- Bills Rediscounting

The following figure shows the components of financial market.

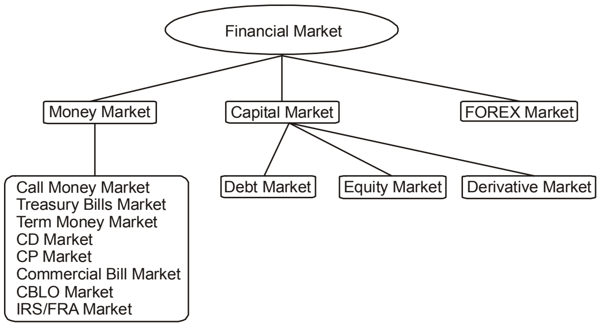
Financial Market
Money Market
Capital Market
FOREX Market
Call Money Market
Treasury Bills Market
Term Money Market
CD Market
CP Market
Commercial Bill Market
CBLO Market
IRS/FRA Market
Debt Market
Equity Market
Derivative Market

Fig. 3.1 *Components of Financial Market*

Components: The money market has two components namely the organized and the unorganized. The participants of the organized money market are the Reserve Bank of India, Life Insurance Corporation, General Insurance Corporation, Unit Trust of India, Securities Trading Corporation of India Ltd., Discount and Finance House of India, other primary dealers, commercial banks and mutual funds. The mainstay of the money market is the inter-bank call money market where short-term money borrowing/lending is carried out to manage temporary liquidity mismatches.

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Capital Market

The capital market provides long-term funds for corporates, central and state governments. The capital market has sub-markets like debt market, equity market and derivative market.

- Fixed income securities of various types and features are issued and traded in the debt market. Debt markets are therefore markets for fixed income securities issued by Central and state governments, municipal corporations, government bodies and commercial entities like financial institutions, banks, public sector undertakings, public limited companies and structured finance instruments.
- In the equity market, variable income securities like equity shares are issued and traded. Equity shares are issued by the companies and financial institutions.
- In the derivative market, financial products and commodity based derivatives like options and futures are traded. Commodity options and futures on precious metals, oil and agricultural products are traded on the commodity exchanges. Financial product derivatives like stock options and futures, stock index futures and options, and interest rate futures are traded on the stock exchanges.

Equity and debt instruments are issued in the primary market. The primary market is also known as new issue market. An already listed company or unlisted company can make a fresh issue of securities to the public. The primary market has no physical location. A host of intermediaries like lead manager, registrar, underwriter, custodian and depository are involved in the primary market. SEBI regulates the new issue market. Under SEBI guidelines, no company shall make a public issue or right issue of debt instruments (whether convertible or not) unless credit rating is obtained from at least one credit rating agency registered with SEBI. The issuer also has to prominently display the ratings in all the marketing literature and advertisements related to the particular debt instrument. The issued securities are listed in the stock exchanges.

Stock exchanges are the backbone of both the equity and debt markets. The issued securities are listed in the stock exchanges. The secondary market provides a trading place to buy and sell the securities already issued. It also provides liquidity to the initial buyers in the primary market to re-offer the securities to any interested buyer at any price, if mutually accepted. An active secondary market promotes the growth of primary market and capital formation because investors in the primary market are assured of a continuous market and can liquidate their investments. The secondary market consists of 23 stock exchanges including the

National Stock Exchange (NSE), Over-the-Counter Exchange of India (OTCEI) and Inter Connected Stock Exchange of India Ltd. (ISE).

Foreign Exchange Market

The foreign exchange market is the market for foreign currencies. Foreign currency transactions take place in the case of exports, imports, capital movement, interest and repayment of loans. In the foreign exchange market, central-banking institutions, commercial banks and merchant bankers act as dealers under the control of RBI and Foreign Exchange Dealers Association of India (FEDAI). Star hotels, travelling agencies, individuals and institutions are permitted to act as money changers under the provisions of RBI and FEDAI.

Features of Efficient Financial Market

An efficient financial market leads the economy towards efficient use of factors and allocation of factors for socially productive purposes. An efficient financial market has the following features.

- *Operational efficiency:* Efficient market structure and their linkages minimize the administrative and transaction costs of transfer of funds.
- *Information efficiency:* All the available information is absorbed by the prices of securities. The quickness with which the prices reflect all the relevant information indicates the information efficiency. The probability of getting an abnormal profit is much limited in a perfect market.
- *Valuation efficiency:* In an efficient market, the market price of the security should be equal to its intrinsic value. The true economic worth of the asset is its intrinsic value. In a perfectly competitive market, the price of an asset reflects its intrinsic value.
- *Hedging efficiency:* Efficient market provides hedging facilities to reduce risk. Hedging lowers the risk of incurring loss. Options and futures markets provide hedging facilities.

3.2.1 Global Integration of Financial Market

Global integration of financial markets is a phenomenon in which financial markets in neighbouring, regional and/or global economies are closely connected together. Different forms of actual financial integration encompass: Information sharing among financial institutions; sharing of best practices among financial institutions; sharing of cutting edge technologies (through licensing) among financial institutions; firms borrow and raise funds directly in the international capital markets; investors directly invest in the international capital markets; newly engineered financial products are domestically innovated and originated then sold and bought in the international capital markets; and so on.

In integrated financial markets, domestic investors can buy foreign assets and foreign investors can buy domestic assets. Among nations that are fully integrated into the global financial markets, assets with identical risk should command the same expected return, regardless of location.

Check Your Progress

1. What is the main function of the financial market?
2. What is global integration of financial markets?

NOTES

3.3 FINANCE COMPANIES

A finance company is an institution that is engaged in such specialized forms of financing as purchasing accounts receivable, extending credit to retailers and manufacturers, discounting instalment contracts, and granting loans with goods as security. There are two types of finance companies: banks and non-banking financial institutions. Let us study these in detail.

3.3.1 Banks and Non-Banking Financial Companies

The institutions in the financial markets such as commercial banks and non-bank intermediaries undertake the important process of financial intermediation whereby the funds or savings of the surplus sectors are channelled to deficit sectors. The financial institutions channel the funds of surplus economic units to those wanting to spend on real capital investment. Funds are transferred through the creation of financial liabilities such as bonds and equity shares. It was estimated by the Prime Directory that in 1996-97 there were 20,158 financial intermediaries. Among the financial institutions, commercial banks account for more than 64 per cent of the total financial sector assets.

Financial intermediation can enhance growth by pooling funds of the small and scattered savers and allocating them for investment in an efficient manner by using their informational advantage in the loan market. They are the principal mobilizers of surplus funds to finance productive activity and to the extent that they promote capital accumulation, they promote growth.

Brokerage and Asset Transformation

Intermediary services are of two kinds: brokerage function and asset transformation activity. Brokerage function is represented by the activities of brokers and market operators; processing and supplying information is a part and parcel of all intermediation by all institutions. Brokerage function brings together lenders and borrowers and reduces market imperfections such as search, information and transaction costs. The asset transformation activity is provided by institutions issuing claims against themselves which differ from the assets they acquire. Mutual funds, insurance companies, banks and depository institutions undertake size transformation by providing many depositors with a share of a large asset or issuing debt type liabilities against equity type assets. While providing asset transformation, financial firms differ in the nature of transformation undertaken and in the nature of protection or guarantees which are offered. Banks and depository institutions offer liquidity, insurance against contingent losses to assets and mutual funds against loss in value of assets.

Through their intermediary activities, banks provide a package of information and risk-sharing services to their customers. While doing so, they take on part of their risk. Banks have to manage the risks through appropriate structuring of their activities and hedge risks through derivative contracts to maximize their profitability.

Financial institutions provide three transformation services. Firstly, liability, asset and size transformation, consisting of mobilization of funds and their allocation (provision of large loans on the basis of numerous small deposits). Secondly, maturity transformation, by offering the savers a relatively short-term claim or liquid deposit they prefer and providing borrowers long-term loans which are better matched to the cash flows generated by their investment. Finally, risk transformation by transforming and reducing the risk involved in direct lending by acquiring more diversified portfolios than individual savers can. The expansion of the financial network or an increase in financial intermediation as denoted by the ratio of financial assets of all kinds to gross national product accompanies growth. To a certain extent, growth of savings is facilitated by the increase in the range of financial instruments and expansion of markets.

Advantages of Financial Institutions

Benefits provided by financial intermediaries consist of reduction of information and transaction costs, grant of long-term loans, provision of liquid claims and pool risks. Financial intermediaries economize costs of borrowers and lenders. Banks are set up to mobilize savings of many small depositors which are insured. While lending, the bank makes a single expert investigation of the credit standing of the borrower's savings or several investigations of amateurs.

Financial intermediaries make it possible for borrowers to obtain long-term loans even though the ultimate lenders are making only short-term loans. Borrowers who wish to acquire fixed assets do not want to finance them with short-term loans. Although a bank has used depositors' funds to make long-term loans, it still promises its depositors that the latter may withdraw the deposits at any time on the assumption that the law of large numbers will hold. Bank deposits are highly liquid and one can withdraw the deposit any time, though on certain kinds of deposits the interest previously earned on it has to be foregone. Finally, banks, by pooling the funds of depositors can reduce the riskness of lending. Indirect finance reduces the information and transaction costs of lenders and borrowers, renders the deposits liquid and reduces the risk of lending.

The ability of the financial intermediaries to ensure the most efficient transformation of mobilized funds into real capital has not, however, received the attention it deserves. Institutional mechanisms to the ensure end use of funds have not been efficient in their functioning, leaving the investor unprotected. Efficient financial intermediation involves reduction of the transaction cost of transferring funds from original savers to financial investors. The total cost of intermediation is influenced by financial layering which makes the individual institution's costs additive in the total cost of intermediating between savers and ultimate borrowers. The aggregate cost of financial intermediation from the original saver to the ultimate investor is much higher in developing countries than in developed countries.

Financial services contributed 13 per cent of GDP (2007) as compared to 3.7 per cent before liberalization in the late 1980s. Theories of endogenous growth have established firm linkages between financial intermediation and economic growth.

Check Your Progress

3. Define the term 'finance company'.
4. What are the two types of finance companies?

3.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Transferring of funds from the surplus sector to the deficit sector is the main function of the financial market.
2. Global integration of financial markets is a phenomenon in which financial markets in neighbouring, regional and/or global economies are closely connected together.
3. A finance company is an institution that is engaged in such specialized forms of financing as purchasing accounts receivable, extending credit to retailers and manufacturers, discounting instalment contracts, and granting loans with goods as security.
4. There are two types of finance companies: banks and non-banking financial institutions.

3.5 SUMMARY

- The market participants in financial markets are investors or buyers of securities, borrowers or sellers of securities, intermediaries and regulatory bodies.
- Securities are financial instruments that represent the holder's claim on a stream of income or a fixed amount from a corporate or government.
- Monetary assets, which are short term in nature and less than one year are traded in the money market. Money market facilitates RBI's conduct of monetary policy.

- Equity and debt instruments are issued in the primary market. The primary market is also known as new issue market.
- Stock exchanges are the backbone of both the equity and debt markets. The issued securities are listed in the stock exchanges.
- The foreign exchange market is the market for foreign currencies. Foreign currency transactions take place in the case of exports, imports, capital movement, interest and repayment of loans.
- Global integration of financial markets is a phenomenon in which financial markets in neighbouring, regional and/or global economies are closely connected together.
- In integrated financial markets, domestic investors can buy foreign assets and foreign investors can buy domestic assets.
- A finance company is an institution that is engaged in such specialized forms of financing as purchasing accounts receivable, extending credit to retailers and manufacturers, discounting instalment contracts, and granting loans with goods as security.
- The institutions in the financial markets such as commercial banks and non-bank intermediaries undertake the important process of financial intermediation whereby the funds or savings of the surplus sectors are channelled to deficit sectors.
- Intermediary services are of two kinds: brokerage function and asset transformation activity.
- Benefits provided by financial intermediaries consist of reduction of information and transaction costs, grant of long-term loans, provision of liquid claims and pool risks.
- The ability of the financial intermediaries to ensure the most efficient transformation of mobilized funds into real capital has not, however, received the attention it deserves.

3.6 KEY WORDS

- **Money Market:** Money market basically refers to a section of the financial market where financial instruments with high liquidity and short-term maturities are traded.
- **Capital Market:** A capital market is a financial market in which long-term debt or equity-backed securities are bought and sold.
- **Forex Market:** The forex market is the market in which participants can buy, sell, exchange, and speculate on currencies.

3.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

NOTES

Short Answer Questions

1. What are the various money market instruments?
2. Identify the components of financial market.
3. Write a short note on brokerage function.
4. Mention the various advantages of financial institutions.

Long Answer Questions

1. Explain the development of financial markets
2. Describe the global integration of financial market
3. Discuss about the banks and non-banking financial companies
4. "Financial institutions provide three transformation services." Discuss these services.

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UNIT 4 SECONDARY MARKET

NOTES

Structure

4.0 Introduction
4.1 Objectives
4.2 Stock Exchanges: Role of Secondary Markets
4.2.1 Listing of Securities
4.3 Trading in a Stock Exchange
4.4 Role of SEBI and Regulation of Stock Exchanges
4.4.1 Secondary Market and SEBI
4.4.2 Insider Trading
4.5 Speculative Transactions in Stock Exchanges
4.5.1 Types of Speculators
4.6 Answers to Check Your Progress Questions
4.7 Summary
4.8 Key Words
4.9 Self Assessment Questions and Exercises
4.10 Further Readings

4.0 INTRODUCTION

The ‘secondary market’ (also known as ‘aftermarket’) stands for the financial market in which the formerly issued financial instruments like bonds, stock, options and futures are purchased and sold. It also refers to the loans which are sold by a mortgage bank. A newly issued IPO is counted as a primary market trade when the shares are first bought by the investors straightway from the underwriting investment bank. Subsequently, any share traded belongs to the domain of secondary market, i.e., between the investors themselves. Generally, the prices are set beforehand in the primary market; whereas in the secondary market the basic forces such as supply and demand decide the price of the security. The unit will provide an overview of the whole scenario related to the stock markets in India. You will learn the various trading mechanisms, classification of shares and various kinds of transactions in the Indian secondary market.

4.1 OBJECTIVES

After going through this unit, you will be able to:

- Explain the role and functions of stock exchanges
- Examine the SEBI regulations with regard to secondary market
- Describe speculative transactions in stock exchanges

4.2 STOCK EXCHANGES: ROLE AND FUNCTIONS

NOTES

Stock Exchange is a place where individuals, corporates and Foreign Institutional Investors (FIIs) purchase and sell stock. In India, the Bombay Stock Exchange, which was established in 1875, is the oldest one. There are many other stock exchanges in India, like the Calcutta Stock Exchange, the Delhi Stock Exchange and the National Stock Exchange.

History of Stock Exchanges in India

The origin of the stock exchanges in India can be traced back to the latter half of the 19th century. After the American Civil War (1860–61) due to the share mania of the public, the number of brokers dealing in shares increased. In 1875, brokers organized an informal association in Mumbai called The Native Stock and Share Brokers Association.

Increased activity in trade and commerce during the First and Second World Wars resulted in an increase in stock trading. Stock exchanges were established in different cities such as Chennai, Delhi, Nagpur, Kanpur, Hyderabad and Bangalore. The growth of stock exchanges suffered a setback after the end of World War. Their growth was affected by Worldwide depression. Most of the stock exchanges in the early stages had a speculative nature of working without technical strength. Securities and Contract Regulation Act, 1956, gave powers to the central government to regulate the stock exchanges. The stock exchanges in Mumbai, Calcutta, Chennai, Ahmedabad, Delhi, Hyderabad and Indore were recognised by the SCR Act. The Bangalore Stock Exchange was recognised only in 1963. At present we have 23 stock exchanges and 21 of them have hardware and software compliant to solve the Y2K problem.

Till recently, floor trading took place in all the stock exchanges. In the floor trading system, trade takes place through an open outcry system during the official trading hours. Trading posts are assigned for different securities where buy and sell activities of securities took place. This system needs a face to face contact among the traders and restricts the trading volume. The speed of the new information reflected on the prices was rather slow. The deals were also not transparent and the system favoured the brokers rather than the investors.

The setting up of NSE and OTCEI with the screen-based trading facility resulted in more and more stock exchanges turning towards computer-based trading. Bombay Stock Exchange introduced the screen-based trading system in 1995, which is known as BOLT (Bombay Online Trading System).

Madras Stock Exchange introduced Automated Network Trading System (MANTRA) on 7 October 1996. Apart from Bombay Stock Exchange, Vadodara, Delhi, Pune, Bangalore, Calcutta and Ahmadabad stock exchanges too have introduced screen-based trading. Other exchanges are also planning to shift to too screen-based trading. Table 4.1 gives the turnover and market share of the various stock exchanges.

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Table 4.1 *The Turnover of Stock Exchanges in India*

	Total Turnover 2001–02 (₹ crore)	***Total Turnover 2001–03 (₹ crore)***	***Percentage Variation***
Ahmedabad	14,843.54	15,458.864	4.1
BSE	307,392.3	314,073.2	2.2
Bangalore	70.2	0.0	Na
Bhubaneswar	0.0	0.0	Na
Kolkata	27,074.7	6,539.9	– 75.8
Kochi	26.6	0.0	Na
Coimbatore	0.0	0.0	Na
Delhi	5,828.0	11.1	– 99.8
Guwahati	0.0	0.05	Na
Hyderabad	41.2	4.6	– 88.8
ICSE	55.3	64.8	17.2
Jaipur	0.0	0.0	Na
Ludhiana	856.6	0.0	– 100.0
Chennai	24.1	0.0	– 100.0
Magadh	0.0	0.51	Na
Mangalore	0.0	0.0	Na
MPSE	15.9	0.0	– 100.0
NSE	513,166.9	617,988.6	20.4
OTCEI	3.7	0.1	– 97.3
Pune	1,171.0	1.81	– 99.8
SKSE	0.0	0.0	Na
UPSE	25,237.3	14,763.4	– 41.5
Vadodara	10.1	2.59	– 74.3
Total		**895,817.4**	**968,907.6**

Source: SEBI, *Annual Report 2002–03*.
Note: Na = Not applicable.

Role and Function of Stock Exchanges

The stock exchanges provide an organized marketplace for the investors to buy and sell securities freely. The market for these securities is an almost perfectly competitive one because a large number of sellers and buyers participate. The shares listed, however vary broadly in terms of credit rating and often involve carrying cost. The shares, however, are not really homogeneous like a commodity in a perfectly competitive market. The stock exchanges provide an auction market in which members of the stock exchange participate to ensure continuity of price and liquidity to investors.

The active bidding and the resulting two way auction trading ensure that the bargains struck are the fairest, predetermined by the basic laws of supply and demand.

The efficient functioning of the stock exchange creates a conducive climate for an active and growing primary market for new issues. An active and healthy secondary market in existing securities leads to a better psychology of expectations;

considerable broadening of investment enquiries renders the task of raising resources by entrepreneurs easier. Good performance and outlook for equities in the stock exchanges imparts buoyancy to the new issue market.

NOTES

Continuous Market

As seen earlier, the basic function of a stock market is the creation of a continuous market where securities are bought and sold in volume with little variation in the current market price as trades succeed one another. A continuous market provides liquidity through the sale or purchase of securities quickly and easily, at a price that varies little from the previous selling price. The indicators of a continuous market are as follows:

(i) Frequency of sales

(ii) Narrow spread between bids and offers

(iii) Prompt execution of orders

(iv) Minimum price changes between transactions as they occur

The benefits of a continuous market are that, it creates marketable liquid investments and facilitates collateral lending. Listed shares are good collateral for secured loans although the margin is as high as 50 per cent (which used to be 75 per cent before 1993).

Frequency of Sales

The primary criterion for a good market is whether investors can sell their portfolio-holding quickly with minimal price fluctuation at the time of sale. Liquidity occupies a central place in evaluating the efficiency of an exchange.

The characteristics of a liquid market are depth, breadth and resiliency. A market has depth if the buy and sell orders are forthcoming around the price at which the share is transacting. A market that lacks depth is shallow. The adequate volume of the orders gives breadth to the market, in the absence of which the markets are termed thin. Further, the response of the orders to price changes renders the market resilient.

Empirical Measurement of Liquidity

Empirically, liquidity is measured by the number of days a company's share is traded, out of the number of days in the year when the market is open. Normally a share is considered actively traded and liquid if it is traded on 50 per cent of the days when the market is open. On the Bombay Stock Exchange only 27.56 per cent of the shares of companies listed were traded for more than 100 days (which more or less conforms in 1999–2000). In March 2000 of the total listed companies of 8027 only 41 per cent were traded. Liquidity of the market is also measured by the variation of price from one trade to another. If the difference between the lowest asked (or offered) price and the highest bid-price is wide, the market is said to lack depth and considered shallow. Actually, the bid-asked spread is an inverse measure of liquidity. For example, in the United States, variation of one-eighth point in the price from the immediate preceding trade is considered liquid. In our own country the minimum tick starts from ‘ 0.25. BSE defines ‘Tick’ as the minimum difference in rates between two orders on the same side, i.e., buy or sell entered on the system for a scrip. Trading in scrips listed on BSE is done with the tick size of 5 paise. It is 1 paise, in case of mutual funds and others to encourage orders at finer rates and improve liquidity.

Fair Price Determination

The prices in the stock market are determined by the interplay of the forces of supply and demand. As seen earlier, active bidding and a two-way auction trading takes place in the stock exchange. The result is as near a market for free trading and free competition as can be found anywhere. The bargains that are struck are at the fairest price, determined by the basic laws of supply and demand.

The functioning of the market has been subject at times to manipulation. The year 1991–92 witnessed large scale bull runs, to push up prices and create artificial value. On the other hand, the prices in the market were at times pushed down by bear raiders without regard to their fundamental values. Manipulation cannot, of course, occur if the exchanges are alert. In the long-run interests of the securities market, such price manipulations should be discouraged.

The performance of the stock exchange is also subject to speculation which at times drives up the prices above the investment worth, and at others below it. The stock market prices were dormant for considerable stretches of time, especially prior to 1987. But since 1988–89 they have been above their investment worth with some of the shares selling at 50–70 times their earnings in 1991.

There is no obvious relationship between book value/par value and market value in the matter of many shares. The massive flow of funds into the stock market, from individual investors (some of whom disinvesting from contract business, transport and other retail trades) and the mutual funds, without any corresponding increase in the supply of scrips led to the surge in demand for shares in the years 1990–91 and 1991–92. This in turn pushed up the price. This massive flow of funds into the stock market, no doubt motivated by the prospect of capital gains, resulted in a typical situation of too much money chasing too few scrips. Obviously there were not enough shares to absorb the demand.

Under normal circumstances, one would leave the situation to the forces of the market. What the buyers and the sellers are willing to bid and to offer? But in India, a conscious policy is adapted to make shares attractive to the foreign institutional investors who evaluate our market in relation to other emerging markets. The stabilization of the stock market prices around a reasonable level (for PE Ratios to be at mid teens) would be desirable.

Aid to Financing Industries

Listed companies find it helpful to sell further issues of their shares in the primary market based on the good performance of their earlier ones. An active market and a good market price for the company's shares (reflecting the past performance and future prospects) makes the task of raising funds through further issues easier. Rights themselves have an immediate and a wide market in the stock exchanges, provided the price including the premium reflects a fair value. Thus stock exchanges enable a company to market further issues successfully by creating a continuous market for the rights.

Other Functions

The market prices established in stock exchange trading are useful for tax purposes. The stipulation on disclosures and transparency ensure that the investors have access to information on the listed companies, particularly with regard to their financial conditions. This serve to protect the investor's interests by eliminating the dishonest and irregular practices rampant in the brokerage trade.

4.2.1 Listing of Securities

Listing means admission of securities to dealings on a recognized stock exchange. The securities may be of any public limited company, Central or State Government, quasi-governmental and other financial institutions/corporations, municipalities, etc.

In India, a company, desirous of listing its securities on the Stock Exchange, is required to file an application, in the prescribed form, with the Exchange before issue of Prospectus by the company, where the securities are issued by way of a prospectus or before issue of 'Offer for Sale', where the securities are issued by way of an offer for sale. The company is responsible to follow all the requirements specified in the Companies Act, the listing norms issued by SEBI from time to time and such other conditions, requirements and norms that may be in force from time to time and included in the Bye-laws and Regulations to make the security eligible to be listed and for continuous listing on the Exchange.

Listing Conditions

The following are the conditions required to list securities on the stock exchange:

- The Governing Board or Managing Director or Relevant Authority may not grant admission to dealings on the Exchange to a security of an issuer unless the issuer complies with the listing conditions, requirements and norms, under the SCRA, SCRR, the Companies Act, the Rules, Bye-laws and Regulations of the Exchange and the norms, as may be prescribed by the Exchange and/or SEBI from time to time.
- The Governing Board or Managing Director or Relevant Authority should ensure that no listing or trading permission is granted unless the issuer complies with all the conditions, requirements or norms, as may be provided

in the relevant Regulations from time to time, including despatch of physical share certificates to, and/or credit of demat shares to the accounts of all the security-holders, maintained with the depositories.

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- Where the Exchange is the stock exchange with whose consultation the basis of allotment is decided, the Governing Board or Managing Director or Relevant Authority of the said stock exchange should intimate the depositories about approval granted for admission to dealings on the Exchange for any security.
- The company should execute a Listing Agreement, in the prescribed form with the Exchange, prior to approval of the listing application of the company. Any addition or amendment to the provisions of the Listing Agreement, as may be prescribed by SEBI and/or the Exchange becomes applicable to the company as if such addition or amendment was part of the Listing Agreement.
- In the case of a new issue or further issue by any issuer the Governing Board or Managing Director or Relevant Authority may grant permission for trading in any security at the Exchange on the same day as on all other stock exchanges where such security admitted to dealings is granted permission for trading.

Check Your Progress

1. Which Act gave powers to the central government to regulate the stock exchanges in India?
2. Name the screen-based trading system of Bombay Stock Exchange introduced in 1995.
3. List the indicators of a continuous market.
4. Define listing in stock exchange.

4.3 TRADING IN A STOCK EXCHANGE

Trading in stock exchanges takes place either on the basis of the auction system on a trading floor (which is order-driven or customer-driven) or a broker-dealer market (which is quote-driven or dealer-driven). Every one of the worlds stock markets uses one of the two trading systems or a hybrid of both.

In an order-driven system, customers buy and sell orders, reach a central point where they are matched. In a quote-driven system dealers compete to give the customers the best price. Electronic trading simply carries out the same functions, automatically; in the order-driven markets it matches the buyer and the seller and in quote-driven ones it finds the customer the best price available.

The New York Stock Exchange (NYSE) is an order-driven auction market while the National Association of Security Dealers Automated Quotation System (NASDAQ)—a computerized network which serves over the counter—is quote-driven or dealer-driven. Here we have order-driven auction markets in general, at all the major stock exchanges except Bombay. Bombay has a hybrid market auction system which is, however, quote-driven.

The Auction Market

The auction system is based on a current high bid, low offer and those not meeting either of the prices may not participate in the auction. This system allows the buyer and the seller to find a mutually agreeable price, with no intervention from the broker-dealers. The buy and sell orders are automatically matched and in case of any imbalances, the specialists fill in. The specialist is a single designated market maker who stands in the market at all times. In a continuous auction market where brokers trade with each other, the specialists act as combination auctioneer-dealers and ensure greater liquidity in the market. Being more transparent, the auction market offers greater protection to the actual investors and when combined with monopoly specialists, is definitely more efficient. 90 per cent of the trading in the NYSE is performed via the auction market.

The Broker-Dealer Market

On the other hand, the broker-dealer market—such as the over-the-counter market—is a negotiated market. Dealers who buy and sell a particular security regularly make a market in that security not unlike the specialists on NYSE. There are no restrictions limiting the number of market makers in a given share. Competing market makers are obliged to quote prices through the system. Market makers offering the best price are assigned orders on a rotating basis. The dealers negotiate with one another and arrive at the best price. They form the two sides of the market (the bid–the offer) by quoting a price they would pay a prospective seller (bid) or a price they would charge a prospective buyer (an offer or the asking price). The market makers for most of the active shares transmit their quotations electronically. Screens display the best market for an order. The competitively negotiated bid and asked prices are thus determined by the 500 odd market makers. While the auction market depends on the specialists, the broker-dealer market depends on the market makers for effective functioning.

The specialists: The New York Stock Exchange has about 90 specialist firms who are members of the exchange and act as brokers/dealers in shares. The specialists on the floor of exchange who belong to any one of the specialist firms, have a dual function to perform—to represent the customers and to trade on their own account. They buy and sell shares of one or more companies and help in maintaining a free and continuous market in the shares of companies for which they act as specialists.

The specialists are expected to maintain a fair and orderly market for the securities. In their capacity as brokers, they execute orders on behalf of other brokers on a commission and as dealers they trade on their own accounts, profits and risks. They buy from the public when other public bids for purchase are not available, and execute the market orders in the absence of other public offers to sell at or near the last price prior to their order. Their customers are the other members of the exchange. As specialists they do not transact business directly with the public.

The common functions the specialists perform are the following:

- They make a continuous market in shares assigned to them. They are expected to provide the two-sided market, by quoting a bid indicating the price at which they will purchase shares from a seller and an offer or the asking price at which they will sell the shares to a buyer.
- They act as brokers when they accept orders for execution from other members of the exchange.
- They provide a conduit of information electronically quoting and recording current bid and asked-prices for the shares of companies assigned to them. This disseminates information about the prices, the supply and the demand position for any share listed on NYSE.
- They act as dealers and trade on their own accounts when faced with a liquidity imbalance in the market. Specialists have to carry 4000 shares of each company. Most orders left with them are either limit or stop orders which are too far from the current market level.

Market makers: When a dealer creates and maintains a market in a security he is said to 'make a market'. To maintain a market in a security the dealer should be willing at all times, to buy or sell that particular security (usually on his own account, at his own risk and at prices equivalent to the security's trading unit). The dealer's quotations consist of his bid and asked (or offer) prices. The price a dealer will pay for a given security is his bid and the price at which he will sell a given security is his offer. The difference between bid and asked prices in any quotation is the spread.

The market makers who are obliged to offer a continuous two-way market in all their registered securities display the quotes on NASDAQ terminals. They are also obliged to execute trades at their displayed price and size. There is an average of 11 market makers for each listed security although for the more active shares, this figure can sometimes be as high as 40 and as low as two for the lesser-traded issues. NASDAQ has 500 market makers. Transactions are reported within 90 seconds of execution. A dealer may take a position in a security by buying for inventory (long position) or by selling securities that he has not yet purchased. A quotation, at all times must include both sides of the market even though one side may be non-existent.

NOTES

The broker-dealer: The broker-dealer registered with SEC (USA) may buy and sell securities on his own account/risk, or as an agent, trade on behalf of others. A broker-dealer can also handle purchase orders and perform the following functions:

- If he makes a market in a particular share a customer wants to buy, he can sell it out of his inventory.
- When he gets the order for a share (in which he does not make a market) he can act as an agent and buy the same from another market maker or from someone else who owns the securities.
- He can buy shares on his own account and resell them.

The main advantages of the broker-dealer markets are the following:

(i) The market makers are instantly provided with bid and ask quotations in a particular share, as well as the representative bid and asked quotations on 3000 different shares.

(ii) Investors can be assured of the best possible execution of their orders as the traders check with all the market makers concerned.

(iii) Traders can gauge market quickly.

(iv) Competition is stimulated.

(v) Issuing companies stay on and do not move to the floor stock exchanges as soon as they qualify.

(vi) The public has easy access to the information on the volume, the indexes of OTC shares and individual trades.

4.4 ROLE OF SEBI AND REGULATION OF STOCK EXCHANGES

The Securities Contracts Regulation Act, 1956 provides inter alia for the following:

- The recognition of stock exchanges and regulation of their functioning
- The licensing of dealers
- The recognition of contracts
- The control of speculation
- The restriction of the rights of equitable holders of shares
- Empowering the government to compel any public limited company to get its shares listed.

Under the Securities Contracts (Regulation) Act, the government has promulgated the Securities Contracts (Rules, 1957) for carrying into effect the objects of the legislation. The rules are statutory and constitute a code of standardized regulations applicable to all recognized exchanges.

The Securities and Exchange Board of India Act 1992 provides for the establishment of the Securities and Exchange Board of India (SEBI) to protect the investors' interest in securities and to promote and regulate the securities market.

Securities Contracts (Regulation) Act (SC (R)A) 1956

(i) SC(R)A permits the functioning of only those stock exchanges which have been recognized by the Union Government in any notified state or area. The Act vests the Government with wide powers of supervision and control. Recognition is accorded only if the government is satisfied that the rules and by-laws of the stock exchange conform with the conditions prescribed for ensuring fair dealings and protection of investors. Further, the government has to be satisfied that such recognition is in the interests of the public and the trade.

SEBI decided on 10 December 1996 that recognition to new stock exchanges, if considered necessary in the interest of the public and of the trade could be allowed. But the trading is to be only on-line screen-based and the establishment of the clearing house will follow within 6 months.

(ii) The rules and by-laws of the stock exchange have to be first approved by the government. In the interest of ensuring uniformity, the government insists that the exchanges seeking recognition should conform to the model rules and by-laws. The rules of the recognized stock exchanges that necessitate government approval relates to:

- The constitution of the exchange
- The constitution and composition of the general body
- The powers of management of the governing body
- The admission of members
- The qualification for members
- The expulsion, suspension and readmission of members
- The registration of partnership
- The appointment of authorized representatives and clerks

Changes in rules can be affected only with the consent of the government. Any changes in the control of contracts in securities or any other aspect of the trading activities has to be first sanctioned by the government. The government on its own (suo moto) can make or amend any rules or by-laws of a recognized stock exchange, if it is in the interests of the trade and the public.

(iii) The SC(R)A confers on the government drastic powers to:

- Make inquiries into the affairs of a recognized stock exchange and its members

- To supersede the governing body and takeover the properties of a recognized stock exchange
- To suspend its business and withdraw recognition in the interest of the trade and the public

Where there are no stock exchanges, SC(R)A empowers the government to license dealers in securities and prescribe the conditions subject to which they deal in securities.

(iv) Under the SC(R)A, only contracts entered into through, with or between members of recognized stock exchanges are legal. The Act also empowers the government to control speculation, to declare sale or purchase of specified securities in any notified area or state except to the extent and in the manner prescribed. Forward trading in shares was declared illegal in 1969; and trading in options in securities have since been allowed.

(v) The Act also imposes restrictions on the right of equitable shareholders to recover dividends from the registered shareholders and confers powers on the government to compel any public limited company to get its shares listed on a recognized stock exchange.

Securities Contracts (Regulation) Rules 1957

To carry into effect the objects of SC(R) Act the Securities Contracts (Regulation) Rules were promulgated. The rules provide inter alia for:

- The procedures to be followed for the recognition of stock exchanges
- The Submission of periodical returns and annual returns by recognized stock exchanges
- Inquiry into the affairs of recognized stock exchanges and their members
- The Requirements for listing of securities

Recognition of stock exchange: The submission of the application under Section 3 of the SC(R) Act along with a fee of ₹ 500 is the first step for a stock exchange seeking recognition. The application should be accompanied by four copies of rules including the Memorandum and Articles of Association where the applicant stock exchange is an incorporated body and by-laws. The government may make enquiries and if required ask for further clarifications. The recognition is subject to the stock exchange complying with the conditions imposed under SC(R) Act and rules from time to time. Application for renewal should be made three months before the expiry date along with a fee of ₹ 200.

Books of account and other documents to be maintained by stock exchanges: Every stock exchange should maintain and preserve the following books of account and documents for a period of five years:

(i) Minute books of the meetings of

(a) members

   - (b) governing body
   - (c) any standing committee of the governing body or general body of members
- (ii) Register of members
- (iii) Register of authorized clerks
- (iv) Register of authorized assistants
- (v) Record of security deposits
- (vi) Margin deposits books
- (vii) Ledgers
- (viii) Journals
- (ix) Cash book
- (x) Bank passbooks

Submission of Returns

- (i) Every recognized stock exchange has to furnish the Central Government/ SEBI annually with a report about its activities during the preceding year which shall inter alia contain detailed information about the following matters:
   - (a) Changes in rules and by-laws, if any
   - (b) Change in the composition of governing body
   - (c) Any new committee set up and changes in the composition of the existing one
   - (d) Admissions, readmissions, deaths or resignation of members
   - (e) Disciplinary action against members
   - (f) Nature and number of disputes for arbitration between members and non-members
   - (g) Defaults
   - (h) Action taken to combat any emergency in trade
   - (i) Securities listed and delisted
   - (j) Securities brought or removed from the forward list
- (ii) Furnish audited balance sheet and profit and loss account for the preceding year.

Submission of periodical returns: Periodical returns have to be submitted by the stock exchange to Central Government/SEBI relating to the following:

- The official rates for the securities listed thereon
- The number of shares delivered through the clearing house
- The making up prices
- The clearing house programmes

- The number of securities listed and delisted during the previous three months
- The number of securities brought on or removed from the forward list during the previous three months
- Any other matter as may be specified by the Central Government/SEBI

Inquiry into the affairs of stock exchanges or members: The Central Government/SEBI can appoint two or more persons to enquire into the affairs of the governing body of a recognized stock exchange or any of its member. The inquiring authority hands over a statement of issues to the governing body/member who is then given adequate opportunity to state their case. The inquiring body has to submit its report to the Central Government/SEBI.

4.4.1 Secondary Market and SEBI

SEBI has introduced a wide range of reforms in the secondary market. The following critical areas are explained below:

- Demutualization and corporatization
- Infrastructure
- Settlement and clearing
- Block deals
- Debt market
- Price stabilization
- Delisting
- Brokers
- Insider trading

Demutualization and Corporatization of Stock Exchanges

Demutualization refers to the segregation of ownership, management and trading rights in a stock exchange for effective governance. Corporatization refers to the process of converting the organizational structure of the stock exchange from a non-corporate to a corporate one. Exchanges like BSE, the Ahmedabad Stock Exchange (ASE), and the Madhya Pradesh Stock Exchange (MPSE) were established as an 'association of persons'. It is a step in the process of converting these exchanges into incorporated companies. SEBI has announced new regulations to increase the public shareholding of the stock exchanges. According to the new regulation, at least 51 per cent of the shares have to be held by the public. The increase in public shareholding can be carried out through a fresh issue of new shares. The issue of shares should be as per the provisions of the Contract Regulation Act and SEBI (disclosure and investor protection) Guidelines 2000. The regulations of 2006 stated that no person shall directly or indirectly hold more than 5 per cent of the paid-up equity of the stock exchanges. Further, SEBI has made it mandatory for the exchanges to submit a quarterly report of their 10 large shareholders along with the number of shares held by them. In the event of any violation of the regulations, SEBI can levy financial penalties or initiate legal proceedings. As per SEBI's directives, the stock exchanges were demutualized.

Infrastructure

To make trading on the stock exchange more sophisticated, the National Stock Exchange (NSE) was established with screen-based trading. SEBI has also allowed the stock exchanges to expand their online screen-based trading terminals to locations outside their jurisdiction subject to certain criteria. SEBI decided that recognition to the new stock exchanges will be allowed subject to the conditions of online screen-based trading for trading purposes.

Settlement and Clearing

All trades on stock exchanges must be settled through recognized clearing corporations with a minimum net worth of ₹ 100 crore and provide a counter-party guarantee for settlement. Besides, clearing members and trading members of its constituent exchanges together should not hold more than 49 per cent of the equity in such entities. The clearing corporation should maintain a settlement guarantee fund to bear any residual risk in the settlement process.

The NSE and BSE have different clearing agencies to settle trades executed on their exchanges. The Bank of India (BOI) Shareholding clears and settles trade activities on the BSE. It is a subsidiary company of the BSE and Bank of India. It is also known as a clearing house. The National Securities Clearing Corporation Ltd (NSCCL) clears and settles activities of the NSE. NSCCL is a fully-owned subsidiary of the NSE. SEBI introduced rolling settlement for trading in the demat segment for all companies with effect from 15 January 1998 with T+5 day. It has gradually been reduced to T+2 day.

Block Deals

A block deal is a trade with a minimum quantity of 5 lakh shares or a minimum value of ‘5 crore, executed through a single transaction. It is executed through a separate window of the stock exchange. As per SEBI regulations, stockbrokers are required to make a disclosure on a daily basis through the Data Upload Software (DUS) regarding block deals. The following points about block deals should be noted:

- A separate trading window is kept open for a limited period of 35 minutes from the beginning of trading hours.
- Orders should be placed at a price not exceeding +1 per cent or -1 per cent from the ruling market price or the previous day's closing.
- Every trade executed must result in delivery and should not be squared off or reversed.
- Stock exchanges should disseminate information on block deals to the public on the same day after market hours. This should contain information such

as the name of the scrip, name of the client, quantity of shares, traded price and so on.

Debt Market Segment

The wholesale debt market segment in the NSE enables traders to trade in debt instruments. To expedite settlement, the SEBI (Depository and Participants) Regulations, 1996, were amended to allow dematerialization of government securities. SEBI has allowed the listing of debt instrument on the stock exchange even if the company's equity has not been listed earlier.

SEBI has made it mandatory for all debt instruments to be rated by any one of the authorized credit rating companies. Recently, it made dual rating mandatory for issues above ₹ 50 crore. By doing this, SEBI expects to put an end to credit rating shopping, which allows a company not to disclose an adverse rating and instead seek a favourable rating from another agency. A company will not be allowed to get a rating from an agency which is its associated firm.

Price Stabilization

SEBI monitors unusual movements in prices, in coordination with the stock exchanges. It introduced the market wide circuit breaker (MWCB) to prevent large market movements. MWCBs are applied either at 10 per cent, 15 per cent, or 20 per cent of the upward movement or downward movement of the Sensex and Nifty. Risk arises out of transactions entered into by members in various scrips either on their own account or on behalf of their clients. Hence, margin amount is collected from the members. Margins levied in the cash market segment come under the following three categories:

- Value at Risk (VaR)
- Extreme loss
- Mark to market

Margins on the futures and options segment comprise the following:

- Initial margin
- Exposure margin

In addition to these margins, in respect of options contracts, the following additional margins are collected:

- Premium margin
- Assignment margin

To help investors utilize their margins in an effective way, SEBI has allowed cross margining across cash and derivatives markets. Initially, this facility will be available only to institutional traders. SEBI allows institutional investors to swap corresponding margins between the cash and debt markets.

Delisting

SEBI's Delisting of Equity Shares Regulations 2009 governs the guidelines to be followed by a company for delisting its shares from a stock exchange. According to this, the offer price for delisting shall be determined by calculating the average of the weekly high and low of the closing prices during the preceding 26 weeks or two weeks preceding the date on which the recognized stock exchange was notified.

Brokers and SEBI

The regulation of the functioning of brokers starts with the registration of brokers. Brokers get registration on the basis of their eligibility to become a member of stock exchanges and infrastructure facilities. A broker should have experience in the business of buying, selling or dealing in securities. Capital adequacy norms are laid down depending on the stock exchanges and the members' turnover. Registration fee also has to be paid by the brokers.

A code of conduct is laid down for every stockbroker wanting to be registered with SEBI. The code seeks to ensure that a broker will not indulge in malpractices and manipulation. The code of conduct deals with brokers' duties towards execution of orders, issue of contract note, breach of trust, fairness to clients and investment advice. Contract notes are aimed at showing transparency in deals regarding price, brokerage and service tax. The contract notes and bills must be passed on time, failing which brokers are liable to penalties depending on the days of default.

Brokers have to furnish SEBI with a copy of the audited balance sheet and profit and loss account within six months of each accounting period. They are expected to preserve the books of account and other records for a minimum period of five years. SEBI has the right to inspect brokers' books of accounts and other records and documents and can appoint qualified auditors to investigate the books of accounts.

Regional offices are set up by SEBI to attend to complaints against brokers and stock exchanges. They are located in New Delhi, Kolkata, Chennai and Mumbai. Disciplinary action such as a reprimand, warning, suspension and cancellation of registration are taken against erring stockbrokers. A broker's registration may be suspended in any of the following cases:

- He violates the provisions of the SEBI Act, rules and regulations.
- He does not follow the code of conduct laid down by SEBI.
- He is guilty of:
    - o Failing to furnish any information related to his securities as required by the board
    - o Furnishing wrong or false information
    - o Not submitting periodical returns as required by the board.
    - o Not cooperating in any enquiry conducted by the board

- He fails to resolve the complaint of the investor or fails to give a satisfactory reply to the board on the case.
- He indulges in manipulating prices or related activities in the market.
- He is guilty of misconduct.
- His financial position deteriorates to such an extent that the board is of the opinion that his continuance in the securities business is not in the interest of investors and other stockbrokers.
- He fails to pay the fees.
- He violates the conditions of registration.
- His membership is suspended by the stock exchange.

A stockbroker's registration may be cancelled if:

- He violates any provisions of insider trading regulations or takeover regulations.
- He is guilty of fraud, or is convicted of a criminal offence and has his membership cancelled by the stock exchange.

Know Your Customer (KYC)

SEBI requires all market intermediaries, including mutual funds and stockbrokers, to submit know your customer (KYC) details of existing customers to the KYC registration agency (KRA) by 31 March 2013 in a phased manner. KRAs are institutions that maintain KYC details. They are wholly owned subsidiaries of stock exchanges and depositories.

SEBI has notified five phases for updating KYC details of existing customers by 31 March 2013. The KRA system allows for the centralization of KYC records in the securities markets to avoid duplication of KYC processes with every intermediary. According to the SEBI circular, the intermediaries have to maintain only electronic records of the KYC details of their clients and can do away with the physical records.

The intermediary should indicate the date of account opening or activation information while uploading the existing clients' KYC details in the KRA system. If a client's KYC data already exists, the intermediary needs only to upload the modifications, if any. This ensures that the latest information about the client is available on the system. SEBI has directed the stock exchanges and depositories to make amendments to the relevant by-laws, rules and regulations for the accomplishment of the KYC norms in co-ordination with one another. In mutual funds, compliance of this circular will be monitored by the boards of asset management companies (AMCs) and the trustees.

Sub-broker

SEBI has made it mandatory for a sub-broker to obtain a certificate of registration from SEBI. The affiliating stockbroker and the sub-broker should enter into an agreement specifying the obligations of both. In May 1997, SEBI permitted the security deposit received from the sub-broker to be kept with the sharebroker. Share broker can keep the security deposit received from the sub-broker from May 1997.

Corporate members

Stock exchanges allow corporate membership. SEBI has laid down capital adequacy norms and maintenance of net worth for them. Multiple memberships are permitted, but separate accounts have to be kept. SEBI can inspect their accounts and take positive action in case of defaults.

4.4.2 Insider Trading

The most profitable technique employed in the stock market is using one's access to price-sensitive information ahead of others. For example, Hindustan Lever announced the merger of Brooke Bond Lipton India with itself on 16 April 1996. Hectic trading took place on the two scrips preceding the announcement. Once the information became public, the trading volume and price declined. Several examples like this can be cited. To prevent this, SEBI came out with the SEBI Insider Trading Regulation 1992. The Act defined an insider as one who:

- Was or is connected with the company
- Is deemed to have been connected with the company and is reasonably expected to have access by virtue of such connection to unpublished price information
- Has received or has had access to unpublished price-sensitive information

Connected person is any person who is:

- A director or is deemed to be a director as per the Companies Act
- An officer or employee of the company
- In a position involving a professional or business relationship with the company and who may reasonably be expected to have access to unpublished price-sensitive information
- A subsidiary as per Section (370) (1B) on 372 (11)
- An official or member of a stock exchange
- A dealer in securities or an employee of such dealer member
- A merchant banker, share transfer agent, registrar, debenture trustee, broker, portfolio manager, investment adviser, sub-broker, investment company or an employee thereof, a trustee of a mutual fund, or director on the board of an asset management company
- A director or employee of a public financial institution
- An official or employee of a self-regulatory organization

- A relative of any of the aforementioned
- A banker to the company

Unpublished price sensitive-information refers to:

- Financial results of the company
- Intended declaration of dividends
- Rights or bonus share offers
- Major expansion plans or execution of new projects
- Amalgamation, mergers and takeovers
- Disposal of the whole of the undertaking
- Such other information as may affect the earnings of the company
- Any changes in policies, plans or operations of the company

Prohibition of deals

SEBI prohibits an insider from dealings. The board is empowered to investigate cases of insider trading. The person being investigated by SEBI is required to produce books, accounts and other documents that the investigating authority may require. SEBI has the authority to restrain the insider from dealing in securities. Any person violating the provisions of insider trading regulations is liable to be punished with a fine or imprisonment under the SEBI Act 1992.

SEBI has directed all stock exchanges to amend their listing agreements and bring them in line with the Bhave Committee recommendations, effective from the quarter ending June 1998. Companies now have to disclose immediately to the stock exchanges any changes in material events that will have an impact on share prices.

SEBI has also expanded the definition of 'material events' to encompass events that could have an impact on the company's earnings or stock prices. So far, Clause 36 of the listing agreement restricts the scope of such disclosure to events such as strikes, lockouts and closures. Companies are now required to disclose all information concerning litigation, revision in debt or equity ratings in India or abroad, commencement of commercial production, issue of any class of securities, mergers, demergers, acquisitions, cancellation of dividends, rights or bonus, and alteration in terms of redemption of any security issued.

SEBI has also endowed the term 'material event' with a broader meaning. It now covers any change in the general nature of the business, disruption owing to natural calamities and significant developments with respect to pricing in the realization of its goods and services. Disclosures on the above lines ensure that information with earnings implications for a listed company is made public at the earliest.

These disclosures aid superior price formation for stocks and reduce the incidence of insider trading. Experiences show that cases of insider trading can be extremely difficult to prove. Even when proven, it may be difficult to identify and compensate the affected party for losses suffered through such trading. So when it comes to price manipulation or insider trading, prevention is better than cure.

Check Your Progress

5. What does the 'T' group represent in the BSE's classification of scrips?
6. List the two ways of protection available for the investor by the NSE.
7. Name the promoters of the MCX-SX.
8. Which institution grants the registration of brokers in India?

4.5 SPECULATIVE TRANSACTIONS IN STOCK EXCHANGES

Basically, buyers and sellers who operate on stock exchanges can be divided into two categories based on their operations as investors or speculators. Investors purchase securities to earn a regular income from the investment and possibly make some long-term gain in the event of the security's price rising, in the future. Investors pay the full price for securities in which they invest, and expect the securities to be delivered to them. Speculators buy securities to make a quick gain, in hopes of selling them shortly at higher prices. Speculators tend to sell short, in hopes of buying the same shares at a lower price. The main objective of their operations is to take advantage of price differences at different times. The stock exchange also facilitates the settlement of such transactions by receiving or paying, as the case may be, just the difference in prices, provided both the transactions take place during the same settlement period, which is only one day under T + 2 trading, which is known as intra-trading. For example, Dheera has bought 200 shares of Secals Ltd at ₹ 210 per share in the morning and sold them at ₹ 235 per share before the exchange closes on the same day. She does not take and give delivery of the shares but settles the transactions by receiving the difference in prices amounting to ₹ 5,000 minus brokerage for both buying and selling. In another case, There has sold 200 shares of Andhra Papers Ltd at ₹ 69,without their actual possession, anticipating that the price would fall to buy in the later part of the day. Since this did not happen, he has to buy the same shares at ₹ 87 per share on the same date. He settles these transactions by simply paying the difference: ₹ 4,400 plus brokerage.

Investment transactions refer to the actual purchase or sale of securities undertaken with a long-term prospect relating to their yield and price. It involves the actual delivery of security and payment of its full price. In a speculative transaction, the delivery of the security does not take place and amount of price difference is adjusted.

At present, stock exchanges have a system of rolling settlement on the T + 2 basis. The facility of buying and selling is limited to the same day for squaring off as no carry forward is allowed.

NOTES

Difference between speculation and investment: Though speculation and investment are different in some respects, in practice, it is difficult to distinguish between genuine investors and pure speculators. Sometimes, someone who has purchased the shares as a long-term investment may, suddenly, decide to sell to reap the benefit, if the price of the shares goes up spectacularly or do it to avoid heavy loss when the prices starts declining, steeply.

Speculative transaction means a transaction in which a contract for sale and purchase of any commodity, including stocks and shares, is periodically or ultimately settled otherwise by actual delivery or transfer of the commodity.

In strict technical terms, the transaction is regarded as speculative only if it is settled by receiving or paying the difference in prices, without involving the delivery of securities. It is so because, in practice, it is quite difficult to ascertain the intention. In other words, the actual occurrence of the transaction determines whether a transaction is investment or speculation as intentions cannot be known.

4.5.1 Types of Speculators

There are basically four types of speculators in a stock market. These are as follows:

- **Bull:** A bull is a type of optimistic speculator who anticipates an increase in the price of the securities in which he deals. Therefore, he enters into purchase transactions with a view to sell them at a profit in the future.
- **Bear:** Unlike a bull, a bear is a pessimistic speculator who anticipates a decrease in the price of securities in which he deal. Thus, he into selling contracts in certain securities on a future date. If the price of the security falls as he expects he shall get the price difference.
- **Stag:** A stag is a type of investor who applies for fresh shares with the objective of selling them at a profit as soon as he gets the shares allotted.
- **Lame duck:** When a bear is unable to meet his commitment immediately, he is said to be struggling like a lame duck.

Check Your Progress

9. State the main objective of speculators.
10. Name the type of speculator who applies for fresh shares with the objective of selling them at a profit as soon as he gets the shares allotted.

4.6 ANSWERS TO 'CHECK YOUR PROGRESS'

1. The Securities and Contract Regulation Act, 1956 gave powers to the central government to regulate the stock exchanges in India.
2. BOLT or Bombay Online Trading System is the name of the screen-based trading system of Bombay Stock Exchange introduced in 1995.
3. The indicators of a continuous market are as follows:
    - Frequency of sales
    - Narrow spread between bids and offers
    - Prompt execution of orders
    - Minimum price changes between transactions as they occur
4. Listing means admission of securities to dealings on a recognized stock exchange.
5. In BSE's classification of scrips, the 'T' group represents scrips which are settled on a trade-to-trade basis.
6. The two ways of protection for investor given by the NSE are the Investor Protection Fund (IPF) and the Investor Grievance Cell (IGC).
7. The MCX-SX is promoted by Multi Commodity Exchange (MCX) and Financial Technologies (India) Ltd. (FTIL).
8. SEBI grants the registration of brokers in India.
9. The main objective of speculators is to take advantage of price differences at different times.
10. Stag is the kind of speculator who applies for fresh shares with the objective of selling them at a profit as soon as he gets the shares allotted.

4.7 SUMMARY

- Stock Exchange is a place where individuals, corporates and Foreign Institutional Investors (FIIs) purchase and sell stock. In India, the Bombay Stock Exchange, which was established in 1875, is the oldest one. There are many other stock exchanges in India, like the Calcutta Stock Exchange, the Delhi Stock Exchange and the National Stock Exchange.
- The stock exchanges provide an organized marketplace for the investors to buy and sell securities freely. The market for these securities is an almost perfectly competitive one because a large number of sellers and buyers participate. The shares listed, however vary broadly in terms of credit rating and often involve carrying cost.

- Trading in stock exchanges takes place either on the basis of the auction system on a trading floor (which is order-driven or customer-driven) or a broker-dealer market (which is quote-driven or dealer-driven). All stock markets world over use one of the two trading systems or a hybrid of both.
- SEBI introduced margin trading with effect from 1 April 2004. Liquidity is one of the important characteristics of a financial market. Illiquidity can lead to 'liquidity risk' which has been reported to drive away institutions/high net worth investors from the market. Illiquidity/poor liquidity is known to have caused high transaction costs.
- Mark to market margin amount is collected on the outstanding settlement obligations of the member.
- Speculators buy securities to make a quick gain, in hopes of selling them shortly at higher prices. The types of speculators include bull, bear, stag, and lame duck.

4.8 KEY TERMS

- **Stock Exchange:** It is a place where individuals, corporates and Foreign Institutional Investors purchase and sell stock.
- **Market Makers:** It refers to the dealers who create and maintain a market in a security.
- **Broker-Dealer:** It refers to the person who may buy and sell securities on their own account/risk, or as agents, trade on behalf of others.
- **Stock Broker:** It is a name given to a regulated professional broker who buys and sells shares and other securities through market makers or Agency Only Firms on behalf of investors.
- **Speculators**: It refers to players in the secondary market who buy securities to make a quick gain, in hopes of selling them shortly at higher prices. The types of speculators include bull, bear, stag, and lame duck.

4.9 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. Give a brief note on the history of stock exchanges in India.
2. What do you understand by the empirical measurement of liquidity?
3. Write a short note on OTCEI.
4. List the speculative transactions in stock exchanges.

Long Answer Questions

1. Explain the role and functions of stock exchanges in the economy of a country.
2. Discuss the trading mechanisms of online trading, screen-based treading and scripless trading.
3. Describe the concept of stock indices, their computation and differences between different indices.
4. Explain SEBI regulations relating to stock exchanges.

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UNIT 5 BANKS AS FINANCIAL INTERMEDIARIES

NOTES

Structure

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5.5 Answers to Check Your Progress Questions
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5.0 INTRODUCTION

In this unit, we will discuss banks as financial intermediaries. Banks have been an important primary market intermediary for many years in advanced nations such as the US, the UK and other European countries, though in developing countries such as India, it has assumed importance in recent years in the wake of economic liberalization. The Indian capital market witnessed tremendous changes both in quantitative and in qualitative terms after the 1990s, as can be seen from the number and amount of equity issues, different capital market innovative instruments and structural developments in the capital market. The elimination of CCI in 1992 and the constitution of SEBI marked the beginning of the regulation of the capital market, consistent with its growth and development.

5.1 OBJECTIVES

After going through this unit, you will be able to:

- Examine the role of banks as financial intermediaries
- Discuss the role played by banks in financing different sectors
- Describe the functions and objectives of IDBI and LIC

5.2 BANKS AS FINANCIAL INTERMEDIARIES

NOTES

Commercial banks, being financial institutions, perform diverse types of functions. They satisfy the financial needs of different sectors in the economy and society, such as agriculture, industry, trade and international trade, etc. They play a very significant role in the process of satisfying economic and social needs. The functions performed by banks change with the times. Banks are becoming customer-centric and widening their functions.

Banks are regarded as the nerve centres of the trade, industry and commerce of a country. A bank denotes an institution that deals in money and credit. A banker is regarded as a dealer in debt, either his own or that of his customers.

Commercial banks mobilize savings from other sections of society and make them accessible to the needy. In short, by discharging this function, they render a very valuable service to the community by increasing the productive capacity of the country and thereby accelerating the pace of economic development.

Commercial banks, of late, have shifted their focus from their traditional role, acceptance of deposits and lending money, to unexplored areas of creating financial products and services, based on the securities markets.

5.2.1 Financial Intermediaries

Commercial banks undertake the important process of financial intermediation whereby the funds or savings of the surplus sectors are channelled to deficit sectors. Commercial banks, along with other financial institutions, channel the funds of surplus economic units to those wanting to spend on real capital investments. Funds are transferred through lending by banks or by creation of financial liabilities such as bonds and equity shares. Banks intermediate by obtaining the funds of savers in exchange for their own liabilities such as entries in a passbook and then, in turn, make loans to others. Financial intermediaries including banks buy and sell the right to future payments. Banks collect deposits from savers by offering interest. In 2008-09, savings of the households in the form of bank deposits constituted 54.9 per cent of total financial savings. Deposits of commercial banks can be of any denomination which have the characteristics of low risk and high liquidity. The small deposits are put together to make large loans.

Through their intermediary activities, banks provide a package of information and risk-sharing services to their customers. While doing so, they take on part of their risk. Banks have to manage the risks through appropriate structuring of their activities and hedge risks through derivative contracts to maximize their profitability.

5.3 COMMERCIAL BANKS ROLE IN FINANCING

NOTES

Fund-based services are those services where there is an outflow of cash from banks on the different types of loans provided. Interest is the source of income on fund-based lending. This implies that any income arising due to the fund corpus of banks is known as fund-based income. Different types of loans fall into this category.

The outflow of money is involved in fund-based activity where different types of loans are provided by banks. The primary function of a commercial bank is to make loans and advances to all types of persons, particularly businessmen and entrepreneurs. The most common form of lending is by cash credit.

Cash Credit

Under this account, the bank lends to the borrowers against a certain security, such as stocks/receivables to meet working capital requirements. Banks allow the borrowers to withdraw the amount as and when needed up to the limit or drawing power, whichever is lower. The borrower is required to pay interest only on the actual amount availed, not on the total limit.

Cash credit is the most popular form of credit with borrowers for meeting working capital requirements.

The bank considers a firm’s sales and production plans to sanction a particular working capital limit, called a ‘sanctioned limit’ in a cash credit account. In case of seasonal industries, the bank sanctions a peak credit limit to meet working capital requirements during the season, which is always higher in comparison to the limit sanctioned for non-peak period. So, the bank sanctions separate limits for peak and non-peak periods as the working capital requirement is highest during the peak season.

Margin Banks do not finance 100 per cent of current assets. They stipulate a margin for the safety of funds lent. The drawing power (amount that can be drawn) is calculated after deducting the required margin from the value of stocks. The borrower has to submit a stock statement monthly as per terms of sanction, declaring the physical value stocks on a specified date, generally at the end of each month. If the margin requirement is 30 per cent, the bank lends only up to 70 per cent of the value of stocks. The amount so calculated is called ‘drawing power’. The borrower is allowed to draw to the extent of the drawing power. Drawing power is allowed based on the value of stocks, not exceeding the sanctioned limit. Against stocks of ₹ 80, 000, the borrower can avail of a drawing power of ₹ 56,000 (80,000 -30 % of 80,000).

Cash credit facility provides the flexibility for customers to deposit and withdraw funds, while enabling them to benefit from lower interest burden, as no customer needs the full limit throughout the year.

Ideal form for business

The greatest convenience of a cash credit account is its flexibility. The borrower can deposit sale proceeds daily to reduce the outstanding balance in a cash credit account and can draw as and when needed to the maximum extent of drawing power or cash credit limit, whichever is lower. Interest is charged on the outstanding balance only. In other words, the borrower is required to pay interest on only the amount utilised and not on the total sanctioned limit. This feature in cash credit account is the greatest convenience for borrowers. On account of this convenience, the actual interest rate on a sanctioned limit would be lower than the interest rate offered by banks, as no borrower requires money on a continuous basis. Moreover, there is no commitment charge for the limit not utilised. By virtue of margin, the bank is secured even if the value of stocks falls to the extent of the margin.

In a loan account, this facility of withdrawing money again does not exist. Once deposited into the loan account, the amount is not available for withdrawal as the money is deemed to be set aside towards the closure of the loan account.

Period of sanction: Cash credit limits are normally sanctioned for one year. At the end of the year, limits are reviewed by banks. Technically, advances are repayable on demand. However, the bank recalls an advance only when the conduct of the account is not satisfactory.

Pledge/hypothecation: Cash credit facility can be sanctioned either in the form of a pledge or the hypothecation of goods. In case of a pledge, goods are kept in the godowns, under the bank's lock and key. So the possession of goods and control thereon is with the bank, not the borrower. As and when payments are made, goods are released, even proportionately to the borrower. Normally, banks sanction this facility to new borrowers or when their credit worthiness is not fully known or established. However, the borrower does not enjoy total convenience with the pledge facility as the physical possession of goods is with the bank. The borrower deposits a proportionate amount into the pledge account so that goods can be sold. While the pledge provides almost total safety to the bank, this facility is not convenient for the borrower. However, a pledge facility is good enough for new borrowers or in situations when goods are stored for a long period for sale in season. In case of hypothecation, the possession of goods is with the borrower, who can sell goods without the bank's prior approval. However, the borrower is required to deposit the sale proceeds of goods into the cash credit—hypothecation account. As the borrower enjoys possession of the goods, who does as he pleases with them in the ordinary course of business, the bank assumes more risk while sanctioning a hypothecation limit. So the hypothecation facility is extended to borrowers whose creditworthiness is well known to the bank.

Cash credit is a common form of financing to meet working capital requirements, which affords the greatest flexibility to a borrower at little cost. A hypothecation facility gives the borrower more flexibility compared to a pledge.

Overdraft

Banks sanction regular overdraft limits normally against the security of fixed deposit receipts, shares, life insurance policies, postal certificates etc. Interest is charged on the amount utilized. A cheque facility is made available for an overdraft account. Cash credit is a normal feature in business while an overdraft facility is, normally, availed of by professionals/individuals for their working capital requirements/urgent needs. In addition to permanent overdraft limit, bank sanctions temporary overdraft in current account of customers as and when cheques received are in excess of balance in current accounts. This is a temporary arrangement.

Purchase or Discounting of Bills

Banks often experience difficulty in checking and controlling the diversion of funds i.e. utilization for purposes other than sanctioned. In that context, this form of finance is ideal as banks can control its utilization and end use better.

Banks sanction the limit against bills of exchange drawn by the supplier on its buyers. A supplier can avail of the limit for bills drawn on his buyers, covering the supply of goods made. If the bill of exchange is payable on demand, the bill of exchange is purchased by bank. If the bill of exchange is drawn on acceptance basis, the bank discounts the bill. The buyer has to make a payment on the due date. In both cases, the working capital is provided by bank by purchasing or discounting bills, as the case may be. Bank credits customer’s account, after deducting their commission. The borrower can avail of the limit for goods sold only as invoice; the documentary proof of dispatched goods, such as railway receipts or motor receipts, are necessary for submission to the bank. Through the accompanying documents, the bank can ensure the utilization of limit for working capital purposes only.

The greatest and most convenient feature of this advance is its self-liquidating character. When a buyer makes a payment, the advance sanctioned against the bill is recovered.

Purchase or discounting of bills finance has a self-liquidating character with greater control for banks to monitor the utilization of finances for working capital requirements. Banks can monitor utilization of limits in this scheme better as chances for abuse in a cash credit limit scheme increase. The diversion of funds for other purposes is difficult in a bill scheme.

Priority Sector Categories

For priority sector lending, RBI has fixed a target of 40 per cent of the adjusted net bank credit (ANBC) or the credit equivalent amount of the off-balance sheet exposure, whichever is higher in domestic commercial banks, while it is 32 per cent in foreign banks.

The different categories of priority sector lending are as per the RBI circular No. RBI/2012-13/138RPCD.CO.Plan.BC 13/04.09.01/2012–13 dated 20 July 2012.

Agriculture (Direct and Indirect Finance)

Direct finance to agriculture includes short, medium and long-term loans given for agriculture and allied activities (dairy, fishery, piggery, poultry, bee-keeping, etc.) to individual farmers, self-help groups (SHGs) or joint liability groups (JLGs) of individual farmers without limit and to others, such as corporates, partnership firms and institutions, up to certain limits for taking up agriculture and allied activities. Indirect finance to agriculture includes loans given for agriculture and allied activities to those engaged in distribution of inputs like fertilisers, pesticides, seeds cattle and feeds etc. and to state electricity boards and such other organizations.

RBI has set a target of 18 per cent of ANBC or the credit equivalent amount of off-balance sheet exposure, whichever is higher, to total agricultural advances.

Micro and Small Enterprises (Direct and Indirect Finance)

Direct finance to micro and small enterprises includes all loans given to micro and small (manufacturing) enterprises engaged in manufacture/production, processing or preservation of goods, and micro and small (service) enterprises engaged in providing or rendering of services. There is no separate limit for advances to small enterprises. These advances are taken into account in the total priority sector target of 40 per cent of ANBC or the credit equivalent amount of off-balance sheet exposure, whichever is higher

Investment limits in plant, machinery and equipment (original cost excluding land and building and such items as mentioned therein) are detailed later. The micro and small (service) enterprises include small road and water transport operators, small businesses, professional and self-employed persons and retail trade. However, the advances granted to retail traders dealing in essential commodities (fair price shops), consumer co-operative stores and advances granted to private retail traders with credit limits should not exceed ₹ 20 lakh and all other service enterprises.

Definition of MSMEs: According to the definition of micro, small and medium enterprise, the limit in respect of investments in plant and machinery/equipment (excluding land and building) is as shown in Table 5.1.

Table 5.1 *Limits in Respect of Investments in Plant and Machinery/Equipment*

	Manufacturing Enterprises	**Service Enterprises**
Micro	Up to ₹25 lakh	Up to ₹10 lakh
Small	More than ₹25 lakh and up to ₹5 crore	More than ₹10 lakh and up to ₹2 crore
Medium	More than ₹5 crore and up to ₹10 crore	More than ₹2 crore and up to ₹5 crore

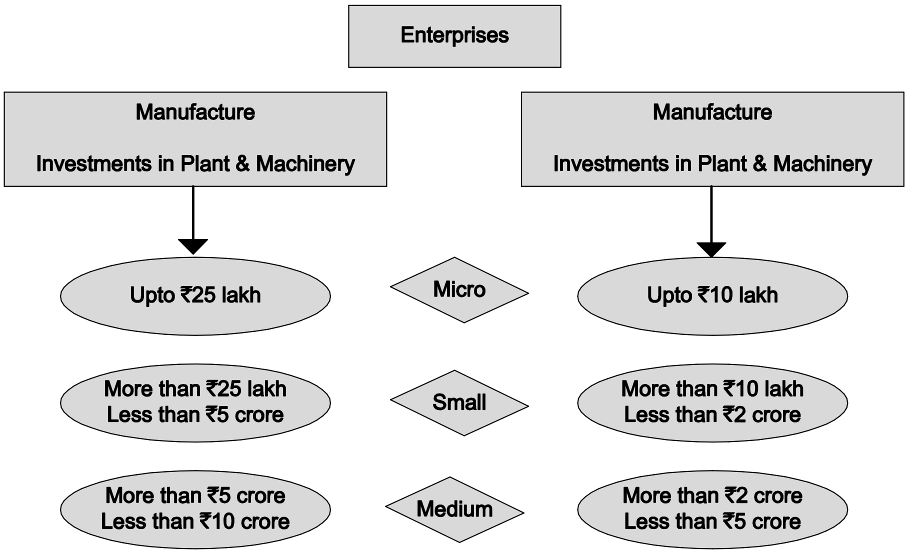
Enterprises
Manufacture
Investments in Plant & Machinery
Manufacture
Investments in Plant & Machinery
Upto ₹25 lakh
Micro
Upto ₹10 lakh
More than ₹25 lakh
Less than ₹5 crore
Small
More than ₹10 lakh
Less than ₹2 crore
More than ₹5 crore
Less than ₹10 crore
Medium
More than ₹2 crore
Less than ₹5 crore

Fig. 5.1 *Classification of Enterprises Under MSMED Act, 2006*

Investment in plant and machinery/equipment excludes the cost of land, buildings and furniture, fittings and other items not directly related to the service rendered or as may be notified under the MSMED Act, 2006.

Micro credit

RBI has given the highest importance for this category of lending and has set separate targets even in the total advances to micro and small enterprises sector to compel the banks to lend to this category, which are as under:

(a) 40 per cent of total advances to micro and small enterprises sector should go to micro (manufacturing) enterprises with up to ₹ 5 lakh investment in plant and machinery and micro (service) enterprises with up to ₹ 2 lakh investment in equipment

(b) 20 per cent of total advances to the micro and small enterprises sector should go to micro (manufacturing) enterprises with above '5 lakh and up to ₹ 25 lakh investment in plant and machinery, and micro (service) enterprises with above ₹ 2 lakh and up to ₹ 10 lakh investment in equipment. (Thus, 60 per cent of micro and small enterprises advances should go to the micro enterprises).

(c) The increase in share of micro enterprises in MSE lending to 60 per cent should be achieved in stages, viz. 50 per cent in the year 2010–11, 55 per cent in the year 2011–12 and 60 per cent in the year 2012–13.

Retail Trade

Advances granted to private retail traders with credit limits not exceeding ₹ 20 lakh only come under the category of a priority sector. The category of retail trade includes retail traders/private retail traders dealing in essential commodities (fair price shops), and consumer co-operative stores.

Educational Loans

Educational loans include loans and advances granted only to individuals for educational purposes—up to ₹ 10 lakh for studies in India and ₹ 20 lakh for studies abroad—and do not include those granted to institutions.

Loans granted to educational institutions are eligible to be classified as priority sector advances under micro and small (service) enterprises, provided they satisfy the provisions of The Micro, Small and Medium Enterprises Development (MSMED) Act, 2006.

Housing Loans

Loans up to ₹ 25 lakh to individuals for purchase/construction of dwelling unit per family (excluding loans granted by banks to their own employees) and loans given for repairs to the damaged dwelling units of families—up to ₹ 1 lakh in rural and semi-urban areas and up to ₹ 2 lakh in urban and metropolitan areas—fall in the ambit of priority sector. Housing loans up to the above limits are the thrust area of lending for commercial banks as this category, with above limits fall in the priority sector.

Banks consider lending to housing sector serves the purpose of achieving the target of priority sector lending, which also provides a profitable business opportunity, with risk diversification over a large number of borrowers.

Exports: Export credit is not a separate category. Export credit to eligible activities under agriculture and micro and small enterprises (MSE) will be reckoned for priority sector lending under respective categories.

Banks have to lend 10 per cent of advances to weaker sectors, while it is 1 per cent of total advances to differential rate of interest scheme.

The media has highlighted the importance given to exports, recognizing bank lending to exports as priority sector lending.

Shortfall Lending to Priority Sector

Domestic scheduled commercial banks, which do not achieve the priority sector target (40 per cent) and/or agriculture lending target (18 per cent) or weaker sections lending target (10 per cent) have to make contributions to the Rural Infrastructure Development Fund (RIDF) established with NABARD or funds with other financial institutions, as specified by the RBI.

Check Your Progress

1. How do banks undertake the important process of financial intermediation?
2. What does direct finance to micro and small enterprises include?

5.4 IDBI

IDBl was established in July 1964 under the Industrial Development Bank of India Act, as a wholly owned subsidiary of the Reserve Bank of India. However, in February 1976, it was delinked from the Reserve Bank and has since emerged as an independent organization. It now serves as an apex financial institution.

The Industrial Development Bank of India was converted into a limited company through the enactment of the Industrial Development Bank (Transfer of Undertaking and Repeal) Act, 2003. As a result, IDBI has become the Industrial Development Bank of India Ltd with effect from 1 October 2004 as a company registered under the Companies Act, 1956 and a Scheduled Bank under the Reserve Bank of India Act. Subsequently, a subsidiary of the erstwhile IDBI was also merged with IDBI with effect from 1 October 2004.

Resources

The principal resources of IDBI are: (*i*) Share capital and reserves, (*ii*) Borrowings from the Government of India and RBI, (*iii*) Market borrowings by way of bonds, (*iv*) Foreign currency borrowings, and (*v*) Repayment of past assistance by borrowers.

As at the end of March 2004, IDBI's equity capital was ₹ 652.8 crore and reserves and funds aggregated to ₹ 6,651.9 crore. The Board of Directors of IDBI may from time to time increase its issued share capital by allotment of shares to such persons and on such terms and conditions as the Board may determine. However, at no time will the shareholding of the Central Government be less than 51 per cent of the issued equity capital of IDBI.1

Management

IDBI has a Board of Directors appointed as follows:

(*a*) A Chairman and a Managing Director appointed by the Central Government, provided that the same person may be appointed to function as both the Chairman and the Managing Director.

(*b*) One full-time director appointed by the Central Government on the recommendations of the Board.

(*c*) Two directors who shall be officials nominated by the Central Government.

(*d*) Three directors nominated by the Central Government having special knowledge and professional experience in science and technology, economics, industry, banking, industrial co-operatives, industrial finance, marketing or any other matter useful to IDBI.

(*e*) Such number of directors elected in the prescribed manner by shareholders other than the Central Government where the total amount of equity share capital issued to such shareholders is:

(*i*) 10 per cent or less of the total issued equity capital–two directors

(*ii*) More than 10 per cent but less than 25 per cent of the total issued equity capital–three directors

(*iii*) 25 per cent or more of the total issued equity capital-four Directors.

Objectives and functions

The main objective of IDBI was to serve as the apex institution for term finance for industry in India.

The Bank was assigned a special role with regard to the following matters:

(*i*) Planning, promoting and developing industries to fill the gaps in the industrial structure in India.

(*ii*) Coordinating the working of institutions engaged in financing, promoting or developing industries and assisting in the development of such institutions.

(*iii*) Providing technical and administrative assistance for the promotion, management or expansion of industry.

(*iv*) Undertaking market and investment research and surveys as also techno-economic studies in connection with the development of industry.

The Bank's charter provided for considerable operational flexibility. IDBI could finance all types of industries irrespective of the form of the organization or the size of the unit. Also, there were no restrictions on the nature and type of security and quantum of assistance which the Bank could provide.

It may be noted that even after the conversion of IDBI into a universal bank, it continued to perform the role of a development bank in addition to wholesale and retail banking.

Schemes of assistance

The schemes of assistance operated by IDBI can be broadly divided into the following two categories:

(*i*) Direct assistance schemes: These include,

(*a*) Project finance scheme

(*b*) Modernization assistance scheme

(*c*) Textile modernization fund scheme

(*d*) Technical development fund scheme

(*e*) Equipment finance scheme

(*ii*) Indirect assistance schemes: These include-,

(*a*) Re-finance of industrial loans scheme

(*b*) Bills re-discounting scheme

(*c*) Seed capital assistance scheme

(*d*) Resources support scheme

With the acquisition of the entire shareholding of Tata Finance Ltd in September 2003, IDBI diversified its business domain further. This signalled IDBI's foray into the retail finance sector. 'IDBI Home Finance Ltd' is the new name of the fully-owned housing finance subsidiary.

This transformation of IDBI into a commercial bank provided a gateway to low-cost deposits such as savings and current bank deposits. This facilitated lending at more competitive rates to its clients and had a positive impact on the bank's overall cost of funds. The new entity offers various retail products, leveraging upon its existing relationship with retail investors under its existing suvidha/ flexibond schemes. The new IDBI in the emerging scenario hopes to realize its mission of positioning itself as a one-stop super-shop for total financial and banking solutions to corporates and individuals.

Working of IDBI

The cumulative sanctions by IDBI upto 31 March 2004 under its various schemes since its inception amounted to ₹ 2,23,524 crore while the disbursements amounted to ₹ 1,75,572 crore.

5.4.1 IFCI

The Corporation was set up in 1948 under an Act passed by the Parliament with the objective of providing medium and long-term financial assistance to industry. For ensuring greater flexibility and to cater to the needs of the changing financial system, the undertaking of the IFCI now stands transferred to a newly formed company, the Industrial Finance Corporation of India Ltd (IFCI Ltd) with effect from June 1993. Every shareholder of IFCI under the IFCI Act, 1948 became a shareholder of IFCI Ltd with effect from the same date. Financial assistance from IFCI is available to industrial concerns both in the corporate and cooperative sectors. State owned public limited companies can also obtain financial assistance from the Corporation.

To formulate a medium to long-term strategic plan for IFCI, an expert committee was constituted. It has made recommendations that are wide ranging and touch the operational and structural areas of IFCI such as future business strategies, reduction of NPAs, recapitalization, improvement in recoveries and rethinking HR policies. In the interim, to arrest further deterioration of IFCI's financial health, the Government also put into effect a restructuring package. With the aim of achieving long-term viability, the IFCI Board of Directors also agreed, in principle, to a merger with Punjab National Bank. A due diligence exercise is being carried out on which a final view will be taken at the time of the merger. The exercise covers, *inter alia*, legal aspects, share exchange ratio, all assets, liabilities (including contingent liabilities), etc.

NOTES

Resources

As on 31 March 2004, IFCIs paid-up capital stood at ₹ 1,068 crore, while its reserves and surplus aggregated to ₹ 435 crore. Its borrowings from the Government of India amounted to ₹ 961.5 crore, bonds and debentures to ₹ 13,061 crore and other borrowings to ₹ 1,302 crore.2

Management

The management of the Corporation vests in a Board of Directors appointed as follows:

	No. of Directors
Nominated by the Central Government	3
Nominated by the Reserve Bank	3
Elected by banks, insurance companies, investment trusts and cooperative banks	6
Total	12

The Board of Directors has delegated its powers to a committee of directors consisting of five members, one of whom is the Managing Director of the Corporation.

Functions

The functions of the Corporation, as given in the Act, are as follows:

(*i*) Guaranteeing loans raised by industrial concerns that are repayable within a period not exceeding twenty-five years and are floated in the public market.

(*ii*) Undertaking the issue of stocks, shares, bonds or debentures issued by industrial concerns. However, they must be disposed of by the Corporation within seven years of their acquisition.

(*iii*) Granting loans or advances or subscribing to the debentures of industrial concerns repayable within a period not exceeding twenty-five years.

(*iv*) Extending guarantees with respect to deferred payments by importers who are able to make such arrangement with foreign manufacturers.

(*v*) Acting as the agent of the Central Government or the World Bank (International Bank for Reconstruction and Development) with respect to loans sanctioned to industrial concerns.

(*vi*) Undertake financing of projects with the Industrial Development Bank of India and other financial institutions. These would include guaranteeing loans raised by industrial concerns from other financial institutions, the purchase of stock, shares, bonds and debentures from existing holders, doing merchant banking operations, undertaking research to carryout techno-economic studies in connection with industrial development.

The Corporation provides financial assistance for setting up new industrial projects, or renovating, modernizing, expanding or diversifying existing ones. It also provides financial assistance on concessional terms for setting up industrial projects in industrially less-developed districts in the union and state territories as may be notified by the Central Government.

IFCI has also been registered with SEBI as a Category I Merchant Banker since 1 August 1993 and has also been granted registration to act as a debenture trustee. IFCI Financial Services Ltd Incorporated, 1994–95, commenced its operations in 1996–97. The merchant banking services of IFCI have been transferred to this new company.

Working

Ever since its inception in 1948, till the end of March 2004, its cumulative sanctions and disbursements amounted to ₹ 46,294 crore and ₹ 44,399 crore respectively.

5.4.2 GIC

The entire general insurance business in India was nationalised by General Insurance Business (Nationalisation) Act, 1972 (GIBNA).

The Government of India (GOI), through Nationalisation took over the shares of 55 Indian insurance companies and the undertakings of 52 insurers carrying on general insurance business.

General Insurance Corporation of India (GIC) was formed in pursuance of Section 9(1) of GIBNA.

It was incorporated on 22 November 1972 under the Companies Act, 1956 as a private company limited by shares.

GIC was formed for the purpose of superintending, controlling and carrying on the business of general insurance.

As soon as GIC was formed, GOI transferred all the shares it held of the general insurance companies to GIC.

Simultaneously, the nationalised undertakings were transferred to Indian insurance companies.

After a process of mergers among Indian insurance companies, four companies were left as fully owned subsidiary companies of GIC

- National Insurance Company Limited.
- The New India Assurance Company Limited.
- The Oriental Insurance Company Limited.
- United India Insurance Company Limited.

The next landmark happened on 19th April 2000, when the Insurance Regulatory and Development Authority Act, 1999 (IRDAA) came into force.

This Act also introduced amendment to GIBNA and the Insurance Act, 1938. An amendment to GIBNA removed the exclusive privilege of GIC and its subsidiaries carrying on general insurance in India.

In November 2000, GIC was renotified as the Indian Reinsurer and through administrative instruction, its supervisory role over the four subsidiaries was ended.

With the General Insurance Business (Nationalisation) Amendment Act 2002 (40 of 2002) coming into force from March 21, 2003; GIC ceased to be a holding company of its subsidiaries.

The ownership of the four erstwhile subsidiary companies and also of the General Insurance Corporation of India was vested with Government of India.

5.4.3 UTI

UTI came into existence on 1 February 1964 under the Unit Trust of India Act, 1963. Its establishment has been a landmark in the history of investment trusts in India.

The initial capital of ₹ 5 crore was subscribed fully by the Reserve Bank of India (2.5 crore), the Life Insurance Corporation (₹ 75 lakh), the State Bank of India (₹ 75 lakh), and scheduled banks and other financial institutions (₹ 1 crore).

The general administration and management of UTI is vested in the Board of Trustees consisting of a Chairman and nine other Trustees.

The objective of the Unit Trust is to stimulate and pool the savings of the middle and low income groups and to enable them to share the benefits and prosperity of the rapidly growing industrialization of the country.

The above objective is achieved by UTI through a three-fold approach:

(*i*) By selling units of the Trust among as many investors as possible in different parts of the country.

(*ii*) By investing the sale proceeds of the units as well as the initial capital fund in industrial and corporate securities.

(*iii*) By paying dividends to those who have bought the units of the Trust.

Working

UTI is playing an important role in mobilizing the savings of the community through the sale of units under various schemes, and channelizing them into corporate investments. Over the years, it has floated forty-three schemes including two off-shore country funds to suit the diverse investment needs of investors. Consequent upon amendment to the UTI Act, effective from 23 April 1986, UTI has been extending assistance to the corporate sector by way of term loans, bills re-discounting, equipment leasing and hire-purchase financing. In June 1990, UTI set up the UTI Institute of Capital Markets with a view to promote advanced professional education and training and research in the fields of capital markets.

With the repeal of the UTI Act, 1963, UTI has been re-organized into two separate institutions effective from 1 February 2003, viz., administrator of the specified undertaking of the Unit Tntst of India (popularly known as UTI-I), comprising US-64 and all other assured return schemes, and UTI Mutual Fund (UTIMF), which houses all the net asset value-based schemes of UTI. While UTI-I is headed by an administrator and is governed by an advisory board, UTIMF is modelled on the norms of the securities and Exchange Board of India, with sponsors, a trustee company and an asset management company, to manage its affairs.

At the end of January 2003, the total unit capital outstanding of UTI amounted to ₹ 48,096 crore. The cumulative sanctions and disbursements to the corporate sector at the end of October 2002 amounted to ₹ 70,458 crore and ₹ 53,954 crore respectively.

5.4.4 LIC

The Life Insurance Corporation of India (LIC) was formed in September 1956 under the Life Insurance Corporation Act, 1956, with capital contribution from the Government of India. The life insurance business of all companies was brought under the ownership of one organization, LIC. The various objectives of LIC are:

- To provide efficient service to policyholders in order to make insurance widely popular
- To provide life insurance to the people at a reasonable cost
- To promote a sense of pride and job satisfaction among the agents and the employees of LIC
- To guide the policyholders and protect their individual interests

Types and Structure of Insurance Plans

A large number of insurance policies have been introduced by LIC. The basic types of policies are term insurance, permanent life insurance, pension plans and children's plans. These policies are mostly specific to the people who have different incomes and belong to different age groups. In the case of permanent life insurance policies, a premium is charged throughout one's life while term insurance policies are taken for a fixed period. Term policies provide life cover and adequate return, whereas permanent life insurance policies provide life cover but do not provide any return.

Life policies can be 'with profits' or 'without profits'. In the latter case, an assured amount of sum is paid out on maturity or at the death of a policyholder. In the case of the former, extra earnings from various investments are added to the assured sum and it is paid out in cash. The premiums on 'with profits' policies are higher than those on without profits. Life insurance policies and pension funds are popular because they act as a life cover or protection and medium of saving with the added benefits of profits and many tax advantages.

Valuation of Life Policies

The funds collected through the sale of life insurance policies are invested in such a manner that they produce profits. The life fund is built from the excess amount of premiums collected. The life fund is valued from time to time with the help a method of discounting future income. The rate of discount used is equal to the rate of interest, which the fund's assets are expected to earn on an average. If the life fund is in surplus, then the valuation of the fund is greater. Only half of the surplus is distributed among policyholders. There are three methods of distributing surplus among policyholders. The surplus can be distributed in the form of cash, as a reduction in premium and as an addition to the value of the policy. If the surplus is distributed in the form of addition to the value of the policy, then it is known as a reversionary bonus. The surplus can be of two types, revenue surplus and capital surplus. Revenue surplus is the excess amount of premium earned and capital surplus, which arises when the value of the fund is balanced by the values of various assets as recorded in the balance sheet.

Major Principles Guiding LIC's Investment Policy

The principles of investment policy in India are similar to the ones followed by insurance companies in other countries. The major principles of the LIC investment policy are ensuring the security of funds and maximizing the rate of return on investment. One of the principles of LIC is that it finances priority sectors such as the agricultural sector and other sectors in the economy. A part of LIC's income is invested in the industrial sector too. However, there are mixed opinions about LIC's investment policy. Many policyholders think that they do not get a fair deal in LIC's investment policy because they think that they pay high premium rates but receive low bonus rates in return. At present, it is not possible to change LIC's current investment policy. LIC has to provide funds to the priority sectors and the Government. However, it is possible to increase the rate of interest on the investments without raising the rate of interest on government investments as well.

5.4.5 Investments Companies

A company that in the business of the acquisition of securities and trading in such securities to earn a profit is known as an investment companies. Investing in various types of assets is an interesting activity that attracts people from all walks of life, irrespective of their occupation, economic status, education and family background. Investment is the employment of funds on assets with the aim of earning income or capital appreciation. Investment has two attributes, namely, time and risk. In the process of investment, the present consumption is sacrificed to get a return in the future. The sacrifice that has to be borne is certain but the return in the future may be uncertain. This attribute of investment indicates the risk factor. The risk is undertaken with a view to reaping returns from investment. For the layperson, investment means a monetary commitment. A person's commitment to buy a flat or a house for his personal use may be an investment from his point of view. This, however, cannot be considered as actual investment because it involves sacrifice but does not yield any financial return.

To the economist, investment is the net addition made to the nation's capital stock that consists of goods and services that are used in the production process. A net addition to the capital stock means an increase in buildings, equipment or inventories. These capital stocks are used to produce other goods and services. Financial investment is the allocation of money to assets that are expected to yield some gains over a period of time. It is an exchange of financial claims such as stocks and bonds for money. They are expected to yield returns and experience capital growth over the years.

Financial and economic meanings are related to each other because, the savings of the individual flow into the capital market as financial investments to be used in economic investment. Even though they are related to each other, we are concerned only with the financial investment made on securities.

Check Your Progress

3. When was IDBI established?
4. When was LIC formed?

5.5 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Commercial banks undertake the important process of financial intermediation whereby the funds or savings of the surplus sectors are channelled to deficit sectors.
2. Direct finance to micro and small enterprises includes all loans given to micro and small (manufacturing) enterprises engaged in manufacture/ production, processing or preservation of goods, and micro and small (service) enterprises engaged in providing or rendering of services.
3. IDBl was established in July 1964 under the Industrial Development Bank of India Act, as a wholly owned subsidiary of the Reserve Bank of India.
4. The Life Insurance Corporation of India (LIC) was formed in September 1956 under the Life Insurance Corporation Act, 1956, with capital contribution from the Government of India.

5.6 SUMMARY

- Commercial banks, being financial institutions, perform diverse types of functions. They satisfy the financial needs of different sectors in the economy and society, such as agriculture, industry, trade and international trade, etc.

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- Commercial banks mobilize savings from other sections of society and make them accessible to the needy.
- Commercial banks, along with other financial institutions, channel the funds of surplus economic units to those wanting to spend on real capital investments.
- Fund-based services are those services where there is an outflow of cash from banks on the different types of loans provided. Interest is the source of income on fund-based lending.
- Banks often experience difficulty in checking and controlling the diversion of funds i.e. utilization for purposes other than sanctioned.
- IDBl was established in July 1964 under the Industrial Development Bank of India Act, as a wholly owned subsidiary of the Reserve Bank of India.
- The main objective of IDBI was to serve as the apex institution for term finance for industry in India.
- The entire general insurance business in India was nationalised by General Insurance Business (Nationalisation) Act, 1972 (GIBNA).
- The life insurance business of all companies was brought under the ownership of one organization, LIC.
- A company that in the business of the acquisition of securities and trading in such securities to earn a profit is known as an investment companies.
- Investing in various types of assets is an interesting activity that attracts people from all walks of life, irrespective of their occupation, economic status, education and family background.

5.7 KEY WORDS

- **Overdraft:** It means a deficit in a bank account caused by drawing more money than the account holds.
- **Cash Credit:** It is a facility to withdraw money from a current bank account without having credit balance but limited to the extent of borrowing limit which is fixed by the commercial bank.
- **Life Insurance:** It means insurance that pays out a sum of money either on the death of the insured person or after a set period.
- **Investment Companies:** They are financial institutions principally engaged in investing in securities.

5.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

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Short Answer Questions

1. Write a short-note on the financing of small and micro enterprises.
2. What are the various objectives of Life Insurance Corporation?
3. Discuss investment companies.

Long Answer Questions

1. Discuss the functions of commercial banks as financial intermediaries.
2. Examine the various financing roles of commercial banks.
3. Discuss the management, role and functions of the IDBI.

5.9 FURTHER READINGS

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BLOCK - II
FINANCIAL INSTITUTIONS

UNIT 6 MARKETS FOR CORPORATE SECURITIES

Structure

6.0 Introduction
6.1 Objectives
6.2 New Issue Markets and Functions for Issue Mechanism
6.2.1 Relationship between Primary and Secondary Market
6.3 Methods of New Issue
6.3.1 Underwriting
6.4 Answers to Check Your Progress Questions
6.5 Summary
6.6 Key Words
6.7 Self Assessment Questions and Exercises
6.8 Further Readings

6.0 INTRODUCTION

Companies raise funds to finance their projects through various methods. Promoters can bring in their own money or borrow from financial institutions or mobilize capital by issuing securities. Funds may be raised through the issue of fresh shares at par or premium, preference shares, debentures or global depository receipts. Stocks that are available for the first time are offered through the new issue market. The issuer may be a new company or an existing company. These issues may be of a new type or the security used in the past. In the new issue market, the issuer can be considered as a manufacturer. The issuing houses, investment bankers and brokers act as channels of distribution for the new issues. They take the responsibility of selling the stocks to the public.

The main service functions of the primary market are origination, underwriting and distribution. Origination deals with the origin of the new issue. The proposal is analysed in terms of the nature of the security, the size of the issue, timing of the issue and floatation method of the issue. The underwriting contract makes the share predictable and removes the element of uncertainty in the subscription. Distribution refers to the sale of securities to the investors. This is carried out with the help of the lead managers and brokers to the issue. In this context, the unit discusses the functions and methods of new issue market.

6.1 OBJECTIVES

After going through this unit, you will be able to:

- Describe markets for corporate securities
- Explain the methods of new issue market
- Discuss the concept of underwriting

6.2 NEW ISSUE MARKETS AND FUNCTIONS FOR ISSUE MECHANISM

Stock market or securities market is a market where securities issued by companies in the form of shares, bonds and debentures can be bought and sold freely. The components of stock market are primary market and secondary market. Primary market or new issues market is concerned with the issue of new securities.

Features of Primary Market

The features of primary market are as follows:

- It is a market for long-term capital where the securities are sold for the first time. Hence, it is also called **New Issue Market (NIM)**.
- Funds are collected and securities are issued directly by the company to the investors.
- Primary issues are carried out by the companies for the purpose of inception and functioning of business.

Benefits of Primary Market

The benefits are as follows:

- Company need not repay the money raised from the market.
- Money has to be repaid only in the case of winding up or buyback of shares.
- There is no financial burden, because it does not involve interest payment. If the company earns profit, dividend may be paid.
- Better performance of the company enhances the value for the shareholders.
- It enables trading and listing of securities at stock exchanges.
- There is greater transparency in the corporate governance.
- If the company performs well; the image of the company brightens.

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Disadvantages of the Public Issues

The disadvantages are as follows:

- It is a time consuming process involving the fulfillment of legal formalities.
- It is expensive and many intermediaries are involved in it. It necessitates constant adherence to listing of agreements and legal requirements.
- Cornering of shares and hostile takeover may take place.
- Speculative trading of the company's equity affects the reputation of the company.

6.2.1 Relationship between Primary and Secondary Market

Stocks that are available for the first time are offered through the new issue market. The issuer may be a new company or an existing company. These issues may be of a new type or the security used in the past. In the new issue market, the issuer can be considered as a manufacturer. The issuing houses, investment bankers and brokers act as channels of distribution for the new issues. They take the responsibility of selling the stocks to the public.

The relationship between primary and secondary markets is described below.

1. The new issue market cannot function without the secondary market. The secondary market or the stock market provides liquidity for the issued securities. The issued securities are traded in the secondary market offering liquidity to the stocks at a fair price.
2. Stock exchanges, through their listing requirements, exercise control over the primary market. The company seeking for listing on a stock exchange has to comply with all the rules and regulations given by that stock exchange.
3. Primary market provides a direct link between the prospective investors and the company. By providing liquidity and safety, the stock markets encourage the public to subscribe to new issues. The marketability and capital appreciation provided in the stock market are major factors that attract the investing public towards the stock market. Thus, it provides an indirect link between the savers and the company.
4. Even though they are complementary to each other, their functions and the organizational set-up are different from each other. The health of the primary market depends on the secondary market and vice-versa.

Check Your Progress

1. What is a stock market?
2. List any two features of primary market.

6.3 METHODS OF NEW ISSUE

Issues are classified into the following:

1. Public issues
2. Preferential issues (also known as private placements)
3. Rights issues

Public Issue

When a company wants to raise capital by issuing shares to general investors, the process is generally called public issue of shares or a primary market issue. Public issues can be further classified as:

(i) Initial public offering

(ii) Follow-on public offering

(iii) Fast-track issue

(i) Initial Public Offering

If the company is a new entrant to the capital markets, the issue made by such a company is called Initial Public Offering (IPO). In other words, if the company makes the public issue for the first time, it is an IPO. These issues are listed and traded on stock exchanges as specified in the offer documents.

(ii) Follow on Public Offering (FPO)

If a company whose shares are already listed on a stock exchange, issues shares, such an offering is called a further public offering. These are also called follow-on public issues. Sometimes, the term IPO is interchangeably used with FPO. Listing or continuous listing has to be satisfied by the FPO company. In 2006-2007, out of the 85 public issues, 77 were IPOs and the remaining were FPOs.

(iii) Fast-track Issue

The fast-track system introduced by SEBI in November 2007, was suggested by the SEBI's Primary Market Advisory Committee (PMAC). In the Fast-Track Issue (FTI), well established and compliant listed companies need to make only rationalized disclosures, rather than comprehensive ones, for follow-on public offers and rights issues. The compliant company here means the company which complies with the required rules and regulations. Provisions of the fast-track issue are on the lines of the well known seasoned issuers model of the US. This facility is available to the companies that are listed on the Bombay Stock Exchange (BSE) or the National Stock Exchange (NSE) for at least three years.

Companies eligible for a fast-track issue of shares must have an average market capitalization of ₹ 10,000 crore of public shareholding for a period of one year. The trading on the securities market should constitute at least 2 per cent of the total listed shares of the last one year. No prosecution proceedings or show-cause notice issued by SEBI should be pending against the company, its promoters or whole-time directors.

Preferential Issue

Listed companies issue securities to a select group of persons under section 81 of the Companies Act, 1956. The select group may be financial institutions, mutual funds, or high net worth individuals. It is not a rights issue or a public issue. The issuer company has to comply with the Companies Act and SEBI (Disclosures and Investor Protection) guidelines regarding the preferential issue. This helps the companies to raise capital quickly as compared to the public issue. The use of PAN has been made mandatory for preferential allotment of shares, as in the case of most of the transactions in the capital markets.

Rights Issue (RI)

It means an issue of capital to be offered by the company to its existing shareholders through a Letter of Offer, under section 81(1) of the Companies Act, 1956. In simple terms, a listed company issues fresh securities to its existing shareholders only. The rights are offered in a specificied ratio to the number of securities held prior to the issue by the shareholder. The ratio is fixed on the basis of the capital requirement of the company. The stake of the existing shareholders is not diluted in the right issue. When the right issue size is more than ₹ 50 lakh, the company has to file a draft offer document with SEBI for observations. SEBI's observation letter is valid for three months.

Right issues are seen as a way to reward the company's shareholders as the issue of new shares is normally made at a price which is lower than the current market price. Indian companies raised over ₹ 14,085 crore through various right issues in 2007. The Tata Group had announced a mega right issue of about ₹ 9,134 crore in November 2007.

IPOs and Bonus Issue

Unlisted companies which do not meet the eligibility condition to make initial public offer were permitted (August, 2003) by the amendment to the SEBI DIP Guideline to make an IPO through book building process, on meeting the conditions stipulated. An issuer company making an IPO of equity shares through book building mechanism can avail of Green Shoe Option (GSO) facility, for stabilizing the post-listing price of its shares.

Initial public offering (IPO) refers to the first sale of shares by a private company to the public. Although IPOs enlarge the equity base of the company, investors lack information about the company's past performance and its track record. There is no information available about them while details of listed companies are available. Investor confidence suffered a further setback when prices of IPOs floated in mid-1990s by dot com stocks declined. Stringent entry and disclosure norms introduced by SEBI have however led to an improvement in the quality of issues floated in the market as well as their post-listing performance.

Variation in IPO share prices for the period 2001–02 to 2003–04 indicates that share prices of 75 per cent of IPOs improved upon listing.

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Table 6.1 *New Capital Issues by Non-Government Public Limited Companies in Sale*

(₹ in crore)

	1991–92		*1995–96*		*2000–01*		*2004–05*	
Security and Type of issue	*No. of issues*	*Amount*	*No. of issues*	*Amount*	*No. of issues*	*Amount*	*No. of issues*	*Amount*
1	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*
1. Equity shares (a + b)	367	1,729.5	1,615	12,243.5	128	2,607.61	51	12,004.0
	(56)	(227.5)	(469)	(5,037.2)	(52)	(1,327.3)	(45)	(8,010.9)
(a) Prospectus	158	1,043.1	1,400	8,742.3	111	2,312.4	25	8,388.0
	(16)	(26.7)	(306)	(2,624.0)	(48)	(1,182.0)	(24)	(4,791.7)
(b) Rights	209	686.4	215	3,501.2	17	295.2	26	
	(40)	(200.8)	(163)	(2,413.2)	(4)	(45.9)	(21)	(3,219.2)
2. Preference shares (a + b)	3	1.5	9	150.1	2	142.2	—	—
(a) Prospectus	2	0.5	5	166.6				
(b) Rights	1	1.0	4	33.5	2	142.2	—	—
3. Debentures (a + b)	146	4,019.8	64	3,977.6	2	90.2	—	—
(a) Prospectus	50	860.1	16	1,669.8				
(b) Rights of which	96	3,159.7	48	2,307.8	2	90.2	—	—
(i) Convertible (a + b)	133	3,489.2	49	3,445.9	1	36.2	—	—
(a) Prospectus	47	848.4	15	1,569.8				
(b) Rights	86	2,640.8	34	1,876.1	—	—	—	—
(ii) Non-convertible (a + b)	13	530.6	15	531.7	1	54.0	—	—
(a) Prospectus	3	11.7	1	100.0	1	54.0		
(b) Rights	10	518.9	14	431.7	7	2,050.0	—	—
4. Bonds	—	—	(Prosp.)	—	—	—	9	1,478.0
5. Total (1 + 2 + 3 + 4)	516	5,750.8	1,688	16,371.2	139	4,890.0	54	13,482.0
(a) Prospectus	210	1,903.7	1,421	10,528.7	118	4,362.0	28	9,866.0
(b) Rights	306	3,847.1	267	5,842.5	21	527.6	26	3,616.0

Source: Reserve Bank of India, *Annual Report*, 1992–93 to 1999–2000, 2002–03 and 2004–05 and *Report on Currency and Finance*, 1994–95 and 1997–98.

Note: Figures in brackets indicate data in respect of premium on capital issues which are included in respective totals.

Figures exclude data on private placement and offer for sale but include amounts raised by private financial institutions and issues through OTCEI.

At the outset, the term issue needs clarification. Initial issues are issue of shares for the first time either after incorporation or conversion from a private limited to a public limited company. Further issue of shares are made by existing companies either by public issue or rights issue or composite issue.

The initial as well as further issues may be offered for either cash subscription or for consideration other than cash such as change of ownership either of physical assets or technical know-how. Joint ventures or foreign direct investment may take the form of provision of machines/process or technology and drawings.

An exchange issue is one in which shares of one company are exchanged for another as in the case of takeovers and mergers. An example (1993) is HLL-TOMCO merger under which 2 HLL shares were exchanged for 15 TOMCO shares.

An exchange issue does not add to the funds of the company making the exchange, although the merger may result in synergy. Another type of issue which does not result in raising new funds is the **bonus issue**. When retained profits or free reserves are converted into additional share capital, no addition to liabilities in the balance sheet takes place. Bonus shares are distributed in determined proportion to existing shareholders, 1:1 or 1:2, that is, for every share held, one bonus share is issued, or for every two held, one bonus share is issued.

Rights issue is the issue of new shares in which existing shareholders are given pre-emptive rights to subscribe to new issue. The right is in the form of new shares to which existing shareholders are entitled to subscribe to in some stated proportion to the ones held by them. Rights shares are issued at a premium which is freely determined by the company making the issue.

Private Placements, Book Building and Green Shoe Option

It is a direct private offering of securities to a limited number of sophisticated investors. It is the opposite of a public offering. Investors are mainly financial institutions, insurance companies, pension funds and high net worth individuals. Securities issued as private placements include debt, equity and hybrid securities.

The private placement market in India has witnessed a very rapid growth in the recent past with companies increasingly adopting the private route for funds mobilization.

Steps in private placement

Collateral preparation: As a first step, the most effective capitalization strategy is decided on the basis of the existing business profile of the companies. A complete set of information is prepared to be presented to the potential investors. This would enable the transaction to be carried out in a structured way.

Road show and investor short listing: In this phase, the lead manager helps the issuer to decide the kind of private equity and investors. He holds initial discussions with the investors helps the issuer have road shows by meeting the potential investors and advises the issuer to prioritize among the investors to create a short list of investors. He also helps the company to use its network of relationships to identify the right investors.

Negotiation: The company and the lead manager analyse various offers from the potential investors and drive deal negotiations with investors, which meets the issuer's strategic objectives. Finally, the most effective transaction suitable for the issuers shareholders and employees is created.

Due diligence and closure: In this phase, the lead manger helps the client in coordinating the overall due diligence process and negotiates on the final definitive agreements with the potential investor. Thus, the deal is closed.

Advantages of private placement

The phenomenal growth of private placement of securities may be attributed to the following reasons.

Convenience: Issues of smaller size can be privately placed whereas the public issues market does not permit an issue below a certain minimum size.

Flexibility: The negotiation part of the private placement provides flexibility in working out the terms of issue. For example, in a non-convertible debenture issue, a discount may be given to institutional investors to make the issue attractive.

Less time: A private placement requires a lesser period, perhaps a month or two, as the elaborate procedure followed in a public issue is not required.

Less issue costs: The issue cost for a private placement is considerably less as compared to the public issue. The public issue involves several statutory and non-statutory expenses associated with underwriting, brokerage, printing, mailing, announcements, promotion and so on.

However, it should be remembered that:

- Private placement investors' interest in a firm is limited to a short period with the aim of maximizing their returns within a limited period of time. This may lead to under-investment. It may be detrimental to the long-term growth of the company.
- Private placements generally involve a few investors who have a higher control over the policy decisions of the company. This could either act in favour or against the interests of a firm.

Factors to be considered

Before participating in a private placement, the investors need to look into a number of factors like:

- The track record of the company
- Net worth of the company
- Debt equity ratio
- Debt redemption provisions
- Profit before tax
- The asset cover
- The dividend record
- The percentage of unsecured deposits/borrowings
- The historical price of the company's stock

Book Building

It is a process adopted in Initial Public Offer (IPO) for efficient price discovery. During the offer period, the investor bids the offer either above or equal to the floor price. Thus, in book building method, bids are collected from investors at various prices. The offer price is determined only after the closure of the issue. As per the SEBI guidelines, an issuer company can issue securities to the public through a prospectus either by 100 per cent of the net offer to the public through book building process or 75 per cent of the net offer to the public through book building process and 25 per cent at the price determined through book building. The fixed price portion is conducted like a normal public issue after the book built portion, during which the issue price is determined.

The Process

The normal procedure is given below.

- The issuer appoints a lead merchant banker as a 'book runner' by the issuer.
- The issuer decides the price or price band for the issue and the number of securities to be issued.
- The issuer appoints the syndicate members after consulting the lead merchant banker.
- The form for applying/bidding of shares is made available with all the syndicate members, collection centers, brokers to the issue and bankers to the issue.
- A book should remain open for a minimum of five days.
- Investors bid through the syndicate members. The syndicate members input the investors' orders into the electronic book.
- Bid has to be made for the minimum quantity specified by the issuer or in multiples thereof.
- An investor can alter his bid, both price and quantity, anytime before the close of the issue.
- Syndicate members aggregate and forward all offers to the book runner.
- After consulting the issuer, the book runner determines the issue price as a weighted average of the offers received.
- Securities are alloatted to the successful bidders.

Difference between the Fixed Price Process and Book Building Process

Difference between the fixed price process and book building process is as follows:

Table 6.2 *Difference between Fixed Price and Book Building Process*

Factors	*Fixed price process*	*Book building process*
Price	Offer price of the securities is known in advance to the investor.	Only an indicative price range is given. Offer price of the securities is not known in advance to the investor.
Demand	Demand for the issue is known only after the closure of the issue.	Demand for the securities offered is known everyday as the book is built.
Payment	Payment is made at the time of subscription. Refund is given after allocation.	Payment is made only after allocation.
Information	The spread of information may not be even.	Before applying, all the investors can see on an hourly basis how the book is being built. Therefore, there is no asymmetry of information.

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Green Shoe Option

If the issue is over-subscribed, the issuing companies can allocate up to 15 per cent shares over and above the original issue size. The amount raised should be used to operate a post-listing price stabilizing mechanism. Administered through an external agency called a stabilizing agent, this scheme tries to minimize the post-listing price volatility, if the stock turns weak.

It should be kept in mind that the stabilizing agent is not under any obligation to keep the price above the issue price at all time. It is not mandatory to keep a green shoe option. The details of a green shoe option should be disclosed in the prospectus and should be made available for thirty days from the date of listing.

ASBA

SEBI has introduced the applications supported by blocked amount (ASBA) process in issues, to smoothen the payment/refund process. Under ASBA, application money is blocked in a bank account and debited only to the extent of allotment entitlement while it continues to earn interest. According to the SEBI Annual Report 2011, this process has resulted in the following benefits:

- Savings for investors on account of interest earnings
- Savings for issuers on account of lower costs arising from savings in refund expenses
- Systemic savings arising out of unclogging of the payment system, work load reduction, better liquidity management by banks and reduction in refund-related concerns

ASBA forms are available for download through websites of exchanges. Advertisements for issues prominently highlight the use of ASBA facility.

ESOP and Indian Depository Receipts

An employee stock ownership plan, also known as ESOP, is a type of employee benefit plan whose objective is to encourage employees to obtain stocks or ownership in the firm. Under an ESOP, the employer gives certain stocks of the firm to the employee for negligible or less costs which remain in the ESOP trust fund, until the options vests and the employee exercises them or the employee leaves/retires from the company or institution. The aim of an ESOP plan is to improve the performance of the firm and increase the value of the shares by involving stock holders, who are also the employees, in the working of the firm. The ESOPs help in minimizing problems related to incentives.

Indian Depository Receipts

An Indian Depository Receipts (IDR) is an instrument denominated in Indian Rupees in the form of a depository receipt created by a Domestic Depository (custodian of securities registered with the Securities and Exchange Board of India) against the underlying equity shares of issuing company to enable foreign companies to raise funds from the Indian securities markets. The Central Government notified the Companies (Issue of Indian Depository Receipts) Rules, 2004 (IDR Rules) pursuant to the Section 605 A of the Companies Act. The Securities and Exchange Board of India (SEBI) issued guidelines for disclosure with respect to IDRs and notified the model listing agreement to be entered between Stock Exchange and the foreign issuer specifying continuous listing requirements.

The eligibility criteria given under IDR Rules and Guidelines are as under:

The foreign issuing company should have:

- Pre issue paid up capital and free reserves of at least US$ 50 million and have a minimum average market capitalization (during the last 3 years) in its home country of at least US$ 100 million.
- A continuous trading record or history on a stock exchange in its home country for at least three immediately preceding years.
- A track record of distributable profits for at least three out of immediately preceding five years.
- Listed in its home country and not been prohibited to issue securities by any Regulatory Body and has a good track record with respect to compliance with securities market regulations in its home country.
- The size of an IDR issue shall not be less than ‘ 50 crores

The following intermediaries are involved in issuance of IDRs:

- Overseas Custodian Bank is a banking company which is established in a country outside India and has a place of business in India and acts as custodian for the equity shares of issuing company against which IDRs are proposed to be issued in the underlying equity shares of the issuer is deposited.

- Domestic depository who is a custodian of securities, registered with SEBI and authorised by the issuing company to issue Indian Depository Receipts.
- Merchant banker registered with SEBI who is responsible for due diligence and through whom the draft prospectus for issuance of the idr and due diligence certificate is filed with sebi by the issuer Company.

6.3.1 Underwriting

Underwriting is an agreement with or without conditions to subscribe to the securities of a body corporate in the event of non-subscription by the public. In other words, if there is under-subscription (the amount received is less than the issue size), the underwriters subscribe to the unsubscribed portion. The person who assures the sum is called an underwriter. The underwriters are paid an underwriting commission. A certificate of registration from SEBI has to be obtained by the agencies that wish to carry out underwriting activities. After the selection of the underwriter, the issuing company enters into an agreement with the underwriter. The agreement contains the following details:

- The period during which the agreement will remain in force
- The amount of the underwriting obligation
- The maximum period within which the underwriter will have to subscribe to the offer after the company's intimation
- The rate and amount of commission or brokerage chargeable by the underwriter

We will discuss underwriting in detail in unit 11.

Check Your Progress

3. What do you understand by the term Initial Public Offering (IPO)?
4. Define Rights Issue (RI).
5. What is the aim of an ESOP plan?

6.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Stock market or securities market is a market where securities issued by companies in the form of shares, bonds and debentures can be bought and sold freely.
2. The features of primary market are as follows:
    - It is a market for long-term capital where the securities are sold for the first time. Hence, it is also called New Issue Market (NIM).

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- Funds are collected and securities are issued directly by the company to the investors.

3. If the company is a new entrant to the capital markets, the issue made by such a company is called Initial Public Offering (IPO).
4. Rights Issue (RI) means an issue of capital to be offered by the company to its existing shareholders through a Latter of Offer, under section 81 (1) of the Companies Act, 1956.
5. The aim of an ESOP plan is to improve the performance of the firm and increase the value of the shares by involving stock holders, who are also the employees, in the working of the firm.

6.5 SUMMARY

- Stock market or securities market is a market where securities issued by companies in the form of shares, bonds and debentures can be bought and sold freely.
- The components of stock market are primary market and secondary market. Primary market or new issues market is concerned with the issue of new securities.
- When a company wants to raise capital by issuing shares to general investors, the process is generally called public issue of shares or a primary market issue.
- If the company is a new entrant to the capital markets, the issue made by such a company is called Initial Public Offering (IPO).
- If a company whose shares are already listed on a stock exchange, issues shares, such an offering is called a further public offering.
- The fast-track system introduced by SEBI in November 2007, was suggested by the SEBI's Primary Market Advisory Committee (PMAC).
- Unlisted companies which do not meet the eligibility condition to make initial public offer were permitted (August, 2003) by the amendment to the SEBI DIP Guideline to make an IPO through book building process, on meeting the conditions stipulated.
- Initial public offering (IPO) refers to the first sale of shares by a private company to the public. Although IPOs enlarge the equity base of the company, investors lack information about the company's past performance and its track record.
- If the issue is over-subscribed, the issuing companies can allocate up to 15 per cent shares over and above the original issue size. The amount raised should be used to operate a post-listing price stabilizing mechanism.

- The placement size of QIPs shall not exceed five times the pre-issue net worth as per the audited balance sheet of the previous financial year. Minimum of 10 per cent of specified securities shall be allotted to mutual funds.
- An employee stock ownership plan, also known as ESOP, is a type of employee benefit plan whose objective is to encourage employees to obtain stocks or ownership in the firm.
- An Indian Depository Receipts (IDR) is an instrument denominated in Indian Rupees in the form of a depository receipt created by a Domestic Depository (custodian of securities registered with the Securities and Exchange Board of India) against the underlying equity shares of issuing company to enable foreign companies to raise funds from the Indian securities markets.
- Underwriting is an agreement with or without conditions to subscribe to the securities of a body corporate in the event of non-subscription by the public.

6.6 KEY WORDS

- **Debenture:** It is a type of debt instrument that is not secured by physical assets or collateral.
- **Indian Depository Receipts (IDR):** It is an instrument denominated in Indian Rupees in the form of a depository receipt created by a Domestic Depository (custodian of securities registered with the Securities and Exchange Board of India) against the underlying equity shares of issuing company to enable foreign companies to raise funds from the Indian securities markets.
- **ASBA (Applications Supported by Blocked Amount):** It is a process developed by the India's Stock Market Regulator SEBI for applying to IPO. In ASBA, an IPO applicant's account doesn't get debited until shares are allotted to them.
- **ESOP:** It is a type of employee benefit plan whose objective is to encourage employees to obtain stocks or ownership in the firm.

6.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. Define the new issue market.
2. List the characteristic features of debentures.
3. Write a short note on ESOP and Indian depository receipts.
4. What do you understand by the term 'underwriting'?
5. Mention the various advantages of private placement.

Long Answer Questions

1. 'Primary and secondary markets are complementary to each other but their organizational set ups are different'. Explain.
2. What are the different functions of underwriters?
3. Evaluate the relative advantages and disadvantages of various kinds of equity shares.
4. Discuss the methods of new issue.
5. Describe markets for corporate securities.

6.8 FURTHER READINGS

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UNIT 7 OVERVIEW OF COMMERICAL BANKING

NOTES

Structure

7.0 Introduction
7.1 Objectives
7.2 Commercial Banking
7.3 Fund Based and Non-Fund Based Financial Services of Commercial Banking
7.4 Lease
7.4.1 Lease Financing
7.5 Answers to Check Your Progress Questions
7.6 Summary
7.7 Key Words
7.8 Self Assessment Questions and Exercises
7.9 Further Readings

7.0 INTRODUCTION

A commercial bank is defined as a financial institution which accepts deposits, makes business, and provides loans and various other kinds of financial services to its customers. However, the most common bank management is risk management and there are various types of risks which a bank may have to face. This unit will explain the types of risks and the ways in which banks handle the risks.

Banks offer various services to its customers and partners such as savings account, transactional account, mutual funds, mortgage and loans and so on. Lease is defined as a contract which is made between two parties, the lessor and the lessee. It is contract by which a party gives their land, property to another party for a specified period.

In this unit, the functions of commercial banks and their working have been explained. The services offered by banks and the features of lease agreements have been highlighted. The unit will also explain the accounting of lease agreements along with examples and the concept of lease financing.

7.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss the functions and working of commercial banks
- Explain the concept of risk management
- Analyse the various types of risks

- Describe the Fund Based and Non-Fund Based Financial Services offered by banks
- Discuss the meaning and features of lease agreements
- Explain the methods of accounting related to leasing
- Analyse the concept of lease financing and its methods

7.2 COMMERCIAL BANKING

Banks are financial firms and depend on economies of size and gains arising from internalizing certain activities rather than relying on market transactions. Banks provide packages of financial services which individuals find too expensive to search out, produce and monitor by themselves.

The functions of a commercial bank are as follows:

- To change cash for bank deposits and bank deposits for cash.
- To transfer bank deposits between individuals and/or companies.
- To exchange deposits for bills of exchange, government bonds, the secured and unsecured promises of trade and industrial units.
- To underwrite capital issues. They are also allowed to invest 5 per cent of their incremental deposit liabilities in shares and debentures in the primary and secondary markets. The commercial banks have set up subsidiaries to provide advice on portfolio management or investment counselling. They also offer their constituents' services to pay insurance advice on-tax problems and undertake executive and trustee services.

Payment Systems

Commercial banks are institutions which combine various types of transaction services with financial intermediation. Banks provide three types of transactions: first to convert deposits into notes and coins to enable holders of deposits to undertake transactions in cash. Secondly, bank deposits are used as a means of settling debts. Thirdly, where exchange controls do not exist, banks exchange cash and deposits from one currency into cash and deposits of another currency.

Commercial banks earlier had a monopoly on transaction services. Other financial intermediaries such as savings and loans, saving banks and credit unions in the United States have been authorised to offer transaction accounts. Money market mutual funds, another type of financial service organizations have developed financial products against which checks may be written.

Commercial banks are at the very centre of the payment systems. Bank money constitutes 39.5 per cent of the money supply (Ml) of the Indian economy. An efficient payment system is vital to a stable and growing economy and the bank's role is important.

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In advanced economies, commercial banks are also at the heart of the electronic payment system which is replacing paper-based payment methods. In USA, electronic payment between commercial banks are done through Fedwire which is a wholesale wire transfer system operated by the Federal Reserve System. About 3, 00,000 transfers per day amounting to $1 trillion are made. Large banks in New York operate a private electronic transfer system called CHIPS (The Clearing House Interbank Payments System) which transfers $1 trillion a day involving international movement of funds.

Finally, SWIFT (the Society for Worldwide Interbank Financial Telecommunication) based in Brussels is operated by 2000 banks, brokerage firms and non-banking financial institutions worldwide.

Intermediation

Commercial banks undertake the important process of financial intermediation whereby the funds or savings of the surplus sectors are channelled to deficit sectors. Commercial banks along with other financial institutions channel the funds of surplus economic units to those wanting to spend on real capital investments. Funds are transferred through lending by banks or by creation of financial liabilities such as bonds and equity shares. Banks intermediate by obtaining the funds of savers in exchange for their own liabilities such as entries in a passbook and then in turn make loans to others. Financial intermediaries including banks buy and sell the right to future payments. Banks collect deposits from savers by offering interest. In 2004–05, savings of the households in the form of bank deposits constituted 32.1 per cent of total financial savings. Deposits of commercial banks can be of any denomination which has the characteristics of low risk and high liquidity. The small deposits are put together to make large loans.

Through their intermediary activities, banks provide a package of information and risk- sharing services to their customers. While doing so, they take on part of their risk. Banks have to manage the risks through appropriate structuring of their activities and hedge risks through derivative contracts to maximise their profitability.

Transformation Services

Banks combine various types of transformation services with financial intermediation. They provide three transformation services when they undertake intermediation process. Firstly, transformation related to liability, asset and size which comprises of mobilisation funds and their allocation (provision of large loans on the basis of numerous small deposits). Secondly, maturity transformation by offering the savers, the relatively short-term claim on liquid deposits they prefer and providing borrowers long-term loans which are better matched to the cash flows generated by their investment. Finally, risk transformation by transforming and reducing the risk involved in direct lending by acquiring more diversified portfolios than individual savers can. Commercial banks by effectively appraising credit requests can channel funds into productive uses.

Transformation Services and Risks

Banks incur risks while undertaking transformation services. In the past three decades, banks abroad assumed new roles and accepted new forms of financial intermediation by undertaking currency and interest rate swaps and of dealing in financial futures, options and forward agreements. These new instruments reflect considerable flexibility in responding to market situations and adjusting continually assets and liabilities both on and off balance sheet, while enhancing profitability.

Risk Management: Basic Function of Bank

Risk is inherent in banking and is unavoidable. The basic function of bank management is risk management. In the words of Alan Greenspan, former Chairman of the Federal Reserve Board of US (Conference at Federal Reserve Bank of Chicago, May 12, 1994), 'traditional banking can be viewed at an elemental level as simply the measurement, management and acceptance of risk' and banking involves understanding, processing and using massive amounts of information regarding the credit risks, market risks and other risks inherent in a vast array of products and services, many of which do not involve traditional lending, deposit taking and payment services.

Mismatch, Source of Risk

If banks had balance sheets where all assets are exactly matched by liabilities of the same maturity, the same interest rate conditions and the same currency, then the only balance sheet risk would be credit risk. Such exact matching does not obtain in practice and even if we assume that it does it would offer reduced profit opportunities. Mismatching within limits is an inherent feature of banking. Risks arise from the common cause of mismatching. When maturities of assets exceed those of liabilities there is inevitably liquidity risk; when interest rate terms differ there is inevitably interest rate risk; when currency denomination of assets differ there is inevitably currency risk. When transactions are undertaken for settlement at a later date, counter party risk of the other party to a transaction will not complete, as agreed exists. Banks should have the capacity to anticipate change and to act so as to structure and restructure bank's business to profit from it or minimise losses.

Credit Analysis: Traditional Technique

For banks, the traditional activity was balance sheet lending and the risk management technique was credit analysis. Banks always managed assets and liabilities and took decisions on liabilities they were able to create and the assets they would acquire. These decisions reflected long run choices and relatively stable roles and did not require management in the near term. Variations in interest rate usually followed changes in the discount rate of the Central Bank and the type and terms of loans were subject to official constrains, notably on pricing. The source of funds was core deposits which were not sensitive to interest rates but increased with national income. They were also stable. Since interest rates were regulated banks concentrated on asset management.

Banks in the process of providing financial services assume various kinds of risks, credit, interest rate, currency, liquidity and operational risks. To some extent, these risks could be managed through sound business practices and the others through a combination of product design and pricing. In the past, banks concentrated on asset management with liquidity and profitability being regarded as two opposing considerations. As a result, banks ended up distributing assets in such a way that for given liquidity level, the return was the maximum.

Overall Risk of a Bank

A bank's overall risk can be defined as the probability of failure to achieve an expected value and can be measured by the standard deviation of the value.

Types of Risk

Banks have to manage four types of risk to earn profits for maximizing shareholder wealth. These are as follows:

(i) Credit risk

(ii) Interest rate risk

(iii) Liquidity risk

(iv) Operational risk

In addition there is a systematic risk arising due to various disruptions in the working of a major bank, which in no time could spread to other banks or the whole financial system. Credit risk arises when a bank cannot get back the money from loan or investment. Interest rate risk arises when the market value of a bank asset, loan or security falls when interest rates rise. The solvency of the bank would be threatened when the bank cannot fulfill its promise to pay a fixed amount to depositors because of the decline in the value of the assets caused by an increase in interest rate. Liquidity risk arises when the bank is unable to meet the demands of depositors and needs of the borrowers by turning assets into cash or borrow funds when needed with minimal loss. Finally, operational risk arises out of an inability to control operating expenses, especially non-interest expenses such as salaries and wages. In a competitive environment, high operational expenses would jeopardise the banks prospects to survive. Empirical analysis reveals that banks risk exposure depends upon volatility of interest rates and asset prices in the financial market, the banks maturity gaps, the duration and interest elasticity of its assets and liabilities and the ability of the management to measure and control the exposure.

Interest Sensitive Assets

These risks are a part of either assets or liabilities or both of a bank them. Assets are managed through money market instruments such as interbank lending, treasury bills and repos. Shortening the maturity of these assets makes them interest sensitive.

Shifting liabilities such as interbank borrowing, issue of CDs while shortening the maturity of the liability side of the balance sheet makes liabilities more interest-sensitive and increases the risk of the bank's portfolio.

Credit Risk

The assets of a bank whether a loan or investment carries credit risk. Credit risk is the risk of losing money when loans default. Credit risk or default risk gives rise to problems of bank management. The principal reason for bank failures is bad loans. Banks can raise their credit standards to avoid high risk loans. Guarantees and collaterals can reduce risk. After the loan is made, compliance can be ensured by monitoring the behaviour of the borrower which reduces risk. Credit risk can be transferred by selling standardised loans. Loans portfolio can be diversified by making loans to a variety of firms whose returns are not perfectly and positively correlated.

RBI Guidelines

RBI guidelines envisage that banks should put in place the loan policy covering the methodology for measurement, monitoring and control of credit risk. Banks are also expected to evolve comprehensive credit rating system that serves as a single point indicator of diverse risk factors of counter parties in relation to credit and investment decisions.

Interest Rate Risk

Interest rate risk management may be approached either by on-balance sheet adjustment or off-balance sheet adjustment or a combination of both. On-balance sheet adjustment involves changes in banks portfolio of assets and liabilities, as interest rates change. When medium or long-term loans are funded by short-term deposits, a rise in the rate of interest will increase the cost of funds but the earnings on the assets will not, thereby reducing the margin or spread on the assets. The problem could be resolved by adopting adjustable interest rate on loans on the assets side of the balance sheet and increasing the maturity pattern of deposits on the liability side of balance sheet. These decisions relating to banks portfolio of assets and liabilities represent balance sheet adjustments.

The interest rate risk position can also be adjusted by the bank by making off-balance sheet adjustments which involve the use of various non-traditional financial instruments referred to as derivatives such as futures, options, swaps or creation of synthetic loans through use of futures.

Liquidity Risk

Liquidity risk refers to the bank's ability to meet its cash obligations to depositors and borrowers. A liability-sensitive position than to assets of interest rates reduces the liquidity position of a bank. The mismatch between short-term liabilities and long-term assets creates a severe funding problem as the liabilities mature. Again, if the duration of assets exceeds the duration of liabilities, the ability to realize liquidity from the assets of the bank is reduced. Liquidity needs are increasingly met by deposit and non-deposit sources of funds paying market rates of interest. Banks have decreased the quantity of liquid assets they hold for the purpose of deposits withdrawal and loan demand. Liability management has replaced asset management as a method to fund liquidity needs. The effect of replacement of asset management by liability management would be enhancement of credit risk since liquid assets have been replaced by loans. The replacement of short-term assets by long-term assets would also require an increase in gross rates of return, since upward sloping yield curves require higher rate of return on long-term assets than on short-term assets.

Asset liquidity is a reserve that a bank can fall back upon when bank's access to funds is reduced. Liquid assets can also be used to fund loans when interest rates are relatively high. Short-term assets are a less expensive source of funds than relatively high interest rate deposits.

Monitoring Risks

To monitor risks, various techniques such as maturity profile, rate of interest ladder and concept of duration have been developed. A maturity profile shows all assets and all liabilities by maturities to enable the calculation of mismatches within each period. Rate-of-interest ladder classifies all assets and liabilities by repricing dates and allows the calculation of rate of interest risk for each period. Duration presents the interest exposure.

Asset and liability management is not a static technique but a dynamic approach to deal with the problem banks face and changes in bank's goals. Frozen lending was offset by increasing flexibility by making new loans against the provision of tradable assets which could be sold before expiry, in case of need. Against a background of rapid growth in the banking business, integrated approach to managing all assets and all liabilities evolved as balance sheets became more complex and as the volatility of interest rates and exchange rates increased. In the eighties, the rescheduling of debt of developing countries on account of their serious payments difficulties involved conversion of short-term and medium-term assets into long-term and became frozen. Banks abroad met the problem by raising long-term funds including capital liabilities. In the process, banks could meet the rise in capital adequacy norms stipulated by bank supervisors. Banks shifted their focus from growth to profitability and asset quality. Banks also started lending against negotiable assets and to the packaging for resale of conventional bank loans. Borrowers were encouraged to raise funds directly through issue of negotiable short-term paper by providing guarantees, stand-bys and back-up facilities. Banks benefited from fee income without expanding balance sheet which would worsen capital ratios. Of course, off-balance sheet contingent liabilities went up.

There was a deliberate attempt to extend asset liability management beyond the range of on-balance sheet assets and liabilities which arises from the bank acting as principal in direct transactions with borrowers and lenders of money. Asset and liability management has helped to bring about securitisation of banking blurring the distinction between commercial banking and investment banking.

RBI Guidelines for Risk Management

Consequent to the liberalization of domestic market in India, the volatility in interest/ exchange rates would be transmitted to the financial sector as a whole. To address these risks, banks have to undertake a comprehensive asset liability management (ALM) strategy. The objectives of ALM are to control volatility of net interest income and net economic value of a bank.

Credit Risk

Banks should put in place the loan policy covering the methodologies for measurement, monitoring and control of credit risk. Banks should also evolve comprehensive credit rating system that serves as a single point indicator of diverse risk factors of counter parties in relation to credit and investment decisions.

Proposals for investment should be subjected to the same degree of credit risk analysis as loan proposals. Portfolio quality should be evaluated on an ongoing basis rather than near about balance sheet date. Risk evaluation should be on the basis of total exposure, credit and investment decisions combined.

As regards off-balance sheet exposures, the current and potential credit exposures may be measured on a daily basis. A suitable framework to provide a centralised overview of the aggregate exposure on other banks is to be evolved. The banks should also develop an internal matrix that reckons the counter party and country risk.

Liquidity Risk

Banks should put in place prudential limits on interbank borrowings, especially call fundings, purchased funds, core deposits to core assets, off-balance sheet commitments and swapped funds. Liquidity profile should be evaluated under bank specific and market crisis scenarios. Contingency plans should be prepared to measure the ability to withstand sudden adverse swings in liquidity conditions.

Interest Rate Risk

A time-frame should be fixed for moving over to value at risk (VAR) and duration approaches for measurement of interest rate risk.

Market Risk

Explicit capital cushion based on international standards should be provided for the market risks to which banks are exposed.

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Operational Risk

In view of the phenomenal increase in the volume of financial transactions, proper systems for measurement, monitoring and control of operational risk should be set up. Suitable methodologies for estimating and maintaining economic capital should be developed.

The design of the risk management should be oriented towards the banks own requirement dictated by the size and complexity of business risk philosophy, market perception and the existing level of capital. Banks can evolve their own systems compatible with the type and size of operations as well as risk perception. It is neither possible nor necessary to adopt uniform risk management system in all banks on account of the diversity and varying size of balance sheet items.

The success of ALM depends on the effective existence of (1) information and policies, and (2) risk management system. There should be asset-liability managers and an asset-liability committee (ALCO) that manages the bank's balance sheet in such a manner so as to minimize the volatility in its earnings, liquidity and equity to changes in market conditions. The successful pursuit of the objective would manifest in stable net interest margins, optimal earnings, adequate liquidity and effective control of financial risk. For this purpose, the information base in a bank must be sound and strong.

Check Your Progress

1. What are the three types of transactions provided by banks?
2. How does interest rate risk arises?
3. What is liquidity risk?

7.3 FUND BASED AND NON-FUND BASED FINANCIAL SERVICES OF COMMERCIAL BANKING

Retail banking refers to the banking process where banks carry out transactions directly with clients, rather than with corporations or other banks. Services offered include the following and are explained as follows:

1. **Savings account:** Savings account is a kind of operating account maintained by customers of a bank for non-commercial business. The purpose of having this type of an account is to enable customers to conduct their day-to-day banking transactions, and simultaneously, earn some interest on the deposits. It should be noted that though savings account deposits are not primarily investments, still they may be considered as a kind of a short-term investment. Usually, there are some limitations on the total withdrawable amount and the number of times withdrawals can be made during a given period. There

is also a minimum fixed balance that has to be maintained in the account at all times. Generally, a cheque operated savings bank account entails a higher amount of minimum account balance to be maintained than that in a non-cheque operated savings bank account. An overdraft facility is prohibited in a savings bank account; however, occasional overdrawing may be allowed in case of an emergency.

2. **Current/transactional account:** A transactional account or current account is a bank account where interest is not allowed on the maintained balance. It is a cheque operated account maintained mainly for business purposes. In a current account, the clients can deposit and withdraw money according to their needs, subject to whether they have sufficient balance. The legal heirs of a deceased current account holder are paid interest at the rates applicable to savings bank accounts from the date of death of the customer till the date of settlement. Certain service charges are levied for operating a current account.

   A current/transactional account allows the account holder to make or receive payments by the following means:

   - ATM cards (withdraw cash at any Automated Teller Machine)
   - Debit card (cashless direct payment at a store or merchant)
   - Cash money (coins and banknotes)
   - Cheque and money order (paper instruction to pay)
   - Direct debit (pre-authorized debit)
   - Electronic funds transfers (transfer funds electronically to another account)
   - Giro (funds transfer, direct deposit)
   - Standing order (automatic funds transfer)
   - SWIFT: International account to account transfer
   - Online banking (transfer funds directly to another person via internet banking facility)

   Internet or online banking refers to the utilization of a bank's secure website to check available cash balance and banking statements; execute transactions and payments; and avail various other facilities. This kind of banking is especially beneficial when an individual wants to avail of banking facilities after bank working hours, and does not want to be restricted by the location of the bank. Most retail banking institutions have integrated online banking solutions since the emergence of the internet revolution.

3. **Mutual funds:** Mutual fund is an investment vehicle which is made up of a pool of funds collected from a number of investors, especially small investors for whom it is difficult to create diversified portfolios of equities and fixed income securities. with a small amount of capital, and who are generally not

well-informed and competent enough to understand the intricacies of the stock market. The fund is created with the object of investing in a wide variety of securities and managed by a fund manager, who is professionally qualified and who is in charge of looking out for the best type of securities. By using their investment management skills and necessary research work, they determine the investments in which to invest the fund's capital, thereby ensuring much better return than what individual investors can manage on their own. In other words, the capital of the fund collected from various investors is invested in a wide variety of securities with a view to produce capital gains and steady returns for the investors of the fund. The capital appreciation and other income earned by way of interest/dividend from the investments made by the fund are distributed to the investors in proportion to the shares/units owned by each investor. When an investor invests in a mutual fund, he/she is buying units or portions of the fund. He or she becomes a shareholder or unit holder of the fund on investing. It may be noted that the unit holders of a mutual fund do not have voting rights or any role in appointing, supervising or removing the fund's management. They are just the beneficiaries. A question which can naturally arise in this connection is the manner in which unit holders ensure the running of the fund in their best interest. This is taken care of partly by the regulatory framework surrounding mutual funds and partly by the tight competition among the various mutual funds for the investors' money.

Every mutual fund has a Board of Trustees, an Asset Management Company (AMC) and unit holders. In India, there is also a promoter or 'sponsor' who takes the initiative of starting the fund, but has no active role once the fund has been launched. According to SEBI regulations, the effective control of the AMC is with the Board of Trustees and not with the sponsor. A majority of the trustees are chosen from among independent persons and the remaining are nominees of the sponsor. The governing body of a mutual fund is the Board of Trustees.

4. **Mortgage:** Section 58 of the Transfer of Property Act defines a 'mortgage' as follows:

   'A mortgage is the transfer of an interest in a specific immovable property for the purpose of securing the payment of money advanced or to be advanced by way of loan, an existing or future debt, or the performance of an engagement which may give rise to pecuniary liability.'

   In terms of this definition, the essentials of a mortgage are as follows:

   - There must be a transfer of interest in an immovable property.
   - The immovable property must be a specific one.
   - The consideration of a mortgage may be either money advanced or to be advanced by way of a loan, or the performance of a contract.

5. **Personal loans:** The term ‘loan’ is popularly used to denote the granting of an advance in lump sum, generally on the basis of securities acceptable to the banker. The distinguishing feature of a loan is that interest on it is payable on the entire amount, whether it is fully utilized or not. It is granted for a definite period and the borrower is given the facility to repay it in one lump sum or in installments. As far a banker is concerned, the operating cost of a loan is lower as compared to a cash credit or an overdraft. This method of granting an advance has the advantage of strengthening the financial discipline in the use of bank credit. Follow up, supervision and control of end-use of bank credit could be made more effective in the case of loans as compared to cash credits and overdrafts.

   A personal loan refers to a short-term loan that is given to an individual as a mode of financial assistance. Personal loans have become quite common nowadays, and those needing cash can easily get their requirements met. One may take a personal loan for personal, family or household use. A personal loan is neither a business loan, nor a long-term mortgage loan.

   An unsecured loan is one where the lender has to depend upon the borrower’s promise to pay the cash back. Since the risk involved is quite a lot, the interest paid is also much higher. Usually in this type of loan, the borrower has to pay the loan balance in installments. In case the borrower is able to pay the whole loan early, penalties may be assessed. Unsecured loans often come dear and lack flexibility, but these loans are suitable if the lender wants a short-term loan (one to five years).

   The most common forms of personal loans include mortgage loans, car loans, home equity lines of credit, credit cards, installment loans and payday loans. The credit score of the borrower is a major component in the underwriting and interest rates (APR) of these loans. The monthly payments of personal loans can be decreased by selecting longer payment terms, but overall interest paid increases as well.

6. **Debit and credit cards:** With the increase in the customer base in the banking industry, the banks want less and less people to have to visit the brick and mortar structure. For the convenience of the customer, banks have launched ATM cum debit cards and credit cards. These are known as the plastic money.

   As the disposable income of an average Indian has increased over the years, they want more luxuries in their lifestyle. They want to enjoy life to the fullest. If you ask your parents, they would definitely advice you to go slow and earn well before you can afford the present lifestyle. The youth today is more exposed than their parents. The retailers have also visualized this need. You visit any mall or even a small time retailer; he or she will have a machine where you can use your plastic money. The ease and comfort involved in using plastic money has brought a boom in this market. The plastic money is in form of debit card or credit card.

A credit card is a payment mechanism which enables the holder of the card to purchase goods or services without paying immediate cash and make a one-time payment at the end of a specified period (known as the billing cycle which is usually a month). The advantage to the card holder is that he or she can manage to postpone the expenditure by availing credit from the issuer of card. If we need credit, we have to secure a loan but when the loan amount is less and we require such funds on a regular basis, it is better to have a credit card. The concept of credit card has been a boon to customers and retailers if it is used judiciously.

Credit card can be viewed as a 'pay later product'. It is a form of consumer loan. A revolving credit account has a credit line of a specific amount that can be borrowed against in part or in full. As the outstanding balance is paid, the available credit line is restored for use again. The defaulters have to pay a heavy penalty, and the bank has a recovery department that has the responsibility of recovering the payments from the defaulters. If you are a regular defaulter, CIBIL will give you a bad rating. This will remain in your credit history and if in the future, you need credit facility of the existing bank or want to have a new bank provide you a credit card, you will not be able to do so. The customers have to be regular in their payments if they wish to avail such services time and again.

Check Your Progress

4. What is the purpose of a savings account?
5. State the main objective of mutual fund.
6. What are the most common forms of personal loans?

7.4 LEASE

A lease is a right to use an asset. There are two parties to a normal lease transaction: Lessor and Lessee. The former is the legal owner of the asset and the latter is the beneficial owner. The lessor allows the lessee to utilize the asset for a stipulated period of time for a consideration of periodical payments.

A contract of lease can be defined as 'A contract whereby the owner of an asset (Lessor) grants to another party (Lessee) the exclusive right to use the asset, usually for an agreed period of time in return for the payment of rent.'

In other words, a lease contract provides a person (lessee) an opportunity to use an asset which belongs to another person (lessor). Thus, in a lease transaction, two important rights to the property emerge: (a) Ownership and (b) Right to use the asset.

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Features of a Lease

The following are the important features of lease agreements:

- There are two parties to a lease: the lessor and the lessee.
- Lease agreements are for a fixed period and at a fixed rent.
- The lessee is not the legal owner of the capital asset. He or she can only make use of the asset.
- The lessee is not the legal owner; hence, he or she cannot claim depreciation, though he uses the asset, nor can he show the asset in the balance sheet.
- Payments are made over the term of the lease.
- The lessee pays rentals periodically, and these are taken as operating expenses and can be deducted for tax purposes.
- The lessee has to return the asset after the expiry of the lease period. Sometimes, the lease agreement may provide a purchase option after the expiry of the lease period.
- The duties of the lessor/lessee are to service the leased asset.

Essential Elements of Leasing

The following are the essential elements of leasing:

(i) Parties to the contract

In every lease agreement, as seen earlier, there are two parties—the owner and the user, called the lessor and the lessee respectively.

Lessor: The lessor is the legal owner of the asset. He allows the lessee to use the asset for a specific period for a consideration which can be paid periodically, in instalments.

Lessee: The lessee is the beneficial owner. He enters into a normal lease agreement, agreeing to take the capital asset on lease for a specific period and make specified lease payments. Usually, the period of the lease does not exceed the asset's economic life.

(ii) Asset

The asset, property or equipment to be leased is the subject matter of a contract of lease financing. The asset may be plant and machinery, equipment, land and buildings, a factory, a running business, an air craft, a ship, an automobile and so on. The asset must, however, be of the lessee's choice, suitable for his business needs.

(iii) Duration

The term of lease is the duration for which the agreement of lease remains in operation. Every lease should have a definite period, otherwise it becomes legally inoperative. The lease period may sometimes stretch over the entire economic life of the asset or may be for a period shorter than the asset's functional life. It may also be perpetual with an option to renew the lease for a further specific period at the end of the existing period.

(iv) Lease rentals

The consideration which is paid by the lessee to the lessor for the lease transaction is the lease rental. The lease rentals are structured in such a manner that they compensate the lessor for the investment made in the asset in the form of depreciation, interest on the investment, repairs, and servicing charges.

Types of Leases: Operating and Financial Leases

Generally, leases are classified into Financial leases and Operating leases. These leases have entered the picture in various parts of the world and are practised according to the convenience of the lessor and the lessee.

(i) Financial Leases

A financial lease is also known by various names such as capital lease, long-term lease and full payment lease. It is a non-cancellable contract. The lease period is usually equal to or shorter than the asset's functional life. During the life of the contract, the cost of the property and the financial and servicing charges are recovered through periodic payments.

In a financial lease, the lessor transfers the risks and rewards incident to the ownership of the equipment to the lessee. Rentals are paid in instalments so that the cost of the equipment and a reasonable interest on funds invested in the purchase or manufacture of the equipment can be covered. Thus, a financial lease involves financing the equipment purchase and lending it out to the lessee for use with or without the transfer of ownership immediately. Under this kind of lease agreement, the leasing company simply acts as a financial institution. The lessee specifies the equipment needed and acts as the lessor's agent in the matter of ordering, inspecting and maintaining it. The lessor is simply interested in the capital asset as it is legally owned. He raises the money, accepts the invoice from the supplier and pays accordingly.

(ii) Operating Leases

An operating lease is also known as a short term, service or maintenance lease. In this type of lease, the lease period is generally less than the full expected economic life of the equipment. Unlike a financial lease, the contract is cancellable with prior notice. Under an operating lease, the lessor does not transfer all the rewards and risks incidental to the proprietorship of the asset and the cost of the asset is not fully amortized during the primary lease period. The lessor provides all the services attached to the asset, such as maintenance, repair and technical advice. For this reason, an operating lease is also called a 'service lease'.

Financial Lease vs Operating Lease

A lease can be categorized as a financial lease if all the rewards and risks incidental to proprietorship are transferred substantially. It may or may not eventually transfer the title.

In the case of an operating lease, all the rewards and risks incidental to proprietorship are not transferred substantially.

Advantages and Limitations of Leasing

The advantages of leasing are given below.

Advantages of Leasing

In this context, a question arises—why has lease financing become so popular? This question can be answered by understanding the unique advantage that lease financing offers over other types of finances available for financing fixed assets. Leasing is advantageous to both the lessor and lessee. The following are the advantages of leasing:

(i) **Financial benefits:** The lessee does not have to pay the cost of the asset outright. If the cost of buying is analysed against the cost of the lease, the company incurring losses may prefer to have a low cash outflow at present and resort to lease financing.

(ii) **Flexibility of lease:** Leasing is more convenient for assets that are meant to be used for short periods and for companies who find it difficult to get loans from banks and financial institutions. The leasing and payment of rentals can be synchronized with the cash inflows of the company.

(iii) **Risk of obsolescence:** The lessee can pass on the risk of obsolescence to the lessor, which is more suitable for such appliances which are subject to high technological obsolescence, such as computers and electronic equipment.

(iv) **Need for maintenance and specialized services:** If the lessee has to depend on the manufacturer or supplier for service and maintenance, as in the case of air craft and ships; it is more convenient for the lessee to lease and pass on these risks to the lessor who can provide these specialized services.

Disadvantages of Leasing

The following are the disadvantages of leasing:

(i) **Loss of ownership:** The main drawback of a lease is that the ownership remains vested with the lessor.

(ii) **More expensive:** Long-term leasing is generally more expensive to the lessee.

(iii) **Disadvantages during inflation:** During a period of inflation, real estate values may increase during the lease period. In such cases, the benefit of the capital gain is enjoyed by the lessor.

(iv) **Asset alterations are not possible:** As the lessee is not the owner of the asset, he cannot make any substantial changes in the asset. Contrary to it, in case of outright purchase, the buyer can modify or alter the asset to increase its utility.

(v) **Loss of salvage value:** An asset generally has a certain salvage value at the expiry of its useful life. As the lessee does not become the owner of the asset, he cannot release the salvage value at the expiry of the lease; rather, he has to return the asset to the lessor.

Is a Lease an Asset or a Liability?

There has been a lot of discussion among accountants regarding whether a lease should be reported as an asset on the balance sheet of the lessee or not. One argument states that the equipment leased is an asset because it is continuously used by the lessee like any other asset in the company, and as such, should be shown in the balance sheet. The opposite argument holds that the lessee actually borrows the equipment and uses it on a temporary basis. Hence, the lease rent is a current expenditure like other rentals, and can therefore neither be shown as an asset on the balance sheet nor can it be depreciated by the lessee.

The Financial Accounting Standards Board (FASB) of USA, which sets the accounting procedures, studied this subject carefully. According to FASB, it is important to understand the difference between a capital lease and an operating lease: the value of a capital lease is reported as both a liability and an asset on the balance sheet of the lessee, while the cost of an operating lease is deducted as current expenditure in the profit and loss account.

Accounting Treatment of Leasing

The accounting treatment for a lease has been the subject of much controversy. The controversy relates to the following points:

(a) Whether lease transactions are to be disclosed in the books of the lessee and the lessor

(b) When lease transactions are disclosed in the financial statements, should they be shown only by way of a foot note or should they be a vital element of the annual accounts

(c) In case lease transactions form a vital element of the financial statements, how should they be treated in the lessor and lessee's books

An appropriate accounting methodology is necessary for income recognition from both the lessee and the lessor's point of view. In this regard, the national and international Accounting Standard Boards have issued several guidelines/notes and standards from time to time. In September 1982, the International Accounting Standard Board issued IAS–17, known as 'Accounting for Lease'. In India, the Institute of Chartered Accountants of India (ICAI) issued a Guidance Note on Accounting for leases in 1988, which was almost similar to IAS–17. This guidance note, which was recommendatory in nature, was kept in abeyance by the Madras High Court. However, the abeyance was lifted by the court on 14 July 1995. A revised Guidance Note on Accounting for leases was issued by ICAI in September 1995. The Reserve Bank of India constituted a study group on the Guidance Note, and on the basis of the study group's recommendations, made it compulsory for it to be applied to all the assets leased by leasing companies. Accordingly, ICAI issued AS–19 in January 2001.

Accounting for Financial Lease in the Books of the Lessee

According to AS–19, lessees should recognize assets and liabilities at amounts equalling the lower of the fair value of the asset that is leased or the present value of the lowest lease payments using the interest inherent in the lease or the incremental borrowing rate of the lessee as the discount factor.

The lease payments should be distributed between the financial charges and the decline in the outstanding liability. The former must be apportioned to periods within the terms of the lease. Full depreciation of the asset must be carried out during the term of the lease or the functional life of the asset, whichever is briefer, and charged to the profit and loss account.

Operating leases

Operating leases give the lessee the right to use the leased assets over a period of time, but they do not give the lessee the risks and benefits relating to the assets. Under an operating lease, lease payments are recognized as expenses in the profit and loss account. The lease rentals are allocated to each accounting period in a manner that reflects the time pattern of the benefit to the lessee and are charged to the profit and loss account.

Illustration 7.1

Nagarjuna Limited entered on a lease agreement with First Leasing Limited on 1 January 2000. The following are the conditions of the lease:

A. Fair value of the asset ₹ 1,00,000

B. Life of the asset is 5 years, residual value is zero

C. Lease rentals are ₹ 27,740 for 5 years payable at the end of each year

Show how this transaction would be recorded in the books of Nagarjuna Ltd. for the first two years; also show the profit and loss account and balance sheet for these two years.

Solution:

(a) Computation of implicit rate of interest:

Fair value of the asset = ₹ 1,00,000

Period of lease is 5 years

Rental payable at the end of each year = ₹ 27,740

Total lease payments ₹ 27,740 × 5 = ₹ 1,38,700

Annuity factor: 1,00,000/27,740 = 3.605

Look at the Present Value (PV) of annuity table to find out the implicit rate of interest. In the PV of annuity table, corresponding to 5 years, locate the annuity factor of 3.605 – we will find exactly 12 per cent in the column corresponding to interest. Therefore, the implicit rate of interest is 12 per cent (The implicit rate of interest, in the majority of cases, should be recognized by a trial and error method).

The total finance charge is ₹ 1,38,700 (–) ₹ 1,00,000 = ₹ 38,700

(b) Allocation of finance charges over the 5 years period:

Year	Amount Outstanding	Interest @ 12 per cent	Rental at the End of the Year	Principal Paid
1	1,00,000	12,000	27,740	15,740
2	84,260	10,111	27,740	17.629
3	66,691	8,039	27,740	19,701
4	46,990	5,639	27,740	22,101
5	24,889	2,961	27,740	24,829
	TOTAL	38,700	1,38,700	1,00,000

Journal of Nagarjuna Limited
Lessee Books

Date	Particulars	Debit	Credit
01-01-2000	Asset A/c Dr	1,00,000/-	
Beginning of the year	To First Leasing Ltd		1,00,000/-
	(Being the asset taken on lease)		
31-12-2000	Interest A/c Dr	12,000/-	
End of the year	To First Leasing Ltd		12,000/-
	(Being the finance charge in respect of the lease)		
	Depreciation A/c Dr	20,000/-	
	To Asset A/c		20,000/-
	(Being the depreciation or asset on Straight Line Method (SLM) for the year)		
	Profit and Loss A/c Dr	32,000/-	
	To Interest		12,000/-
	To Depreciation		20,000/-
	(Being the transfer of interest and depreciation to profit and loss A/c)		

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	First leasing Ltd A/c Dr	27,740/-	
	To Bank		27,740/-
	(Being the payment of lease rental)		
31-12-2001	Interest A/c Dr	10,111/-	
End of the year	To First Leasing Ltd		10,111/-
	Depreciation A/c Dr	20,000/-	
	To Asset		20,000/-
	(Being the depreciation for the second year)		
	Profit and Loss A/c Dr		30,111/-
	To Interest		10,111/-
	To Depreciation		20,000/-
	(Being the transfer of depreciation and interest to profit and loss account)		
	First Leasing Ltd A/c Dr	27,740/-	
	To Bank		27,740/-
	(Being the payment of lease rentals)		

Ledger of Nagarjuna Limited

Asset A/c

Dr.			Cr.
01-01-200 To First leasing Ltd	₹ 1,00,000/-	31-12-2000 By Depreciation	20,000/-
		By Balance c/d	80,000/-
	1,00,000/-		1,00,000/-
01-01-2001 To Balance b/d	80,000/-	31-12-2001 By Depreciation	20,000/-
		By Balance c/d	60,000/-
	80,000/-		80,000/-

First Leasing Limited A/c

Dr.			Cr.
31-12-2000 To Bank – Rental	27,740/-	01-01-2000 By Asset	1,00,000/-
To Balance c/d	84,260/-	31-12-2001 By Interest	12,000/-
	1,12,000/-		1,12,000/-
31-12-2001 To Bank – Rental	27,740/-	01-01-2001 By Balance	84,260/-
To Balance c/d	66,631/-	31-12-2001 By Interest	10,111/-
	94371/-		94,371/-

The depreciation and interest charged to the profit and loss account over the five year period of the lease are:

Year	1	2	3	4	5	**Total**
Interest Debit	12000	10111	8039	5639	2911	**38700**
Depreciation Debit	20000	20000	20000	20000	20000	**100000**
Total	**32000**	**30111**	**28039**	**25639**	**22911**	**138700**

The relevant items will appear in the balance sheets as shown under:

Year	1	2	3	4	5
Leased Asset (–)Depreciation	1,00,000/- 20,000/-	80,000/- 20,000/-	60,000/- 20,000/-	40,000/- 20,000/-	20,000/ 20,000/-
Net Book Value	80000/-	60,000/-	40,000/-	20,000/-	NIL

Liabilities Side Under the Heading Credit or Outstanding

Year	1	2	3	4	5
Obligation under Finance lease	84,260/-	66,691/-	46,990/-	24,889/-	NIL

Accounting for Financial Lease in the Books of the Lessor

Firstly, the lessor should ascertain and record the assets mentioned in a finance lease as 'account receivable' in the balance sheet. The amount in the account receivable column must be equal to the net investment in the lease. The net investment is arrived at by subtracting the unearned finance income from the gross investment in the lease. The former refers to the discrepancy between the gross investment and the PV of the lowest lease payments.

Finance income can be seen as being based on a paradigm that reflects a constant periodic rate of return on the investment of the lessor, and is outstanding in the case of finance leases.

In order to understand the above stated aspects—account receivable, net investment, gross investment and unearned finance income—observe the following illustration from the lessor's point of view.

Illustration 7.2

Mahaveer takes an asset on finance lease from Raghuveer. The following are the terms and conditions of the lease:

Lease period	4 years
Fair value at the inception of the lease	₹ 25,00,000
Lease rent at the end of the year	₹ 8,00,000
Guaranteed residual value	₹ 1,70,000
Expected residual value	₹ 3,77,800
Implicit rate of return	15 per cent

You are required to show how the accounting is done in the books of Raghuveer (lessor).

Solution:

First, 'Accounts receivable' should be ascertained and recorded in the books of the lessor. Account receivable is the amount which should be equivalent to the net investment in the finance lease.

At the commencement of the lease, for the lessor, the net investment or fair value will be treated as Accounts receivable by making the following entry:

Account receivable A/c	Dr	25,00,000
To cash		25,00,000
(Being the asset purchased and given on finance lease)		

Workings:

(a) Gross investment = Lease payments + guaranteed residual value + un-guaranteed residual value

= 8,00,000 × 4 + 1,70,000 + 2,07,800 = 35,77,800.

(b) Unearned finance income = Gross investment – present value of investment

= 35,77,800 – 25,00,000 = 10,77,800.

(c) Net investment = Gross investment – unearned finance income

= 35,77,800 – 10,77,800 = 25,00,000.

Allocation of finance income over the lease period:

Year	Balance Outstanding	Lease Payment	Finance Income @ 15 per cent	Net
1	25,00,000	8,00,000	3,75,000	4,25,000
2	20,75,000	8,00,000	3,11,250	4,88,750
3	15,86,250	8,00,000	2,37,938	5,62,062
4	10,24,188	11,77,800	1,53,612	10,24,188
		35,77,800	10,77,800	25,00,000

At the end of each year, the finance income is calculated at the given rate of interest on the outstanding balance. The entry for this at the end of the first year will be.

(i)	Account receivable A/c	Dr	3,75,000
	To Finance income		3,75,000
	(Being the finance income due for the first year)		
(ii)	Account receivable A/c	Dr	3,75,000
	To Profit and Loss A/c		3,75,000
	(Being the finance income transferred to profit and loss A/c)		

For the lease rental received at the end of the first year, the following will be the entry.

(iii)	Cash Account Dr = 8,00,000	
	To Account received	8,00,000
	(Being the receipt of the lease rental)	

After making the entries for all the years, the accounts receivable account will appear as under and only the closing balances will appear in the balance sheet.

Lessor Books
Accounts Receivable A/c

Dr.			Cr.
First Year Beginning		End of the Year	
To Cash	25,00,000/-	By cash (lease rental)	8,00,000/-
To Finance income	3,75,000/-	By balance c/d	20,75,000/-
	28,75,000/-		28,75,000/-
2nd year beginning		End of 2nd year	
To balance b/d	20,75,000/-	By Cash (lease rental)	8,00,000/-
To Finance income	3,11,250/-	By Balance c/d	15,86,250/-
	23,86,250/-		23,86,250/-
3rd year beginning		End of 3rd year	
To Balance B/d	15,86,250/-	By Cash (lease rental)	8,00,000/-
To Finance income	2,37,938/-	By Balance c/d	10,24,188/-
	18,24,188/-		18,24,188/-
4th year beginning		End of 4th year	
To balance b/d	10,24,188/-	By Cash (lease rental)	8,00,000/-
To Finance income	1,53,612/-	By Cash expected residual value	3,77,800/-
	11,77,800/-		11,77,800/-

If the expected residual value is more or less than what was estimated at the inception of lease, there will be surplus or deficiency; in either case, the amount should be transferred to the profit and loss account.

Accounting for Operating Leases

In a finance lease, the lessee has the sole use of the asset and is also responsible for its maintenance. An operating lease, on the other hand, is a short term hire of assets such as vehicles, computers and furniture. For operating leases, the rewards and risks of proprietorship are not passed on to the lessees. The following are the main features of the treatment of operating leases in books of account:

(a) The asset is treated as a fixed asset in the lessor's books and depreciation is provided for its functional life.

(b) Lease rentals are treated by the lessor as income, and other costs or expenses, including depreciation incidental to the lease, are treated as expenses in the year in which they are incurred.

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(c) Depreciation on assets that are leased is in keeping with the lessor's usual depreciation policy for similar assets. The depreciation charge is computed in accordance with AS–6.

(d) For the lessee, rental paid is an expense and is charged to the profit and loss account.

Lease or Buy Arrangements

The problem of whether to lease or purchase capital assets is one of the most common and fundamental problems faced by banking and insurance companies hiring office buildings, large retail stores, oil companies having service stations etc. An analysis of the profitability in such commitments is often complicated and requires a very serious consideration of a number of financial factors.

On exercising the choice between leasing a property and buying outright, the deciding criterion is the relative economy of both the courses of action. From the firms' point of view, the question of which is more economical—leasing or buying—has to be seen. Thus, the profitability of the projects involved in these arrangements can be ascertained.

Evaluation

When 'lease or buy' alternatives have to be evaluated, the first step is to reduce them to a common time period. When an asset is purchased outright, usually, it has a useful life of 30–40 years; but if obtained on lease, it may be acquired only for 20 years. To reduce both the alternatives to a common time period for analysing the profitability of the projects, it is necessary that the value of ownership in the case of outright purchase be taken for the same period as the lease. If the asset is purchased outright, then its likely scrap value at the end of the period should be adjusted for the lease period; say for example, the asset's functional life is 30-40 years. In case of outright purchase, 20 years of the lease arrangement, and then the scrap value, should be adjusted for 20 years to have a common factor for assessing profitability.

When lease or buy alternatives have been reduced to a common time period, it is necessary to analyse the following financial factors in detail to make the crucial choice:

(a) The initial payment in the case of outright purchase

(b) If the sum required is obtained through issue of shares, then dividend is payable

(c) The period and scrap value should be adjusted to a common period

(d) The rate of tax and cost of equity after tax

(e) The risk involved in the alternatives

(f) The capital allowance on the property purchased

(g) The impact on the credit status of the firm

All the above mentioned financial factors exercise their impact on the profitability of the project. Their impact must be checked in detail, so that a decision can be arrived at.

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7.4.1 Lease Financing

Lease financing is one of the methods of long-term financing. Assets may be acquired by purchase through borrowing or on a lease basis. Whether it is economical to buy an asset through borrowing or to obtain it on a lease basis has to be decided. A decision has to be taken on the basis of the present value analysis of alternatives available.

Financial evaluation of leasing

The most important part of a leasing transaction, for both the lessor and the lessee, is the financial evaluation of the proposal. Financial evaluation can be done separately: (i) from the lessee's perspective and (ii) from the lessor's perspective.

From the lessee's point of view

It involves a choice between debt financing and lease financing. The following are the steps to be followed for evaluation:

(1) Calculate the PV of net cash flow of the buying option, called NPV (B)

(2) Calculate the PV of net cash flow of the leasing option, called NPV (L)

(3) Decide whether to buy or lease the asset or reject the proposal altogether by applying the following methods:

   (a) If NPV (B) is positive and greater than NPV (L), purchase the asset

   (b) If NPV (L) is positive and greater than the NPV (B), lease the asset

   (c) If NPV (B) as well as NPV (L) are both negative, reject the proposal altogether

Most financial analysts argue that lease financing decisions arise only after a firm has made a decision about the investment; it only involves comparing the cost of the leasing and borrowing options. The following steps are involved in such an analysis:

(i) Determining the PV of after tax cash outflows under the leasing option

(ii) Determining the PV of after tax cash outflows under the buying or borrowing options

(iii) Comparing the PV of cash outflow from the leasing and buying/borrowing options

(iv) Selecting the option with the lower PV after tax cash outflow

Illustration 7.3

Reliance Industries Limited is interested in acquiring the use of an asset costing ₹ 10,00,000/-. It has two options: (a) borrow the amount at 20 per cent p.a., repayable in 5 equal instalments or (b) take the asset on lease for a period of 5 years at year end rentals of ₹ 2,40,000/-. The corporate tax is 50 per cent and depreciation is allowed on WDV at 20 per cent. The asset will have a salvage value of ₹ 3,60,000/- at the end of the fifth year.

You are required to advice RIL on the lease or buy decision. Will the decision change if the firm is allowed to claim investment allowance at 25 per cent?

Note: (a) The PV of ₹ 1 at 20 per cent discount factor is:

1st year	2nd year	3rd year	4th year	5th year	Total
0.833	0.694	0.579	0.482	0.402	2.991

Solution:

(i) Determine loan instalment:

$$\frac{\text{Amount of loan}}{\text{PV factor of Anuity}} = \frac{10,00,000/-}{2.991} = 3,34,336/-$$

(ii) Schedule of Loan Payments

Year	Loan Balance at the Beginning of the Year	Loan Instalment	Interest Payment	Principal Payment	Loan Balance at the End of the Year
1	10,00,000/-	3,34,336/-	2,00,000/-	1,34,336/-	8,65,664/-
2	8,65,664/-	3,34,336/-	1,73,133/-	1,61,203/-	7,04,461/-
3	7,04,461/-	3,34,336/-	1,40,892/-	1,93,444/-	5,11,017/-
4	5,11,017	3,34,336/-	1,02,203/-	2,32,133/-	2,78,884/-
5	2,78,884/-	3,34,336/-	55,452/-	2,78,884/-	N I L
	Total	16,71,680/-	6,71,680/-	10,00,000/-	——

(iii) Calculation of present value of after tax cash out flow under the borrowing/ buying option

Total preset value after tax: net cash outflow		5,62,702
Less : PV of salvage value at the end of the 5th year		
	3,60,000 × 0.402	1,44,720/-
		4,17,982/-

(iv) Calculation of present value of after tax cash outflows under the lease option

Year End	Lease Rent on Lease Rent	Tax Savings Cash Outflow	After Tax Factor @	P V Annuity 20 per cent	Total P V of Cash Outflow
1 – 5	2,40,000/-	1,20,000/-	1,20,000/-	2.991	3,58,920/

(v) Evaluation

As the PV of after tax cash outflows under the leasing option is less than the PV of the after cash outflows of the buying option, it is advisable to take the asset on lease.

Decision if investment allowance is allowed

If investment allowance is allowed on the purchase of the asset, the total PV of net cash outflows will decrease by the PV of the tax savings on the investment allowance as calculated below:

Allowed at the end of the 1st year 10,00,000/- × 25 per cent	2,50,000/-
Tax savings (50 per cent	1,25,000/-
PV factor at the end of 1 year	0.833
PV of tax savings on investment allowance 1,25,000/- × 0.833	1,04,125/-
Hence PV of cash outflows in the buying option 4,17,982/- (–) 1,04,125/- =	3,13,857/-

If the investment allowance is allowed, the PV of cash outflows under the buying option will be less than the PV of outflows under the leasing option and hence, the company should buy the asset.

From lessor's point of view

The financial evaluation of the lease from the point of view of the lessor aims at ascertaining whether to accept a lease proposal or choose from an alternative proposal. This can be evaluated with the help of the following two time adjusted methods of capital budgeting:

(a) Present Value method

(b) Internal Rate of Return method

Method of computing lease rentals

The steps involved in computing lease rentals are:

(a) Determining the cost of the asset, which includes the actual purchase price plus expenses such as fright, insurance, taxes and installation.

(b) Determining the cash flows to the lessor on account of ownership of the asset. These include tax advantages provided by depreciation and investment allowance.

(c) Calculating the PV of cash flows of ownership and the advantage from the cost of the asset, determined in steps so that the minimum required net recovery through lease rentals can be determined.

(d) Calculating post tax lease rentals by dividing the minimum required net recovery through lease rentals by the present value factor of annuity.

(e) Computing the pre-tax lease rentals by adjusting the post-tax lease rentals for the tax factor.

Lease Financing vs Hire-purchase

Lease financing resembles hire-purchase in certain ways. Both are similar insofar as the use of the asset by the hirer or the lessee is concerned. In both the cases, the right to use the equipment is transferred to the hirer or the lessee.

In case of leasing, the user of the asset (lessee) is not the owner of the asset. Hence, depreciation on the asset cannot be claimed by the lessee as a deduction from the taxable income. As against this, the hire-purchaser capitalizes the asset bought under the hire-purchase contract, although the ownership does not pass on to him until the last instalment is paid. The hire-purchaser charges depreciation to the profit and loss account. The liability for future hire-purchase instalments is shown separately in the balance sheet.

Under leasing, all the lease rentals represent a 'hire charge' and can therefore be treated as expenses and hence are tax deductible.

Under hire-purchase, one part of the instalment represents capital outlay and the other part is interest on loan and is considered as revenue expense that is tax deductible.

In case of leasing, the asset that is leased is not shown in the lessee's balance sheet, and in case of hire-purchase, the asset is shown in the hirer's balance sheet.

Generally, there is no down payment in case of leasing. But down payment is a precondition in the case of hire-purchase.

Lease Financing vs Buying

When a firm finances the asset by normal financing, it takes two steps:

1. Purchases the asset for cash
2. Procures the necessary cash by selling a package of its financing instruments (debit and/or equity)

In a buy vs lease situation, the decision revolves around the question of whether it would be better to lease or to buy.

Check Your Progress

7. What are the main features of lease agreements?
8. State the main drawback of lease.
9. How is net investment calculated?

7.5 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Banks provide three types of transactions: first to convert deposits into notes and coins to enable holders of deposits to undertake transactions in

cash. Secondly, bank deposits are used as a means of settling debts. Thirdly, where exchange controls do not exist, banks exchange cash and deposits from one currency into cash and deposits of another currency.

2. Interest rate risk arises when the market value of a bank asset, loan or security falls when interest rates rise.
3. Liquidity risk refers to the bank's ability to meet its cash obligations to depositors and borrowers.
4. The purpose of a savings account is to enable customers to conduct their day-to-day banking transactions, and simultaneously, earn some interest on the deposits.
5. The mutual fund is created with the object of investing in a wide variety of securities and managed by a fund manager, who is professionally qualified and who is in charge of looking out for the best type of securities.
6. The most common forms of personal loans include mortgage loans, car loans, home equity lines of credit, credit cards, installment loans and payday loans.
7. The main features of lease agreements are as follows:
    a) Lease agreements are for a fixed period and at a fixed rent.
    b) The lessee is not the legal owner of the capital asset. He or she can only make use of the asset.
    c) The lessee is not the legal owner; hence, he or she cannot claim depreciation, though he uses the asset, nor can he show the asset in the balance sheet.
    d) Payments are made over the term of the lease.
8. The main drawback of a lease is that the ownership remains vested with the lessor.
9. The net investment is arrived at by subtracting the unearned finance income from the gross investment in the lease.

7.6 SUMMARY

- Banks are financial firms and depend on economies of size and gains arising from internalizing certain activities rather than relying on market transactions.
- Banks provide packages of financial services which individuals find too expensive to search out, produce and monitor by themselves.
- Commercial banks are institutions which combine various types of transaction services with financial intermediation.
- Commercial banks undertake the important process of financial intermediation whereby the funds or savings of the surplus sectors are channelled to deficit sectors.

- Banks combine various types of transformation services with financial intermediation. They provide three transformation services when they undertake intermediation process.
- Risk is inherent in banking and is unavoidable. The basic function of bank management is risk management.
- For banks, the traditional activity was balance sheet lending and the risk management technique was credit analysis.
- Banks in the process of providing financial services assume various kinds of risks, credit, interest rate, currency, liquidity and operational risks.
- A bank's overall risk can be defined as the probability of failure to achieve an expected value and can be measured by the standard deviation of the value.
- Credit risk or default risk gives rise to problems of bank management. The principal reason for bank failures is bad loans.
- RBI guidelines envisage that banks should put in place the loan policy covering the methodology for measurement, monitoring and control of credit risk.
- Interest rate risk management may be approached either by on-balance sheet adjustment or off-balance sheet adjustment or a combination of both.
- Liquidity risk refers to the bank's ability to meet its cash obligations to depositors and borrowers.
- Asset liquidity is a reserve that a bank can fall back upon when bank's access to funds is reduced.
- To monitor risks, various techniques such as maturity profile, rate of interest ladder and concept of duration have been developed.
- Asset and liability management is not a static technique but a dynamic approach to deal with the problem banks face and changes in bank's goals.
- The design of the risk management should be oriented towards the banks own requirement dictated by the size and complexity of business risk philosophy, market perception and the existing level of capital.
- Retail banking refers to the banking process where banks carry out transactions directly with clients, rather than with corporations or other banks.
- Savings account is a kind of operating account maintained by customers of a bank for non-commercial business.
- A transactional account or current account is a bank account where interest is not allowed on the maintained balance.
- Mutual fund is an investment vehicle which is made up of a pool of funds collected from a number of investors, especially small investors for whom it is difficult to create diversified portfolios of equities and fixed income securities.

- The term ‘loan’ is popularly used to denote the granting of an advance in lump sum, generally on the basis of securities acceptable to the banker.
- A personal loan refers to a short-term loan that is given to an individual as a mode of financial assistance.
- An unsecured loan is one where the lender has to depend upon the borrower’s promise to pay the cash back.
- With the increase in the customer base in the banking industry, the banks want less and less people to have to visit the brick and mortar structure. For the convenience of the customer, banks have launched ATM cum debit cards and credit cards.
- A lease is a right to use an asset. There are two parties to a normal lease transaction: Lessor and Lessee.
- A lease contract provides a person (lessee) an opportunity to use an asset which belongs to another person (lessor).
- The term of lease is the duration for which the agreement of lease remains in operation. Every lease should have a definite period, otherwise it becomes legally inoperative.
- A financial lease is also known by various names such as capital lease, long-term lease and full payment lease. It is a non-cancellable contract. The lease period is usually equal to or shorter than the asset.
- An operating lease is also known as a short term, service or maintenance lease. In this type of lease, the lease period is generally less than the full expected economic life of the equipment.
- Finance income can be seen as being based on a paradigm that reflects a constant periodic rate of return on the investment of the lessor, and is outstanding in the case of finance leases.
- Lease financing is one of the methods of long-term financing. Assets may be acquired by purchase through borrowing or on a lease basis.
- Lease financing resembles hire-purchase in certain ways. Both are similar insofar as the use of the asset by the hirer or the lessee is concerned.

7.7 KEY WORDS

- **Banks**: It refers to financial firms and depends on economies of size and gains arising from internalizing certain activities rather than relying on market transactions.
- **Bank’s Overall Risk**: It refers to the probability of failure to achieve an expected value and can be measured by the standard deviation of the value.
- **Retail Banking**: It refers to the banking process where banks carry out transactions directly with clients, rather than with corporations or other banks.

7.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

NOTES

Short Answer Questions

1. What are the main functions of a commercial bank?
2. State the basic function of bank management.
3. What are the essential elements of mortgage?
4. How does credit risk arises?
5. What is a transactional account?
6. How is financial lease different from operating lease?

Long Answer Questions

1. Analyse the transformational services provided by banks.
2. Discuss any two types of risks faced by banks in detail.
3. How are lease accounts maintained by an organization? Explain in detail.
4. Analyse the main elements of lease agreements.
5. Explain the various types of services provided by banks.
6. Interpret the advantages and disadvantages of lease agreements.

7.9 FURTHER READINGS

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UNIT 8 OVERVIEW OF HIRE PURCHASE

NOTES

Structure

8.0 Introduction
8.1 Objectives
8.2 Hire Purchase: Features, Guidelines, Functions, Components and Costs
8.2.1 Lease Financing versus Hire-Purchase Financing
8.3 Answers to Check Your Progress Questions
8.4 Summary
8.5 Key Words
8.6 Self Assessment Questions and Exercises
8.7 Further Readings

8.0 INTRODUCTION

Hire purchase refers to an arrangement in which buyers can buy expensive consumer goods on credit and he or she can make an initial payment. The balance is paid in installments and interest is also levied. The hire purchase plan is similar to an installment plan; however in this case, the buyer does not get the ownership rights. The ownership is transferred only when the full payment is paid.

Hire purchase agreements are similar to rent-to-own transactions as it provides lessee the option to buy at any time during the agreement. However, it may prove expensive because of high interest rates.

In this unit, the meaning of hire purchase plan and its features has been highlighted. The functioning of the hire purchase plan and its advantages and disadvantages has been explained. The unit will also explain the taxes levied on hire-purchase agreements and the concept of bill discounting.

8.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss the meaning and features of hire-purchase planning
- Explain the working of hire-purchase planning
- Analyze the advantages and disadvantages of hire-purchase finance
- Identify the tax considerations on hire-purchase planning
- Discuss the difference between lease financing and hire purchase financing

8.2 HIRE PURCHASE: FEATURES, GUIDELINES, FUNCTIONS, COMPONENTS AND COSTS

NOTES

Hire purchasing is an alternative way of financing assets and is commonly used by finance companies to finance commercial vehicles. In fact, hire-purchase is also popularly used for equipment financing. Hire-purchase is defined as a contractual agreement in which the owner gives his goods on hire to the hirer and gives the option to the hirer to purchase the goods as per the terms of the contract.

Hire-purchase is a means of obtaining the use of an asset before completion of the payment for the asset. According to the Hire-Purchase Act, 1972, a hire-purchase agreement is an agreement under which goods are let on hire and under which the hirer has no option to purchase them in accordance with the terms of the agreement. The Hire-Purchase Act includes an agreement under which:

- Possession of goods is delivered by the owner thereof to a person on condition that such person pays the agreed amount in periodical installments.
- The property in the goods is to pass to such persons on the payment of the last of such installments and that such person pays the agreed amount in periodical installments.
- A person has a right to terminate the agreement at any time before the property passes.

In case of a hire-purchase arrangement, a finance company may buy the asset that its client needs. The finance company will retain ownership of the asset but allow the hirer firm to use it against periodic payment of hire-purchase installments. There is a clear clause whereby at the end of the term of the agreement ownership of the asset will be transferred to the hirer. However, the operational risk during the hire-purchase period would be borne by the hirer (and not the financier) because it is the hirer who has complete control of the asset. This aspect is of added importance in accidental liabilities in case of vehicles.

Apart from finance companies, a manufacturer or distributor of an asset (e.g., vehicles and consumer durables) may also offer to be the financier on a hire-purchase arrangement. The objective is to facilitate sale of the item to the consumer. Often such firms extend this kind of facility through a financial subsidiary.

Features of Hire-Purchase

The various features of hire-purchase are as follows:

- The hirer has the option to purchase the goods any time during the contract.
- The hirer has the right to terminate the contract any time before the last installment.
- One can charge a higher rate of interest, and since the calculation is on the original advance, a higher income would then be realized.

- Since, the company is the owner in the hire-purchase arrangement, attachment of the vehicle and subsequent sales, even by private auction, would keep the level of non-performing assets low.
- The scope of defaults is very low in this arrangement because the borrowers would end up losing the installments paid as well as the vehicle.
- Banks can recycle effectively the funds recovered in hire-purchase.

Advantages of Hire-Purchase

Hire-purchase finance has become a very popular means of industrial and consumer credit in many countries. It can be used in the sale of durables and high-priced goods. Some of the advantages are as follows:

- **Easy possession:** It facilities people of limited resources to fulfill their dreams by purchasing articles through this means of financing.
- **No immediate cash payment required:** In this system, assets can be created without immediate cash payment.
- **Thrift in buyers:** Hire-purchase helps the buyer to save so that installments can be paid without default.
- **Growth of economy:** Hire-purchase facilitates economic growth by increasing investment and sales. Also, bulk sales of consumer durable results into employment generation, mass production and industrial development.
- **Relief to buyer:** It gives relief to the buyer who does not have to arrange for loans and advances to pay for the assets thus bought. It is beneficial for small-sector industrialists and farmers.

Disadvantages of Hire-Purchase

Some of the disadvantages of hire-purchase are as follows:

- It is available to reputed buyers only.
- The buyer's future income has to be mortgaged.
- A higher price has to be paid, hence this is costly.
- In the event of default, buyer may lose even the paid installment.
- During depression the buyer may lose the property, as the value of the property may decrease.
- This may lead to liberal and casual purchases and hence may lead to bankruptcy.
- In case of repossession after default, the seller may not recover the full price of the article, for example, real estate prices in the subprime crisis.

Mathematics of Hire-purchase

Two types of hire-purchase plans are prevalent in India.

(i) Down-payment plan

(ii) Deposit-linked plan

- The rate of interest charged on the hire-purchase contract is always a flat rate. The following approximate formula can be used under the down-payment plan to convert flat rate (*F*) into effective rate (*E*):

$$i = \frac{n}{n+1} \ldots\ldots\ldots 2F$$

- If installments are paid in advance, the relationship between *i* and *F* changes. In case of a deposit-linked plan, the effective rate of interest is calculated by:

$$i = \frac{n}{n-1} \ldots\ldots\ldots 2F$$

(a) Defines the cash flow over the relevant periods

(b) The calculated rate of interest that equates the present value of cash inflows to the present value of cash outflows. The rate interest is the effective rate of interest used in the plan.

Tax Consideration of Hire-purchase

The various aspects in tax consideration of hire-purchase include:

1. **Income tax aspects**: Hire-purchase transactions from the point of view of income tax are governed by Central Board of Direct Taxes (CBDT) circular issued in 1943. This circular specifies that the hirer is entitled to the tax shield on depreciation, which is calculated with reference to the cash purchase price and tax shield on the consideration for hire.
2. **Sales tax aspects**: It specifies that the hire-purchase transactions are liable to sales tax. Apart from this, hire-purchase has the following sales tax aspects:
   - With the aim of levying sales tax, a sale is deemed to take place if only the hirer exercises an option to purchase.
   - When the hirer exercises the option to purchase, the sales tax amount must be fixed with reference to the depreciated value of the goods.
   - The state in which the goods have been delivered is entitled to levy and collect sales tax.
   - Sales tax cannot be levied on hire-purchase transaction structured by finance companies, under the condition that these companies do not deal in the class of goods let on hire.

- There is no uniform rate of sales tax applicable to hire-purchase transaction because the rate varies from one state to another.
- Interest tax is payable on the total amount of interest aggregating to a hire-purchase.

3. **Interest tax aspects**: The interest tax aspects are as follows:
   - Interest tax is payable on the total amount of interest aggregating to a hire-purchase company in the previous year at the rate of 3 per cent.
   - The payable amount of interest that is established during the previous year can be deducted from the chargeable interest. The interest tax payable by the hire-purchase company is treated as tax-deductible expenses for the purpose of computing the taxable income under the Income Tax Act.

8.2.1 Lease Financing versus Hire-Purchase Financing

Both leasing and hire-purchase are methods of 'asset-based financing'. In spite of their similarity, historically the assets generally leased out have been different from those offered on hire-purchase. The intent of leasing is targeted mostly towards plant and machinery, aircraft, and so on, whereas hire-purchase is targeted for vehicles and consumer durables. The players involved are also different.

The hire-purchase arrangement has been prevalent in India since the colonial times. However, leasing is basically an American innovation that has forayed here mostly only in the early 1980s, by posing as an alternative to traditional modes of industrial finance. Leasing gained an early popularity due to the investment allowance that was prevalent on industrial plant and machinery.

For many years, vehicles had no system of leasing because security under the motor vehicles law that was prevalent at that time was not applicable to a lease. In addition, there was no investment allowance on vehicles. For reciprocal reasons as well, no hire purchasing of industrial machinery also took place.

In the current scenario, leases and hire-purchase are treated at the same level under the provisions of the motor vehicles law from the viewpoint of financier protection. In addition, since investment allowance has been abolished, there is no additional tax benefit to a lease. The RBI also treats lease and hire-purchase at par and has stopped giving a distinctive classification to leasing and hire-purchase companies. Therefore, apart from the aspects of income tax and sales tax, there is barely any difference between lease and hire-purchase.

The following points of distinction exist between lease financing and hire-purchase financing.

Table 8.1 *Difference between Lease Financing and Hire-purchase Financing*

Sl. No	Characteristics	Lease Financing	Hire-Purchase Financing
1	Ownership	Ownership of the property lies with the finance company to the lessee, the user	Ownership of the property is transferred to the hirer on the payment of the last installment
2	Depreciation	Lessor, and not the lessee, is entitled to claim depreciation tax shield	The hirer (owner) is entitled to claim depreciation tax shield
3	Capitalization	Capitalization of the asset is done in the books of the lessor, the leasing company	Capital of the asset is done in the books of the hirer
4	Payments	The entire lease payment is eligible for tax computation in the books of the lessee	Only the hire interest is eligible for tax computation in the books of the hirer
5	Salvage value	The lessor, and not the lessee, has the right claim the benefit of salvage value	The hirer can claim benefit of salvage value as the prospective owner of the asset
6	Magnitude	Leasing is used as a source of finance, usually for acquiring high-cost assets such as machinery, ships, airplanes, etc.	Hire purchase is used as a source of finance, usually for acquiring relative low-cost assets such as automobiles, office equipments, etc
7	Down payment	No down payment is required for acquiring the use of the leased assets	Down payment is required to be made for acquiring the asset and there is a margin maintained to the extent of 20–25 per cent
8	Reporting	In the books of the lessee, leased assets are disclosed by way of a note only	The asset bought on hire purchase will be shown as an asset, and the amount of installments payable to the lessor as a liability
9	Maintenance of asset	While the lessee has to maintain the leased asset in the case of financial lease, upkeep is the responsibility of the lessor in the case of operating lease	It is the hirer's responsibility to ensure the maintenance of the asset bought
10	Suitability	It is not suitable for the low-capital enterprises that desires to show a strong asset position in their balance sheets	It is highly suitable for the low-capital enterprises that need to show a strong asset positions in their balance sheets
11	Nature of asset	An asset given on lease by leasing company is considered as the fixed asset of the lessor	The hire vendor normally shows the asset under hire purchase either as stock-in-trade or as receivables
12	Receipts	All receipts from the lessee are taken into the lessor's profit and loss account	Only the interest portion is taken into the hire vendor's profit and loss account
13	Income	Lessor's income declines as the investment outstanding in the lease declines	In the case of HP transactions, finance charges are allocated to the HP period equally

Difference in tax treatment

In India, tax treatment is based on whether the agreement qualifies as a lease or should be treated as hire-purchase.

In case of lease, the lessor shall be eligible for depreciation on the asset. The lease rental will be taxed as income of the lessor. The lessee will not claim any depreciation but will be entitled to treat the rentals as expense.

In the case of hire-purchase, which is a conditional sale transaction, the hirer will be allowed to claim depreciation. Hire installments will be taxed as the hire-purchase company's income and allowed as the hirer's expense.

Difference between Hire-Purchase System and Installment Credit System

The difference between hire-purchase system and installment credit system is tabulated as follows.

NOTES

Table 8.2 *Difference between Hire-purchase system and Installment Credit System*

S. No.	Features	Hire-Purchase System (HPS)	Installment Credit System (ICS)
1	Legal ownership	The buyer gets the possession of goods without legal ownership	The buyer gets both possession and ownership immediately after the first installment to the seller and the agreement is executed
2	Actual sale	Hire purchase become complete sale only after the last installment is paid	In Installment credit after the payment of the first installment, it become in actual sale
3	Default	In case of default, the buyer can lose both the article and the entire amount paid	No risk of loss, even on default, to the buyer
4	Legal protection	Seller get maximum protection from the law	Buyer get maximum protection from the law
5	Hirer/Owner	Buyer is not the real owner as he is only hiring the article	The buyer becomes the real owner on payment of first installment
6	Bad debt	Limited risk	High risk
7	Seller's ownership	In case of default, the seller can get back the ownership	In case of default, the seller cannot repossess but can sue the buyer in the court
8	Right to sell	The article cannot be sold by the hire purchaser until the last installment is paid	The article can be sold by buyer any time

Bill Discounting

A bill arises out of credit sales. The buyer will accept a bill drawn on him or her by the seller. In order to raise funds, the seller may get the bill discounted with his or her bank. The bank will charge a discount and release the balance amount to the drawer. These bills normally do not exceed 90 days.

A company may also discount the bills as a bank does, thus using its surplus funds. Bill discounting is considered superior to inter-corporate deposits. The company should ensure that the discounted bills are as follows:

(i) Trade bills (resulting from a trade transaction) and not accommodation bills (helping each other).

(ii) Bills backed by the letter of credit of a bank will be most secure as these are guaranteed by the drawee's bank.

The following concepts regarding bill discounting must be taken into consideration.

- Funding the importer through banker's acceptance—non-LC transaction. This is illustrated in Figure 8.1 (a).
- Funding the importer through banker's acceptance—LC-backed transaction. This is illustrated in Figure 8.1 (b).
- Bankers acceptance—funding an exposure. This is illustrated in Figure 8.1(c).

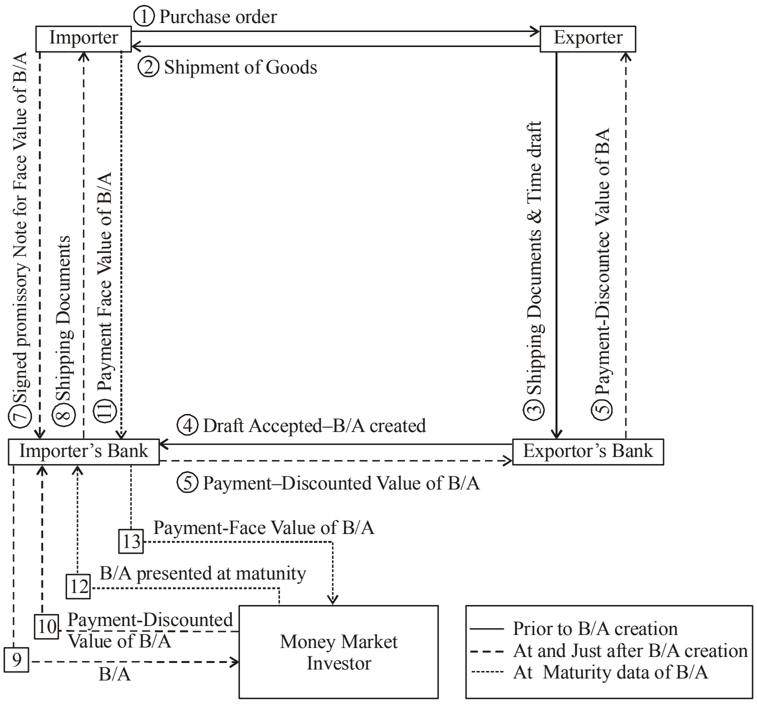
Importer
① Purchase order
Exporter
② Shipment of Goods
⑦ Signed promissory Note for Face Value of B/A
⑧ Shipping Documents
⑪ Payment Face Value of B/A
③ Shipping Documents & Time draft
⑤ Payment-Discountec Value of BA
④ Draft Accepted–B/A created
Importer's Bank
Exportor's Bank
⑤ Payment–Discounted Value of B/A
13 Payment-Face Value of B/A
12 B/A presented at matunity
10 Payment-Discounted Value of B/A
Money Market Investor
9 B/A
—— Prior to B/A creation
– – – At and Just after B/A creation
······· At Maturity data of B/A

Fig. 8.1 (a) *Non-LC Transaction*

Source: *Report of the working group on discounting of bills by banks.*

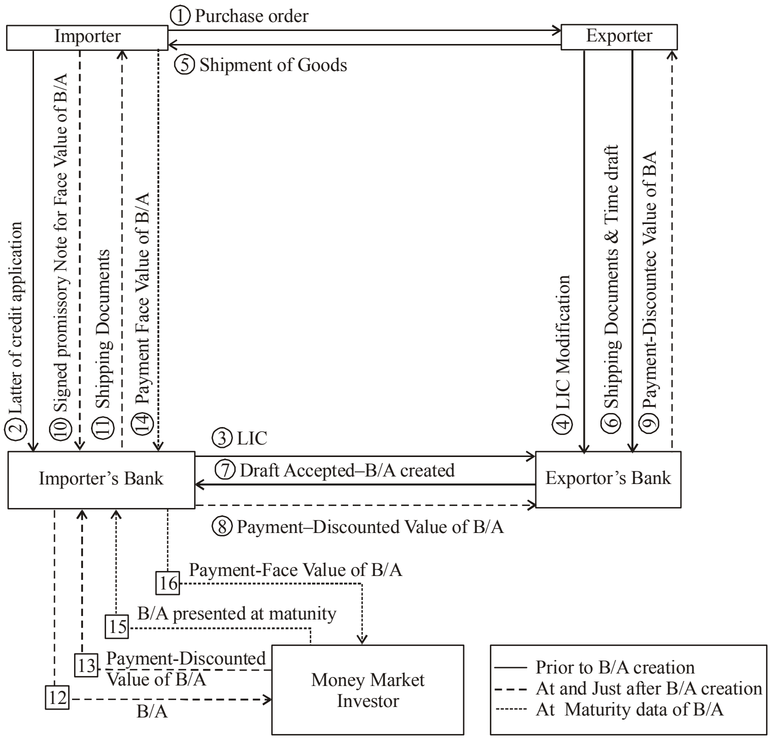
Importer
① Purchase order
Exporter
⑤ Shipment of Goods
② Latter of credit application
⑩ Signed promissory Note for Face Value of B/A
⑪ Shipping Documents
⑭ Payment Face Value of B/A
④ LIC Modification
⑥ Shipping Documents & Time draft
⑨ Payment-Discountec Value of BA
③ LIC
⑦ Draft Accepted–B/A created
Importer's Bank
Exportor's Bank
⑧ Payment–Discounted Value of B/A
16 Payment-Face Value of B/A
15 B/A presented at maturity
13 Payment-Discounted Value of B/A
Money Market Investor
12 B/A
—— Prior to B/A creation
– – – At and Just after B/A creation
······· At Maturity data of B/A

Fig. 8.1 (b) *LC Backed Transaction*

Source: *Report of the working group on discounting of bills by banks.*

NOTES

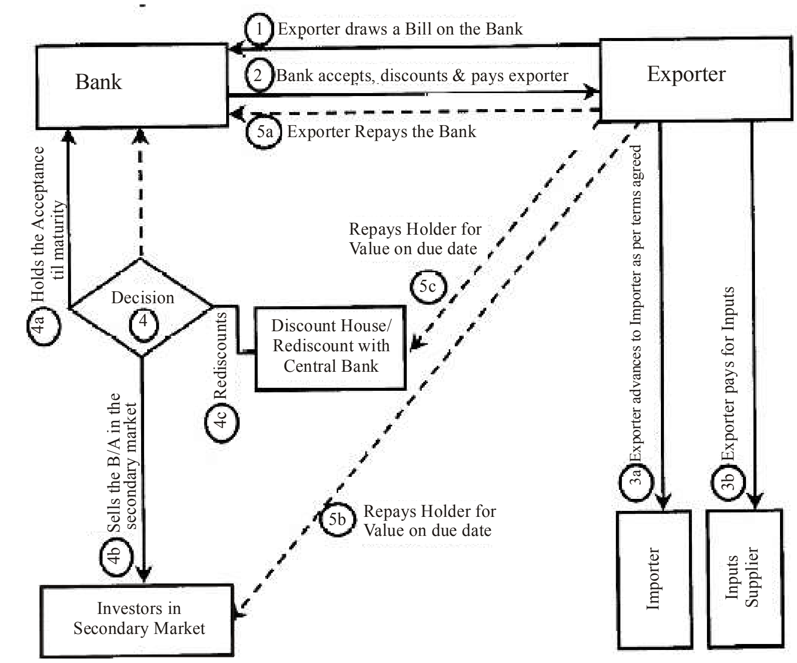
1 Exporter draws a Bill on the Bank
Bank
2 Bank accepts, discounts & pays exporter
Exporter
5a Exporter Repays the Bank
4a Holds the Acceptance til maturity
Repays Holder for Value on due date
5c
Decision
4
Discount House/ Rediscount with Central Bank
4c Rediscounts
4b Sells the B/A in the secondary market
5b Repays Holder for Value on due date
3a Exporter advances to Importer as per terms agreed
3b Exporter pays for Inputs
Importer
Inputs Supplier
Investors in Secondary Market

Fig. 8.1 (c) *Funding an Exporter*

Source: *Report of the working group on discounting of bills by banks.*

Check Your Progress

1. What is a hire-purchase agreement?
2. State the basis of tax treatment in India.
3. Why did vehicles have no system of leasing in the past?
4. What are the two main types of hire-purchase plans in India?

8.3 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. A hire-purchase agreement is an agreement under which goods are let on hire and under which the hirer has no option to purchase them in accordance with the terms of the agreement.
2. The tax treatment in India is based on whether the agreement qualifies as a lease or should be treated as hire-purchase.
3. Vehicles had no system of leasing because security under the motor vehicles law that was prevalent at that time was not applicable to a lease.
4. The two types of hire-purchase plans in India are as follows:
   (a) Down-payment plan
   (b) Deposit-linked plan

8.4 SUMMARY

- Hire purchasing is an alternative way of financing assets and is commonly used by finance companies to finance commercial vehicles.
- Hire-purchase is defined as a contractual agreement in which the owner gives his goods on hire to the hirer and gives the option to the hirer to purchase the goods as per the terms of the contract.
- Hire-purchase is a means of obtaining the use of an asset before completion of the payment for the asset.
- According to the Hire-Purchase Act, 1972, a hire-purchase agreement is an agreement under which goods are let on hire and under which the hirer has no option to purchase them in accordance with the terms of the agreement.
- A person has a right to terminate the agreement at any time before the property passes.
- The finance company will retain ownership of the asset but allow the hirer firm to use it against periodic payment of hire-purchase installments.
- However, the operational risk during the hire-purchase period would be borne by the hirer (and not the financier) because it is the hirer who has complete control of the asset.
- Hire-purchase finance has become a very popular means of industrial and consumer credit in many countries.
- Hire-purchase facilitates economic growth by increasing investment and sales. Also, bulk sales of consumer durable results into employment generation, mass production and industrial development.
- The calculated rate of interest that equates the present value of cash inflows to the present value of cash outflows. The rate interest is the effective rate of interest used in the plan.
- Hire-purchase transactions from the point of view of income tax are governed by Central Board of Direct Taxes (CBDT) circular issued in 1943.
- With the aim of levying sales tax, a sale is deemed to take place if only the hirer exercises an option to purchase.
- Interest tax is payable on the total amount of interest aggregating to a hire-purchase.
- The payable amount of interest that is established during the previous year can be deducted from the chargeable interest.
- Both leasing and hire-purchase are methods of ‘asset-based financing’. In spite of their similarity, historically the assets generally leased out have been different from those offered on hire-purchase.

- Leasing gained an early popularity due to the investment allowance that was prevalent on industrial plant and machinery.
- In the current scenario, leases and hire-purchase are treated at the same level under the provisions of the motor vehicles law from the viewpoint of financier protection.
- In India, tax treatment is based on whether the agreement qualifies as a lease or should be treated as hire-purchase.
- A bill arises out of credit sales. The buyer will accept a bill drawn on him or her by the seller. In order to raise funds, the seller may get the bill discounted with his or her bank.
- Bills backed by the letter of credit of a bank will be most secure as these are guaranteed by the drawee's bank.

8.5 KEY WORDS

- **Hire Purchasing**: It refers to an alternative way of financing assets and is commonly used by finance companies to finance commercial vehicles.
- **Bill Discounting**: It refers to an arrangement in which the seller recovers an amount of sales bill from the financial intermediaries before it is due.
- **Installment Credit System**: It refers to a **c**redit system which is granted on condition of its repayment at regular intervals.
- **Sales Tax Aspects**: It refers to aspects of sales tax which specifies that the hire-purchase transactions are liable to sales tax.

8.6 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. What are the disadvantages of hire-purchase finance?
2. Write a short note on the meaning of hire-purchase planning.
3. What are the main provisions of the Hire-Purchase Act?
4. State the different aspects of interest tax.
5. How is hire purchase system different from installment credit system?

Long Answer Questions

1. Identify the main features of hire-purchase planning.
2. How does a finance company work under the hire-purchase planning? Explain in detail.

3. Discuss the advantages of hire-purchase finance.
4. Interpret the aspects of sales tax on hire-purchase planning.
5. Explain the functioning of bill discounts.

NOTES

8.7 FURTHER READINGS

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UNIT 9 OVERVIEW OF MUTUAL FUNDS

Structure

9.0 Introduction
9.1 Objectives
9.2 Mutual Funds
  9.2.1 Objectives and Benefits
  9.2.2 Major Mutual Funds Institutions in India
9.3 Types of Mutual Funds
9.4 Regulations
9.5 Answers to Check Your Progress Questions
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9.0 INTRODUCTION

Mutual fund (MF) is considered as one of the most popular and useful financial instruments. Nowadays most of the investors prefer investing in mutual funds to letting money rot in saving accounts. However, investors need to understand that there is no guarantee that investment in mutual funds will always be fruitful. Therefore, it is essential to have basic knowledge about the concept of MF, its benefits and scope in order to receive good returns.

According to the SEBI Mutual Fund Regulation, 1993, MF can be defined as a fund established in the form of a trust by a sponsor, to raise money 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. It will be interesting to mention that the concept of MF took birth in Europe, when William I established a society for such a purpose. Until 1987, Unit Trust of India was India's only mutual fund. But, over the past few years, the Indian MF industry has grown significantly. The industry's growth can be divided into five significant phases.

It is important for a finance student to study about the evaluation measures of portfolio performance. It is measured by combining the risk and return levels into a single value. Apart from this, you must also familiarize yourself with the SEBI regulations regarding the mutual funds. Another important part of Indian MF industry is the Association of Mutual Funds in India (AMFI). It has helped the Indian Mutual Fund Industry transformed into a professional and healthy market.

In this unit, the meaning of mutual funds and its objectives and benefits have been discussed. The types of mutual funds and the main institutions of mutual funds in India has been highlighted. The unit will also explain the regulation of mutual funds.

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9.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss the meaning of mutual funds
- Explain the main objectives of mutual funds
- Identify the main types of mutual funds
- Discuss the government regulation policies of mutual funds

9.2 MUTUAL FUNDS

Mutual fund is a mechanism for pooling resources by issuing units in securities to the investors and investing funds in accordance with the objectives disclosed in the offer document. A mutual fund is a corporation, trust or partnership, which manages the collected money with the help of professional expertise. Different persons have defined mutual funds different ways. 'A mutual fund is almost like a cooperative society of investors. That is why the word 'mutual' is used. It collects money from investors by issuing mutual fund units, invests it in securities, and divides whatever dividend or interest is received among its members.' (A John Halin)

The SEBI Mutual Fund Regulations, 1993 defines mutual fund as 'a fund established in the form of a trust by a sponsor, to raise money by the trustees through sale of units to the public, under one or more schemes, for investing in securities in accordance with the regulations'. Mutual funds are financial intermediaries which bring a wide variety of securities within the reach of the most modest investors. The financial intermediary is known as 'investment company' in the US and most other countries. They are called 'investment trusts' in the United Kingdom. In India, they are known by the term 'mutual funds'.

The origin of mutual fund

The history of mutual fund can be traced back to Europe where William I established a society in Belgium for such a purpose. The foreign and colonial Government Trust of Lund in 1868 is considered as the forerunner of the concept of mutual fund. Massachusetts Investor's trust was the first mutual fund set up in the US in the year 1929. The mutual fund industry witnessed a boon in the US market after the 1990's and became a popular source of investment. In India, the Unit Trust of India set up the first mutual fund in 1964.

Structure and Operation of Mutual Funds

The formation and operations of the mutual funds are governed by the Securities Exchange Board of India Mutual Funds Regulation 1993. Later, it was replaced by the SEBI Mutual Fund Regulations 1996. The mutual funds comprise four separate entities, namely, sponsor, mutual fund trustee, asset management company and the custodian (Figure 9.1). They are assisted by independent entities such as banks, registrars and transfer agents.

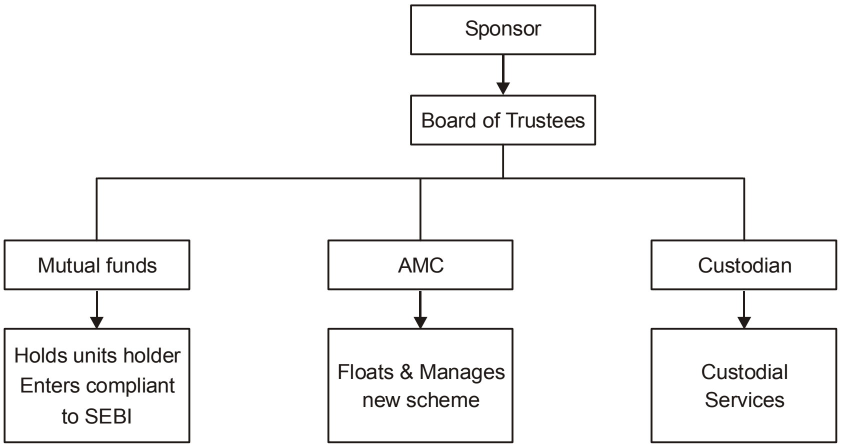
Sponsor
Board of Trustees
Mutual funds
AMC
Custodian
Holds units holder Enters compliant to SEBI
Floats & Manages new scheme
Custodial Services

Fig. 9.1 *Structure of a Mutual Fund*

Sponsor

A mutual fund is to be established by a sponsor and registered with the SEBI. A sponsor can be any person acting alone or in combination with a corporate body. However, a sponsor should have the following requirements:

- Should have a sound track record
- Should have been carrying on business in financial services for a period of not less than five years
- Should have a positive net worth in all the preceding five years
- Should have profits after providing for depreciation, interest and tax in three out of the immediately preceding five years including the fifth year
- Should contribute at least 40 per cent of the net worth of the asset management company
- Should not have been guilty of fraud or convicted for any offence

Trustee

Mutual funds are established in the form of a trust. The trustees should be persons of ability, integrity and standing. Two-third of them should be independent persons (1998). A trustee should not be an associate or a subsidiary or be associated with a sponsor in any manner. He should be appointed with the prior approval of the

SEBI. The meeting of the trustees shall be held at least once in two calendar months and atleast six such meetings shall be held in every year. An AMC or any of its officers/employees are not eligible to act as trustees to any mutual funds.

The trustees have the responsibility to safeguard the interest of the investors. They have wide powers to overview, supervise and monitor the activities of an asset management company. If the conduct of the business is not in compliance with SEBI's regulations, they can take remedial measures against an AMC as required. They have powers to dismiss an AMC. Nevertheless, it should be approved by SEBI.

Asset management company

A sponsor or the trustees appoint an AMC, and it should be approved by the board. An appointee can be terminated by a majority of the trustees or 75 per cent of the unit holders of the scheme. An AMC should have a sound track record, general reputation and fairness in transactions. The directors of AMC should possess adequate professional experience in finance and financial services. An AMC should have a net worth of not less than ₹10 crore. Each director of an asset management company is required to give the details of his dealings in securities with the trustees, on a quarterly basis.

An AMC manages the various schemes of mutual funds with the help of a team of professionals with adequate experience. They carry out market research for building the portfolio of a particular mutual fund. An AMC takes all reasonable steps, exercises and due diligence to ensure that investment of funds pertaining to any scheme is not contrary to SEBI's regulations and trust deed.

Custodian

Mutual funds have a custodian. Custodians carry out custodial services for the various schemes of a fund. It is their duty to send intimation of the custodial services rendered to the board. A custodian, or its directors, or partners will not be directly or indirectly associated with any AMC in any way. A custodian shall not be appointed in case a sponsor or its associates hold 50 per cent or more of the voting rights of the share capital of a custodian, or where 50 per cent or more directors of the custodian represent the interest of the sponsors or its associates.

Operation of the mutual fund

Mutual fund offers units or shares to the public by issuing an offer document or prospectus and collecting the funds. The money collected is invested as per the investment objectives stated in the offer documents/prospectus. Mutual funds generally invest in a wide range of securities in different industries with the aim of reducing the risk exposure. The investments should be within the norms prescribed by SEBI.

An expert fund manager is employed to manage each scheme. He carries out the specific task of purchasing and selling shares and debentures at the appropriate time in the market. Mutual fund managers are under the control of the board of trustees of the fund. They guide the operation of the fund.

All the mutual fund websites allow investors to download the application forms and offer documents of their products. Some of the mutual funds permit downloading other transaction forms such as redemption slips and transfer forms as well.

Mutual funds generally publish their net asset value every Friday. After the annual accounts are audited, the mutual funds ascertain the income earned by them. They distribute at least 90 per cent of their income by the way of dividends to the unit holders. After the duration of the scheme is over, mutual funds sell the securities pertaining to the scheme. It redeems the units by paying the investors their capital and also pays capital gains according to the number of units held by the investors.

Net Asset Value (NAV) of a mutual fund

The NAV of a mutual fund is like a company's book value. NAV is the market value of the assets of a fund scheme for every outstanding unit as on the date of mutual fund valuation. Net asset is the asset under a mutual fund as on the date of NAV computation. Net asset value is calculated on the basis of total asset value of a company, minus the administrative expenses. Repurchase price for units of a mutual fund is computed after considering the net asset value. NAV is universally used because it is a single number and is easily related to the face value of the unit.

The formula for calculating the NAV is to divide the net assets by the total number of units. In other words, it is obtained by dividing the difference between the total assets and liabilities by the total number of units.

NAV = (Total assets – liabilities) ÷ Total number of units or

= Market value of all investments + other assets – liabilities ¸ total number of units

Consider a mutual fund with the following investments:

X Ltd.	500 shares of ₹ 10 each (current market price ₹ 40)
Y Ltd.	1000 shares of ₹ 10 each (current market price ₹ 110)
Other assets	₹ 10000
Accrued expenses	₹ 15000

The market value of investment

$$= 500 \times 40 + 1000 \times 110 = ₹\,20000 + 110000$$

Total assets = 130000 + 10000 = 140000

The fund has issued 10000 units

$$\text{NAV} = \frac{140000 - 15000}{10000} = \frac{125000}{10000} = 12.5\%$$

The NAV is received as a barometer of performance of schemes. When the NAV is lower than the value of the unit, it signifies a poor performance and vice-versa. However, if the NAV appears simple, it may not be completely relied upon. The way in which the liabilities and the expenses of running the scheme are accounted for and apportioned, affect the NAV. The net asset value of the mutual funds is provided either in a table or as a running ticker on the home page. All the mutual funds update their NAVs on a daily basis. The historical values of NAVs are available only for a few funds. Prudential ICICI Mutual fund, Kotak Mahindra Mutual fund and Sundaram Newton fund provide historical NAVs.

Factors Influencing the NAV

The factors that influence NAV are as follows:

Load and no load factor

In a no load factor fund, an AMC bears most of the expenses, and the initial NAVs tend be closer to the issue price as compared to those of a load scheme. The repurchase price for units of mutual fund of UTI is determined as follows

$$\frac{\text{NAV} - \text{M}}{\text{Units}} = \text{RP (Repurchase price)}$$

M – management expenses

$$\frac{\text{NAV} + \text{M}}{\text{Units}} = \text{RP (Resale price)}$$

Valuation

SEBI regulations prescribe that closing prices of the securities are to be taken for the purpose of valuation. Sometimes the fund may not put through a deal at the closing price. Further, to assign a realizable value, funds may use the lowest traded price of the day for NAV calculation. The extent of traded volumes in securities could also present problems. Adoption of prices established through low trading volumes relative to the fund's holdings, could inflate the NAV if the prices are higher.

Non–traded debt instruments

The SEBI regulation states that all traded securities—equities and debt are to be valued at market value. In case of non–traded securities, the valuation process becomes difficult in hybrid securities like convertible debt. In convertible debt, the debt and the equity component must be valued separately. According to SEBI, the non–traded debt instruments are to be valued on a yield-to-maturity basis. The discounting rate depends on the prevailing interest rate and the opportunity cost of the funds. If the discounting rate is not correctly assigned, the NAV is affected. In case the debt instrument is downgraded by a rating agency, the discounting factor would be high, and the NAV would be low.

Debt-equity mix

The debt equity mix also affects the NAV. In a rising interest rate situation, if the debt component is high, the NAV will be low and vice- versa. Thus, in the case of balanced fund or debt fund, an investor should look into the market interest rate as well.

9.2.1 Objectives and Benefits

Mutual funds have specific investment objectives, which are stated in their prospectus. The main objectives are growth, growth-income, balanced income, and industry specific funds. Growth funds strive for large capital gains, while growth-income funds seek both dividend income and capital gains from the common stocks. The balanced fund generally holds a portfolio of diversified common stocks, preferred stocks and bonds with the hope of realizing capital gains, dividend and interest income, while at the same time, conserving the principal. Income funds concentrate heavily on high interest and high dividend yielding securities. The industry specific mutual funds obviously specialize in selected industries such as chemicals, petroleum or power stocks. In general, growth funds seem to have the highest risk, balanced funds, the lowest risk and income growth funds, intermediate risk.

Benefits of mutual funds

Tax shelter is the most important advantage the mutual funds industry enjoys in India. A mutual fund set up by a public sector bank or a financial institution or one that is authorized by the SEBI is exempted from tax, under Section 10 (23 D) of the IT Act, provided it distributes 90 per cent of its profits.

(*a*) The Union Budget for 1999-2000 granted tax exemption for a period of three years for US 64 scheme and for all open-ended equity-oriented schemes of UTI and other mutual funds with more than 50 per cent investment in equity. It also announced the exemption from income tax of all income from UTI and other mutual funds received in the hands of investors. The Budget for 2000-01, however, raised the tax rate on income distributed by debt-oriented mutual funds and UTI from 10 per cent to 20 per cent.

As compared to direct investment, mutual funds offer firstly, reduced risk and diversified investment. Mutual funds help small investors in reducing risk by diversification, economies of scale in transaction cost and professional portfolio management. Secondly, mutual funds offer revolving type of investments. Automatic reinvestment of dividends and capital gains provide tax relief to the members. Thirdly, selection and timing of investment are undertaken by mutual funds. The fund as an organization, supplies expertise in stock selection and timing purchase and sale of securities to investors on the invested funds to generate higher returns to them. Finally, mutual funds assure liquidity and investment care. The units of mutual funds could be converted to cash without any loss of time, relieving investors from various rules and regulations, which they must comply with indirect investments.

Mutual Fund Holder's Account

There are three types of accounts offered by most of the mutual funds. The investors select the type that matches their objectives. The various accounts are:

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Regular Account

An investor is permitted to purchase any number of shares of the mutual fund, at any time he/she chooses. An investor is paid the dividend either monthly, quarterly or half-yearly as per the scheme. This income can be reinvested to acquire additional units by the investor.

Accumulation Account

An investor is allowed to open an account, with a very small initial investment and continue adding to the fund, periodically. Accumulation account may be voluntary or contractual. In the voluntary accumulation plan, an investor has flexibility to make periodic investment at his/her choice. But, in the contractual plan, the investor has to make investments at regular intervals.

Withdrawal Account

Under this plan, the individual investor can withdraw the amount of funds on a regular basis, which suits elderly people to supplement their pension benefits.

9.2.2 Major Mutual Funds Institutions in India

Until 1987, Unit Trust of India was the sole mutual fund in the country. This was due to the restrictive policies adopted by the Government of India with regard to the financial services industry. The growth of the mutual fund industry has been divided into different phases.

Phase I

The mutual fund in India came into existence in 1964 when Unit Trust of India was incorporated as a statutory corporation. The maiden scheme launched by the Unit Trust of India was the unit scheme of 1964, an open-ended scheme, which is still in operation. At that time, public awareness about mutual fund was limited. There was no disclosure norm. The institution was modelled along the lines of mutual funds in the UK. The name 'Unit Trust' itself has been borrowed from the UK where mutual funds are called 'investment trusts'.

The Unit Trust of India played a commendable role by launching a number of open as well as close ended schemes, keeping in view the varied needs of the different groups of investors. The schemes targeted everyone from a new-born child to a retired individual.

Phase II

Unit Trust of India's monopoly came to an end in 1987. The Government of India amended the Banking Regulations Act, permitting commercial banks in the public sector to set up mutual funds. The first non UTI mutual fund was launched by the State Bank of India in November 1987 by the name 'SBI Mutual fund'. Its first scheme, Magnum Regular Income Scheme launched in 1987, was well received by the investors.

Canara Bank established its subsidiary, Canbank Mutual Fund in Dec 1987. It launched two schemes, i.e., Canstock (income scheme) and Canshare (growth scheme), which were both close ended. They were also followed by two open-ended schemes—Cancigo and Cangilt in the succeeding year.

Indian Bank, Bank of India and Punjab National Bank introduced mutual funds during the year 1989–90. The Government permitted insurance corporations in the public sector to establish mutual funds. Life Insurance Corporation of India set up LIC mutual fund in June 1989. It targeted small investors particularly from rural and semi-urban areas. Unlike the other mutual funds, LIC offered insurance protection to the investors. This was in addition to the benefits of liquidity, safety and return. Shortly the General Insurance Corporation of India also entered into the mutual fund industry.

The Government of India issued comprehensive guidelines in June 1990 covering all mutual funds. Registration of mutual funds with the SEBI was made compulsory. The guidelines covered the norms for registration, management, investment objectives, disclosure and pricing. The Securities Exchange Board of India (mutual funds) Regulations, 1993 came into effect on 20 January 1993. The establishment of Asset Management Company (AMC) and the listing of close-ended schemes became mandatory. Disclosure norms were tightened to protect the small investors.

Phase III

The innovative promotional campaigns launched by different mutual funds created investor awareness. Exclusion of the private sector was widely criticized. The liberalization policy and new economic policy advocated by Doctor Manmohan Singh paved way for the entry of private sector into the mutual fund industry. The SEBI accorded approval to a number of players in the private sector to launch mutual funds in October 1993. Kothari group in collaboration with the Pioneer fund, the oldest fund in U.S, launched Prima fund in November 1993. The other private sector mutual funds include Twentieth Century Mutual Fund, Taurus Mutual Fund, Morgan Stanley Mutual Fund, HDFC Mutual Fund and Zurich Mutual Fund etc. After the entry of the private sector, the declaration of Net Asset Value (NAV) of the schemes became regular. At present NAV's are declared weekly. The portfolios are also disclosed periodically.

Phase IV

After 1996, the mutual fund industry witnessed a healthy growth. This is shown in Table 9.1. With the growth of investors' interest in mutual funds, the number of players operating in the industry reached new heights. SEBI (Mutual Funds) Regulations, 1996 was introduced by SEBI to set uniform standards for all mutual funds in India and safeguard the interest of the investors. The Union Budget in 1999 exempted all dividend incomes of the mutual funds in the hands of investors from income tax. The SEBI and the Association of Mutual Funds in India (AMFI) launched various Investor Awareness Programmes to educate investors and inform them about the mutual fund industry.

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Table 5.1 *Fund Mobilization* (₹ in crore)

Years	*UTI*	*Public Sector*	*Private sector*	*Total*
1998–99	11,679	1732	7966	21377
1999–2000	13,536	4039	42,173	59,748
2000–01	12,413	6192	74,352	92,957
2001–02	4643	13,613	1,46,267	1,64,523
2002–03	5505	22,923	2,20,551	2,48,979

Phase V

The Unit Trust of India Act 1963 was repealed in 2003, and Unit Trust of India was bifurcated into two separate entities. The US 64 scheme which assured return and certain other schemes were brought under the Specified Undertaking of the Unit Trust of India with ₹29,835 crore of assets under the management as on January 2003. This Specified Undertaking of Unit Trust of India does not come under the purview of the Mutual Fund Regulations, but under the rules framed by the Government of India.

The second is the UTI Mutual Fund Ltd., sponsored by SBI, PNB, BOB and LIC. It is registered with SEBI and functions under the Mutual Fund Regulations. It was in this phase that the mutual fund industry witnessed a consolidation phase. Mergers and acquisitions became common in the mutual fund industry. Some examples of these are Birla Sun Life mutual fund's acquisition of schemes of Alliance Mutual Fund and Principal Mutual Fund's acquisition of Sun F&C Mutual Fund and PNB Mutual Fund. Many international mutual fund players like Fidelity and Franklin Templeton Mutual Fund have entered India. There were twenty-nine funds in the end of March 2006. The growth phase is still continuing despite the temporary oscillations in the performance.

Check Your Progress

1. What is the role of trustees?
2. How is Net Asset Value (NAV) calculated?
3. What are the main objectives of mutual funds?

9.3 TYPES OF MUTUAL FUNDS

A mutual fund scheme can be classified into close ended or open ended depending on its maturity period.

Close-ended scheme

Close-ended scheme has a prefixed maturity period, e.g., five to seven years. Both the corpus amount and the number of units are prefixed. The fund is open for subscription only for a specified period after the launch of the scheme. Mutual funds are required to despatch certificates or statements of accounts within six weeks from the date of closure of the initial subscriptions of the schemes. The investors can invest in the scheme during this period. After the closure of the subscription period, investors can buy and sell the units of the scheme at the stock exchanges where the units are listed. They would either get a demat account statement or unit certificates as traded in the stock exchanges.

According to SEBI regulations, one or two exit routes should be provided to the investors. It may either be in the form of regular repurchase or by listing them in stock exchanges. Some of the close-ended mutual funds provide the option of selling back of the units to the mutual funds. The prices are fixed on the basis of net asset value. The NAV of the schemes is disclosed on a weekly basis.

The entire corpus is disinvested after the maturity period and the proceeds are distributed among the investors in proportion to their unit holdings.

Open-ended schemes

Open-ended schemes are available for subscription and repurchase on a continuous basis. These schemes do not have a maturity period. Investors can buy and sell units at prices fixed by a mutual fund. Prices are fixed on the basis of NAV. The NAVs of these schemes are declared daily. Liquidity is the main advantage of the open-ended scheme. The main difference between the open-ended and the close-ended schemes is that the latter is traded on stock exchanges, whereas the former is not. Also, open ended schemes are available at all times, whereas the close-ended schemes are available only for a prescribed period.

Schemes on the basis of investment objectives

Schemes are classified as growth scheme, income scheme or balanced scheme as per the investment objectives. These schemes may either be open-ended or close-ended. Some of them are given below.

Index funds

Index funds are equity funds that passively mimic a market index. The portfolio of the index fund is designed to reflect the composition of some stock market index. The index funds avoid the risk of poor stock selection by the fund manager. The aspects that are in favour of index funds are:

- Low costs
- Predictability
- Diversification

All the index funds, which are currently in operation, are modelled either on the Nifty or the Sensex. Several fund houses have launched passive index funds in the past. Some of them are Franklin Templeton India Index fund (formerly Pioneer ITI Index fund, offering both Sensex and Nifty Plans), UTI Nifty Index fund, UTI Master Index fund and IDBI Principal Index fund.

These funds suffer because of tracking error. This error is the percentage by which returns from the funds deviate from the underlying index. If the error is positive, the funds generate higher returns than that of the index. One of the reasons cited for the tracking error is the transaction cost. Index funds have to incur brokerage and other costs to make changes in their portfolios in line with those in the index. This results in increase in cost. Besides this, the lack of depth in the Indian stock market also affects the index funds.

Investment management fee affects the return and recurring expenses such as advertisement, investor communication costs and administration costs. Though these expenses form a small portion of the returns each year, the compounding effect over the years becomes quite significant.

It is felt that if the index funds could track down broad based market indices such as S&P CNX 500 and BSE 200, it would help the investors to capture broad market trends more accurately. However, lack of liquidity of many small and mid-cap stocks would result in high transaction costs.

Exchange traded funds (ETFs)

Exchange traded funds are passively managed funds that track a particular index and have the flexibility to trade like a common stock. These types of funds combine the attributes of mutual funds with those of the stocks. Without large investment, an average investor can have an entire range of index stocks. It is different from the index funds where units are issued in return for cash and redeemed as per the net asset value in cash. However, ETF issues units in lieu of shares and vice versa.

The ETFs are priced throughout the day. They can be bought and sold at any time during a trading day just like a stock. The fund may either represent market index or a specific industry sector or an international sector. An investor can buy it on a margin. Short selling can be carried out. The expense ratio is similar to the open end mutual funds. They range from 0.18 per cent of the value of the fund to 0.84 per cent.

ETFs came into existence in the US in 1993. The first ETFs were based on the S & P 500 and were popularly known as spiders. Presently, diamonds are the other type of ETFs representing all thirty stocks in the Dow Jones Industrial Average and traded in American stock exchange. The Benchmark Asset Management Company (BAMC) has launched Nifty BeEs. It was listed on the capital market segment of the NSE on 8 January 2002. Nifty BeEs tracks the Standard Poor (S&P) CNX Nifty index. The minimum investment for taking the index exposure through Nifty BeEs is just one unit (around 1/10 of the Nifty).

Balanced funds

Balanced funds invest both in equity and fixed income securities. They are also called 'income-cum-growth' funds. They aim at regular income and capital appreciation. They have the equity and debt portfolios to fulfil this objective. The portfolio beta is less than one and the price of units does not rise in proportion to the aggregate stock market price because of the debt component in the portfolio. Some of the balanced funds are: Prudential ICICI Balanced fund, Kothari Balanced fund, Alliance 95 fund and DSP Merrill Lynch Balanced fund. The performance of the balanced funds differs due to the ratio of stocks to the fixed income securities that varies from fund to fund and their different levels of exposure to individual sectors like IT, media or telecom. The weightage of individual stock in funds differs. Hence, an investor has to go through the portfolios before investing in the funds.

Money market funds or liquid funds

Money market funds were initiated during 1973 in the US when interest rates on short term money market securities were high. They are also income funds and attempt to provide current income and safety of principal by investing in short term securities such as treasury bills, bank certificates of deposits, bank acceptances, commercial papers and inter bank call money. Returns on these schemes fluctuate much less as compared to the other funds. These funds are appropriate for corporate and individual investors to invest their surplus cash for a short period.

Gilt funds

Gilt funds are also known as G-Sec funds. These invest in the Government of India securities, and have gained popularity in the Indian market. The Securities Exchange Board of India has issued new guidelines in 2002 with an aim to provide better checks and balances for the mutual funds. The following are the salient features of the new requirements:

- Mutual funds have to reconcile their balance with the monthly RBI report
- Internal audit, continuous checks by the auditors and reports to audit committees form a part of the requirements
- The same report must also be placed before the boards of the asset management company and the trustee company
- Mutual funds will have to submit a compliance certificate to the RBI on a quarterly basis, indicating their adherence to the norms
- Public debt offices of the RBI will issue monthly statements to mutual funds maintaining SGL/CSGL accounts

Growth funds

The main objective of growth funds is to provide capital appreciation over medium to long term. They invest a major portion of their collected money in equity. This makes them prone to risk. As per their preference, the investors may either choose the option of dividend or the option of capital appreciation. Investors have to specify their choice while applying for units. However, if they want to change at a later date, they are permitted to do so. The year 1999–2000 was one of the best periods for growth funds in the Indian market. Fresh sales by growth schemes were about 1000 crore. Growth funds outperform bench mark index in bull phase and underperform in bearish times. Another common problem cited by the fund managers is that investors put more money when the NAVs are high and sell when NAVs are low, making the managers busier in redemption than in managing the funds.

Income/Debt-oriented funds

The objective of income/debit-oriented funds is to provide regular and steady income to investors. A major part of the funds corpus is invested in fixed-income securities such as bonds, corporate debentures, government securities and money market instruments. The scope for capital appreciation is limited in these schemes. These funds carry only modest risks as compared to equity funds.

The NAVs of debt funds are affected because of change in interest rate in the country. If the interest rates increase, NAVs of such funds are likely to fall in the short run and vice-versa. For instance, debt funds lost heavily in July 2000, when the RBI raised the interest rate to defend the rupee. Thus, the debt funds are prone to risk because of changes in the rate of interest. The NAV is calculated based on the market price and not just the income earned from holding from the bonds. The NAV fluctuates with the volatility of the bond prices.

Like all instruments, the bond price is based on demand and supply. This means that the bond prices will fall when supply is relatively more than the demand. This happens when rupee is falling sharply against the dollar or when the call rates are very high. During this period, banks generate resource by selling the bonds. The excessive supply of bonds in the market pulls down the price.

Fall in the prices of bonds leads to fall in NAVs of the debt funds. Thus the debt funds are also prone to market risk. However, long-term investors prefer these funds. Some of the debt funds/income funds include Birla Income Plus, Prudential ICICI Income plan, SBI LiquiBond, UTI Bond fund and DSP Merrill Lynch Bond fund.

Reinvestment risk is defined as the risk of having to reinvest the intermediate cash flows (coupon payments at a lower interest rate). In falling interest climate, the mutual funds may earn a lower return by reinvesting the coupon payment. To understand this, the funds should provide two distinct NAVs—one inclusive of the coupon payments, and other exclusive of the coupons. This would give an idea about the reinvestment risk to the investors.

Sector specific funds

Sector specific funds/schemes invest in securities of those sectors or industries specified in the offer documents, e.g., information technology, pharmaceuticals, fast moving consumer goods (FMCG) and petroleum. The returns on these funds depend on the performance of these sectors. Since they are investing in a particular sector, the risk is high as compared to the other funds. The performance of the sector should be closely followed in order to take the entry and exit decisions.

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A complaint often levelled against these funds is that they invest in sectors other than the ones suggested by their name. This is because most offer documents spell out the investment strategy in vague terms and this allows the funds to move away completely from the nature of the scheme as indicated by its name. For example, Tata Core sector fund was designed to invest in the core sector (steel, cement, power and infrastructure) in 1999, but it shifted out of cyclicals into technology stocks. By Nov 1999, 71 per cent of its assets were invested in technology stocks.

Tax saving schemes

These schemes provide tax rebates to the investors under the supervision of the Income Tax Act 1961. The government offers tax incentives for investment in specified avenues. Equity linked savings schemes and pension schemes offered by mutual funds offer tax benefits. These schemes resemble the equity-oriented schemes and invest mostly in equities.

Load and no load funds

In load funds, a fee is charged for the entry and exit. The charge is a percentage of NAV. Whenever an investor buys or sells units in the fund, he has to pay a charge. If the entry as well as exit load is one per cent to buy a unit worth ₹ 10, he has to pay ₹ 10.10. Likewise, if he sells a unit, he will get ₹ 9.90 per unit. The load factor affects the return and the investor has to consider the load factor before investing in a mutual fund.

No load funds do not charge a fee for entry or exit. No additional charges are levied on the purchase or sale of units. However, SEBI regulations allow no load funds to hike the investment management fees by up to one per cent per annum until they recover their initial expenses.

Check Your Progress

4. How are open-ended and the close-ended schemes different from each other?
5. What are exchange traded funds?
6. State the main objective of balanced funds.

9.4 REGULATIONS

The governmental regulations regarding mutual funds are as follows:

Conversion of close-ended schemes into open-ended schemes

According to Regulation 33 (3) of SEBI (Mutual funds) Regulation 1996, the units of the close-ended schemes may be converted into open-ended scheme, if the offer document of such schemes discloses the option and the period of such conversion or the unit holders are provided with an option to redeem their units in full. Before the conversion, a draft of the communication to unit holders shall be submitted to SEBI, which shall include the following:

(a) A latest portfolio of a scheme in the format prescribed for half yearly disclosures, the details of financial performance of a scheme since inception in the manner prescribed under the standard offer and a document along with comparison with appropriate bench marks.

(b) The addendum to the offer document detailing the modifications (if any) made in the scheme.

Further, when a scheme is re-opened for fresh subscriptions, the disclosures contained in the offer document of a scheme should be revised and updated.

Moreover, the unit holders shall be given a period of at least thirty days for the purpose of exercising the exit option. The unit holders who opt to redeem their holdings in part or full, shall be allowed to exit at the net asset value applicable for the day on which such request is received during the prescribed period.

Investments by mutual funds

SEBI has laid down rules and regulations regarding the investments of mutual funds to protect an investor. Some of these are listed as follows:

- The funds collected under any scheme of the mutual fund shall be invested only in transferable securities in the money, capital and debts markets.
- Money market scheme of the mutual fund shall be invested in the money market instruments in accordance with the directions issued by the RBI.
- The mutual fund shall not advance any loans for any purpose.
- Every mutual fund shall compute and carry out valuation of its investments in its portfolio and publish the same in accordance with the valuation norms specified in the eighth schedule.
- Every mutual fund shall compute the NAV of each scheme by dividing the net assets of the scheme by the number of units outstanding on the date of valuation.
- The NAV of a scheme shall be calculated and published at least in two daily newspapers at intervals of not exceeding one week.

- The price at which the units are sold and repurchased should be made available to an investor.
- A mutual fund scheme can invest up to 10 per cent of its NAV in the listed and unlisted securities or units of venture capital funds.

Restrictions on investment

Mutual funds should not invest more than 15 per cent of its NAV in a single debt instrument rated below the investment grade by a credit rating agency. It can be extended to 20 per cent of the NAV of a scheme with prior approval by the board of trustees and the board of AMC. The mentioned condition is also applicable to the unrated debt instruments. No mutual fund under all its schemes should own more than 10 percent of any company's paid up capital carrying voting rights. Transfer of investments from one scheme to another scheme in the same mutual fund shall only be allowed if:

- Such transfers are done at the prevailing market price for quoted instruments on spot basis.
- The securities so transferred should be in conformity with the investment objective of a scheme to which such transfer has been made.
- The aggregate of the inter scheme management made by all schemes under the same management or in schemes under the management of any other scheme of AMC should not exceed 5 per cent of net asset value of the fund.
- Every mutual fund shall get the securities purchased or transferred in the name of the mutual fund on account of the concerned scheme, wherever investments are intended to be of long-term nature.
- If there is a pending deployment of funds in securities in terms of investment objectives of the scheme, a mutual fund can invest the funds of the scheme in short term deposits of scheduled commercial banks.
- No mutual fund scheme shall make an investment in any unlisted security of an associate or group company of the sponsor; or any security issued by way of private placement by an associate or group company of the sponsor; or the listed securities of group companies of a sponsor which are in excess of 30 per cent of the net assets of all the schemes of a mutual fund.
- No mutual fund scheme shall invest more than 10 per cent of its NAV in the equity shares or equity related instruments of any company. However, the limit of 10 per cent shall not be applicable for investments in index funds or sector or industry specific schemes.
- A mutual fund scheme shall not invest more than 5 per cent of its NAV in equity shares or equity related instruments of any company in case of open-ended schemes and 10 per cent of its NAV in case of close-ended schemes.
- Investments in foreign securities

The MFs can now make investments in foreign debt securities in countries with fully convertible currencies. They invest in short-term as well as long-term debt instruments with high credit ratings. They may also invest in government securities if the countries are AAA rated. They may also invest in units issued by overseas MFs/unit trusts which invest in aforesaid securities. Each MF can invest up to 4 per cent of its net assets as on Feb 28 2002, subject to a maximum of US $50 million. However, while investing they have to adhere to the following guidelines.

The boards of AMCs and trustees shall exercise due diligence in making investment decisions. They shall make a detailed analysis of risks and returns of investments in foreign securities by comparing them with the likely yields of securities available in the domestic market.

- Investments shall be made in liquid and actively traded securities.
- The intention to invest in foreign securities shall be disclosed in the offer document along with the attendant risk factors and exposure limits.
- The existing schemes can invest in the foreign securities if the offer document provides for such investments. Any additional disclosures as specified above shall be informed to unit holders by way of addendum.
- The AMCs shall send periodic reports to the trustees, which would include the performance of investments made in foreign securities in various countries. It should also inform the amount invested in various schemes and any breach of exposure limit laid down in the offer document.

Rules regarding advertisements

- An advertisement should disclose the objective of a scheme.
- It should be truthful, fair, clear and shall not contain a statement of promise or forecast which is untrue or misleading.
- It should not be framed to exploit the lack of experience or knowledge of the investors.
- All the advertisements issued by a mutual fund or its sponsor or asset management company, shall state, ‘all investments in mutual funds and securities are subject to market risks and the NAV of the schemes may go up or down depending upon the factors and forces affecting the securities market’.
- The advertisement shall not compare one fund with another, explicitly or implicitly, unless the comparison is fair and all information relevant to the comparison is included in the advertisement.
- The offer document and advertisement shall not be misleading or contain any statement or opinion, which is incorrect or false.

General aspects

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- An AMC shall launch no scheme unless the trustees approve such a scheme and a copy of the offer document has been filed with the board.
- Each mutual fund shall pay filing fees along with the offer document of each scheme.
- The offer document shall contain disclosures which are adequate to enable an investor to make informed investment decisions. It shall include the disclosure on maximum investments proposed to be made by a scheme in the listed securities of the group companies of the sponsor.
- Every close-ended scheme shall be listed in a recognized stock exchange within six months from the closure of the subscription. The asset management company may repurchase or re-issue the repurchased units of a close ended scheme.
- A close-ended scheme shall be fully redeemed at the end of the maturity period, unless a majority of the unit holders decide for its roll over by passing a resolution.
- Every MF and AMC shall publish their un-audited financial results before the expiry of one month from the close of each half-year, i.e., 31 March and 30 September.
- Every MF and AMC shall have to dispatch the dividend.
- Warrants shall reach the unit holders within thirty days of the declaration of

Check Your Progress

7. What are the rules regarding the advertisements of mutual funds?
8. How is money market scheme of mutual fund invested?

9.5 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. The trustees have the responsibility to safeguard the interest of the investors. They have wide powers to overview, supervise and monitor the activities of an asset management company.
2. The Net Asset Value (NAV) is calculated by dividing the net assets by the total number of units.
3. The main objectives of mutual funds are growth, growth-income, balanced income, and industry specific funds.
4. The main difference between the open-ended and the close-ended schemes is that the latter is traded on stock exchanges, whereas the former is not.

NOTES

Also, open ended schemes are available at all times, whereas the close-ended schemes are available only for a prescribed period.

5. Exchange traded funds are passively managed funds that track a particular index and have the flexibility to trade like a common stock.
6. Balanced funds aim at regular income and capital appreciation. They have the equity and debt portfolios to fulfil this objective.
7. The rules regarding the advertisements of mutual funds are as follows:
   (a) An advertisement should disclose the objective of a scheme.
   (b) It should be truthful, fair, clear and shall not contain a statement of promise or forecast which is untrue or misleading.
   (c) It should not be framed to exploit the lack of experience or knowledge of the investors.
8. Money market scheme of the mutual fund shall be invested in the money market instruments in accordance with the directions issued by the RBI.

9.6 SUMMARY

- Mutual fund is a mechanism for pooling resources by issuing units in securities to the investors and investing funds in accordance with the objectives disclosed in the offer document.
- The SEBI Mutual Fund Regulations, 1993 defines mutual fund as ‘a fund established in the form of a trust by a sponsor, to raise money by the trustees through sale of units to the public, under one or more schemes, for investing in securities in accordance with the regulations’.
- The history of mutual fund can be traced back to Europe where William I established a society in Belgium for such a purpose.
- The formation and operations of the mutual funds are governed by the Securities Exchange Board of India Mutual Funds Regulation 1993.
- A mutual fund is to be established by a sponsor and registered with the SEBI. A sponsor can be any person acting alone or in combination with a corporate body.
- Mutual funds are established in the form of a trust. The trustees should be persons of ability, integrity and standing.
- A sponsor or the trustees appoint an AMC, and it should be approved by the board. An appointee can be terminated by a majority of the trustees or 75 per cent of the unit holders of the scheme.
- Mutual funds have a custodian. Custodians carry out custodial services for the various schemes of a fund.

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- Mutual fund offers units or shares to the public by issuing an offer document or prospectus and collecting the funds.
- NAV is the market value of the assets of a fund scheme for every outstanding unit as on the date of mutual fund valuation.
- SEBI regulations prescribe that closing prices of the securities are to be taken for the purpose of valuation.
- Mutual funds have specific investment objectives, which are stated in their prospectus. The main objectives are growth, growth-income, balanced income, and industry specific funds.
- Tax shelter is the most important advantage the mutual funds industry enjoys in India. A mutual fund set up by a public sector bank or a financial institution or one that is authorized by the SEBI is exempted from tax, under Section 10 (23 D) of the IT Act, provided it distributes 90 per cent of its profits.
- The mutual fund in India came into existence in 1964 when Unit Trust of India was incorporated as a statutory corporation.
- The Unit Trust of India Act 1963 was repealed in 2003, and Unit Trust of India was bifurcated into two separate entities.
- Close-ended scheme has a prefixed maturity period, e.g., five to seven years. Both the corpus amount and the number of units are prefixed.
- Open-ended schemes are available for subscription and repurchase on a continuous basis. These schemes do not have a maturity period.
- Schemes are classified as growth scheme, income scheme or balanced scheme as per the investment objectives.
- Index funds are equity funds that passively mimic a market index. The portfolio of the index fund is designed to reflect the composition of some stock market index.
- Exchange traded funds are passively managed funds that track a particular index and have the flexibility to trade like a common stock.
- Balanced funds invest both in equity and fixed income securities. They are also called ‘income-cum-growth’ funds.
- Gilt funds are also known as G-Sec funds. These invest in the Government of India securities, and have gained popularity in the Indian market.
- The main objective of growth funds is to provide capital appreciation over medium to long term.
- The objective of income/debit-oriented funds is to provide regular and steady income to investors.
- In load funds, a fee is charged for the entry and exit. The charge is a percentage of NAV. Whenever an investor buys or sells units in the fund, he has to pay a charge.

- Mutual funds should not invest more than 15 per cent of its NAV in a single debt instrument rated below the investment grade by a credit rating agency.

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9.7 KEY WORDS

- **Index Funds**: It refers to equity funds that passively mimic a market index. The portfolio of the index fund is designed to reflect the composition of some stock market index.
- **Mutual Fund**: It refers to a mechanism for pooling resources by issuing units in securities to the investors and investing funds in accordance with the objectives disclosed in the offer document.
- **Net Asset**: It refers to the asset under a mutual fund as on the date of NAV computation.
- **Net Asset Value**: It refers to the value which is calculated on the basis of total asset value of a company, minus the administrative expenses.
- **Sector Specific Funds**: It refers to the securities or funds of those sectors or industries specified in the offer documents, e.g., information technology, pharmaceuticals, fast moving consumer goods (FMCG) and petroleum.

9.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. What are the main benefits of mutual funds?
2. Write a short note on the origin of mutual fund.
3. What is the role of Asset Management Company (AMC) in managing mutual funds?
4. State the main aspects of index funds.
5. What are the schemes related to mutual funds?
6. Why are balanced funds called ‘income-cum-growth’ funds?

Long Answer Questions

1. Discuss the structure and working of mutual funds.
2. Analyze the factors which influence the Net Asset Value of mutual funds.
3. Discuss the role of governmental institutions of mutual funds in India.
4. Explain the main types of mutual funds.
5. Describe the government regulations regarding the functioning of mutual funds?

9.9 FURTHER READINGS

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BLOCK - III

BILL MARKET

NOTES

UNIT 10 FACTORING AND FORFEITING

Structure

10.0 Introduction
10.1 Objectives
10.2 Factoring
10.2.1 The Process; 10.2.2 Forfeiting
10.2.3 Comparison of Factoring and Forfeiting
10.2.4 Mechanics of Forfeiting
10.3 Securitization
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10.5 Credit Cards: Salient Features, Guidelines, Functions
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10.6 Answers to Check Your Progress Questions
10.7 Summary
10.8 Key Words
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10.10 Further Readings

10.0 INTRODUCTION

Factoring is a financial service whereby receivables are purchased by the factor and a financial option for credit sales is affected on open account terms. Forfeiting refers to a service which provides medium-term financial support for export or import of capital goods. Securitization is defined as a process in which liquid assets are taken and converted to a security.

Venture capital fund refers to a form of private equity in which finance is provided by firms to small organizations and have a high potential growth. Consumer credit is the credit given to customers for purchase of goods and services.

In this unit, the meaning of factorization and forfeiting has been analysed. The concept of venture capital fund, securitization and the main sources of consumer credit have been discussed. Th e unit will also discuss the uses of debit and credit cards and the guidelines set by RBI related to their usage.

10.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss the meaning and process of factoring
- Analyze the mechanics of forfeiting
- Explain the process of securitization
- Identify the features of a venture capital fund
- Discuss the meaning and sources of consumer credit
- Analyze the features and RBI guidelines related to credit and debit cards

10.2 FACTORING

Factoring is a package of services providing integrated receivables management. Factoring is often used synonymously with accounts receivable financing.

The word, factor is derived from the Latin word *facio* which means 'to make' or 'do' or 'get things done'. In simple terms, a factor is an agent who does things for his client for a consideration called commission. In factoring, a company or firm converts its receivables into cash by selling them to a factoring agent or institution at a discount. The factor assumes the risk of collection and the loss on account of bad debt falls on the factor.

According to the International Institute for Unification of Private Law (UNIDROIT) Rome, factoring means an arrangement between a factor and his client that includes at least two of the following services to be provided by the factor: (1) finance (2) maintenance of accounts (3) collection of debts and (4) protection against credit risk. Thus, factoring is a package of services providing integrated receivables management.

10.2.1 The Process

The main function of factoring is the realization of credit sales. Once the sales transaction is completed between the firm and the buyer, the factor starts realizing the sale proceeds. The seller/business entity enters into an agreement with a factor whereby the factor provides the facility of debt collection. Sometimes the seller's bank is also involved in the factoring business. The seller hands over the duly signed copy of invoice to the factor. Generally, 80 per cent of the invoice value is given as advance by the factor. The remaining 20 per cent is paid against the realization. The factor collects service charge and discount charge (comparable to bank interest rate) from the seller/client. The factor furnishes periodical statement to both, the seller/client and buyer/customer. The maximum debt period permitted under factoring is 150 days inclusive of a maximum grace period of 60 days.

The buyer

A buyer buys the material in accordance with the negotiated terms from the business entity or firm. He receives the delivery of goods with the invoice and an instruction to settle the amount to the factor. If he is not able to settle the amount, he has to get an extension of time from the factor. However, in the case of default, legal action is taken by the factor.

The seller

A seller enters into a MoU with the buyer. He chooses the customer invoices he wants to factor. He sells the goods to the buyer as per the MoU. After the delivery of goods, he sends copies of the invoice, delivery challan, MoU and the instruction to make payment to the factor. The seller receives advance payment from the factor for selling the receivables from the buyer. Normally, this ranges from 80 per cent to 90 per cent of the invoice amount. The remaining amount is settled as per the agreement.

The factor

A client sends the business name, address and amount he wants to factor for a particular business client. Credit is verified and limits are established for the business client. There is no charge for credit validation. The seller and the factor enter into an agreement for availing the factoring service. The factor after reviewing the invoice and other documents makes payments to the seller. The factor receives payments from the buyer on due dates and gives the remaining amount due to the seller after deducting his service charges.

The essential documents

Certain documents are essential for availing the factoring service. These are as follows:

- The invoice, bills or other documents by the seller with a mention of factoring service.
- A written statement by the seller to ensure that the bills are free from any encumbrances, charges, lien, pledge, hypothecation, etc.
- Deed of assignment to enable the factor to recover the money from the seller, if there is any default.
- A letter of confirmation stating that all the conditions of the sell-buy contract between the buyer and the seller have been complied with and the transaction is complete, should be issued by the seller
- A letter of waiver in favour of the factor is needed, if the banks have any charge over the assets sold. The seller should arrange for the letter of waiver.

Functions of factor

The services provided by the factor are enlisted as follows:

- Assumption of credit risk
- Maintenance of sales ledger
- Collection of accounts receivables
- Finance of trade debt

- Provision of advisory services
- Credit analysis of the customer

10.2.2 Forfeiting

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The arrangement of 'forfeiting' resembles factoring. In this arrangement, finance is provided by a finance company to exporters against longer-term notes drawn on their overseas customers.

Factoring is not suitable for every industry. For example, in construction and engineering business payment is to be received from the customer over extended periods. Hence, factoring is unlikely to be offered.

It is also important to note that factoring is *not* a substitute for poor credit assessment of its credit customers by a company. As already mentioned above, a factor may refuse to take up the receivables from customers with poor credit worthiness. Even if it does, the charges will be higher. The situation is very similar to insurance business. In fact, a 'without recourse' factoring is like 'credit insurance'. In both of these, the higher is the perceived risk that is getting transferred from the insured (or client firm) to the insurer (or the factor), the higher will be the premium (or factoring charges). We may consider a case of fire insurance. By avoiding fire prevention measures a company may not save on its overall expenses. The insurance company will not offer fire insurance cover at the same premium as it would when necessary preventive measures were in place. It will either refuse to insure such a property or charge a higher premium. Similar is the situation in case of factoring.

In effect, therefore, factoring is usually more suitable for a company that is suffering from adverse cash flows rather than from bad debtors.

The advantage by way of reduction in administrative expenses (due to credit administration responsibility being taken over by the factor) is usually most pronounced in case of small and medium enterprises (SMEs) which may find it uneconomic to maintain a credit management set-up of their own.

10.2.3 Comparison of Factoring and Forfeiting

There is a lot of similarity between factoring and forfeiting, but, there are certain differences too. These are stated in Table 10.1.

Table 10.1 *Difference between Factoring and Forfeiting*

Context	Factoring	Forfaiting
Financing	Generally only 80 per cent of the invoice is financed	100 per cent financing
Credit worthiness	Credit rating of the counterparty done by the factor bank in case of a non recourse factoring transaction	Forfaiting bank has to rely on the credibility of the availing bank
Services	Sales ledger administration, credit protection, collection of receivables, advisory services	No allied services provided
Maturity	Deals with short-term advances	Deals with medium-term advances

10.2.4 Mechanics of Forfeiting

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The mechanics of forfeiting are shown in Figure 10.1.

- Here the exporter gives up the right to claim payments for goods and services provided to the importer in favours of the forfeiter.
- All this is mentioned in the deed, which is subsequently prepared and the exporter gets cash payment from the forfeiter.
- All the forfeiting transactions are performed by the bank, to whom the default risk carried by the importer is transferred.
- Important point to understand is that the exporter critically evaluates the underlying goods and services, before he extends finance for the forfeiting transaction. Some of the points, considered by the exporter, are perishability/ durability of the goods, how authentic the product is, the packaging arrangement and other precautions taken during shipment of the goods exported.

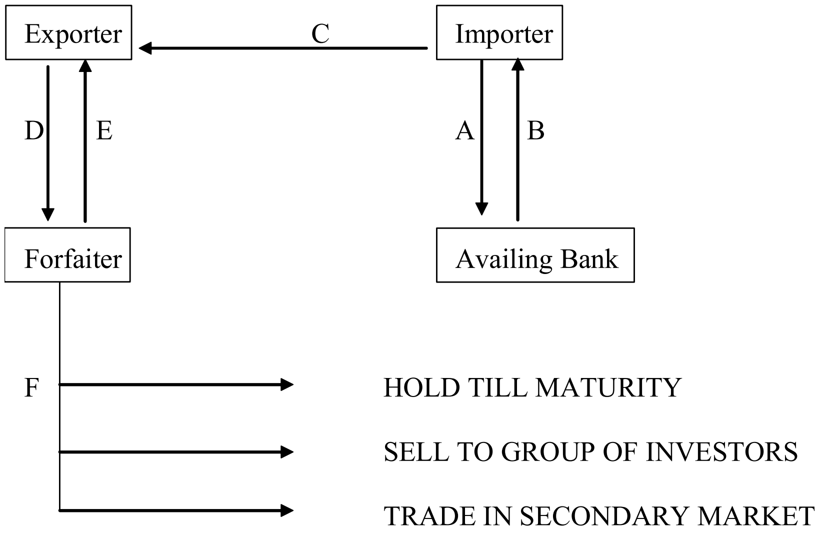

Fig. 10.1 *Mechanics of Forfeiting*

A. Promissory notes for availing to importer's bank

B. Availed notes return to the importer

C. Availed notes send to exporter

D. Availed notes sold at a discount to a forfeiter on a non-recourse basis

E. Exporter obtains finance

F. Forfeiter holds the notes till maturity or securitizes these notes and sells the short-term paper either to a group of investors or to investors at large in the secondary markets

Costs Involved in Forfeiting Transactions

In a forfeiting transaction, different type of fees is charged by the forfeiter depending on the relationship with the exporter, cost of funds and the volume of trade. Some of the costs involved are:

- **Commitment cost:** The commitment fee is paid by the exporter to the forfeiter for executing the forfeiting transaction at a particular discount rate, and within a specified time. It ranges between 0.5 and 1.5 per cent per annum and is always calculated on the unutilized amount of the forfeiting transaction. The commitment fee is required to be paid irrespective of the execution of the export contract.
- **Discount cost:** This cost is required to be paid on the credit sanctioned under the factoring deal, by the exporter to the forfeiter. This cost is not charged separately but is deducted by the forfeiter from the amount it owes to the exporter against the bill of exchange or the promissory notes as required. The discount rate is based on London Inter-Bank Offer Rate (LIBOR) for the period under consideration. The exporter gets the money from the forfeiter instantly but has to wait to recover the amount from the importer. The profit of the forfeiter may be subjected to exchange rate risk during the intervening period.
- **Documentation cost:** This type of cost is generally incurred on transaction involving complex legal formalities and not when legal procedures and the documentations required are less.

Check Your Progress

1. State the main function of factoring.
2. What are the services provided by a factor?

10.3 SECURITIZATION

Securitization is a process by which long-term loans, whether backed by security or not, lease receivables, credit card balance, hire purchase debtors and trade debtors or any scheduled cash flows are converted into securities and are issued to investors. In other words, if some assets have predictable cash flows associated with them and a measurable default rate risk (credit rating), they are converted into tradable negotiable certificates and can be subscribed by investors. Thus, the securitization process converts long-term assets into cash/liquid assets and enables the originator funds for further business. Securitization enhances the lending ability of a financial institution by converting a balance sheet item to non-balance sheet item. In factoring, the receivables of the client are converted into cash after deducting commission. It is a transaction between two parties for a certain set of receivables and the underlying is not tradable. The first reported securitization transaction was between Citibank and GIC Mutual Fund in 1990s.

Parties Involved in securitization Process

The following participants are involved in the securitization process:

(i) **Originator:** The person/entity whose assets are to be securitized and in whose books of accounts the assets exist. The originator receives the cash generated from the assets in his books of accounts. He is the person who transfers legal right with respect to the assets to the SPV.

(ii) **SPV:** SPV buys assets which are to be securitized from the originator. It is also called Special Purpose Entity or Special Purpose Company. Generally, SPV is a company which has independent trustees and is a low capitalized company. SPV plays a crucial role in securitization as it purchases assets from the originator and makes advance payment against those assets.

(iii) **Debtor:** These are the originator's obligators who have to repay the interest and principal to the originator. The debtor's repaying capacity is a crucial factor for credit rating as well as subscription of the securitization process.

(iv) **CRA:** Credit rating assess the cash flows on the assets and find its strengths which ensures that the debtors will pay as per payment schedule or not. In short, the credit rating agency rates the underlying asset's credit quality with respect to default and timely repayment.

(v) **Receiving and paying agent:** Collects payment on an underlying asset from the debtor and provides the same to the SPV, checks whether all legal aspects have been adhered to, and if required, initiates legal action against the original debtor. Usually the agent is a mediator between the SPV and the final borrowers.

(vi) **Investor:** Can be an individual, institutional investor, mutual fund, provident fund, etc. They purchase some part of the securitized asset and receive payments of interest and principal amount as per the terms of the security.

(vii) **Other persons involved:** A credit enhancer is a bank or financial institution which provides a letter of credit to increase credit support to the securitization. This is usually required in case the credit rating for the underlying asset is below investment grade and needs to be enhanced to provide a wider investor base for subscription. A legal counsel makes suggestions on the legal aspect of the securitization process.

Securitization of Debts

The money market is a growing at a rapid pace in India. The traditional methods of financing are making way for the modern methods of financing which are providing multiple options to the investors.

Changes and developments in the money market in foreign countries catch the attention of the regulating authorities to identify new means to provide finance and pioneer multi-options instruments to the money market in India. These days, financial institutions and banks, including financial companies, can recycle their term loans and avail finance against qualifying terms loans by means of securitization. These term loans involve risk of liquidity, default in the repayments and losses on account of default by the borrowers. Securitization is a new and innovative source of enhancing lending capability of the financial institutions and banks by converting their assets into usable funds. In a nutshell, the balance sheet is freed up for further lending, enhancing the return of the financial institution.

Steps in the Securitization Process

The main steps involved in the process of securitization are as follows:

1. First, long-term loans are converted to different packages of loans based on tenor, risk grading and underlying asset.
2. These packages are then offered to the investors.
3. Next, selected investors are issued PTCs. SPVs can also be issued to the investors.
4. Final issue is made on the basis of pro rata basis as mentioned in the offer document.

Types of Securitization

Securitization can be divided into two parts— assets-backed securitization and mortgage-backed securitization. Assets-backed securitization is financed by the movable fixed assets and current assets. Mortgaged-backed securitization is backed by the immovable fixed assets. Recently, Life Insurance Corporation of India (housing finance) launched a mortgage-backed securitization scheme for home loans.

10.3.1 Venture Capital

Venture capital can be defined as investment (long term) which is made in:

- Ventures that are promoted by persons who, though they are qualified and technically sound, may not have any prior entrepreneurial experience.
- Technologies in which the entrepreneur are interested are still emerging, and witnessing changes on short intervals.
- Projects that involve high degree of risk, as risk of failure is high on account of technological uncertainty as well as unknown potential of market for the product or service.
- Projects at a very nascent stage, with high investment/cash requirement with negative/nil or negligible cash flows.

Growth of venture capital started from the USA in the 1950s, but has now spread worldwide, including India. In India, the initial step for the establishment of venture capital was taken by the government in November 1988, by issuing guidelines for the establishment of venture capital funds. After that, in 1990s, venture capital emerged as a new mechanism for the financing of new and innovative businesses.

The concept of venture capital financing is very old, but today's changing business environment makes it more tempting for businesses. The reason being, venture capital companies give risky capital to the entrepreneur so that they can meet the minimum requirements of the promoter's contribution. The main advantage of venture capitalists is that they not only provide the finance for risky business, but also provide value added services for business and managerial support. In situations where firms are not able to raise finance by conventional means, like public issue, the importance of venture capital is greater.

Thus, we can say that venture capital institutions are financial intermediaries between the entrepreneurs who need institutional capital (as they are not ready for public finance) and investors who are looking for higher returns.

Features of a Venture Capital Fund

As venture capital is required for businesses which involve higher risk and also a higher rate of return, it has some specific features. These are as follows:

(i) **Long-term investment:** Venture capital is provided for long-term. This is generally provided to high-risk businesses (small and medium enterprises in sunrise sectors) who cannot arrange funds from other sources of finance. Venture capital is for that project which starts earning returns after a lag. Due to all these reasons, venture capital is provided for the long term.

(ii) **Participation in equity capital:** Venture capital is always invested in equity capital (actual or potential). The reason for this is that the venture capitalist can liquidate part of equity when the ventures start earning profit. In the beginning, the equity capital of new ventures is risky but when they start earning profits and the market gains confidence in them, the venture capitalist can sell his portion of equity capital at a substantial profit.

(iii) **High risk:** Venture capital signifies equity investment (ownership participation) in highly risky projects which have growth prospective and a projected high rate of return. Projects, in which markets have no earlier experience of earning profits or valuing businesses, are the target of the venture capitalists.

(iv) **Management participation:** Venture capital funds not only provide equity capital to the firms or businesses but also provide various kinds of services like participation in management of the assisted business. Due to their active involvement in the running of the enterprise, venture capitalists are different from bankers. Venture capitalists are also different from other stock market investors who do not participate in the management of companies but invest and trade in shares in the stock market. In this way, venture capital is different from investors (equity). Also, it is the combination of bankers, stock market investors and entrepreneurs.

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(v) **Liquid investment:** Investment made by venture capital fund is in equity portion of the company which makes it less liquid. Funds cannot demand its money back anytime during the life of the assisted business. They get their money back when the assisted business goes into liquidation or the enterprise lists its shares. Another way for venture capitalist to liquidate their investment is by offer for sale.

(vi) **Fulfils its social objectives:** Venture capital funds help in the development of new and innovative business by assisting them with capital and helping in balanced growth of the economy.

(vii) **Large scope of venture capital activities:** Venture capital is not merely a means for financing technology. It extends to financing small and medium enterprises at their early stages of business and help them establish in the market. So it can be said that the scope of venture capital activities is big.

Check Your Progress

3. How is securitization divided?
4. What is the main advantage of venture capitalists?

10.4 CONSUMER FINANCE

The term 'consumer credit' includes all asset-based financing plans that are used for acquiring consumer durables by individuals. The most common form of consumer credit transaction is one where part payment is done on taking delivery of the asset and the balance amount is paid over a specified period of time, with interest. A wide range of consumer durable products like passenger cars, TVs, VCRs, two–wheelers, personal computers, washing machines, food processors, cooking ranges and mini generators can be purchased through consumer finance.

Consumer Credit Act, 1974

The aim of the Consumer Credit Act, 1974, of the United Kingdom was to protect the borrower from loans, mortgages and credit agreements. Full written details of the annual percentage rate have to be quoted, a cooling-off period (the time in which borrower may change his mind and cancel agreements) to be stated and the entire agreement has to be given in writing.

Consumer Credit Act, 1986

The Consumer Protection Bill, 1986, was introduced in the Lok Sabha on 5 December 1986 in order to provide better protection to the interest of the consumers.

The various concepts relating to consumer credit are discussed in the following section.

Sources of Consumer Credit

The popular sources of consumer finance are as follows:

- **Commercial banks:** Banks provide finance directly or indirectly for consumer durables. Either banks lend huge amounts of money at wholesale rate to hire purchase, finance companies or other financial intermediaries, or they finance consumers directly through personal loans for purchasing consumer durable goods.
- **Credit card institutions:** These institutions make arrangement for credit purchases of consumer articles through banks that offer credit cards. In the credit card system, goods and services are purchased on credit. The payment can be made every month of the entire amount spent or 5 per cent of the total amount due. The system of revolving credit is available through credit cards, but it can prove very costly to the consumer in the long run.
- **Traders:** Traders are a very popular source of consumer finance. They include hire-purchase companies, finance companies or other financial intermediaries.
- **Credit unions:** In a credit union, a group of people get together and agree to save a fixed amount of money every month. This money is further used to provide loan to each other at a low rate of interest. In India, credit unions are also called cooperative credit societies.
- **NBFCs:** Non-banking finance companies (NBFCs) provide personal cash loan to consumers but charge a rate of interest that is higher than the market rate, for example, Sundaram Finance.
- **Middlemen:** Dealers of consumer articles act as middlemen and as part of their promotional campaign grant credit to consumer. Dealers frequently work in close association with banks and finance companies, guiding consumers towards friendly finance companies.
- **Other sources:** Other sources of consumer credit are as follows:
  (a) Mutual saving banks
  (b) Saving and loan associations

Factors Contributing to the Growth of Consumer Credit

The factors that have contributed to the growth of consumer credit are as follows:

- Increase in disposable income of the consumer
- Down payment and credit contract
- Growth in nuclear families
- Convenient size of installment payment

Features of Consumer Credit Transactions

Some of the salient features of consumer credit transactions are as follows:

- **Number of parities in the transactions**

The transactions can be between two parties involving the consumer/borrower and dealer-cum-financier or between three parties where the financier and dealer are two separate entities. The transactions can be of sales-aid type, where the finance is arranged by the dealer who also does the necessary paperwork on behalf of the borrower. Under these transactions, the dealer takes the credit granting decision, based on the eligibility criteria given by the finance company. Besides, the transaction could be of the convenient type also, where the finance company is approached by the consumer to avail the credit facilities.

- **Structure of transactions**

The structure of consumer credit transactions can be in the form of hire purchase, credit sales transactions or conditional sales. As discussed, hire purchase is defined as a contractual agreement, in which the owner gives his goods on hire to the hirer, and gives the option to the hirer to purchase the goods as per the terms of the contract. In a conditional sale contract, the consumer does not get ownership of the product until the total purchase price is paid, and the consumer also cannot terminate the agreement in between. In a credit sale contract, the buyer gets the ownership on the payment of the first installment. Here also, like the conditional sales contract, the agreement cannot be cancelled before the total purchase price is paid.

- **Down payment**

Like the hire purchase agreement, consumer credit schemes can be broadly divided into credits, down payment and deposit-linked schemes. The down payment ranges between 20 and 25 per cent of the value of consumer durable. Besides, the security deposit ranges between 15 and 25 per cent of the amount financed. It is important to understand that here the deposit is of a cumulative nature, where the interest is charged at a given rate. Some finance companies may also offer zero-deposit schemes in which the EMI is more than the EMI in the 15–25 per cent deposit schemes.

- **Repayment period and rate of interest**

The repayment period is between 1 and 5 years and is based on monthly installments over that period. A wide range of options are given, and the most convenient repayment schedule is chosen by the borrower, while the rate of interest is generally taken as the flat rate. Certain banks like CitiBank choose the effective rate of interest. Nowadays, equated monthly installments (EMIs) associated with different repayment periods are used by companies and the borrower has to find out the effective rate of interest himself. The repayment is through postdated cheques.

• Security

Consumer credit is secured through a first charge on the asset concerned, and the borrower cannot sell or pledge or hypothecate the asset during the credit period.

• Product range

A wide range of consumer durable products like passenger cars, TVs, VCRs, two-wheelers, personal computers, washing machines, food processors, cooking ranges and mini generators can be purchased through consumer finance.

Check Your Progress

5. What are the factors which led to the growth of consumer credit?
6. How is consumer credit scored?

10.5 CREDIT CARDS: SALIENT FEATURES, GUIDELINES, FUNCTIONS

An ATM card has a very limited use, viz. it can be used only for cash withdrawals from an ATM. As a contrast, debit cards or credit cards have a much wider use; they may be used both for cash withdrawals from an ATM and for electronic funds transfer at the point of sale (EFTPOS), i.e., for tendering a legally valid payment at the counter of a shop or any other point of sale (POS).

- A debit card permits payment out of the balance available in the customer's account.
- A credit card does not require any balance (or even a deposit account) to be maintained by the customer but offers a credit.

For an ATM operation through a debit or credit card, the same PIN system is used. Each of these cards contains coded information about the particular customers and when it is swiped through an electronic reader at the POS, a connection is established with the bank's computer system. Depending upon whether it is a debit card or a credit card, the amount of transaction is either debited online to the customer's account or recorded as a credit availed. Additionally, there will be a charge-slip which the customer would sign physically.

When a debit card is issued to a customer, an ATM card actually becomes redundant because this same card can be used at an ATM as well. In fact, as more and more banks are issuing debit cards, ATM cards are phasing out.

A debit card is issued by a bank simply as a transaction facilitator. However, issue of credit cards is equivalent to offer of a revolving credit limit. This calls for a prior appraisal of the credit card customer and approval of a suitable limit.

When a credit is obtained on a credit card, a grace period is allowed to the borrower. If the entire payment is made within the due date, no interest is charged on the borrowed sum; if not, the outstanding balance attracts interest, which is usually much higher than the commercial borrowing rate. There is a 'minimum amount due' indicated in the statement which must be paid by the due date to retain the validity of the card. A default in the payment of this minimum due attracts penalty charges at a very high rate. Apart from charging the cardholder, the issuer charges the card acceptor (shop, etc.) a certain percentage of every transaction against a credit card. Thus, on the one hand merchants are inclined to accept payment by a credit card because this is likely to increase consumer spending; but on the other hand, they have to weigh this benefit against the cost, viz. fees charged by the service provider.

A credit card can be used not only at a POS but also for obtaining credit by way of cash withdrawal from an ATM. Usually there is a sub limit under the overall credit limit up to which credit may be obtained in cash. For cash withdrawals, interest is charged from the date of transaction itself and the card holder is required to pay a service charge. This is because in case of cash borrowing the card issuer does not get any payment from a third party.

Card Charges

For ATM cards and debit cards a service charge between ₹ 50 and ₹ 100 may be charged by a bank for every card.

In case of a credit card, there is an annual charge, which is waived by some banks. If additional cards are issued, e.g., to the spouse or children of the original credit card holder, annual charges for them may be additional but lower.

On the face of it, banks charge a very high interest on credit card outstanding balances beyond the due date. It is a paradox, though, that the service provider actually does not make a high profit on credit card operations.

If a 'user pays' approach was followed, the service provider would unbundle the charges in such a manner that card holders would be charged separately for overhead costs (a fixed administration fee), transactions (based on actual use) and use of credit (starting from the date of transaction). This would have lowered the interest rates for borrowings on credit cards. However, what with a high proportion of administrative costs and what with a high default-risk premium, credit cards would still be a costly source of credit. Also, the concept of 'free credit' would no longer be there.

The Pressure on Service Providers

It is alleged that the providers of credit card service often do not treat their small customers professionally. While a large customer base with a low per-customer return does put obvious pressure on the service provider's ability to serve, it is much more serious if any service provider resorts to some unscrupulous practices. A recent probe by the Government of India laid bare some such intentional practices by a few service providers, ranging from delayed dispatch of account statements, delayed encashment of cheques, false promise by agents, 'hidden charges' communicated in 'small print' in the MITC (most important terms and conditions), mechanical handling of customer grievances at call centres, helpline not being toll-free, terms communicated only in English – a language with which a large section of the Indian population is not familiar, no address is made available for communication, and so on. Undoubtedly, at a juncture where a vast untapped potential exists in India for increasing credit card business, such instances will only prove to be counter-productive.

RBI Guidelines on Credit Card Operations

The broad guidelines issued by the RBI are as follows:

1. Issue of cards

- Credit risk of issuing cards to persons with no independent financial means, especially students, is to be independently assessed by the issuer.
- Add-on cards may be issued as subsidiary to the principal card, with the liability clearly lying with the principal cardholder.
- Credit limits granted on a card must consider the total credit available to a holder of multiple cards.
- All KYC (know your customer) requirements must be fulfilled in order to avoid fictitious card holding; it will be the issuer's responsibility even when DSAs/DMAs or other agents are involved on their behalf.
- Terms and conditions of a credit card should be mentioned comprehensively not only in English but also in Hindi and the local language.
- The Most Important Terms and Conditions (MITCs) must be highlighted and advertised or sent separately to the customers (details are given in the Annexure to this Unit).

2. Interest rates and other charges

- There should be no delay in despatching the statement and at least one fortnight's time will be given for making interest-free payments.
- Annualized percentage rates (APR) should be quoted clearly on card products with examples.
- Late payment charges and their methods of calculation should be prominently indicated.
- Method of charging interest on the unpaid outstanding amount should be clearly explained.
- No charge (other than service taxes, etc) can be taken from the card holder beyond what was explicitly indicated at the time of issue / agreed upon by the card holder.
- There should be no negative amortization.

- Changes can be made in non-interest charges only with prospective effect, with at least one month's notice.
- Surrender of credit card due to any disadvantageous changes in charges should not attract any extra charge.

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3. Wrong billing

- If a customer complaint against any bill, if necessary, he should be provided explanation and documentary evidence within a maximum period of sixty days.
- Statements of accounts may be provided online, with suitable built-in security.

4. Use of DSAs/DMAs and other agents

- Such appointment should not compromise with the quality of customer service or the service provider's ability to manage credit, liquidity and operational risks.
- The need to ensure confidentiality of customer-records, respect customer privacy, and adhere to fair practices in debt collection must be kept in mind.
- The code of conduct for Direct Sales Agents (DSAs) formulated by the IBA could be used in formulating the service provider's own codes.
- Marketing by such agents must follow the service provider's code of conduct for credit card operations which should be displayed on the website and made easily available to any credit card holder.
- There should be a system of random checks and mystery-shopping to ensure that the activities of the agents are satisfactory, including hours for calling, privacy of customer information, conveying the correct terms and conditions, etc.

5. Protection of customer rights

- As the principal, the service provider would be responsible for customer's right to personal privacy, preservation of customer records, confidentiality of customer information and fair practices in debt collection.

  (i) ***Right to privacy***

  a) If a card is issued and activated without consent, the service provider will not only reverse the charges forthwith but will also pay a penalty of twice the value of the charges reversed.

  b) If a customer objects to any unsolicited loan or other credit facilities extended without his/her consent, the service provider will not only withdraw the credit limit but will also be liable to pay an appropriate penalty.

c) Credit card limits should be enhanced only with prior consent of the borrower.

d) A 'do not call registry (DNCR)' should be maintained containing both cell phone and landline phone numbers of customers as well as non-constituents who have informed that they do not wish to receive unsolicited marketing calls/SMS.

e) Inclusion in the DNCR should be facilitated through a website or letter.

f) DSA/DMA/call centres will first submit to the bank/NBFC a list of numbers they intend to call. Only numbers not figuring in the DNCR may be cleared for calling.

g) There should be no invasion of privacy viz and persistent bothering at odd hours.

(ii) Customer confidentiality

a) No customer information should be revealed without specific consent.

b) In case information is provided on credit history or repayment record of the card holder under the Credit Information Companies (Regulation) Act, 2005, to an authorised credit information company, the card holder must be explicitly informed.

c) Before reporting the default status of a credit card holder to the Credit Information Bureau of India Ltd. (CIBIL) etc., the service provider must ensure compliance to approved and transparent procedures, including issuing of sufficient notice to such card holders. Particularly care should be taken for cards with pending disputes. The said procedures should be a part of the MITCs.

d) Any disclosure to the DSA/recovery agent should be only on a need-to-know basis.

(iii) Fair Practices in debt collection

a) RBI's Fair Practice Code for lenders (DBOD Circular dated 5 May 2003) as also IBA's Code for Collection of dues and repossession of security are to be followed.

b) Third party agencies for debt collection must refrain from actions either damaging the integrity and reputation of the bank or violating customer confidentiality.

c) All letters from recovery agents must provide contact details of a responsible senior officer of the bank.

d) There should be no resorting to intimidation or harassment, either verbal or physical, no public humiliation or intrusion of privacy of the members of the credit card holders' family.

6. Redressal of grievances

- In general, 60 days may be given to the card holder for preferring complaints or grievances.
- A grievance redressal machinery should be constituted and given wide publicity.
- Contact details of designated grievance redressal officer of the bank/NBFC should appear on credit card statements.
- The designated officer should ensure prompt disposal of genuine grievances.
- A complainant not getting a satisfactory response within 30 days may approach the Banking Ombudsman.
- The bank/NBFC shall be liable to compensate the complainant for loss of time, expenses, financial loss, harassment, mental anguish, etc. due to delay in redressal.

7. Internal control and monitoring systems

- The Standing Committee on Customer Service in each bank / NBFC may conduct a monthly review of credit card operations, default reports to the CIBIL, card related complaints and take appropriate measures to improve service.
- A detailed quarterly analysis of credit card related complaints is to be put up to the top management.
- A suitable mechanism should be put in place for randomly checking the genuineness of merchant transactions.

8. Right to impose penalty

- Under the provisions of the Banking Regulation Act, 1949, the RBI reserves the right to impose penalty on a bank / NBFC for violation of its guidelines.

Credit Card Fraud and Security Systems

Theft of credit card data over the Internet is one of the most dreaded cyber frauds. In the manual system, frauds involving a credit card were by and large confined to physical loss of the card and its unscrupulous use through forgery of the cardholder’s signature. Loss on stolen cards was suitably insured and banks followed their traditional mechanism for dealing with forged signatures.

In the age of e-Commerce, the flow of card information has gone out of the bank’s own network connecting its ATMs. On the one hand, ensuring the same level of security protection over all networks connecting thousands of Points of Sale is an extremely tall order; on the other hand, for a hacker with criminal motives a database containing information on a large number of cards is a far more attractive target than physically acquiring a single credit card.

This calls for a comprehensive security system with built-in encryption technology for data communication over the networks. It is equally important to have a security system for storage of credit card information.

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10.5.1 Strategies Involved in Financing

Every financial service company needs the right marketing strategy to generate high-quality leads. Financial services include a wide range of businesses that manage money, including credit unions, credit-card organizations, accountancy organizations, consumer finance organizations, stock brokerages, individual managers, banks, private lending companies, and some government-sponsored companies. Financial marketers act as a connection between financial services providers and business organizations that are in need of specific financial services. Some of the financial marketing strategies are:

- **Pay Per Call Marketing Services:** By implementing PPC marketing services, financial companies can tap into business owners or individual consumers seeking the help of specific financial services. Business List Targets: Business lists are beneficial whenever financial services providers look for new leads.
- **Good Industry Experience:** If financial service providers opt for lead generation services, then they should ensure that the latter possess plenty of experience in direct mailing. Only then will a business be certain that the service provider will generate good quality leads.
- **No Cold Calling:** Finance companies need to ensure that calls made to the prospective leads by the hired marketing team are not cold calls.
- **Adding Digital Marketing to Traditional Outreach Methods:** These include Search Engine Optimization, Blogging and Social Media Marketing.

Check Your Progress

7. What is the role of financial marketers?
8. Why is service charge applied in case of withdrawal of money from a credit card?

10.6 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. The main function of factoring is the realization of credit sales. Once the sales transaction is completed between the firm and the buyer, the factor starts realizing the sale proceeds.
2. The services provided by a factor are as follows:
   a) Assumption of credit risk
   b) Maintenance of sales ledger

c) Collection of accounts receivables

d) Finance of trade debt

e) Provision of advisory services

f) Credit analysis of the customer

3. Securitization can be divided into two parts— assets-backed securitization and mortgage-backed securitization. Assets-backed securitization is financed by the movable fixed assets and current assets. Mortgaged-backed securitization is backed by the immovable fixed assets.
4. The main advantage of venture capitalists is that they not only provide the finance for risky business, but also provide value added services for business and managerial support. In situations where firms are not able to raise finance by conventional means, like public issue, the importance of venture capital is greater.
5. The factors which led to the growth of consumer credit are as follows:

   a) Increase in disposable income of the consumer

   b) Down payment and credit contract

   c) Growth in nuclear families

   d) Convenient size of installment payment
6. Consumer credit is secured through a first charge on the asset concerned, and the borrower cannot sell or pledge or hypothecate the asset during the credit period.
7. Financial marketers act as a connection between financial services providers and business organizations that need specific financial services.
8. For cash withdrawals, interest is charged from the date of transaction itself and the card holder is required to pay a service charge. This is because in case of cash borrowing the card issuer does not get any payment from a third party.

10.7 SUMMARY

- Factoring is a package of services providing integrated receivables management. Factoring is often used synonymously with accounts receivable financing.
- The main function of factoring is the realization of credit sales. Once the sales transaction is completed between the firm and the buyer, the factor starts realizing the sale proceeds.
- A client sends the business name, address and amount he wants to factor for a particular business client. Credit is verified and limits are established for the business client. There is no charge for credit validation.

- The arrangement of 'forfeiting' resembles factoring. In this arrangement, finance is provided by a finance company to exporters against longer-term notes drawn on their overseas customers.
- The advantage by way of reduction in administrative expenses (due to credit administration responsibility being taken over by the factor) is usually most pronounced in case of small and medium enterprises (SMEs) which may find it uneconomic to maintain a credit management set-up of their own.
- In a forfeiting transaction, different type of fees is charged by the forfeiter depending on the relationship with the exporter, cost of funds and the volume of trade.
- Securitization is a process by which long-term loans, whether backed by security or not, lease receivables, credit card balance, hire purchase debtors and trade debtors or any scheduled cash flows are converted into securities and are issued to investors.
- The money market is a growing at a rapid pace in India. The traditional methods of financing are making way for the modern methods of financing which are providing multiple options to the investors.
- Securitization can be divided into two parts— assets-backed securitization and mortgage-backed securitization.
- As venture capital is required for businesses which involve higher risk and also a higher rate of return, it has some specific features.
- The term 'consumer credit' includes all asset-based financing plans that are used for acquiring consumer durables by individuals.
- The Consumer Protection Bill, 1986, was introduced in the Lok Sabha on 5 December 1986 in order to provide better protection to the interest of the consumers.
- For an ATM operation through a debit or credit card, the same PIN system is used. Each of these cards contains coded information about the particular customers and when it is swiped through an electronic reader at the POS, a connection is established with the bank's computer system.
- Financial marketers act as a connection between financial services providers and business organizations that are in need of specific financial services.

10.8 KEY WORDS

- **Consumer Credit**: It refers to credit which includes all asset-based financing plans that are used for acquiring consumer durables by individuals.
- **Factoring**: It refers to a package of services providing integrated receivables management.
- **Forfeiting**: It refers to an arrangement in which finance is provided by a finance company to exporters against longer-term notes drawn on their overseas customers.

- **Securitization**: It refers to a process by which long-term loans, whether backed by security or not, lease receivables, credit card balance, hire purchase debtors and trade debtors or any scheduled cash flows are converted into securities and are issued to investors.

10.9 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. What are the documents required for availing factoring services?
2. Write a short note on the mechanics of forfeiting.
3. What are the steps involved in the process of securitization?
4. List the main features of venture capital.
5. What are the main sources of consumer finance?

Long Answer Questions

1. Discuss the process of factoring.
2. What are the various costs involved in forfeiting transaction? Explain.
3. Analyse the parties involved in the process of securitization.
4. Discuss the concept of venture capital.
5. Interpret the features of consumer credit transactions

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UNIT 11 OVERVIEW OF MERCHANT BANKING

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Structure

11.0 Introduction
11.1 Objectives
11.2 Merchant Banking
11.3 Public Issue Management
11.4 Underwriting
11.5 Portfolio Management
11.6 Stock and Security Broking
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11.0 INTRODUCTION

A merchant bank is an organization which deals in business loans for companies and underwriting and international finances. They are skilled in handling international trade business. Issue management is defined as a management in which issues are identified and then resolved. It comprises of capital issues such as rights issues or dilution of shares.

Underwriting refers to a process in which an individual or institution takes a financial risk for a certain amount of fee. The risk mostly involves investments and loans. Portfolio management is defined as a management in which decisions regarding investments are managed in such a way that objectives can be achieved. Merger is carried out between companies to form a new company. They are done to expand business and increase their capital and stock market price.

In this unit, the meaning of merchant banking, the role of merchant bankers and the guidelines set up by SEBI for the effective functioning of these banks have been highlighted. The concept of issue management, portfolio management and its types have been explained. The unit will also help you to analyse the meaning, forms and theories of mergers and the process of takeovers.

11.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss the concept of merchant banking
- Explain the process of issue management
- Analyse the types of underwriting and underwriters
- Describe the registration process of underwriters
- Interpret the phases of portfolio management
- Discuss the meaning of IPO financing
- Identify the forms, types and theories of mergers

11.2 MERCHANT BANKING

Merchant banking was initiated and grew in Europe. It was enhanced by American patronage by offering services to both banking and non-banking institutions.

Merchant banks are a kind of diversification of banking services and were originally the real form of banks. The ancient practice of merchant banking was associated with financing the long trading journeys of commodities invented by Italian merchants.

In France, during the 17th and 18th centuries a merchant banker (marchand-banquier) was given the status of being an entrepreneur. But in the United Kingdom, merchant banks came into existence in the 19th century and Barings Bank was the oldest merchant bank. For hundred years merchant banking grew as a way of financing the trades and then extended to crop loans. After that the merchant bankers also got involved in future transaction in grains. This practice was continued, and they started making settlements for other trades. In this way the merchant's 'benches' (bank is derived from the Italian word for bench) in the great grain markets became centres for holding money against a bill and these funds were kept for the settlement of trades in grains. This is how the activity of discounting of bill became a part of the merchant banker's activity.

The increased trade and liberal policies by the sovereigns across the world helped the emergence of private merchant bankers in various countries. Moreover, the banks expanded their services beyond the traditional banking activities and started focusing on other functions like investment banking and issue management etc. Therefore, merchant banking has become an important activity done by banks these days. And these days merchant bankers have extended their services in various other areas also.

Modern merchant bankers provide financial as well as advisory services. In India too, the same functions are performed by merchant banks. Initially the role

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of merchant bankers was played by major lead bankers like ICICI, IDBI, IFCI, LIC and UTI. All these banks helped to raise capital through the stock markets, but the scope of services provided by these lead bankers was very narrow and a strong need was felt to broaden the scope of merchant banks as a result of increased demand of the capital by the corporate. Merchant banking in India was formally introduced by the National and Grindlays Bank which was known as Grindlays Bank in 1967. The Reserve Bank of India issued a license of merchant banking to Grindlays Bank in 1967. The bank started with the functions like facilitation in capital issue and financial advice to the corporate.

SEBI Guidelines for Merchant Bankers

Securities and Exchange Board of India (Merchant Bankers) Rules, 1992

The notification of the Ministry of Finance 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'.

Merchant banking is a combination of banking and consultancy services. Merchant bankers provide consultancy to their clients for financial, legal, marketing and managerial services. They help to raise finance and perform a slew of other activities. As of now there are 135 merchant bankers who are registered with SEBI and they include the public sector, private sector and foreign players.

Some of the prominent public sector merchant bankers are SBI Caps and PNB; the private sector merchant bankers are ICICI Securities, Axis Bank and Kotak Mahindra. Some of the foreign players are Goldman Sachs, Deutsche Bank and Citigroup Global Markets.

SEBI (merchant bankers) rules contains the following chapters:

CHAPTER	CONTENTS
CHAPTER I	PRELIMINARY
CHAPTER II	REGISTRATION OF MERCHANT BANKERS
CHAPTER III	GENERAL OBLIGATIONS AND RESPONSIBILITIES
CHAPTER IV	PROCEDURE FOR INSPECTION
CHAPTER V	PROCEDURE FOR ACTION IN CASE OF DEFAULT

Source: www.sebi.gov.in

Check Your Progress

1. What is the main role of merchant bankers?
2. Name some of the prominent merchant bankers of India.

11.3 PUBLIC ISSUE MANAGEMENT

Issue management is one of the important functions of merchant bankers and lead bankers. The management of issues for raising funds through various types of instruments by companies is known as issue management. Let us look at a grab of the Punjab National Bank Investment Services website to understand the concept of issue management by a merchant banker.

Here, PNB Investment Services Ltd, which is a subsidiary of the PNB, is claiming to be a Category I merchant banker registered with SEBI. They also say they have the expertise in merchant banking and issue management, an insight in the regulatory compliances as well. Their product portfolio includes managing IPOs, rights offerings, buy-back of securities, equity mobilization and managing public offerings of corporate structure bonds, among others. This means that they have the registration and license from SEBI to be the bankers to an issue. Merchant bankers act as intermediaries between the issuers of capital and the ultimate investors who purchase these securities.

There is a slew of activities that are involved in the pre- and post-issue management. Let us study them in detail:

(i) Pre-issue management

Pre-issue obligations: The pre-issue obligations are detailed as follows:

(a) The lead merchant banker shall exercise due diligence.

(b) The standard of due diligence shall be such that the merchant banker shall satisfy himself about all the aspects of offering, authenticity and adequacy of disclosure in the offer documents.

(c) The liability of the merchant banker shall continue even after the completion of the issue process.

(d) The lead merchant banker shall pay a requisite fee in accordance with regulation 24A of Securities and Exchange Board of India (Merchant Bankers) Rules and Regulations, 1992, along with draft offer documents filed with the Board. In the case of a fast track issue, the requisite fee shall be paid along with the copy of the red herring prospectus, prospectus or letter of offer, as the case may be, filed under clause.

(e) The lead merchant banker shall ensure that facility of Applications Supported by Blocked Amount is provided in all books built public issues which provide for not more than one payment option to the retail individual investors.

(ii) Post-issue obligations

(a) **Post-issue monitoring reports:** Irrespective of the level of subscription, the post-issue lead merchant banker shall ensure the submission of the post-issue monitoring reports as per formats specified in Schedule XVI. These reports shall be submitted within three working days from the due dates. The due date for submitting post-issue monitoring report in the case of public issues by listed and unlisted companies:

Three-day monitoring report in the case of issue through book building route, for book-built portion: The due date of the report shall be the third day from the date of allocation in the book-built portion or one day prior to the opening of the fixed price portion whichever is earlier.

Three-day monitoring report in other cases, including fixed price portion of book-built issue: The due date for the report shall be the third day from the date of closure of the issue.

Final post-issue monitoring report for all issues: The due date for this report shall be the third day from the date of listing or seventy-eight days from the date of closure of the subscription of the issue, whichever is earlier. The due dates for submitting post-issue monitoring report in the case of rights issues.

Three-day post-issue monitoring report: The due date for this report shall be the third day from the date of closure of subscription of the issue.

Fifty-day post-issue monitoring report: The due date for this report shall be the 50th day from the date of closure of subscription of the issue.

Due diligence certificate to be submitted with final post-issue monitoring report. The post-issue lead merchant banker shall file a due diligence certificate in the format given in Schedule XVI-A along with the final post-issue monitoring report.)

(b) **Redressal of investor grievances:** The post-issue lead merchant banker shall actively associate himself with post-issue activities namely, allotment, refund, dispatch and giving instructions to Self-Certified Syndicate Banks and shall regularly monitor redressal of investor grievances arising therefrom.

(c) **Co-ordination with intermediaries:** The post-issue lead merchant banker shall maintain close coordination with the registrars to the issue and arrange to depute its officers to the offices of various intermediaries at regular intervals after the closure of the issue to monitor the flow of applications from collecting bank branches and /or Self-Certified Syndicate Banks, processing of the applications including application form for Applications Supported by Blocked Amount and other matters till the basis of allotment is finalized, dispatch security certificates and refund orders completed and securities listed. The merchant banker shall report any act of omission or commission on the part of intermediaries to the securities agency.

(d) **Underwriters:** If the issue is proposed to be closed at the earliest closing date, the lead merchant banker shall satisfy himself that the issue is fully subscribed before announcing closure of the issue.

(e) **Bankers to an issue:** The post-issue lead merchant banker shall ensure that money received pursuant to the issue and kept in a separate bank (i.e. bankers to an issue), as per the provisions of section 73(3) of the Companies Act, 1956, is released by the said bank only after the listing permission under the said section has been obtained from all the stock exchanges where the securities were proposed to be listed as per the offer document.

(f) **Post-issue advertisements:** Post-issue lead merchant banker shall ensure that in all issues, advertisement giving details relating to oversubscription, basis of allotment, number, value and percentage of all applications including Applications Supported by Blocked Amount (ASBA), number, value and percentage of successful allottees for all applications, including ASBA, date of completion of dispatch of refund orders/instructions to Self-Certified Syndicate Banks by the registrar, date of dispatch of certificates and date of filing of listing application is released within ten days from the date of completion of the various activities at least in an English national daily with wide circulation, one Hindi national paper and a regional language daily circulated at the place where the registered office of the issuer company is situated.

(g) **Basis of allotment:** In a public issue of securities, the executive director/managing director of the designated stock exchange along with the post-issue lead merchant banker and the registrars to the issue shall be responsible to ensure that the basis of allotment is finalized in a fair and proper manner in accordance with the following guidelines: Provided that in the book-building portion of a book built public issue notwithstanding the above clause, Clause 11.3.5 of Chapter XI of Securities and Exchange Board of India (Disclosure and Investor Protection) Guidelines, 2000, shall be applicable.

(h) **Proportionate allotment procedure:** Allotment shall be on proportionate basis within the specified categories, rounded off to the nearest integer subject to a minimum allotment being equal to the minimum application size as fixed and disclosed by the issuer.

Check Your Progress

3. State the basis of proportionate allotment procedure.
4. What do you understand by the term, ‘issue management’?

11.4 UNDERWRITING

Underwriting is an agreement, entered into by a company with a financial agency or agencies, to ensure that the public will subscribe for the entire issue of shares or debentures made by the company. The financial agency is known as the underwriter and it agrees to buy that part of the company issues which are not subscribed to by the public in consideration of a specified underwriting commission. The underwriting agreement, among others, must provide for the period during which the agreement is in force, the amount of underwriting obligations, the period within which the underwriter has to subscribe to the issue after being intimated by the issuer, the amount of commission and details of arrangements, if any, made by the underwriter for fulfilling the underwriting obligations. The underwriting commission may not exceed 5 per cent on shares and 2.5 per cent in case of debentures. Underwriters get their commission irrespective of whether they have to buy a single security or not.

Benefits of underwriting

Underwriting has become vital in recent years due to the growth of the corporate sector. Some of the benefits are as follows:

- The company is free of the risk and uncertainty of marketing the securities.
- Underwriters have specialized knowledge of the capital market.
- They help in financing the new ventures and in the expansion of the existing projects.
- The issuing company is assured of the availability of funds and important projects are not delayed for want of funds.
- Underwriters have a broad reach as they maintain contacts with investors throughout India.

Types of underwriting

The following are the types of underwriting:

- **Syndicate underwriting:** Syndicate underwriting is one in which two or more agencies or underwriters jointly underwrite an issue of securities.
- **Sub-underwriting:** Sub-underwriting is one in which an underwriter gets a part of the issue further underwritten by another agency. This is done to diffuse the risk involved in underwriting.
- **Firm underwriting:** Firm underwriting is one in which the underwriters apply for a block of securities. Under it, the underwriters agree to take up and pay for this block of securities as ordinary subscribers in addition to their commitment as underwriters.

For example, if the IndusInd Bank as an underwriter has underwritten the entire issue of ten lakh shares offered by XYZ company and has in addition applied for two lakh shares for firm allotment. If the public subscribes to the entire issue, the underwriter would be allotted two lakh shares even though he is not required to take up any of the shares.

Types of underwriters

Underwriting of capital issues has become very popular due to the development of the capital market and special financial institutions. The lead taken by public financial institutions has encouraged banks, insurance companies and stock brokers to underwrite on a regular basis.

- **Development banks like IFCI, ICICI and IDBI:** They follow an entirely objective approach. They stress upon the long-term viability of the enterprise rather than immediate profitability of the capital issue. They attempt to encourage public response to new issues of securities.
- **Institutional investors like LIC:** Their underwriting policy is governed by their investment policy.
- **Financial and development corporations:** They follow an objective policy while underwriting capital issues.
- **Investment and insurance companies and stock-brokers:** They put primary emphasis on the short-term prospects of the issuing company as they cannot afford to block large amount of money for long periods of time.
- **Banks:** They provide long- and short-term funds.

Registration of Underwriters

To get registered as an underwriter, a certificate of registration must be gained from SEBI. The concerned person has to apply for a certificate. A registered merchant banker need not get a separate certificate for underwriting from SEBI if they are already registered. Before granting a certificate, SEBI considers information about the following:

(i) Availability of necessary infrastructure like adequate office space, equipment's, and manpower to effectively discharge his activities.

(ii) Any past experience in underwriting or if he has in his employment a minimum of two persons who have experience in underwriting.

(iii) Any person directly or indirectly connected with the applicant who has not been granted registration by SEBI under the Act.

(iv) Whether the applicant fulfils the capital adequacy requirements specified in SEBI regulations/rules.

(v) Any of the applicant's director, partner or principal officer is or has at any time been convicted for any offence involving moral turpitude or has been found guilty of any economic offence.

(vi) Capital adequacy requirement shall not be less than the net worth of ₹ 20 lakh. In addition to this, every stock-broker who acts as an underwriter shall fulfill the capital adequacy requirements specified by the stock exchange of which he is a member.' Besides, the applicant must be a proper and fit person.

Procedure for Registration

When SEBI is satisfied that the applicant is qualified for the certificate it shall send an intimation (within one month of such satisfaction) to the applicant, mentioning that he has been found eligible for the grant of certificate. After that SEBI grants a certificate subject to payment of fees as specified below:

According to 2011 guidelines, every underwriter shall pay fee of ₹ 13,33,300 at the time of grant of certificate of initial registration.

Code of Conduct

There are several codes of conduct laid down for an underwriter.

The general code of conduct is as follows:

(i) Every underwriter shall maintain high standards of integrity, dignity and fairness in all his dealings with his clients and other underwriters in the conduct of his business.

(ii) An underwriter shall ensure that he and his personnel will act in an ethical manner in all dealings with a body corporate making an issue of securities.

(iii) Every underwriter shall, at all times, render high standards of service, exercise due diligence, ensure proper care and exercise independent professional judgment.

(iv) Every underwriter shall disclose to the issuer company his possible source or potential areas of conflict of duties and interest while providing underwriting services.

(v) The underwriter shall not indulge in any unfair competition, which is likely to be harmful to the interest of other underwriters or likely to place other underwriters in a disadvantageous position in relation to the underwriter while competing for, or carrying out any assignment.

(vi) No underwriter shall make any statement, either oral or written, which would misrepresent— (a) the services that the underwriter is capable of performing for the, or has rendered to other issuer company; (b) his underwriting commitment.

Source: http://www.sebi.gov.in/acts/act16s3.html

Appointment of a Compliance Officer

Every underwriter shall appoint a compliance officer who shall be responsible for monitoring the compliance of the Act, rules and regulations, notifications, guidelines and instructions issued by the Board or the central government and for redressal of investors' grievances. The compliance officer shall immediately and independently report to SEBI any non-compliance observed by him.

Source: http://www.sebi.gov.in/acts/act162.html#reg%2015

Power to Call for Information

SEBI may at any time call for any information from an underwriter with respect to any matter relating to the underwriting business and where any information is called for, under any regulations, it shall be the duty of the underwriter to furnish such information as early as possible to the SEBI.

Source: http://www.sebi.gov.in/acts/act162.html#reg%2015

Board's Right to Inspect

Where it appears to SEBI to inspect, it may appoint one or more persons as inspecting authority to undertake the inspection of the books of accounts, other records and documents of the underwriter in the following conditions:

- To ensure that the books of accounts and other records and documents are being maintained in the manner required.
- To ensure that the provisions of the Act, rules and regulations are being complied with.
- To investigate into the complaints received from investors, other underwriters or any other person on any matter having a bearing on the activities of the underwriter.
- To investigate suo motu in the interest of securities business or investors' interest into the affairs of the underwriter.

Procedure for Inspection

The following points cover the procedure for inspection:

1. SEBI shall give a reasonable notice to the underwriter, before an inspection against that underwriter.
2. Where SEBI is satisfied that in the interest of investors or the public no such notice should be given, it may by an order in writing directing that the inspection of the affairs of the underwriter may be taken up without such notice.
3. On being empowered by SEBI, the inspecting authority shall undertake the inspection and the underwriter against whom an inspection is being carried out shall be bound to discharge his obligations as per rules.

Liability for Action in Case of Default

If any underwriter fails to comply with SEBI Act/rule/regulation then an indisciplinary action is taken against him or her as per the rules specified in SEBI Intermediaries Act, 2008.

Check Your Progress

5. Define sub-underwriting.
6. What are the main benefits of underwriting?

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11.5 PORTFOLIO MANAGEMENT

Mr Ajay reads a statement in a newspaper that says, ‘To construct a portfolio successfully, one has to understand oneself and the market’. He is perplexed. Why should an individual know himself or herself to construct a portfolio? Is portfolio anything to do with one’s temperament? How can one understand the market?

A portfolio is a combination of securities. The portfolio is constructed in such a manner to meet the investor’s goals and objectives. The investor should decide how best to reach the goals with the securities available. The investor tries to attain maximum return with minimum risk. Towards this end he diversifies his portfolio and allocates funds among the securities. Constructing an investment portfolio depends, to a significant degree, on the nature of the investor. Understanding market instruments and market movements can help one understand the market. Portfolio refers to a combination of securities such as stocks, bonds and money market instruments. Portfolio construction is the process of combining the broad asset classes to yield optimum return with minimum risk.

Basic principles of effective portfolio management

The two basic principles for effective portfolio management are:

(i) **Effective investment planning:** An investor has to make judicial decision about his investments by considering fiscal, monetary policies of the government, industrial economic environment etc

(ii) **Constant review of investments:** Continuous evaluation and review of the investments need to be carried out by the portfolio managers to identify the better avenues to purchase or sell their Investors.

Phases of portfolio management

1. Security analysis
2. Portfolio analysis
3. Portfolio selection
4. Portfolio revision
5. Portfolio evaluation

Diversification: Diversifying one’s investments helps to spread the risk over many assets. The main objective of diversification is the reduction of risk in the loss of capital and income. A diversified portfolio is comparatively less risky than holding a single portfolio. There are several ways to diversify the portfolio. Diversification of securities in a portfolio assures the anticipated return. In a diversified portfolio, some securities may not perform as expected while others may exceed expectations, thus bringing the actual return of the portfolio reasonably close to the anticipated one. Keeping a portfolio with a single security may lead to a greater likelihood of the actual return being quite different from that of the expected return. Hence, it is a common practice to have a diverse portfolio of securities.

Debt and equity diversification: Debt instruments provide assured return with limited capital appreciation. Equity stocks will have higher return and capital appreciation subject to uncertainty of the various factors of the market.

Industry diversification: Industries' growth and their reaction to government policies differ from each other. Banking industry shares may provide regular returns but with limited capital appreciation. Information technology stocks yield high returns and capital appreciation, but their growth potential after 2002 has not been predictable. Thus, industry diversification is needed and it reduces risk.

Company diversification: Securities from different companies are purchased to reduce risk. Technical analysts suggest that investors buy securities based on the price movement. Fundamental analysts suggest the selection of financially sound and investor friendly companies.

Selection: Based on the diversification level, the industry and the company analyse the securities to be selected. Funds are allocated for selected securities. Selection of securities and the allocation of funds seals the construction of portfolio.

The following avenues can be used to form a portfolio in order to minimize the risk or maximize the returns:

- Shares
- Debentures
- Derivatives (options and futures)
- Precious Metals (gold, silver, etc.)
- Foreign currency
- Post office saving schemes
- Bank deposits
- Real estate
- Antique pieces
- Mutual funds
- Off-shore funds
- Provident funds
- Insurance policies

The following are the two broad categories of portfolio strategies:

(a) **Active portfolio strategy:** The vast majority of the funds in India follow an active investment approach, wherein fund managers spend a great deal of time on researching individual companies, gathering extensive data about financial performance and management characteristics. There are four principle vendors of an active strategy are:

(i) Market timing

(ii) Sector rotation

(iii) Security selection

(iv) Use of specialized investment concept

(b) **Passive portfolio strategy:** Passive strategy, rests on the tenet that the capital market is fairly efficient with respect to the available information. Hence, they search for superior return. Basically, passive strategy involves adhering to two guidelines. They are:

(i) Create a well-diversified portfolio at a predetermined level of risk.

(ii) Hold the portfolio relatively unchanged overtime unless it becomes adequately diversified or inconsistent with the investor risk return preference.

Let us look at a grab of the portfolio of a balanced fund ICICI Prudential Equity-Volatility Advantage Fund. It shows the holdings in equity in various sectors and their percentage allocation or exposure. Also note that the fund has allocated 34 per cent of the assets in call money, which shows that the fund has kept some liquidity to meet quick redemptions and maintains a safe margin of funds.

Types of Risk

Following are the two broad categories of risks involved in portfolio management:

1. **Systematic Risk:** Systematic risk refers to that portion of variation in return caused by factors that affect the price of all the securities. It is also known as undiversifiable risk as this risk cannot be reduced by diversification. The factors responsible for systematic risk are out of the investor's or portfolio manager's control. Therefore, the investor has to bear the systematic risk.

   #### Causes of Systematic Risk

   The following are the main causes of systematic risk:

   - **Interest rate risk:** The uncertainty of future market values and the size of future incomes, caused by fluctuations in the general level of interest is known as interest rate risk.
   - **Market risk:** Variations in price sparked off due to real social, political and economic event is, referred to as market risk.
   - **Inflation risk/purchasing power risk:** This risk is caused due to the inflation in the general economic environment.

2. **Unsystematic risk:** Uncertainty risk refers to that portion of the risk which is caused due to factors which are unique or related to a firm or industry.

Unsystematic risk is also known as diversifiable risk as by increasing the number of securities in the portfolio the investor can reduce the unsystematic risk.

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Check Your Progress

7. State the main objective of diversification.
8. What are the four principle vendors of an active portfolio strategy?

11.6 STOCK AND SECURITY BROKING

Companies who come out with public issues appoint brokers to get subscription. The brokers obtain the prospectuses and application forms from the managers to the issue. These brokers form an important link in the distribution value chain of financial products. Let us take the example of a piece of news of an IPO of Bharti Infratel, in December 2012, to understand the role of brokers.

IPO-financing is back in currency with Bharti issue; brokers, NBFCs freeing up capital for individual investors.

IPO finance, which involves financing individual investors to buy shares of public issues, is slowly making a comeback with many brokers readying themselves for the upcoming ₹ 4,500-crore Bharti Infratel issue. Non-banking finance companies, some banks and finance arms of brokerages, which make a lot of money disbursing short-term IPO loans, are freeing up capital in anticipation of a turnaround in the primary market. Top brokers like Motilal Oswal Financial Services, Religare Finvest, Edelweiss Capital and India Infoline, among others, expect IPO funding to resume once the Infratel issue garners sufficient investor interest and manages a positive listing. Many of the brokers are already in touch with their clients asking them if they want funds to invest in the Infratel issue.

IPO loans, as they are known in market parlance, are short-term borrowings with a maximum holding period of 90 days. Astute traders and operators, however, borrow only for 12 days from the last day of IPO subscription phase. Brokers may charge 500-600 basis points higher than current CP (commercial paper) rates. Commercial papers are currently trading at 10 per cent pa. IPO funding is an important revenue stream for brokers and financiers as it helps them earn a clear spread over bank loans. Most financiers prepare their loan book on short-term loans raised from banks.

11.6.1 Application for Registration of Stock Brokers

(i) An application by a stock broker for a grant of a certificate shall be made through the stock exchange of which he is a member.

(ii) The application must be forwarded to SEBI within thirty days from the date of its receipt.

(iii) The exchange should check that there are no complaints/arbitrage case against the applicant.

(iv) SEBI may require the applicant to furnish such further information or clarifications regarding the dealings in securities and matter connected thereto to consider the application for grant of a certificate.

(v) The applicant or, its principal officer shall appear before the Board for personal representation.

In addition to this, SEBI shall take into account for considering the grant of a certificate, whether the stock broker: is eligible to be admitted as a member of a stock exchange; has the necessary infrastructure like adequate office space, equipments and man power to effectively discharge his activities; has any past experience in the business of buying, selling or dealing in securities; is subjected to disciplinary proceedings under the rules, regulations and bylaws of a stock exchange with respect to his business as a stock-broker involving either himself or any of his partners, directors or employees and is a fit and proper person.

Conditions of registration

SEBI grants registration to a broker subject to the following conditions:

(i) The stock broker holds the membership of any stock exchange.

(ii) He shall abide by the rules, regulations and bylaws of the stock exchange which are applicable to him.

(iii) If the stock broker proposes to change his status or constitution, he shall obtain prior approval of the Board for continuing to act as such after the change.

(iv) He shall pay fees charged by the Board in the manner provided in these regulations.

(v) He shall take adequate steps for redressal of grievances, of the investors within one month of the date of receipt of the complaint and keep the Board informed about the number, nature and other particulars of the complaints received from such investors.

11.6.2 Code of Conduct for Stock Brokers

As per the Security and Exchange Board of India (Stock Brokers and Sub-brokers) Regulations, 1992, there are five elements of the codes of conduct and they are as follows:

(i) **Integrity:** A stock-broker, shall maintain high standards of integrity, promptitude and fairness in the conduct of all his business.

(ii) **Exercise of due skill and care:** A stock-broker, shall act with due skill, care and diligence in the conduct of all his business.

(iii) **Manipulation:** A stock-broker shall not indulge in manipulative, fraudulent or deceptive transactions or schemes or spread rumours with a view to distorting market equilibrium or making personal gains.

(iv) **Malpractices:** A stock-broker shall not create false market either singly or in concert with others or indulge in any act detrimental to the investors interest or which leads to interference with the fair and smooth functioning of the market. A stock-broker shall not involve himself in excessive speculative business in the market beyond reasonable levels not commensurate with his financial soundness.

(v) **Compliance with statutory requirement:** A stock-broker shall abide by all the provisions of the Act and the rules, regulations issued by the government, the Board and the stock exchange from time-to-time as may be applicable to him.

Source: http://www.sebi.gov.in/acts/act141s2.html

11.6.3 Duty towards the Investor

A broker's duties towards the investors are given in detail.

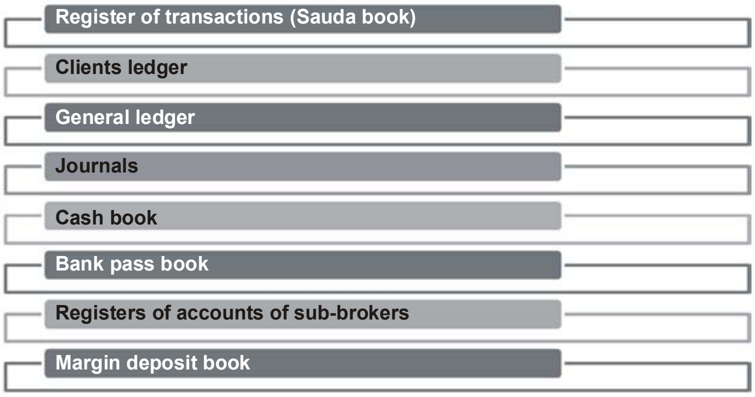
- ***Execution of orders:*** A stock-broker, in his or her dealings with the clients and the general investing public, shall faithfully execute the orders for buying and selling of securities at the best available market price and not refuse to deal with a small investor merely on the ground of the volume of business involved. A stock-broker shall promptly inform his client about the execution or non-execution of an order and make prompt payment in respect of securities sold and arrange for prompt delivery of securities purchased by clients.
- ***Issue of contract note:*** A stock-broker shall issue without delay to his or her client a contract note for all transactions in the form specified by the stock exchange.
- ***Breach of trust:*** A stock-broker shall not disclose or discuss with any other person or make improper use of the details of personal investments and other information of a confidential nature of the client which he comes to know in his business relationship.
- ***Business and commission:*** A stock-broker shall not encourage sales or purchases of securities with the sole object of generating brokerage or commission. In addition to this, he shall not furnish incorrect or misleading quotations or give any kind of wrong information to the clients with a view to stimulate him to do business in particular securities and facilitating himself to earn brokerage or commission thereby.
- ***Business of defaulting clients:*** A stock-broker shall not do business or transact knowingly, directly or indirectly or execute an order for a client who has not fulfilled his commitments in relation to securities with another stock-broker.

- ***Fairness to clients:*** A stock-broker, when dealing with a client, shall reveal whether he is acting as a principal or as an agent and shall make sure at the same time, that no conflict of interest arises between him and the client. In the event of a conflict of interest, he shall inform the client accordingly and shall not try to gain a direct or indirect personal advantage from the situation and shall not consider the clients' interest inferior to his own.
- ***Investment advice:*** A stock-broker shall not make a recommendation to any client who might be expected to rely thereon to get hold of, dispose of, keep any securities unless he has reasonable grounds for believing that the recommendation is suitable for such a client upon the basis of the facts, if revealed by such a client as to his own security holdings, financial situation and objectives of such investment. The stock-broker should seek such information from clients, whenever he feels it is suitable to do so.
- ***Competence of stock-broker:*** A stock-broker should have sufficient skilled staff and arrangements to render fair, prompt and competence services to his clients.

Source: http://www.bsebrokersforum.com/regulatory-info/model-code.html

General Obligations and Responsibilities

Every stock broker shall keep and maintain the following books of account, records and documents, namely:



Register of transactions (Sauda book)

Clients ledger

General ledger

Journals

Cash book

Bank pass book

Registers of accounts of sub-brokers

Margin deposit book

Fig. 11.1 *Books of Accounts*

Every stock broker is required to intimate SEBI the place where the books of account, records and documents are maintained. Every stock broker should submit their audited balance sheet and profit and loss account to SEBI within six months from the close of the accounting year. Brokers have to maintain all these records at least for five years.

Appointment of a Compliance Officer

Every stock broker should appoint a compliance officer who is responsible for monitoring the compliance of the Act, rules and regulations, notifications, guidelines and instructions issued by the Board or the central government and for redressal of investors' grievances. The compliance officer should immediately and independently report to the Board any non-compliance observed by him.

The stock broker should not deal with any person as a sub-broker unless such person has been granted certificate of registration by SEBI.

Procedure for Inspection

SEBI has the right to appoint one or more persons as inspecting authority to undertake inspection of the books of account, other records and documents of the stock brokers to ensure that the books of account and other books are being maintained in the manner required, that the provisions of the Act, rules, regulations and the provisions of the Securities Contracts (Regulation) Act, are being complied with, to investigate the complaints received from investors, other stock brokers, sub-brokers or any other person on any matter having a bearing on the activities of the stock brokers and to investigate suo motu, in the interest of securities business or investors' interest, into the affairs of the stock-broker.

Check Your Progress

9. What are IPO loans?
10. What is the main role of a compliance officer appointed by a stock broker?

11.7 MERGER AND TAKEOVER: SALIENT FEATURES, GUIDELINES AND FUNCTIONS

Merger is the combining of all the assets and liabilities of two or more businesses where only one of the businesses survives. The company which ceases to exist is known as the transferor company and the company which remains in existence is known as the transferee company. A merger has the following conditions:

(i) Shareholders of the selling company become shareholders of the buying company and an exchange ratio is determined to find out how many shares of the selling company will shareholders get in exchange for their shareholdings in the buying company.

(ii) The assets and liabilities of the transferor company will become assets and liabilities of the transferee company.

(iii) The shares of the transferor company will be cancelled and in exchange for their shares, the shareholders will get shares of the transferee company.

(iv) All the operations of the transferor company will be carried out under the name of the transferee company.

(v) All rights and obligations of the transferor company against the third parties will also be transferred to the transferee company.

Merger in India is also referred to as an 'amalgamation'. The Income Tax Act, 1961, [Section 2(1A)] defines amalgamation as the merger of one or more companies with another or the merger of two or more companies to form a new company, in such a way that all assets and liabilities of the amalgamating companies become assets and liabilities of the amalgamated company and shareholders not less than nine-tenths in value of the shares in the amalgamating company or companies become shareholders of the amalgamated company.

Thus, mergers or amalgamations may take two forms:

1. **Merger through absorption:** An absorption is a combination of two or more companies into an 'existing company'. All companies except for one lose their identity in such a merger. For example, absorption of Tata Fertilisers Ltd (TFL) by Tata Chemicals Ltd. (TCL). TCL, an acquiring company (a buyer), survived after merger while TFL, an acquired company (a seller), ceased to exist. TFL transferred its assets, liabilities and shares to TCL.
2. **Merger through consolidation:** A consolidation is a combination of two or more companies into a new company. In this form of merger, all companies are legally dissolved, and a new entity is created. Here, the acquired company transfers its assets, liabilities and shares to the acquiring company for cash or exchange of shares. For example, merger of Hindustan Computers Ltd, Hindustan Instruments Ltd, Indian Software Company Ltd and Indian Reprographics Ltd into an entirely new company called HCL Ltd.

Types of Mergers

The different types of mergers are explained as follows:

1. **Horizontal mergers:** When two firms are engaged in the same/competitive business then it is called a horizontal merger or horizontal integration. The purpose of such a merger is to control the market by creating a monopoly. The merger of two banks is an example of a horizontal merger.
2. **Vertical mergers:** When two firms merge and both are at different stages of the production process or industrial process, it is called a vertical merger or vertical integration. A textile company merging with a company producing different types of fabric is an example of a vertical merger. Vertical merger can be in the form of backward integration or forward integration. When a company merges with another, which provides raw material or semi-finished products to continue production, then it is called backward integration. Similarly, when a manufacturing concern integrates with a trading and distribution firm then it is called forward integration.
3. **Conglomerate mergers:** When the two firms which merge are in diverse businesses then it is known as a conglomerate merger. The basic purpose

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of this kind of merger is to benefit from the diversification and obtain a large customer base for all the products manufactured by both the companies.

4. **Congeneric mergers:** When the two merged firms have no common distribution network or customer-supplier network then it is known as a congeneric merger. The basic purpose of such a merger is to broaden the distribution channel for the combined companies.
5. **Cash merger:** If any of the merged company's shareholders is against the merger of the companies then those shareholders get cash in place of their shareholding and do not stay as shareholders of the merged company. This type of merger is also known as 'cash-out-merger'.
6. **Triangular merger:** Under this type of merger, the target company merges with the subsidiary of the acquirer company. As three parties are involved in the agreement it is called a triangular merger. Generally, such a merger takes place for tax benefit.

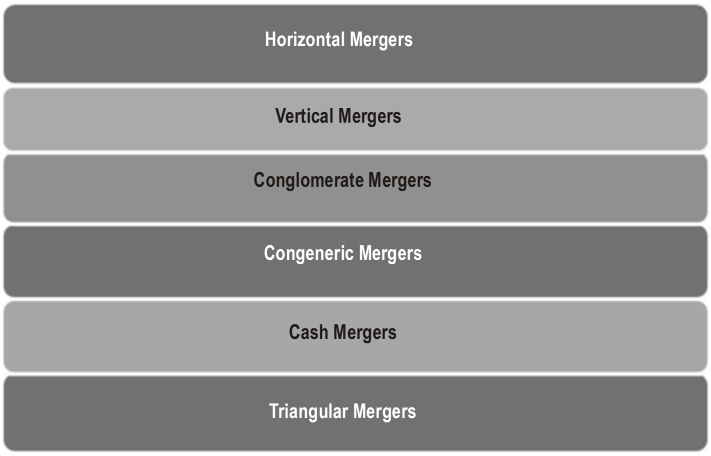

Fig. 11.2 *Types of Mergers*

Acquisitions

Under acquisition, there is a company called a 'target company' and an individual or group of individuals acquires the controlling power over the target company. Here, the controlling power means the power to run the company or power to manage and take policy decisions about the company. It means that the individual or group of individuals have the power to appoint or remove the majority of the directors of the target company. But the business of the target company remains intact and does not merge as discussed in the case of a merger. The acquisition of a company can take place by purchasing the majority of the shares which represent the majority of the voting power, or by getting control over the company through a formal or informal agreement, or by getting control over majority of the investment by the target company or by getting majority of voting power through power of attorney.

Takeover

Takeover is a kind of hostile form of acquisition. When the prospective target company's management is not willing to sell to the prospective buyer company then the prospective buyer can openly start a takeover bid and start buying shares of the target company from the open market to get control over the company. Such an activity is called a takeover.

A takeover route can be friendly or unfriendly. When the management of the target company is receptive and co-operates with the buyer company then it is considered a friendly takeover or acquisition. Generally, under such circumstances, the buyer company pays a higher price for the share than that prevailing in the market. The shares of the target company are purchased in exchange of cash. In the case of unfriendly or hostile takeover, the management of the target company may not be willing or aware of a bid being made and the buyer can bypass the management of the target company and can directly give an offer to the shareholders of the target company. The offer so given is known as a tender offer. The other form of acquisition is leveraged buyouts in which borrowed funds are used to raise funds for the acquisition. When a financially sound company acquires a sick unit then it is known as bailout takeovers.

Benefits of Mergers

Mergers can be beneficial to all parties involved. The main benefits are enlisted as follows:

(i) The transferee company gets the benefit of synergy in all functional areas.

(ii) There is reduction in unnecessary competition in the market.

(iii) The existing company gets the benefit of large levels of distribution channels.

(iv) The customer base of the existing company increases.

(v) The existing company gets the benefit of diversification due to expansion of the product line.

(vi) The existing company also benefits by the managerial expertise of the transferor company.

(vii) When two companies merge then the operating efficiency of the transferee company increases and it reduces the overall cost of production and the existing company gets the benefit of economies of scale.

(viii) It becomes easy to access the new markets.

(ix) The existing company can improve its financial performance as well.

Procedure for Mergers

The following points describe in detail the procedure followed for a merger to take place.

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(i) Making a draft of the scheme of merger/amalgamation, specifying all detailed information related to transferor, transferee, any terms and conditions specifically mentioned for the transfer of assets and liabilities.

(ii) Once the draft is ready, the approval of the board of directors of the transferor and transferee company needs to be obtained. The merger also needs to be approved by specialized financial institutions/banks/trustees for the interest of the debenture holders.

(iii) An intimation of the proposal of the amalgamation is given to the stock exchanges where the transferor and transferee companies are listed.

(iv) An application of the amalgamation proposal must also be sent to the high court.

(v) The high court gives directions to conduct meetings for the members and the notice sent to the members is to be approved by the registrar of the high court.

(vi) Besides, the notice being sent to members, an advertisement is published regarding the notice of the members' meeting as per direction of the court.

(vii) A general meeting of the shareholders is held, and a resolution is passed to execute the amalgamation proposal and intimation of the same is sent to the registrar of the companies.

(viii) The chairman's report of the general meeting is submitted to the high court.

(ix) The transferor and transferee company have to file a joint petition in the high court for the approval of the amalgamation scheme.

(x) The high court sends a notice to the Regional Director of the Company Law Board and if any representation is made by the regional director, then it is also considered.

(xi) The court verifies the scheme of amalgamation after considering all necessary material facts and the orders of the court are filed with the Registrar of the Companies.

(xii) Once the court approves the amalgamation scheme, the assets and liabilities of the transferor company automatically transfer to the transferee company.

(xiii) The exchange ratio for the shareholders of the transferor company is determined. If any cash payment has to be made in exchange of shareholdings in the transferor company then it is also decided upon.

(xiv) Shares are allotted to the shareholders of the transferor company and the transferee company submits an application to the stock exchange (where the stocks of the transferee company are listed) for the listing of newly issued shares to the shareholders of the transferor company.

(xv) The transferee company is required to maintain and keep all necessary records and books of the transferor company.

(xvi) Certain provisions are also made to cancel the merger if the shareholders are not willing to execute the scheme of amalgamation.

Theories of Mergers

There are several theories regarding mergers. Some of these are listed as follows:

1. **Differential efficiency theory:** Differential efficiency theory is based upon the notion that some firms perform below average efficiency and are most vulnerable to be acquired.
2. **Inefficient management theory:** Inefficient management theory is similar to the differential efficiency theory. However, in the case of inefficient management theory the firm is considered to be performing poorly because of poor management in all functional areas.
3. **Synergy:** Synergy theory is based upon the notion of synergy and believes that when two firms merge, the combined value of both the firms gives a push of overall value to the shareholders by creating financial and operational synergy.
4. **Pure diversification:** Whenever two firms merge, benefits of internal and external diversification are generated. The combined firm is benefitted by increased capabilities and skills in its functional areas and similarly it increases its base customers and markets to diversify its business.
5. **Strategic realignment to changing environment:** The idea behind such a merger is to modify the firms according to the fast-changing business environment. When the economic environment has place for only a few capable firms then a merger is the best way to exploit opportunities as the resources of both firms are pooled.
6. **Agency problem:** Often in the case of a widely held company, a merger may not get approval because the perception is that, in order to fulfil the interest of a few shareholders, the majority of the shareholders risk erosion of value of their shares. At times, the company may lose value as a result of the merger.
7. **Q-Ratio:** The Q-ratio is used to study the relationship between the market value of the assets of the company and their replacement cost. Very often due to inflation, the market value of assets falls below their respective book values and companies cannot replace assets because of the high inflationary cost of replacement. These companies represent a good acquisition opportunity for potential buyers looking to enhance their production capacity rather than investing in a new plant, as their cost is much lower than setting up a new production.
8. **Hubris hypothesis:** According to this hypothesis, the benefit of a merger such as financial, synergy and diversification are not the prime motive behind a merger but the managers need to satisfy their own personal objectives

gives shape to merger like activities which works as a primary motivation for a merger. This also called a 'winner's curse' hypothesis because generally the managers overvalue the acquired firm.

9. **Information inefficiency:** In case of an inefficient market, the announcement of big merger gives a positive signal in the market and companies can benefit from manipulated prices because of such information.

10. **Tax aspects:** Certain companies can also make a decision regarding a merger if there are tax benefits attached such as set off of tax losses, tax holidays, among others associated with the combination of two entities.

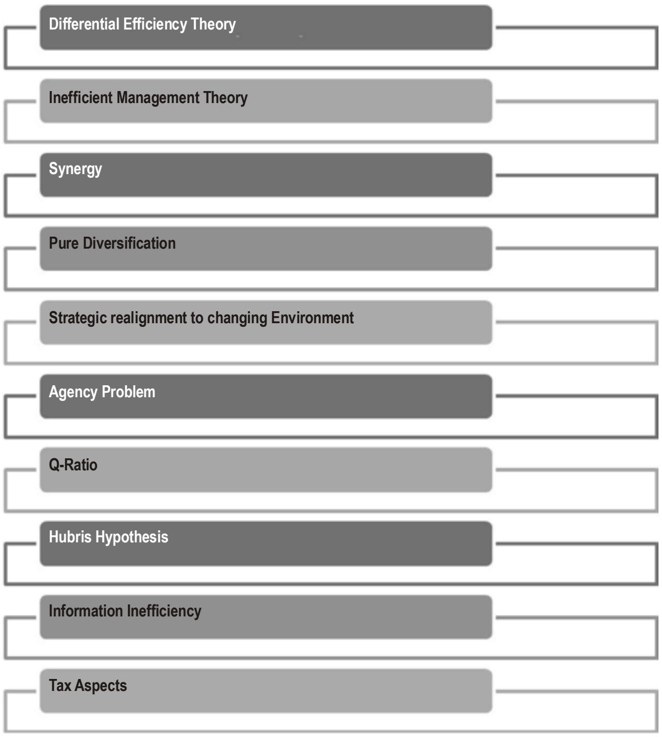
Differential Efficiency Theory
Inefficient Management Theory
Synergy
Pure Diversification
Strategic realignment to changing Environment
Agency Problem
Q-Ratio
Hubris Hypothesis
Information Inefficiency
Tax Aspects

Fig. 11.3 *Different Theories of Merger*

Check Your Progress

11. What are the main forms of mergers?
12. State the premise of differential efficiency theory.

11.8 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Merchant bankers provide consultancy to their clients for financial, legal, marketing and managerial services. They help to raise finance and perform a slew of other activities.

2. Some of the prominent public sector merchant bankers are SBI Caps and PNB; the private sector merchant bankers are ICICI Securities, Axis Bank and Kotak Mahindra. Some of the foreign players are Goldman Sachs, Deutsche Bank and Citigroup Global Markets.
3. Allotment shall be on proportionate basis within the specified categories, rounded off to the nearest integer subject to a minimum allotment being equal to the minimum application size as fixed and disclosed by the issuer.
4. The management of issues for raising funds through various types of instruments by companies is known as issue management.
5. Sub-underwriting is one in which an underwriter gets a part of the issue further underwritten by another agency. This is done to diffuse the risk involved in underwriting.
6. The main benefits of underwriting are as follows:
   a) The company is free of the risk and uncertainty of marketing the securities.
   b) Underwriters have specialized knowledge of the capital market.
   c) They help in financing the new ventures and in the expansion of the existing projects.
   d) The issuing company is assured of the availability of funds and important projects are not delayed for want of funds.
7. The main objective of diversification is the reduction of risk in the loss of capital and income. A diversified portfolio is comparatively less risky than holding a single portfolio.
8. The four principle vendors of an active portfolio strategy are market timing, sector rotation, security selection and use of specialized investment concept.
9. IPO loans, as they are known in market parlance, are short-term borrowings with a maximum holding period of 90 days.
10. Every stock broker should appoint a compliance officer who is responsible for monitoring the compliance of the Act, rules and regulations, notifications, guidelines and instructions issued by the Board or the central government and for redressal of investors' grievances.
11. There are two main forms of mergers which are as follows:
    (*a*) *Merger through absorption:* An absorption is a combination of two or more companies into an 'existing company'.
    (*b*) *Merger through consolidation:* A consolidation is a combination of two or more companies into a new company.
12. Differential efficiency theory is based upon the notion that some firms perform below average efficiency and are most vulnerable to be acquired.

11.9 SUMMARY

- Merchant banking was initiated and grew in Europe. It was enhanced by American patronage by offering services to both banking and non-banking institutions.
- Merchant banks are a kind of diversification of banking services and were originally the real form of banks.
- The increased trade and liberal policies by the sovereigns across the world helped the emergence of private merchant bankers in various countries.
- Modern merchant bankers provide financial as well as advisory services. In India too, the same functions are performed by merchant banks.
- Merchant banking is a combination of banking and consultancy services. Merchant bankers provide consultancy to their clients for financial, legal, marketing and managerial services.
- Issue management is one of the important functions of merchant bankers and lead bankers. The management of issues for raising funds through various types of instruments by companies is known as issue management.
- Underwriting is an agreement, entered into by a company with a financial agency or agencies, to ensure that the public will subscribe for the entire issue of shares or debentures made by the company.
- Syndicate underwriting is one in which two or more agencies or underwriters jointly underwrite an issue of securities.
- Sub-underwriting is one in which an underwriter gets a part of the issue further underwritten by another agency.
- Underwriting of capital issues has become very popular due to the development of the capital market and special financial institutions.
- To get registered as an underwriter, a certificate of registration must be gained from SEBI. The concerned person has to apply for a certificate.
- When SEBI is satisfied that the applicant is qualified for the certificate it shall send an intimation (within one month of such satisfaction) to the applicant, mentioning that he has been found eligible for the grant of certificate.
- Where it appears to SEBI to inspect, it may appoint one or more persons as inspecting authority to undertake the inspection of the books of accounts, other records and documents of the underwriter.
- A portfolio is a combination of securities. The portfolio is constructed in such a manner to meet the investor’s goals and objectives.
- Diversifying one’s investments helps to spread the risk over many assets. The main objective of diversification is the reduction of risk in the loss of capital and income.

- Debt instruments provide assured return with limited capital appreciation. Equity stocks will have higher return and capital appreciation subject to uncertainty of the various factors of the market.
- Systematic risk refers to that portion of variation in return caused by factors that affect the price of all the securities.
- Uncertainty risk refers to that portion of the risk which is caused due to factors which are unique or related to a firm or industry.
- Companies who come out with public issues appoint brokers to get subscription. The brokers obtain the prospectuses and application forms from the managers to the issue.
- IPO-financing is back in currency with Bharti issue; brokers, NBFCs freeing up capital for individual investors.
- Merger is the combining of all the assets and liabilities of two or more businesses where only one of the businesses survives.
- When the prospective target company's management is not willing to sell to the prospective buyer company then the prospective buyer can openly start a takeover bid and start buying shares of the target company from the open market to get control over the company. Such an activity is called a takeover.

11.10 KEY WORDS

- **Merchant Banker**: It refers to 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.
- **Portfolio**: It refers to a combination of securities such as stocks, bonds and money market instruments.
- **Portfolio Construction**: It refers to the process of combining the broad asset classes to yield optimum return with minimum risk.
- **Syndicate Underwriting**: It refers to a type of underwriting in which two or more agencies or underwriters jointly underwrite an issue of securities.

11.11 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. What are the guidelines set by SEBI for merchant banks?
2. How is the underwriting agreement prepared?

3. What are the main types of underwriting?
4. List the causes of systematic risk.
5. What is the code of conduct for an underwriter?
6. State the consequence if an underwriter fails to comply with SEBI.
7. What are the investment avenues in portfolio management?

Long Answer Questions

1. Discuss the steps involved in the pre- and post-issue management of merchant banks.
2. Identify the main types of underwriters.
3. What are the portfolio strategies? Analyse in detail.
4. Explain the procedure related to registration of underwriters.
5. Discuss the basic principles of portfolio management.
6. Analyse the duties of the brokers towards the investors.
7. What are the various types of mergers? Discuss.

11.12 FURTHER READINGS

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UNIT 12 OVERVIEW OF FOREIGN EXCHANGE BROKING

NOTES

Structure

12.0 Introduction
12.1 Objectives
12.2 Foreign Exchange Broking
12.3 Bill Discounting
12.4 Financial Consultancy
12.4.1 Credit Rating Services: Salient Features, Guidelines and Functions
12.5 Answers to Check Your Progress Questions
12.6 Summary
12.7 Key Words
12.8 Self Assessment Questions and Exercises
12.9 Further Readings

12.0 INTRODUCTION

Foreign exchange market is a global decentralized market for the trading of services. It determines the foreign exchange rate and includes aspects such as buying, selling and exchanging of curries at determined prices. Forward market refers to an informal over the counter financial market in which contracts for future delivery are agreed and entered.

Bill discounting refers to an arrangement in which seller recovers amount of sales bill from the financial intermediaries before the due dates. A credit rating service is an organization which assigns credit ratings to the debtor. The debtor has to pay back the debt by making timely payments. A credit rating agency provides a credit rating of issuers and creditworthiness of debt instruments also.

In this unit, the working of forward markets and its types has been discussed. The meaning of bill discounting and the purpose of various bills have been highlighted. The unit will also explain the role of financial advisors, corporate advisory services and the process of credit rating.

12.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss the concept of forward markets
- Analyze the rules of foreign exchange markets set up by Foreign Exchange Dealers Association of India
- Explain the meaning of bill discounting and types of bills

- Interpret the advantages and disadvantages of bill discounting
- Discuss the features and functions of credit rating services
- Describe the process of credit rating

12. 2 FOREIGN EXCHANGE BROKING

The forward market in India is active up to six months where two-way quotes are available. Forward exchange market refers to buying and selling currencies to be delivered at a future date. Forward exchange transactions involve an agreement on a price today for settlement at some date in the future. Forward rates apply to transfer of demand deposits with value dates three or more business days in the future. They are always quoted with reference to spot rates because they are traded at either a premium or discount to spot exchange in the interbank market. Forward rates are quoted in terms of the premium or discount to be added to the spot rate which is quoted in two numbers, the bid price and ask price. The bid and ask spread will always widen with the forward horizon.

Features

In the forward markets, contracts are made to buy and sell currencies for future delivery, say, after a fortnight, one month and two months. The rate of exchange for the transaction is agreed upon on the very day the deal is finalized. The forward rates with varying maturity are quoted in the newspapers and those rates form the basis of the contract. Both the parties have to abide by the exchange rate mentioned in the contract irrespective of whether the spot rate on the maturity date is more or less than that of the forward rate. In other words, no party can back out of the deal, even if changes in the future spot rate are not in his or her favour.

The value date in case of a forward contract lies definitely beyond the value date applicable to a spot contract. If it is a one-month forward contract, the value date will be the date in the next month corresponding to the spot value date. Suppose a currency is purchased on 1 August, if it is a spot transaction, the currency will be delivered on 3 August.

But if it is a one-month forward contract, the value date will fall on 3 September. If the value date falls on a holiday, the subsequent date will be the value date. If the value date does not exist in the calendar, such as 29 February (if it is not a leap year) the value date will fall on 28 February.

Sometimes, the value date is structured to enable one of the parties to the transaction to have the freedom to select a value date within the prescribed period. This happens when the party does not know in advance the precise date on which it would be able to deliver the currency; for instance, an exporter who sells a foreign currency forward without knowing in advance the precise date of shipment.

Again, the maturity period of forward contract is normally for one month, two months, three months, and so on but sometimes it may not be for the whole month and a fraction of a month may also be involved. A forward contract with a maturity period of thirty-five days is an opposite example. Naturally, in this case, the value date falls on a date between two complete months. Such a contract is known as broken-date contract.

Spot and forward markets

The foreign exchange market is of two types: spot and forward market. When currencies are exchanged for urgent delivery (usually within two business days after finalizing a business transaction), it is in the spot market. In the forward market, parties enter into contract to buy or sell foreign currencies at a future specified date. Spot transactions account for about 40 per cent of the market, with forward transactions accounting for further 9 per cent. The residual 51 per cent of the market are swap transactions, which entails a package of a spot and a forward contract.

A forward contract is an understanding between two parties to buy or sell a liability, say foreign currency in the future at prices agreed upon on the day of the agreement. If you are keen to have an exclusive 'unavailable' watch, then you will be inclined to get into a forward contract. Bank quotes for 1, 3, 6, 9, and 12 month maturities are offered as forward contracts. Suppose that forward quotes of Indian rupees (INR) against USD are as follows:

$1	= ₹47.8241;	for a 1 – month forward
	=₹47.8364;	for 6 – months forward
	=₹47.8587;	for 9 – months forward

Clearly the players in the foreign exchange markets expect that the Indian rupees will value less in dollars in nine months. If spot dollar/rupee deal is done on Friday September 8, then value date will be Tuesday September 12. If September 12 is a holiday in NY/India, then the value date is September 13. However, spot deals in some currency pairs such as US dollar-Canadian dollar are settled in one business day. A 3-month forward deal dollar/rupee on Monday November 10, 2008 has the value date February 12, 2009. If the later date is a holiday in NY/India, then the value date is February 13. For a 3-month forward dollar/rupee on December 29, value date March 31. If holiday NY/India, the value date cannot be pushed forward. Pushing forward must not carry to next calendar month. So push the value date back to March 30.

Swap transactions account for around 51 per cent of interbank transactions in foreign exchange. The simultaneous sale (or purchase) of spot foreign exchange against a forward purchase (or sale) of a nearly equal amount of the foreign currency is referred to as a swap transaction. It provides a means for the bank to lessen the foreign exchange exposure while going for a forward contract. Consider the following example. Assume that a customer wants to buy dollars two months forward against Indian rupees through a bank. The bank, while undertaking this transaction for its customer, can at the same time neutralize the foreign exchange exposure by selling (borrowed) rupees against dollars in the spot market.

Forward premium

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When it is necessary to pay more for forward delivery than for spot delivery of a foreign currency, we say that the foreign currency is at a **forward premium**. When a currency costs less for forward delivery than for spot delivery (as is in the case of INR/USD in the quotation earlier), we say that the foreign currency is at a **forward discount.**

Consider the following example. Suppose the € is appreciating against rupees from S (₹ /€) = 60 to F90 (₹ /€) = 62. The 180-day forward premium is given by:

$$F_{90}, (₹ /€) = [\{F_{90} (₹ /€) - S (₹ /€)\}/ S (₹ /€)] \times 360/90$$
$$= \{(62 - 60) / 60\} \times 360/90$$
$$= 0.1333$$

When this expression has a positive value, euro is at a forward premium vis-à-vis the rupee, because in this case the euro costs more rupees for forward delivery than spot delivery. When this expression has a negative value, euro is at a forward discount vis-à-vis the dollar. When the forward rate is equal to the spot rate, we say that the forward currency is flat.

Let us make the following assumptions:

(a) Speculators are risk-neutral, that is, speculators do not care about risk, and

(b) Ignore transaction costs in exchanging currencies

Then forward exchange rates should reflect the expected future spot rates in the market.

Suppose the participants in the market expects dollar to be trading at ₹ 50/ $ in 1-year's time, and the forward rate for 1 year were only ₹49.50/$. Speculators would buy dollar forward for ₹49.50/$, and expect to make ₹0.50 on each dollar when the dollars are sold forward at their expected price of ₹50 /$. In buying the dollar forward, speculators would drive up the forward price of the dollar until it is equal to the expected future spot rate.

Similarly, suppose the participants in the market expects dollar to be trading at ₹50 /$ in 1-year's time, and the forward rate for one year were only ₹50.50/$. Speculators would sell dollar forward, even though they have no dollar and are not expecting any dollar. They would expect to profit from subsequently buying dollar for delivery on the forward contract at their expected price of ₹50 /$which is ₹0.50 less than the price at which they have sold dollar forward. In the course of selling dollar forward, speculators would drive down the forward price of dollar until it is equal to the expected future spot price.

If you have decided to sell foreign exchange forward, you are short. If you have decided to buy foreign exchange forward, you are long. If you decide to sell anything in the future at a fixed price and the spot price later falls then you benefit. If you decide to sell anything in the future at a fixed price and the spot price subsequently increases rises, then you lose.

Arbitrage in forward markets

It is said that the forward rate differential is approximately equal to the interest rate differential. Sometimes, there may be marked deviation between these two differentials. In such cases, covered interest arbitrage begins and continues till the two differentials become equal. This is an arbitrage in forward markets.

Forward markets hedging

Forward markets are used not only by the arbitrageurs but by the hedgers too. Changes in the exchange rates are a usual phenomenon. Such changes entail some foreign exchange risk in terms of loss or gain to the traders and other participants in the foreign exchange market. Risk is reduced or hedged through forward markets transactions. Under the process of hedging, currencies are bought and sold forward. Forward buying and selling depends upon whether the hedger finds himself in a long, or a short position. An export billed in foreign currency creates a long position for the exporter. On the contrary, an import billed in foreign currency leads to a short position for the importer.

Speculation in forward markets

In addition to the arbitrageur or the hedger, speculators are also very active in the forward markets operations. Their purpose is not to reduce the risk but to reap profits from the changes in the exchange rates. The source of profit to them being the difference between the forward rate and the future spot rate, they are not very concerned with the direction of the exchange rate change.

Suppose a speculator sells US $1,000 three-month forward at the rate of ₹40.50/US $. If, on maturity, the US dollar depreciates to ₹40, the speculator will get ₹40,500 under the forward contract. At the same time, he will exchange ₹40,500 at the future spot rate of ₹40/US $ and will get US $1,012.50. Both these activities — the selling and the purchasing of the US dollars will be simultaneous. Thus, without making any investment, the speculator will make a profit of US $12.50 through the forward markets deal. This is an example of speculation in the forward markets.

Speculation in the forward markets cannot extend beyond the date of maturity of the forward contract. However, if the speculator wants to close the speculation operation prior to maturity, say by one month, he may buy an offsetting contract. In other words, if he has already entered into a three-month forward contract for selling the US dollars, he would have to opt for a two-month forward contract for selling the US dollars. The profit or loss would naturally depend upon the exchange rate involved in the two forward contracts.

The above is a very simple example. Many other examples can be cited about speculation in the forward markets. In fact, the type of speculation depends upon the expected movement of the future spot rate.

Foreign Exchange Dealers Association of India (FEDAI) Rules: Contract Amounts RULE 7-Exchange contracts

1. **Contact amounts**

   Exchange contracts shall be for definite amounts i.e. there shall be no provision for excess or shortfall.

   When a bill contract mentions more than one rate for bill of different deliveries, the contract must state the amount and delivery against each such rate.

   Illustration

   Value of the export order dated 1.1.96 for US$60,000/- expiring – Delivery period 31.3.96, 30.4.96 and 30.6.96 – US$20,000/- each.

CONTRACT NO	VALUE	DELIVERY PERIOD	RATE
96/1	US$20,000	1.3.96 TO 31.3.96	RS 36.6200/-
96/2	US$20,000	1.4.96 TO 30.4.96	RS 37,0700/-
96/3	US$20,000	1.6.96 TO 30.6.96	RS 37,9700/-

2. For the first shipment effected say on 15.3.1996 the exporter should indicate the contract No. as 96/1 and the rate as ₹ 36.6200.

3. **Option period of deliver**

   Unless date of delivery is fixed and indicated in the contract, the option period of delivery should be specified as a calendar week (i.e. 1st to 7th, 8th to 15th, 16th to 23rd or 24th to last working day of the month) or a calendar fortnight (i.e. 1st to 15th or 16th to last working day of the month). In any case, the option of delivery shall not extend beyond one calendar month, (i.e. 1st to last working day of the month). If the fixed date of delivery or the last date of delivery option is a holiday/ declared a holiday the delivery shall be affected/ delivery option exercised on the preceding working day. Contracts permitting option of delivery must state the ‘first and last dates of delivery’ or ‘cash’ merchant contract shall be deliverable on the same day. ‘Value next day’ contract shall be deliverable on the day immediately succeeding the contract date. A spot contract shall be deliverable on second succeeding business day following the day when the transaction is closed.

4. **Place of delivery**

   All contracts shall be understood to read ‘to be delivered or paid for at the bank’ and ‘at the named place’.

5. **Date of delivery**

   Date of delivery under forward contracts will be:

   1. In case of bills/ document negotiated, purchased or discounted – date of negotiated, purchased/ discount and payment of rupees to customer.

2. In case of bills/documents sent for collection-date of payment of Rupees to customer on realization of the bills.
3. In case retirement/crystallisation of import bills/document – the date of retirement/crystallisation of liability whichever is earlier.

6. **Option of delivery**

   In all forward merchant contracts, the merchant whether a buyer or a seller will have the option of delivery.

7. **Option of usance**

   The merchant purchase contract should state the tenor of the bills/ documents. Acceptance of delivery of bills/ documents drawn for a different tenor will be at the discretion of the bank.

8. **Merchant quotation**

   In order to simplify and establish transparency, the exchange rate will be quoted in direct terms i.e. so many Rupees and Paise for 1 unit of foreign currency or 100 units of foreign currencies (with effect from 2nd August 1993).

   The merchant (as well as interbank) rate should be quoted up to four decimals, the last two digits being in multiples of 25 (for example US$1 = ₹ 34.3250, 1 Pound Sterling = ₹ 52.4350). The card rates of member banks should be quoted in two rates decimals. For the sake of software programming the card rates may be indicated in four decimals, provide the last two decimals are ₹00' (i.e. US$ = ₹ 34.9000).

   [The exchange rate for the euro will be quoted in direct terms i.e. so many rupees and paise for 1 unit of the euro. The merchant (as well as interbank) rates for the euro shall be quoted up to four decimal, the last two digits being in multiples of 25. The card rates of member banks shall be quoted in two decimals. For the sake of software programming the card rate may be indicated in four decimals provided the last two decimal are 00.]

   A list of common currencies and the unit of rate quotations are as detailed below:

   Currencies to be quoted against one unit of foreign currency:

   1. Australian Dollar
   2. Austrian Schilling
   3. Bahraini Dinar
   4. Canadian Dollar
   5. Danish Kroner
   6. Deutsche Mark
   7. Dutch Guilder
   8. Egyptian pound
   9. European Currency Unit (E.C.U.)

10. Finnish Mark
11. French Franc
12. Hongkong Dollar
13. Irish Punt
14. Kuwaiti Dinar
15. Malaysian Ringgit
16. New Zealand Dollar
17. Norweigian Kroner
18. Omani Rial
19. Qatar Rial
20. Saudi Riyal
21. Singapore Dollar
22. Sterling Pound
23. Swedish Kronor
24. Swiss Franc
25. Thai Bhat
26. UAE Dirham
27. US Dollar
28. EURO2

Currencies to be quoted against 100 units of foreign currencies:

29. Belgian Franc
30. Indonesian Rupiah
31. Italian Lira
32. Japanese yen
33. Kenyan Schilling
34. Spanish Peseta

Asian Clearing Union currencies to be quotes against 100 units of foreign currencies:

35. Bangladesh Taka
36. Burmese Kyat
37. Iranian Rial
38. Pakistan Rupee
39. Sri Lanka Rupee

(Note: With effects from 01.01.96 the settlement procedure has been revised to ACU Dollar)

9. Rounding off Rupee equivalent of the foreign currency at the agreed merchant rate Settlement of all merchant transactions shall be effected on the principle of rounding off the Rupees amounts to the nearest whole Rupee i.e. without paise.

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Note: In terms of the above Rule amount up to 49 paise of the Rupee shall be ignored and amount from 50 to 99 paise of the Rupee equivalent shall be rounded off to the next Rupee.

10. **Charges**

    On each forward sale or purchase contract booked, a minimum commission of ₹ 250/- shall be recovered from the customer. (AR 10/95 dated 20.12.95)

11. **Contract amount**

    Any excess amount over the amount stated in a contract, or shortfall therein, shall be bought or sold, as the case may be, at the bank's current spot rate of the day and the amount of the excess in the contract shall be cancelled as per Rule 8 IV.

Check Your Progress

1. What are the two main types of foreign exchange markets?
2. How is forward premium different from forward discount?

12.3 BILL DISCOUNTING

Bill discounting, as a fund-based activity, has emerged as a profitable business in the early nineties for finance companies and represented a diversification in their activities in tune with the emerging financial scene in India. In the post-1992 (scam) period, its importance has substantially declined primarily due to the restrictions imposed by the Reserve Bank of India. Bills discounting is an asset-based financial service.

Concept

According to the Indian Negotiable Instruments Act, 1881, 'The bill of exchange is an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of, a certain person, or to the bearer of that instrument.' The bill of exchange is used to finance a transaction in goods, which means that it is essentially a trade-related instrument.

Types of Bills

There are various types of bills. They can be classified on the basis of when they are due for payment, and title to the goods.

***Demand* bill**: Demand bill is payable immediately 'at sight' or 'on presentment' to the drawee. A bill on which no time of payment or 'due date' is specified is also termed as a demand bill.

***Usance* bill**: Usance bill is also called time bill. The term usance refers to the time period recognized by custom or usage for payment of bills.

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***Documentary* bills**: Documentary bills of exchange that are accompanied by documents that confirm that a trading transaction has taken place between the buyer and the seller of goods. These documents include the invoices and other documents of title such as railway receipts, lorry receipts and bills of lading issued by custom officials. Documentary bills can be further classified as:

1. **Documents against acceptance (DA bills)**: Documents of title are railway receipts, lorry receipts, bills of lading and air consignment notes. In this case, the documentary evidence accompanying the bill of exchange is deliverable to the drawee against his acceptance. Soon after acceptance, the documents of title, along with other documents, such as invoices, are made available to the drawee. This means the documentary bill becomes a clean bill after delivery of the documents. The drawee enjoys credit till the due date of payment. DA bills are also known as usance bills.
2. **Documents against payment (DP bills)**: In case a bill is a 'document against payment, the documents of title are handed over to the buyer only on receipt of payment'. The drawee does not enjoy any credit as he is required to make the payment to receive documents of title.

Clean bills: Clean bills are not accompanied by any documents of title to goods.

Commercial bills: Commercial bills are associated with sales transactions. Banks finance commercial bills for the purpose of working capital requirements. Usually, the bills consist of an invoice drawn on the buyer, the documents to title to goods and a bill of exchange. The bills are given to the bank to advance money against sale of goods. Commercial bill financing is a post-sale finance. The bill of exchange may be on document against payment (D/P) or document against acceptance (D/A) terms. It is a short-term, negotiable, self-liquidating instrument, which is used to finance a firm's credit sales. It may be a demand bill or a usance bill. When goods are sold on credit, the buyer is liable to make payment on a specific date in future. A commercial bill is an important tool to finance credit sales. The seller (drawer) of the goods draws the bill and the buyer (drawee) accepts it. On being accepted, the bill becomes a marketable instrument and is called a trade bill. These bills can be discounted with a bank if the seller needs funds before the bill matures.

Discounting bills of exchange (B/E): The seller, who is the holder of an accepted B/E, has two options:

1. Hold on to the B/E till maturity and then take the payment from the buyer.
2. Discount the B/E with a discounting agency. This option is by far more attractive to the seller.
3. The seller can take over the accepted B/E to a discounting agency, which can be a bank, NBFC, company or high net worth individual and obtain ready cash. The act of handing over an endorsed B/E for ready money is called discounting the B/E. The margin between the ready money paid and the face value of the bill is called the discount and is calculated at a rate percentage per annum on the maturity value.

4. The maturity of a B/E is defined as the date on which payment will fall due. Normal maturity periods are 30, 60, 90 or 120 days but bills maturing within 90 days seem to be the most popular.

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Difference between Bill Purchase, Bill Discounting and Bill Negotiating

The term 'bill purchase' is used in the context of a demand bill, payable on demand, which is supported by documents to title to goods. When banks purchase bills of exchange, they are safe as they can sell goods, in the event of refusal of payment by the drawee. In respect of a usance bill, which is payable after the specified duration, banks discount and pay cash so the term bill discount is used. It is just like a clean finance as banks part with the documents of title on acceptance and uncertainty is involved in respect of final recovery. Usually, there are no documents to a title to goods hence banks keep high margin and pay less than face value. So, we use purchase of bill in respect of demand bill and discount of bill for usance bill.

Negotiation of documents implies that a letter of credit is available for documents. When banks finance against documents, accompanied by letter of credit, the term negotiation of documents is used.

Advantages of Bill Discounting

Bill discounting is a short-term source of finance provided by banks. If a customer is interested to avail of working capital finance against credit sales, banks grant bill purchase/discount limit. The document of title to goods, which usually accompanies the bill of exchange, constitutes the primary security. Usually, banks ask for certain collateral security while extending this limit. Such a limit is obtained when bills of exchange are almost a regular feature in business. When these documents are presented to the bank for purchase/discounting, banks credit the amount to the customer's account after deducting a discount. In addition, the banks charge interest for the period the bill remains outstanding for payment.

Advantages to Borrowers

The following are the advantages for borrowers:

1. **Immediate availability of cash:** By discounting the bill, the drawer (seller of goods) gets cash immediately. He does not have to wait for payment until the due date of the bill.
2. **No extra security is to be offered:** Banks generally do not ask for any other security while making payment against the bill discounted/purchased.
3. **Liability for repayment:** In a bill of exchange, the primary responsibility for repayment is with the drawee. Banks, therefore, approach the drawee first, who is generally the acceptor of the bill for payment on the due date of the bill. In case the drawee does not pay, the drawer or the person who has got payment after discounting the bill is held responsible for payment.

Disadvantages to Borrowers

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The following are the disadvantages of bill discounting for borrowers:

1. **Payment of interest in advance:** While discounting a bill, the bank deducts the discount and the balance is credited to the customer's account. Thus, a person receiving money through the discounting of a bill has to offer charges in advance on the amount of the bill. In the case of loan or cash credit account, interest is charged at the end of the quarter.
2. **Facility is subjected to the creditworthiness of drawer involved:** Banks generally extend this facility after being satisfied with the creditworthiness of the various parties involved. In case of doubt, the bank may ask for some security. Thus, it is not a very easily available facility.
3. **Additional burden in case of non-payment:** Bills not paid upon maturity are to be certified by notary public and noting charges are paid. Thus, it becomes an additional burden.

Bill financing provides an infusion of funds for the firms that need financial accommodation for their bills of exchange. Financial intermediaries take care of funds requirement.

These following are the advantages of bill discounting for banks:

1. **Safety of funds**: The transaction is practically an advance against the security of the bill. The greatest security for a banker is that a B/E is a negotiable instrument bearing signatures of two parties, a drawer and a drawee, considered good for the amount of bill; so the bank can enforce its claim easily, if required.
2. **Certainty of payment**: A B/E is a self-liquidating advance with the date of maturity known to the banker, well in advance.
3. **Control over utilization:** Bill discounting provides greater control to banks over their withdrawals. It is difficult for the banks to monitor the utilization of limits in respect of cash credit accounts as it is often reported that borrowers divert the cash credit limits for purposes other than working capital purposes. Banks sanction bill purchase or bill discounting limits only when the documents are accompanied with the documents of title such as rail receipt or lorry receipt which would ensure that the borrowers are utilizing the limits for trade purpose only.
4. **Profitability**: Since the discount on a bill is front-ended, the yield is much higher than in other loans and advances, where interest is paid quarterly or half yearly.

Check Your Progress

3. What is a demand bill?
4. State any one advantage of bill financing.

12.4 FINANCIAL CONSULTANCY

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Financial consultants work with organizations or individuals to plan for their financial futures by offering information and guidance on a wide range of topics that encompass taxes, investments and insurance decisions. Thus, financial consultancy can be thought to be essentially offering personalized financial advice. They may also direct the buying and selling of stocks and bonds for their customers. Financial consultants personally meet with their customers to examine their financial situation in order to present a financial plan that includes both short- and long-term financial objectives. In addition, many consultants are licensed to buy and sell financial products such as insurance policies, stocks and bonds.

Corporate Advisory Services

Corporate Advisory Services is an umbrella term that includes specialized advice's rendered to corporate houses by professional advisers such as accountants, investment banks, law practitioners and host of similar service providers. In the context of investment banking, corporate advisory services relate to business advisory, restructuring advisory, project advisory and merger and acquisition advisory. There are numerous professional bodies that provide such services. These professional bodies can be classified under three broad categories. The first are professional bodies such as chartered accounting firms, law firms and so on. The second are investment banks and other financial institutions with merchant banking license. The third are specialist advisory firms who give expert advice in select vertical. AN example of a specialist advisory firm is Mckinsey & Co., which specialize in strategy consulting and advise governments and corporates on strategy and policy issues.

12.4.1 Credit Rating Services: Salient Features, Guidelines and Functions

The business of credit rating can be linked to the US as early as the 1900s. The first mercantile credit agency was set up in New York in 1841 to rate the ability of merchants to pay their loans on time. Later on, it was taken over by Robert Dun. This agency published its first rating guide in 1859. The second agency was established by John Bradstreet in 1849 which was later merged with the first agency to form Dun & Bradstreet in 1933. It also took over the Moody's Investor's Service in 1962. The history of Moody's can be traced back to 100 years ago. The initial rating exercise was started by Henry Poor who published financial statistics of Railroad Companies in 1860. In addition to his publishing business, John Moody (Moody's Investors Services) started publishing ratings for railroad bonds from the year 1909.

The early 1920's saw the expansion of the credit rating industry when the Poor's Publishing Company published its first rating guide in 1916. Subsequently, Fitch Publishing Company and Standard Statistics Company were set up in 1924 and 1922 respectively. The rating activity got a boost after the Great Depression of 1933 when the US Government Controller of Currency directed the banks in the USA to purchase bonds rated BBB and above, and the rest of the bonds came to be known as ‘ Junk Bonds’.

Poor and Standard merged together in 1941 to form Standard and Poor’s which was subsequently taken over by McGraw Hill in 1966. In 1975, the US Securities and Exchange Commission (SEC) laid down the rules for designating National Recognized Statistical Rating Organizations. But in 1997, certification was required for such organizations. Since the 1970’s, a number of credit rating agencies have been set up all over the world including countries like Malaysia, Thailand, Korea, Australia, Pakistan and Philippines etc. In India, CRISIL (Credit Rating and Information Services of India Ltd.) was set up in 1987 as the first rating agency to come in operation followed by ICRA Ltd. in 1991, and Credit Analysis and Research Ltd. (CARE) in 1994. All the three agencies have been promoted by the All-India Financial Institutions. Recently, a report of the committee on comprehensive Regulations for the Credit rating Agencies in India has been submitted in December, 2009. The committee had members from all the financial sectors in India. A research report was prepared by the National Institute of Securities Market (NISM) that was discussed upon.

Need for Credit Rating

The concept of credit rating is limited to borrowing and investment decisions. The investors want to be sure of the safety of their investment. The main purpose of a credit rating estimates the credit worthiness of an individual corporation, or even a country by evaluating the borrower’s overall credit history. You must be wondering what the parameters that are evaluated are and how the past can be the basis for future performance.

The evaluation of a potential borrower’s ability to repay debt is prepared by the credit rating agency at the request of the lender only. A lot of cost is involved in this. So, if the evaluation is done willingly, it is sold in the market otherwise it is always as per the demand of the customer. Ratings are calculated from financial history and current assets and liabilities.

One should not confuse the current rating with the past ratings of a borrower. Good or bad performance of the past is no measure for the present. Credit rating is acquired for every debt instrument that is launched by the company and then the rating is used generally by the company for attracting the investors.

Credit rating is not an audit of the issuing company. The credit rating is always scheme-specific and it is certainly not a onetime assessment of creditworthiness of the issuer. Though it is not a general purpose certification of goodness of a company but investors are attracted by the company if it highlights its good credit rating. Credit rating companies do not recommend the investors to buy, hold or sell the rated security.

This does not mean that credit rating is limited only to debt issuing companies. Even an Individual can be rated. What is the need for individual assessment? An individual credit score along with his or her credit score affects his ability to borrow money from financial institutions such as banks.

The credit rating of a corporation is a financial indicator to potential investors of debt securities as bonds. Now, let us discuss the sovereign credit rating. It is the credit rating of a sovereign entity, i.e. a country. The sovereign credit rating indicates the risk level of the investing environment of a country and is used by investors looking to invest abroad.

Let us try to assess who uses credit rating and why?

I. Investors

1. They are interested in identifying the risk associated with their investment and can diversify it into various assets according to their risk bearing capacity.
2. This helps to determine the Risk Based Pricing of investments.
3. It helps in in-depth research.

II. Issuers

1. They are interested in attracting investors by providing transparency.
2. An independent, unbiased assessment by a third party can be used as a plus point to attract investors.
3. This increases the credibility and acceptability of the financial instrument being launched.
4. As a result, it increases access to funding.
5. This also encourages financial discipline among the issuers.

III. Regulatory Authorities

1. This will help in protecting the Investor against frauds
2. This will also ensure Market discipline

The credit rating companies have to gather information about the company from various sources. This involves time and cost. To avoid any error or wrong information, credit rating agencies have to act ethically. They should not come under the influence of the company and misguide the investors. The credit rating agencies should maintain a high level of competency and integrity.

Rating Methodology

The rating methodology is divided into two broad segments. The first segment is concerned with the operational aspects of the company and the second segment deals with the financial aspects.

Operational aspects include the following sub-parameters:

1. **History of the organization:** The Company that is being rated is critically examined for ownership, size, geographical spread, product spread and the organizational structure. These parameters help to measure the strength of the company.
2. **Quality of accounting practices followed:** This is used to analyse the transparency and the strictness by which the accounting concepts, principles and conventions are followed while preparing the financial records. It should also be screened for the change in accounting policies if any. The company should not frequently change from one policy to another.
3. **Business Fundamentals:** The credit rating company will analyse the strategies, policies, strengths and weaknesses. This will make the picture clear for the future.
4. **Liquidity position of the company:** This will help in making the judgement about the ability of operating in the short term. The company that is liquid will be able to meet short term obligations in a better way than a company that is deficient is cash.
5. **Quality of management:** Even the family owned businesses in India are hiring competent persons as their CEOs. Quality and experience of management helps an organization tide over rough tide in a better way.
6. **Quality of Assets:** The Company should use the latest technology and manage its products well.

Financial aspects include:

1. **Profitability:** Ratios of the past years can be used to judge the profit position of the company. Investors are interested only in investing in profitable business.
2. **Return on Equity and Return on Investment:** These two ratios help to judge the ability of the company to use its assets.
3. Capital Structure
4. Past Financial Performance
5. Interest and Debt coverage ratios

There are a number of agencies that are operating in the Indian market. Some of the few commonly working credit rating agencies in India are enlisted as follows:

- Credit rating Information services of India Limited (CRISIL)
- Investment Information and Credit rating agency of India (ICRA)
- Credit Analysis & Research Limited (CARE)
- Duff & Phelps Credit Rating India Private Ltd. (DCR India)
- ONICRA Credit rating Agency of India Ltd.

Many International Credit rating agencies have also opened their offices in India. Functioning and registration of credit rating agencies in India are done according to the guidelines laid down by the Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999. The registration procedure includes application for the establishment of a credit rating agency, matching the eligibility criteria and providing all the details required.

Credit rating process

The Rating symbols that are assigned to a security issue are an indicator of the following:

1. The nature and terms of the particular security being issued.
2. The ability and the willingness of the issuer of a security to make payments in time.
3. The probability that the issuer will make a default in payments.
4. The degree of protection available to the investors if the security issuer company is liquidated re-organized or declared bankrupt.

Let us understand the factors that influence the ratings to be assigned by a credit rating agency:

1. Credit rating takes into account the security issuer's ability to service its debt. This is done by calculating the past and the likely future cash flows.
2. The fixed interest obligation of the issuer is taken into account. This is done so because the firm may not be giving regular dividend. It cannot keep a hold on interest payment as it will spoil its market name.
3. The volume and composition of outstanding debt is considered to keep the financial risk in view.
4. The stability of the future cash flows and earning capacity of the company is also considered to know the future profitability of the company.
5. Current ratio which is the ratio of current assets to current liabilities is used for assessing the liquidity position of the issuing firm.
6. The market position of the company products is considered while giving the credit rating because it affects the future cash flows and this involves using data for the demand for the products, competitors market share, distribution channels etc.
7. Operational efficiency of the company is judged by capacity utilization, prospects of expansion, modernization and diversification, availability of raw material etc.
8. Track record of promoters, directors and expertise of staff also affect the rating of a company.

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Instruments for Rating

Rating may be carried out by the rating agencies in respect of the following:

(i) Equity shares issued by a company

(ii) Preference shares issued by a company

(iii) Bonds/debentures issued by corporate and government

(iv) Commercial papers issued by manufacturing companies, finance companies, banks and financial institutions for raising short-term loans

(v) Fixed deposits raised for medium-term ranking as unsecured borrowings

(vi) Borrowers who have borrowed money

(vii) Individuals

Credit Rating that was limited to the debt instrument has been extended to all those activities that have an element of uncertainty and risk involved. A list of ratings of other activities is given in the following section.

I. Country Rating

A country may be rated whenever a huge loan is extended or when some major investment by MNAC is to be made. A number of factors such as growth rate, industrial and agricultural production, government policies, inflation and fiscal deficit are taken into consideration to arrive at such ratings.

II. Rating of Real Estate Builders and Developers

CRISIL has started assigning rating to the builders and developers with the objective of helping and guiding prospective real estate buyers. CRISIL thoroughly scrutinizes the sale deed papers, sanctioned plan, and lawyers' report government clearance certificates before assigning rating to the builder or developer. Past experience of the builder, number of properties built by the builder, financial strength and time taken for completion are some of the factors that are taken into consideration by the CRISIL before giving a final rating to the real estate builder/ developer.

III. Chit Funds

Chit funds registered as a company are sometimes rated on their ability to make timely payment of prize money to subscribers.

IV. Rating of States

The various States of India have also approached rating agencies as it helps them in attracting investors both from India and abroad to make investments. Investors feel safety for their funds if they invest in a state with good rating. Foreign companies also come forward and set up projects in states with positive rating. Rating agencies take into account various economic parameters such as industrial and agricultural growth of the State, availability of raw material and labour. It also takes into account the political parties' agenda with respect to industry and labour relation between Centre and State and the freedom enjoyed by the states in taking decisions while assigning final rating to the states.

V. Rating of Banks

CRISIL and ICRA both are engaged in rating of banks based on the following six parameters also known as CAMELS.

C - C stands for capital adequacy of banks. A bank needs to maintain at least 10 per cent capital against risky assets of the bank.

A - A stands for asset quality. The loan is examined to determine non-performing assets. An asset/loan is considered non-performing asset where either interest or principal is unpaid for two quarters or more. Ratios like NPA to Net Advances, Adequacy of Provision and Debt Service Coverage Ratio are also calculated to know the exact picture of quality of the asset of a bank.

M - M stands for management evaluation. Here, the efficiency and effectiveness of management in framing plans and policies is examined. Ratios like ROI, Return on Capital Employed (ROC E), and Return on Assets (ROA) are calculated to comment upon a bank's efficiency to utilize the assets.

E - E stands for earnings ability.

L- L indicates liquidity position. Liquid and current ratios are determined to find out a bank's ability to meet its short-term claims.

S - S stands for Systems and Control. Existing systems are studied in detail to determine their adequacy and efficacy.

Thus, the above six parameters are analysed in detail by the rating agency and then final rating is given to a particular bank. Ratings vary from A to D. Where A denotes financial, managerial and operational soundness of a bank, D denotes that a bank is in financial crisis and lacks managerial expertise and is facing operational problems.

VI. Rating (Recommendation) for Equities

These days analysts specialized in equity ratings make a forecast of the stock prices of a company. They study thoroughly the trend of sales, operating profits and other variables and make a forecast of the earning capacity and profitability position of a company. They use financial statement analysis tools like ratio analysis, trend analysis, fund flow analysis and cash flow analysis to comment upon a company's liquidity, solvency, profitability and overall efficiency position. Analysts suggest a target price of the stock giving signal to the investor to swing into action whenever the stock hits that particular price.

The following are some of the recommendations made by the equity analysts for its investors:

(i) **Buy:** It shows that a stock is worth buying at its current price.

(ii) **Buy on Declines**: This recommendation indicates that a stock is basically good but overpriced now. The investor should go for buying whenever the price declines.

(iii) **Long-term Buy**: This recommendation suggests that a stock should be bought and held for a longer period at least a year in order to realize gains.

(iv) **Strong Buy**: This buy recommendation strongly favors the purchase of a stock because the analysts expect a steep rise in the prices of stock from its current price.

(v) **Out-performer**: This recommendation shows that whatever may be the mood of the stock market, the stock will perform better than the market.

(vi) **Overweight**: This states that an investor can increase the quantum or weight of that stock in his portfolio. This recommendation is applicable to those investors who keep a number of stocks in their portfolio.

(vii) **Hold**: This recommendation is a suggestion to the investor to exit because stock prices are not likely to be appreciated significantly from the current price level.

(viii) **Sell/Dispose/Sub-Standard/Under-weight:** It indicates to the investor to sell/dispose off or decrease the weight of stock from its portfolio because stock is fundamentally overvalued at its current level and the investor should exit from it immediately.

Sovereign Credit Rating

A sovereign credit rating is the credit rating of a sovereign entity, i.e. a national government. It indicates the risk level of the investing environment of a country and is used by investors looking to invest abroad. This is basically used by multinational companies who invest in various countries across the globe. They have to access political risk to calculate the risk involved in their investment.

There are many providers of these ratings but the most common and reliable are Standard & Poor’s (S & P), Moody’s Investors services and Fitch ratings. Even the reliability of the provider of the credit rating is one big issue now. We should follow the renowned names.

Euromoney’s bi-annual country risk index is one such sovereign rating that is prepared by monitoring the political and economic stability of 185 sovereign countries. The methodology used by this index focuses on economics, specifically sovereign default risk and/or payment default risk for exporters.

The need for Sovereign ratings gained importance after the Asian crisis in 1997. When the American markets suffered in 2007-2009, investors started seeking investment in other Asian countries. They needed an assurance that the companies’ investment in the country would be safe. This made the concept of sovereign rating important.

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Personal Credit Rating

With the boom in the service industry in India, the disposable income of an average Indian has increased. At the same time, the age of getting self-independence has decreased. The young and earning Indian wants all the facilities at his disposal. They buy luxury goods and other essentials. The change that has come over the years is that unlike the earlier generations, the present generation is willing to take loans for their various needs. Every retailer in the market has his own scheme of providing finance. The consumer has also started spending more because if he/she likes a product at a shop, he/she does not need to think twice and save for the product. He/she can straight away buy the product and the finance will be provided by the dealer.

This has also increased the pressure on banks and other finance providing agencies because the cases of default are increasing. Therefore, a need was felt to analyze the credit rating of an individual.

With this concept, the Credit Information Bureau of India Ltd. or the CIBIL was incorporated in 2000. CIBIL has been set up by the effort of The Government of India and the Reserve Bank of India. The first promoters and the member banks were the State Bank of India (SBI) and HDFC. Necessary logistics and technology were provided by internationally reputed credit rating agencies like Dun & Bradstreet and Trans-union.

Check Your Progress

5. State the main purpose of a credit rating.
6. How are chit funds rated?

12.5 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. The foreign exchange market is of two types: spot and forward market.
2. When it is necessary to pay more for forward delivery than for spot delivery of a foreign currency, we say that the foreign currency is at a forward premium. On the other hand, when a currency costs less for forward delivery than for spot delivery (as is in the case of INR/USD in the quotation earlier), we say that the foreign currency is at a forward discount.
3. Demand bill is payable immediately ‘at sight’ or ‘on presentment’ to the drawee. A bill on which no time of payment or ‘due date’ is specified is also termed as a demand bill.
4. Bill financing provides an infusion of funds for the firms that need financial accommodation for their bills of exchange.

5. The main purpose of a credit rating estimates the credit worthiness of an individual corporation, or even a country by evaluating the borrower's overall credit history.
6. Chit funds registered as a company are sometimes rated on their ability to make timely payment of prize money to subscribers.

12.6 SUMMARY

- Forward exchange market refers to buying and selling currencies to be delivered at a future date. Forward exchange transactions involve an agreement on a price today for settlement at some date in the future.
- In the forward markets, contracts are made to buy and sell currencies for future delivery, say, after a fortnight, one month and two months.
- When currencies are exchanged for urgent delivery (usually within two business days after finalizing a business transaction), it is in the spot market.
- In the forward market, parties enter into contract to buy or sell foreign currencies at a future specified date.
- When it is necessary to pay more for forward delivery than for spot delivery of a foreign currency, we say that the foreign currency is at a forward premium.
- When a currency costs less for forward delivery than for spot delivery (as is in the case of INR/USD in the quotation earlier), we say that the foreign currency is at a forward discount.
- Forward markets are used not only by the arbitrageurs but by the hedgers too. Changes in the exchange rates are a usual phenomenon.
- Speculation in the forward markets cannot extend beyond the date of maturity of the forward contract. However, if the speculator wants to close the speculation operation prior to maturity, say by one month, he may buy an offsetting contract.
- Bill discounting, as a fund-based activity, has emerged as a profitable business in the early nineties for finance companies and represented a diversification in their activities in tune with the emerging financial scene in India.
- The bill of exchange is used to finance a transaction in goods, which means that it is essentially a trade-related instrument.
- Usance bill is also called time bill. The term usance refers to the time period recognized by custom or usage for payment of bills.
- Commercial bills are associated with sales transactions. Banks finance commercial bills for the purpose of working capital requirements.
- The term 'bill purchase' is used in the context of a demand bill, payable on demand, which is supported by documents to title to goods.

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- Negotiation of documents implies that a letter of credit is available for documents. When banks finance against documents, accompanied by letter of credit, the term negotiation of documents is used.
- Bill discounting is a short-term source of finance provided by banks. If a customer is interested to avail of working capital finance against credit sales, banks grant bill purchase/discount limit.
- Bill financing provides an infusion of funds for the firms that need financial accommodation for their bills of exchange.
- Financial consultants work with organizations or individuals to plan for their financial futures by offering information and guidance on a wide range of topics that encompass taxes, investments and insurance decisions.
- Corporate Advisory Services is an umbrella term that includes specialized advice's rendered to corporate houses by professional advisers such as accountants, investment banks, law practitioners and host of similar service providers.
- The concept of credit rating is limited to borrowing and investment decisions. The investors want to be sure of the safety of their investment.
- The credit rating of a corporation is a financial indicator to potential investors of debt securities as bonds.
- CRISIL has started assigning rating to the builders and developers with the objective of helping and guiding prospective real estate buyers.
- CRISIL and ICRA both are engaged in rating of banks based on the following six parameters also known as CAMELS.
- A sovereign credit rating is the credit rating of a sovereign entity, i.e. a national government. It indicates the risk level of the investing environment of a country and is used by investors looking to invest abroad.

12.7 KEY WORDS

- **Forward Exchange Transactions**: It refers to transactions which involve an agreement on a price today for settlement at some date in the future.
- **Sovereign Credit Rating**: It refers to the credit rating of a sovereign entity, i.e. a national government. It indicates the risk level of the investing environment of a country and is used by investors looking to invest abroad.
- **Usance**: It refers to the time period recognized by custom or usage for payment of bills.

12.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

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Short Answer Questions

1. What are the main features of foreign exchange markets?
2. Differentiate between spot and forward markets.
3. What are the main categories of corporate advisory services?
4. Write a short note on the concept of bill discounting.
5. What are the two types of documentary bills?
6. What is the main role of financial advisors?
7. List the main instruments used for credit rating.

Long Answer Questions

1. Explain the functioning of foreign exchange markets.
2. Analyse the main types of bills.
3. What are the advantages and disadvantages of bill discounting? Discuss in detail.
4. Explain the importance of credit rating.
5. Discuss the process of credit rating methodology.

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UNIT 13 OVERVIEW OF HOUSING FINANCE

NOTES

Structure

13.0 Introduction
13.1 Objectives
13.2 Concept of Housing Finance and its Advantages
13.2.1 Interest Types: Home Loans
13.2.2 Methods of Housing Finance
13.3 Role of National Housing Bank
13.4 Export Finance: Need and Types
13.5 Answers to Check Your Progress Questions
13.6 Summary
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13.9 Further Readings

13.0 INTRODUCTION

Housing demand is one of the three basic necessities of life, the other two fundamental needs being food and clothing. Food and clothing requirements have been met to some extent. However, housing demand still needs to be fulfilled. In India, housing finance is regulated by several agencies, such as the Reserve Bank of India (RBI), the National Housing Bank (NHB) and government bodies. Over the years, the RBI and the NHB have committed to the cause of improving the condition of the Indian housing sector. The supportive policy of the RBI and enabling fiscal regime has together contributed to the growth and expansion in the housing market. NHB channelizes long-term finance to individual households, thereby providing the much needed impetus to the housing sector. It acts as a principal agency to promote housing finance institutions both at local and regional levels and also provides financial and other support to such institutions.

The housing sector in India has been facing many constraints. According to rough estimates, at present, the unfulfilled housing in our country is about 40 million units. An important constraint that has been existent all along for the housing sector is finance for the developers as well as finance for the households, particularly for the low cost/affordable housing category. The current financing mechanism prevalent in the country mostly targets middle and high income sections of the society. The households falling under low income and economically weaker sections category find it difficult to secure formal housing finance. Commercial banks and traditional means of housing finance typically do not serve low-income groups, whose income may vary with crop seasons or is below the 'viable' threshold to ensure repayment or those who cannot provide collateral for loans.

In this unit, the meaning of house financing, its advantages and types of interest rates have been discussed. The objectives and features of National Housing Bank and is functions have been analysed. The unit will also discuss the concept of export finance with special reference to the role of RBI and EXIM in promoting credit facilities.

13.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss the meaning of house financing
- Analyse the advantages of house financing
- Explain the types of interest rates
- Identify the methods of house financing
- Discuss the objectives and role of National Housing Bank (NHB)
- Interpret the main functions of NHB
- Discuss the concept of export finance
- Describe the main functions of RBI and EXIM bank

13.2 CONCEPT OF HOUSING FINANCE AND ITS ADVANTAGES

Banks have shifted their focus from traditional lending (to companies) to home loans, which is basically a retail sector. The advantages are two-fold. First, the banks find home loans to be a lucrative proposition. They utilize their excess liquidity for this type of lending. The middle-class segment constitutes a large proportion in the total population of our country, a class that is set to grow at an impressive rate in the years to come. Home loans have become a growth driver for banks. Secondly, home loans are a retail sector, so the risk is spread and diversified, unlike concentrated risk with a big borrower.

Banks view the housing sector as a sunrise sector with lots of potential to be explored. The main reasons for lending in the housing sector are:

- Start-ups in the commercial and traditional sector have poor credit.
- Growth and credit utilization has been adversely affected by the recession.
- Demand for housing has grown with the rising disposable income of a population with a change in life style and growing aspirations to enjoy quality living.
- Spreading risk amongst a large number of borrowers.
- Improved technology reduced transactions costs on a large number of borrower accounts.

Home Loan: Advantages

Home loan is available for the following purposes:

- Purchase of a dwelling unit, old or new
- House construction
- The purchase of a plot of land for the construction of a house
- Home extension
- Home improvement
- Repaying a loan already taken from other housing finance companies/banks

The benefits of housing finance to the borrower are as follows:

1. **Forced savings:** Many of those living on a salary do not have the habit of saving. A home loan is a long-term loan. Loan induces the borrower to save i.e., by repaying the loan over a long period.
2. **Hedge against inflation:** Real estate prices have increased faster than the rate of savings. People, who have taken a loan to invest in a house, have proved to be wiser than those who have saved their money to buy property without borrowing. The purchase of property is made when money has a certain value; when the loan is repaid, money has lost value due to the high rate of inflation.
3. **Income tax benefit:** Loan instalments, as well as interest on the loan attract income tax benefit.
4. **Lower interest rate:** Interest rates on housing loans are lower than those on other loans, because the housing sector is given priority as a sunrise industry.

13.2.1 Interest Types: Home Loans

The interest rate and method of calculation are the most important factors that influence the borrowers in the selection of home loan lenders. Interest on home loans is critical as it has a significant financial impact on the process of borrowing and repayment. When sanctioning a home loan, the EMI includes an interest component and hence influences the loan amount. With rising interest rates, EMIs are often revised, which creates problems with regard to the repayment and the closure of loans gets postponed due to the increased burden. The following are the different types of interest rates adopted by home loan providers. Each method of calculating interest has serious implications on the EMI; hence, borrowers have to exercise care when agreeing upon the interest rate to be applied to their loan.

Floating Rate

The floating interest rate on housing loans is a pattern where the rate of interest is not stable during the total loan period. The interest rate fluctuates with the change in the rates in the economy. The borrower can gain form this type of interest charge when there is a dip in the rate of interest, bringing down the cost of the loan. This could also take a turn for the worse in case of an increase in interest rate that increases the cost of a loan. It is desirable to opt for a floating rate when the interest rate is high when a loan is sanctioned, and it is likely that the rate will come down in the future.

Banks increase interest rates for existing borrowers immediately, when they revise interest rates upward for new borrowers. However, when the interest rates fall, banks hesitate to pass on the benefit of reduced interest rates to existing home loan accounts and make available only to the new borrowers. , The existing borrowers have to depend on the mercy of banks or lenders for reduction in interest rates. More often, unethical lenders may not reduce interest rates, even though borrowers have opted for floating interest rates for their home loans. The existing borrowers have no other option, other than to wait for the bankers to announce a reduction in interest rates. Banks deny or delay the reduction announcement to their existing borrowers while they immediately offer reduced interest rates, in tune with the fall in RBI's repo rate, to woo new borrowers, because they fear the loss of business to their competitors.

RBI Guidelines on prepayment/foreclosure of home loan accounts

RBI's announcement in June 2012, barring banks from collecting a penalty for the early payment/closure of home loan accounts has forced bankers to realize that their existing borrowers may shift their accounts to other banks to avail of reduced interest rates, when the repo rate is reduced by the RBI. Still, several borrowers may not initiate steps to switch over their home loan, as the process is long and tedious. Some unethical banks deny or delay the reduction of interest rates for existing borrowers to take advantage of the situation. RBI should compel banks to bring about a parity of floating interest rates to new and existing borrowers. When floating rate is the choice between the two parties, why should the matter of reduction of interest rates to existing borrowers is left to the discretion and decision of banks?

The increase or reduction to the existing borrows should be automatic, in line to the new borrowers in case of floating interest rate. Banks have to give parity of treatment in all respects to new and existing borrowers, including the applicability of interest rate from the same date. Otherwise, the term floating interest rate has no real meaning.

Fixed Rate

Fixed rate loans have a stable rate of interest during the loan's tenure. Here, the rate of interest is unaffected by the changing market scenario. This loan is taken by people who prefer to know the exact cost of the loan and are happy to pay a fixed amount, especially when interest rates are expected to rise. However, there is a clause attached with the fixed rate pattern that could actually result in a floating rate loan. The agreements of many banks state that the rate of interest could come up for review after a certain period of time to keep in accord with the market conditions. It is necessary for the borrower to go through the small print too, which may increase their future burden. In other words, a fixed interest rate is not fixed in the long-run.

Borrowers normally believe what is said by the representatives of home loan organizations, who may not have sufficient knowledge or deliberately provide misleading information to sell their products quickly. Since what is written is binding, the borrower has to read the documents to be signed carefully.

Hybrid Structure

A hybrid structure is a combination of a fixed interest rate for an initial period and a floating interest rate for the balance period. This facility is for those who are caught in two minds over the fixed and floating interest rates. This kind of loan brings both options into a single package. First there is the fixed rate pattern, where the borrower need not worry about the fluctuating rates in the economy and make payments based on a fixed rate. After the stipulated period, the second stage of repayment is taken through the fluctuating rate method.

A hybrid interest rate structure is adopted by most home loan providers to attract borrowers to avail of home loans with a fixed commitment in the form of equated monthly instalments (EMIs) in the initial loan period of two or three years.

A hybrid interest rate is a better option for home loan seekers as it provides a fixed commitment for a specified period and a floating rate structure commences only after the stipulated period.

Borrowers are often in a dilemma about the choice between floating rate and fixed interest rates. The choice between the two depends on the perception and likelihood of the expected change in interest rate structure in the future. One can predict likely short-term trends but not long-term as the home loan tenure is 25–30 years, especially when the borrowers are young. It is always better to take a home loan for a long period so that the EMI burden can be reduced and the borrower can take advantage of and benefit from inflation.

Teaser Rates

In teaser rates, the initial interest rates are lower than the fixed rate mortgages and are used by lenders to entice the borrowers. Teaser loans carry abnormally lower interest rates for an initial period with the normal interest rate for the rest of the tenure. The lender’s intention in providing teaser loans is to woo the customers, showing a rosy picture and concealing the real interest rate burden for the major loan period, which is totally unethical. Teaser rates are different from hybrid interest loans. Hybrid loans contain both fixed and floating interest rates for specified periods.

SBI was the first to introduce teaser home loans and RBI has banned introduction teaser interest rates on home loans.

SBI offered lower interest rates for a specified duration to woo customers, offering floating interest rates after the specified period. The initial interest rate offered for the limited period is extremely low, which attracted many borrowers, as they looked to the initial EMI only. The borrowers did not consider that the EMI would go up soon after the expiry of the specified initial period. RBI considers teaser loans an unethical practice and banned its continuity.

13.2.2 Methods of Housing Finance

With rising competition in the home loan market, banks are offering a number of innovative products to lure customers, meeting their specific and unique requirements. Other than the floating rate home loan and fixed rate home loan, a number of products which are combination of the two and coupled with myriad types of repayment facilities have been offered by the banks. A few examples are as under:

Part-fixed, Part-floating

This is a home loan product that combines a floating rate and fixed rate home loan. In this, the borrower can opt to pay a portion of the total loan under a floating interest rate and the balance under a fixed rate scheme. Normally, the interest rate on a fixed rate home loan is one per centage point higher than that on the floating rate loan. But, in the fixed rate home loan, one is insulated from the risk of a rise in the interest rates in the future.

Short-term Bridge Home Loan

A bridge home loan is a short-term loan when the owner of an existing house wants to sell it and buy another, without waiting for the sale proceeds of the existing house. The new home is normally bigger or located elsewhere to suit the changed requirements of the person concerned.

If one is planning to move into a bigger, better and more convenient house from the existing small home, without waiting for its sale proceeds, a short-term bridge loan is the ideal choice.

Here, the individual owns a small house and wants to buy a bigger house. But he does not want to sell the existing house before buying the bigger one. This creates a mismatch in the cash flow. The short-term bridge loan helps him in the interim period between the sale of the existing house and the purchase of a new one.

The procedure is very similar to that of applying for a normal home loan in terms of the eligibility criteria and the documents to be furnished. However, it is mandatory for the borrower to identify the new house that is to be purchased before going to a bank. The application for a bridge loan is generally considered only after ensuring that the prospective borrower has entered into an agreement for the sale of his property. On the negative side, the interest rates on bridge loans are higher than those on home loans because it is a short-term loan, and also, costs and fees are also involved in it.

Step-up Repayment Facility

Another product in the home loan segment is step up repayment facility (SURF). It helps the young borrower, who just has started his career. As the starting income of a young professional is low, the initial EMI is fixed at lower level. In some cases, the initial EMI could be just equal to the interest. Later, the EMI increases progressively with the income and the borrower starts repaying the principal amount too. This scheme helps the young borrower to borrow a large amount. These loans have become popular with the younger generation, who start their life with a home and car, unlike the earlier generation who have aspired to own a home in the later part of their lives.

Flexible Instalment Plan

In the flexible loan instalment plan (FLIP), the EMI reduces as the time passes. This product is for joint borrowers—if one amongst them retires early, the repayment is front-loaded. During the initial period, the EMI is high, when both the applicants are working. This repayment amount is reduced when the income is scheduled to decline after a certain time during the loan tenure, after the retirement of one of the borrowers. Therefore, FLIP offers a step down repayment facility, as retirement benefits can be deposited during the loan tenure. For example, husband and wife are employed and wish to avail of a home loan when the husband and wife have a balance working life of fifteen and twenty years respectively. During the first fifteen years, when both of them are working, they can pay a higher EMI. Later, when the husband retires, a part of his retirement benefits is deposited into the loan account, as originally planned. As the wife is the earning member of the family for the next five years, EMI is reduced during that period.

Smart-fix Home Loans

Many banks are now offering three years fixed interest rates and floating rates thereafter. This type of loan offers the safety of fixed rates and the advantage of floating rates. The smart fix enables the customer to lock at fixed rate of interest at present with the contract to move to a floating rate from the expiry of the stipulated period. For the first three years, the borrower gets a fixed interest rate and from the fourth year, his loan gets switched to the prevailing floating interest rate. In a way, this loan product falls into the category of part-fixed and part-floating type.

Home Saver Plus

Normally, when the excess amount is deposited into a loan account, the excess amount cannot be withdrawn. Foreign banks like Citibank, HSBC and Standard Chartered Bank have launched this product, which helps the borrowers to use their surplus cash to reduce interest burden. At the same time, if the borrower wants to withdraw the excess amount deposited beyond the EMI needed, he is free to do so. It reduces the amount of interest payable and the effective interest rate as well. This helps in the faster repayment of the loan. In other words, the surplus deposit earns the same interest charged on the loan, which brings down the loan repayment tenure.

A home loan saver account virtually works like an overdraft against a fixed deposit, allowing flexibility to the borrower to deposit as well as withdraw the excess balance, as and when needed, beyond the stipulated EMIs.

This type of account enables substantial savings in respect of the interest amount payable and also helps the borrower to get rid of the debt much earlier, as compared to a normal home loan.

Major Advantages

The following are the advantages of house financing:

- The convenience of maintaining one account for salary/business incomes, a current account facility with higher interest earnings.
- The reduction of interest payable on home loan and speedy repayment of the loan.
- The deposit and withdrawal of borrower’s surplus income, without any extra charges.
- Earning interest on the daily balance method followed by banks.
- A single account where salaries and bonuses are deposited.
- Accessing money worldwide, using ATMs and debit cards, when using a multi-city operational account.
- Ideal for business people/self-employed individuals who normally have current account for their business dealings, where daily turnover is high.
- To extend this facility, banks charge a higher interest rate on home savers’ accounts, compared to normal home loan accounts.

Balloon Payment Loans

The concept of a balloon mortgage loan is a very new concept in the Indian mortgage industry. The balloon mortgage loan is similar to a fixed-rate mortgage scheme and has a much shorter payment term. The main feature of the Indian balloon mortgage loan is payment of a hefty amount (i.e., balloon amount) at the end of the loan’s term. The monthly payment structure is also smaller than the fixed-rate mortgage. The advantage of the balloon mortgage loan is low monthly payment, the quantum of which is much lower than the typical fixed-rate mortgage loan.

A balloon mortgage is convenient for those who are expecting a significant amount of cash that would easily pay off the loan balance. People who are due to retire and expecting hefty retirement benefits can go for this type of loan which allows them to pay a small EMI, allowing them to pay the balance in loan account and close the same.

Check Your Progress

1. What is floating interest rate?
2. How is teaser rate different from hybrid rates?
3. State the main feature of the Indian balloon mortgage loan.

13.3 ROLE OF NATIONAL HOUSING BANK

The National Housing Bank (NHB) is an apex level financial institution catering to the housing sector in the country. It is engaged in providing financial assistance in the form of refinance to lending institutions against the home loans they provide to their customers.

The National Housing Bank (NHB) is the regulator for the housing fiancé industry.

Main Objectives of the National Housing Bank (NHB)

The main objectives of the National Housing Bank are as follows:

- To promote a sound, healthy, viable and cost-effective housing finance system to cater to all segments of the population and integrate the housing finance system with the overall financial system.
- To promote a network of dedicated housing finance institutions to adequately serve various regions and different income groups.
- To augment resources for the sector and channelize them for housing.
- To make housing credit more affordable.
- To regulate the activities of housing finance companies based on regulatory and supervisory authority derived under the Act.
- To encourage the augmentation of the supply of buildable land and building materials for housing and to upgrade the housing stock in the country.
- To encourage public agencies to emerge as facilitators and suppliers of serviced land, for housing.

Main Functions

The three main functions of the NHB in the housing finance business in the country are as follows:

1. Promotion and development

The institution was set up when there was no regional and local institutional infrastructure and the banking sector did not view housing finance as a priority. As a result, the sector was grossly capital deficient and the housing shortage in the country grew at an alarming level. The NHB believes that intervention through institutional credit can cater to the needs of different income groups better. The middle-income group constitutes nearly half the total number of households in the country that require housing. NHB encourages financial institutions to lend to this segment through its refinance programmes. There has been a sustained effort at creating and supporting specialized institutions to serve as dedicated centres for housing credit.

NHB's principal mandate is to promote housing finance institutions to improve/strengthen the credit delivery network for housing finance in the country. NHB has played the role of a facilitator in this regard instead of opening such dedicated housing finance institutions itself.

2. Regulation

The second most important function of NHB is the regulatory role assigned to it. Apart from its registration under the Companies Act, 1956, every housing finance company (HFC) also requires registration with NHB to commence or carry on the business of housing finance. This role assumes more importance as the housing finance system in India enters its secondary phase of development in terms of integration with the debt and capital markets. NHB has attempted to put in place an effective system of responsive regulation. It has come up with guidelines for recognizing HFCs for its financial assistance. Besides, it has also issued guidelines for prudential norms for income recognition, asset classification etc.

NHB, in the public interest, regulates the housing finance system to the country's advantage. It protects the interests of the housing finance institutions as well, without being prejudicial to any specific group. For this, NHB has been empowered to determine policy and direct the housing finance institutions and their auditors.

3. Finance

The third important role of NHB is to provide financial assistance to the various banks and housing finance institutions. As an apex refinance institution, the principal focus is to generate the large-scale involvement of primary lending institutions falling in various categories to serve as dedicated outlets for assistance to the housing sector. It supports the housing finance sector in the following ways:

- Extending refinance to different primary lenders in respect of eligible housing loans extended by them to individual beneficiaries.
- Lending directly in respect of projects undertaken by public housing agencies for housing construction and development of housing-related infrastructure.
- Guaranteeing the repayment of principal and payment of interest on bonds issued by housing finance companies.
- Acting as special purpose vehicle for securitizing housing loan receivables.

Housing Finance – Priority Sector Lending

RBI guidelines stipulate that loans of up to ₹ 25 lakh to individuals in metropolitan centres with populations above ten lakh and of ₹ 15 lakh in other centres for the purchase/construction of a dwelling unit per family, excluding the loans sanctioned to a bank's own employees fall within the ambit of a priority sector.

Recent NHB Initiatives

NHB has slashed interest rates, in August 2012, up to 1 per cent on refinance to banks and housing finance companies, to promote affordable finance for low income group dwellings in urban areas. Interest rates on NHB's refinance would be 9 per cent against the existing 10 per cent for loans up to ₹ 2 lakh. For loans between ₹ 2–5 lakh, the rate would be 9.25 per cent. The primary lending institutions are expected to pass on the benefit of reduced refinance rates to the ultimate borrowers by extending housing loans for longer tenures at lower fixed rates, thus enhancing affordability.

NHB has recently constituted a mortgage credit guarantee fund trust, under which individual retail loans up to ₹ 5 lakh will be covered by the guarantee of the fund trust. With this measure, banks and housing finance companies extending loans will have significant credit risk mitigation.

Check Your Progress

4. State the main principle of National Housing Bank (NHB).
5. What are the main objectives of National Housing Bank (NHB)?

13.4 EXPORT FINANCE: NEED AND TYPES

The Indian economy is marked by a number of institutions favouring growth of the export sector. To enhance and develop the export sector, it is important to make available the finance schemes as an incentive. To aid in the development of the export sector, it is essential to understand the presence of various institutions which help in increasing exports. The major institutions offering these financial schemes are as follows:

- Reserve Bank of India
- EXIM Bank
- ECGC
- Commercial Banks

These institutions provide a number of financial facilities for exporters both at the pre-shipment and post shipment stage. The Reserve Bank of India is the central bank which lays down the policy framework for assisting in export related finance and formulates guidelines which need to be implemented. In India, short- or medium-term finance is provided by members of Foreign Exchange Dealers Association of India (FEDAI). FEDAI is an association of banks dealing in foreign exchange and its members are commercial banks and other financial institutions. The Reserve Bank acts as an institution which refinances the short- and medium-term loans provided by commercial banks to exporters or importers. The Export Import bank (EXIM) of India along with commercial banks, provides loans for exports and imports. RBI also provides refinance against the loans provided by these commercial banks at concessional rates of interest. The commercial banks can also avail interest rate subsidies in place of refinancing.

Export Credit Guarantee Corporation of India (ECGC) plays a major role in enhancing export from the country by underwriting various risks involved in exports. It provides a number of policies and guarantees in order to cover risks related to the political and commercial aspect. ECGC was established by the Government of India in 1957 to strengthen and boost the efforts of export promotion by providing cover and security on exporting on credit. ECGC is managed and governed by a Board of Directors, comprising of representatives from Reserve Bank of India, Ministries of Government of India and renowned personnel of the banking and insurance sector. ECGC helps in expansion of sales by exporters into newer markets and at the same time protecting them from bad debts. The organization also aids in providing credit and boosting the borrowing ability of the exporters. All these initiatives by the ECGC of India help in developing trade and exploring new markets due to sustained cash flow. ECGC offers policies both for individual exporters and banks. For individual exporters, specific policies are in place for covering either consignments or entire export transaction. On the other hand, for commercial banks policies related to pre-shipment finance and post shipment finance along with export guarantees are provided.

Assistance by Commercial Banks for Export and Import

The exporter or importer in India seeks finance from commercial banks to perform various business transactions. The commercial banks offer loans for working capital requirements and are established for developing long-term business relationships. The bank can rely on exporters who have been in continuous interaction with the banks. The commercial banks are well versed with the financial standing of the exporter and his repayment ability. The bank is also aware of the credit need of the client and the ability to perform. The commercial banks can assist in export and import by raising the limits for providing working capital and approve export related transactions such as discounting. Commercial banks having separate departments for international transactions can assist in documentary credits and collections as well as discounting of drafts. Commercial banks also provide guarantee for providing short-term loans and working capital requirements. The banks may also offer medium-term loans to the foreign buyers for financing sales transactions. These financial schemes offered to exporters and importers can be divided as follows:

(i) Exports

(a) Pre-shipment finance: This scheme is offered in the form of export packing credit to meet the needs of working capital for manufacturing the product. It is provided both in rupees and in foreign currency.

(b) Letter of Credit advising and confirmation

(c) Purchase or discounting of export bills

(d) Negotiation of export bills

(e) Forfeiting

(f) Factoring

(g) Advance against exports on consignment basis

(h) Export bill collection

(ii) Imports

(a) Issuance of Letter of Credit

(b) Advance against imports

(c) Trade credit

(d) Import bills collection

To enhance exports, the commercial banks offer a wide range of e-services. These services include effecting transactions online and flow of information. The bank also provides notifications through text messages or emails to its clients.

The commercial banks also offer customized programmes for its customers. This helps in mitigating the risks involved.

Role of RBI and EXIM Bank

RBI is the central bank of the country and is hence the apex bank which controls the monetary system in India. The main objectives of the Reserve Bank of India are:

- To manage the monetary and credit functioning within the country
- To stabilize the value of rupee
- To have balanced and systematic development of banking in India
- To effectively develop the money market in the country
- To assist in providing agriculture and industrial finance
- To properly manage public debts
- To maintain the demand and supply of currency in the country
- To partner with international institutions and provide international finance

RBI has its headquarters in Mumbai and several regional offices. It authorizes and extends export credits. It also monitors transactions related to foreign exchange but does not interact directly with the exporters. It formulates policies and initiates measures to encourage and facilitate the lending of export finance by commercial banks and financial institutions. RBI carries out its transactions related to trade finance and foreign exchange through two departments, namely:

1. Industrial and credit department
2. Exchange control department

RBI also offers a wide variety of schemes for encouraging commercial banks to increase lending of credit for export and import. These are:

(a) **Export Bills Credit Scheme, 1963:** Under this scheme, RBI provided finance in advance to scheduled banks against export bills reaching maturity within 180 days. However, this scheme is not functional any longer.

(b) **Pre-Shipment Credit Scheme, 1969:** Under this scheme, RBI provides re-finance facilities to scheduled banks which perform the function of providing pre-shipment loans to customers.

(c) **Export Credit Interest Subsidies Scheme, 1968:** Under this scheme, RBI provides interest subsidies of minimum 1.5 per cent per annum to banks which provide the facility of export finance to exporters. The exporter has to pay interest to the bank within a prescribed limit set by the RBI. The subsidies to the banks are given both against packing credit and post-shipment.

(d) **Duty Draw Back Credit Scheme, 1976:** Under this scheme, RBI gives the exporters an incentive for availing interest free advances from the bank up to 90 days against shipping bill. This shipping bill has to be provisionally certified by the customs authority towards a refund of various duties related to clearance. The advances made under this scheme by scheduled commercial banks are eligible for refinance. This refinancing is free of interest from RBI for maximum period of 90 days from the date of advance.

Apart from these a number of other sanctions are given by RBI on the request of the exporters made through an application. These sanctions are usually:

- Extension of time period for realization of export proceeds.
- Reduction of the invoice value of goods to be exported.
- Fixing of commissions that have to be paid to overseas agents or consignees.
- Release of exchange on lump sum basis for fulfilling various purposes also known as blanket permit.
- Assisting in releasing remittances from India in order to facilitate provisions related to advertising and legal issues.
- Any other foreign exchange related issue which requires clearance from the exchange control department of RBI.

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In order to avail loans in terms of export finance, a proposal has to be submitted. This proposal has to submit in the prescribed application form along with the implementation schedule, cash flows with respect to the currency and also the condition of infrastructure. If the buyer is a non-government entity, then a status report needs to be submitted concerning the client or contractor. These complete applications need to be submitted to the sponsoring bank within 15 days from entering into the contract for consideration. In case the exporter wants to take insurance, cover or guarantees, it is necessary to consult ECGC.

(i) Project Exports

Export of engineering goods on deferred payment terms and execution of turnkey projects and civil construction contracts abroad are collectively referred to as 'Project Exports'. All project export contracts need approval at the post-award stage as per powers delegated by RBI. Post award clearance for project exports of size up to USD 100 million can be approved by Scheduled Commercial Banks/ Exim Bank. For project exports of size beyond USD 100 million post award clearances is provided by working group (comprising members of RBI, EXIM Bank, commercial banks, ECGC and Government of India).

In order to avail post award clearance for exports, it becomes important to submit an application along with copies of the contract through his commercial bank. The EXIM Bank or the working group will approve the proposal depending on their capacity. The terms and conditions of the approved case are decided based on the clearance of the authority. Along with this various fund based and non-fund-based facilities are also provided while operating within the approvals of exchange controls. To clear the proposals of export for availing these financial credits, the authorities have laid down specific criteria. These are:

- Status of overseas client - government/private
- Exporter's financial position, track record
- Risk assessment of buyer's country
- Break-up of contract value - Indian/third country/local
- Estimates of cost and profitability
- Foreign exchange outgo
- Currency of payment - convertible currency/local currency
- Security - Letter of Credit, bank guarantee, government guarantee, externalization undertaking of central bank
- Salient parameters of appraisal for clearance of export proposals
- Facilities required by the exporter
- Payment terms: advance payment, progress/down payment, deferred payment, retention money
- Availability of ECGC cover, where necessary

- Status of exporter: prime contractor/sub-contractor/consortium member
- Pre-shipment Inspection
- Price escalation
- Arbitration
- Force Majeure
- Penalty/liquidated damages for delay in contract execution
- Facilities required by the exporter
- Source of funding: multilateral/local
- Foreign exchange outgo

EXIM Bank

This is the apex bank which deals in providing project finance and direct finance. The EXIM Bank has taken over the operations of the International Finance Wing of the Industrial Development Bank of India (IDBI). It came into existence on 1 January 1982 and started its operations from 1 March 1982. The headquarters of the bank is situated in Mumbai and it has branches in India and abroad. The main purpose of the bank is to finance medium and long-term loans to the exporters and thus facilitate international trade in the country. The main objectives of EXIM Bank are:

1. To provide financial assistance (medium and long-term) to exporters and importers.
2. To promote international trade from the country.
3. To function as the principal financial institution for coordinating the working of institutions engaged in providing trade finance.
4. To deal with all the issues that may be considered to be incidental or conducive to the attainment of above objectives.

The main functions of EXIM Bank are to provide fund based and non-fund-based assistance. This can be summarized as follows:

The fund based and non-fund-based assistance can be further explained as:

A. Fund based assistance

(i) Assistance to exporters in India

(a) Assistance in the form of deferred credit exports.

(b) Credit facilities for deemed exports.

(c) Financing of Indian joint ventures abroad.

(d) Financial assistance to units located in EPZ/SEZ and EOUs.

(e) Availability of pre-shipment finance in order to procure raw materials and other intermediate goods.

(f) Financial assistance for exporting/importing machinery and equipment on lease.

(g) Foreign exchange loans for computer software exporters subject to clearance from RBI.

(h) Deferred credit financing facility for exports of consultancy, technology and other services.

(i) Export financing assistance for undertaking export marketing activities through the export marketing fund.

(j) The export development fund has been earmarked for undertaking technology and economic survey to develop Indian exports.

(ii) Assistance to Indian commercial Banks

(a) Refinance facilities to lend to Indian exporters who extend term credit to importers.

(b) Export bills rediscounting facility to commercial banks in India who have earlier discounted bills of exporters.

(iii) Assistance to Overseas Buyers

(a) EXIM Bank offers 'Overseas Buyer's Credit' facility to foreign importers. This is offered for importing capital goods and related services. The repayment period is spread over a period of years.

(iv) Assistance to Overseas Banks

(a) The EXIM Bank extends lines of credit to provide finance to financial institutions overseas. These international financial institutions extend finance to importers to buy capital goods.

(b) The Bank also provides relending facilities to banks in foreign countries and makes available finance to the clients for import of goods into the country.

B. Non-fund-based assistance

(v) Guarantees and bonds: EXIM Bank provides guarantees as a non-fund-based assistance. These guarantees are usually in the form of bid bonds and performance guarantee. The commercial banks also assist in providing these guarantees.

(vi) Advisory services

(a) The Bank advises Indian companies abroad in order to find sources of financing abroad.

(b) The Bank also provides advisory services on international exchange control practices.

(c) It also offers financial and advisory services for constructions abroad.

(d) The small-scale manufacturers are also advised on the feasible markets for exports and products.

(e) The bank also provides euro financing and global credit to Indian exporters.

(f) Forfeiting services are also offered for the exporters.

The EXIM bank also provides export financing programmes and promotes exports through direct financial assistance, term finance, overseas investment finance, pre-shipment credit, buyer's credit, relending facility, export bills rediscounting, lines of credit and refinancing schemes to commercial banks. In order to understand these facilities, let us analyse them in detail.

(i) Loans to Indian Entities

(a) **Deferred Payment Exports**: The exporters are offered term finance to further offer deferred credit to their overseas buyers. Commercial banks are also directly involved in undertaking and sharing risks.

(b) **Pre-shipment Credit**: This finance is available from EXIM Bank for execution of export contracts and having a maturity of more than six months.

(c) **Term Loan for Production of Exports**: The Bank also provides loans and deferred payment guarantees to Export Oriented Units (EOUs), Free Trade Zones and computer software exporters. Providing facilities for deemed exports and both funded and non-funded facilities.

(d) **Overseas Investment Finance**: Indian firms which have established joint ventures abroad are offered finance towards their contribution of equity in the joint venture.

(e) **Finance for Export Marketing**: The bank also helps in the implementation of export development plans.

(ii) Loans to Commercial Banks in India

(a) **Rediscounting of Export Bills**: Commercial banks have been granted the ability to rediscount short-term export bills with the EXIM Bank. These banks are authorized to deal in foreign exchange and the facility is provided for the unexpired usance period but less than 90 days.

(b) **Refinance of Export Credit**: These authorized dealers can obtain 100 per cent refinance of the deferred payment loans from EXIM Bank for exports of Indian goods.

(c) **Guarantees**: The EXIM Bank along with commercial banks issues guarantees required by Indian companies for various export contracts.

(iii) Loans to overseas entities

(a) **Overseas Buyer's Credit**: EXIM Bank offers credit directly to foreign entities for import of eligible goods and related services on deferred payment.

(b) **Lines of Credit**: Finance is also available to financial institutions, governments and agencies abroad.

(c) **Relending Facility to Overseas Banks**: The Bank offers relending facility to banks overseas and thus enables them to provide term finance. This term finance is offered to importers from India across the globe.

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The EXIM Bank offers a range of services for exports to their clients. The Bank provides a range of information and services to aid in globalization of the Indian organizations. The services being offered include searching of overseas partners, identifying suppliers of technology, negotiating contracts and developing joint ventures abroad.

Trade Financing Schemes

The EXIM Bank of India plays the role of a coordinator, consultant, promoter and a source of finance. The bank acts a coordinator for clearance of Projects and Services Exports and Deferred Payment Exports of the Working Group Mechanism. The working group is comprised of representatives of the Government of India, Reserve Bank of India, ECGC and various other commercial banks. The working group clears contracts sponsored either by the EXIM Bank or Commercial Banks and provides a one window mechanism for clearance of export proposals. A number of financing schemes are provided by RBI. Let us go through each one of them in detail.

Export Credits

The EXIM Bank regularly offers credit facilities for exports to be availed by companies in India and abroad as well as commercial banks. The export credits offered by EXIM Bank of India can be divided in the following manner:

(i) **Companies in India executing overseas contracts**

Various exporters who enter into contracts with foreign counterparts can avail facilities like:

(a) **Pre-Shipment Credit:** This facility is provided at the pre-shipment stage and can be offered in both Indian Rupees and foreign currency. The credit is provided to avail financial facilities for manufacturing and procuring inputs as well as other raw materials.

(b) **Supplier's Credit:** This is a kind of post shipment finance which is given by Indian exporters to their overseas importers.

(c) **Project Exports:** The EXIM Bank extends finance for executing project exports abroad. The costs of mobilization of resources and materials along with equipment and personnel. This finance is usually provided in rupees.

(d) **Export of Consultancy and Technological Services:** The exporters of consultancy and technological services can avail credit facilities so that they can fulfil the requirements of the importers.

(e) **Guarantees:** These instruments are required by Indian exporters to execute export contracts through guarantees. These guarantees are also required for various import transactions.

(ii) **Commercial Banks:** The EXIM Bank of India offers rediscounting facility to commercial banks. This facility enables the banks to rediscount the export bills of their customers. The customers need to be Small Scale Industries customers having usance export bills not exceeding 90 days. The bank also offers refinancing facilities for the supplier's credit. This enables commercial banks to provide credit to exporters of Indian origin. These exporters extend this credit to overseas importers for a credit over 180 days.

(iii) **Facilities for Indian Companies:** The EXIM Bank extends finance for deemed exports. Deemed exports are exports made by Indian companies to units situated in SEZs or EOUs.

(iv) **Overseas Entities:** The EXIM Bank offers buyer's credit for imports from India and abroad. This credit is usually provided on deferred payment terms. The goods eligible for availing buyer's credit are capital goods, machinery, consumer goods and any goods as prescribed by the Foreign Trade Policy of India.

Finance for Export Oriented Units

The EXIM Bank provides finance to export oriented units which are exporting as well as non-exporting. The main kinds of financial instruments are:

(i) **Exporting Companies:** These companies are offered term finance and working capital finance in order to fulfil their export obligations.

(a) Term finance is provided for specific purposes like project finance, financing for equipment, import of technology, acquisition purpose, product development for export, research and development and general corporate finance.

(b) Working capital finance is either funded or non-funded. The funded instruments of working capital are loans for less than 2 years and up to 5 years. It also includes discounting of export bills and export packing credit along with cash flow financing. The non-funded sources are guarantees and letters of credit.

(ii) **Non-exporting companies:** The bank provides working capital finance for importing raw materials in bulk as well as importing equipment.

(a) Export finance is provided as it is provided to general exporters like pre-shipment credit, post shipment credit, buyer's credit, supplier's credit, discounting of bills, export receivables financing, warehousing financing and lines of credit.

Overseas Investment Finance

The EXIM Bank assists Indian companies to finance their equity participation in joint ventures abroad as well as in wholly owned subsidiaries. The Bank also provides direct financing to overseas joint ventures and wholly owned subsidiaries.

Lines of Credit

The EXIM Bank provides a number of lines of credit to financial institutions abroad. It also extends to various regional banks, governments and other entities overseas. These lines of credit enable buyers to import products from India on deferred terms of credit. The payments are provided without recourse to Indian exporters against negotiation of various documents.

The process of granting lines of credit begins from the signing of an agreement with the borrower. The exporter checks the procedures and the service fee charged by the EXIM Bank and further negotiates with the importer. The importer further takes the advice of the borrower and signs the contract with the exporter. The borrower then approves the contract which is also approved by the EXIM Bank and the commercial banks. The exporter further ships the goods and the documents are negotiated by the commercial banks. After negotiation the exporter is paid for the amount of export. The commercial bank is then reimbursed by the EXIM Bank on the basis of the receipt of claim of debit by the borrower. The borrower then repays the EXIM Bank the amount on the due date.

A few precautions need to be taken by the exporter before opening these lines of credit. The exporter should favourably check with the EXIM Bank and obtain advice on the contract and fees payable by the exporter on the lines of credit.

SME and Export Finance

The Small and Medium Enterprise (SME) sector contributes significantly to the socio-economic growth of the country. This growth is aided through growth in exports and employment generation. SMEs also help in building the industrial base of the country and increasing entrepreneurship. This makes the SMEs a well-recognized sector for achieving international competitiveness in today's globalized world. The services offered by various consultants to these SMEs are quite costly. The SMEs do not have a department focused on enhancing these factors and facilitating growth. To recognize and overcome this knowledge gap EXIM Bank provides a number of services to its SME clients. These services include providing new business leads and assisting in various export related issues. EXIM Bank also provides country and sector related information. Apart from these services the EXIM Bank also provides financial and advisory assistance to these SMEs.

Agricultural and Export Finance

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In the post globalization scenario, Indian exports have found scope especially for agricultural products. The bank has a separate agri business group to look into the financing requirements of the export-oriented companies dealing in agricultural products. Agri finance for exports is provided through term loans, export credit in the form pre-shipment and post shipment finance, guarantees, import finance and buyer's credit.

The EXIM Bank in order to develop a strong background for provided export assistance to agricultural units has built strong linkages with various other prominent stakeholders in this sector. The main stakeholders are Ministry of Food Processing Industries, Government of India, NABARD, National Horticultural Board, Small Farmers' Agri Business Consortium and APEDA. The EXIM Bank also provides advisory services to agricultural exporters apart from financial assistance. To further assist the agricultural sector in understanding the export potential across the globe of the products, the Bank also publishes a number of working papers and occasional papers at regular intervals of time. The Bank has also set up a special dedicated portal on the Internet to assist these exporters of agricultural products.

Keeping in the mind the recent initiatives of the EXIM Bank to foray into the rural sector and enhancing exports from the small and medium enterprises a number of initiatives have been taken up. A few of them are:

(i) **Rural Initiatives:** Globalization has led to declining barriers between the national and international markets. This has led to an expansion of opportunities for marketing a number of products and services in which India has a competitive advantage. The EXIM Bank has embarked on a path for building up the rural sector through a number of programmes for two reasons:

   (a) To reduce poverty by forming export linkages

   (b) Bringing the benefits of globalization to the rural enterprises

   To fulfil these two objectives of the Indian Government, the bank has included the rural initiatives programme as its core activity. This foray of the bank into the rural sector will help the bank operate as a credit agency at the rural level and benefit the rural poor by creating export capability of these rural enterprises. Though these initiatives require investment in terms of time and manpower, the results if achieved as desired will enhance the purchasing power of the lowest rung and will have spill over effects in various sectors of the economy.

(ii) **Export Marketing Service:** The EXIM bank has set up another scheme to assist the SMEs and agricultural sector by marketing products of good quality abroad. These exports are carried out by overseas offices through the network established by the bank on the basis of a 'success fee'. This fee is not charged upfront but charged at the rate of 2-3 per cent of the value of sales as a service fee. This fee is also based on the success of securing orders from abroad. The bank has a large network covering countries like USA, UK, Singapore, Dubai and South Africa. Representative offices of the bank have been established in these countries which cater to increasing sales of products exported from India. Some of the products that are being exported from India under this initiative are embroidered cloth, bamboo pens, incense sticks, sandstone blocks, pomegranate fruit juice concentrate, matches, etc. The bank while selling these products collects valuable information about the quality, packaging, requirements of design and in turn acts as a guide to Indian traders for enhancing their exports and the ability to venture into foreign markets.

The bank in order to facilitate exports from SMEs has been organizing special training programmes for export marketing. These trainings are conducted by faculty hailing from the industry and premier management institutions. These programmes are held across the country at regular intervals. Trainers from foreign institutions and trade promotion agencies like CBI (Netherlands) and JETRO (Japan) also interact with exporters on how to formulate and develop market entry strategies. Recently, the bank organized training for handicraft exporters on how to enter the European markets.

(iii) **Enterprise Management Development Services Programme:** The Bank has entered into a pact with the International Trade Centre for implementing the programme named Enterprise Management Development Services Programme. It is a programme which provides IT based solutions to small enterprises and also helps them in preparing business plans with an international market focus. This helps the SMEs to improve their management practices and gain support from lenders. This programme was initially launched for a period of one year with support from the European Union and under the Asia Trust Fund. The bank has also entered into talks with non-profit agency in USA called Aid to Artisans (ATA) for strengthening the handicraft sector and opening up the access of Indian markets to USA.

(iv) **Association of EXIM Bank with NGOs:** The bank has entered into an agreement with the Confederation of NGOs of Rural India (CNRI). This is a non-profit organization with a large number of members in the form of NGOs which are spread across the country. This arrangement will assist the members of CNRI in the area of capacity building, access to global markets and training of the individuals. Apart from this the EXIM Bank has entered into arrangements with NGOs directly in touch with artisans. The major partners NGOs are SEWA (Gujarat), Oorvu (Tribal Association in Kerala), Dhan

Foundation (Tamil Nadu) and BASIX (Andhra Pradesh). The same services are provided to the members of these NGOs too.

The bank is also exploring the possibility of exporting Indian technology and know-how to various other developing countries. To explore this possibility the bank has entered into dialogue with a group of artisans in southern India for accessing technology for manufacturing non-vitrified floor tiles which are handmade. The other arrangements include the use of watermills in the Himalayan region for generating 2-3 KW of power to light up small houses and workshops. These initiatives are advantageous to both the exporter and importer.

Check Your Progress

6. What is the main function of The Export Import bank (EXIM)?
7. What are the main objectives of the Reserve Bank of India (RBI)?
8. Name the two main departments of RBI.

13.5 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. The floating interest rate on housing loans is a pattern where the rate of interest is not stable during the total loan period.
2. In teaser rates, the initial interest rates are lower than the fixed rate mortgages and are used by lenders to entice the borrowers. On the other hand, hybrid rates contain both fixed and floating interest rates for specified periods.
3. The main feature of the Indian balloon mortgage loan is payment of a hefty amount (i.e., balloon amount) at the end of the loan's term.
4. National Housing Bank (NHB)'s principal mandate is to promote housing finance institutions to improve/strengthen the credit delivery network for housing finance in the country.
5. The main objectives of National Housing Bank are as follows:
    a) To promote a network of dedicated housing finance institutions to adequately serve various regions and different income groups.
    b) To augment resources for the sector and channelize them for housing.
    c) To make housing credit more affordable.
    d) To regulate the activities of housing finance companies based on regulatory and supervisory authority derived under the Act.
6. The Export Import bank (EXIM) of India along with commercial banks, provides loans for exports and imports.
7. The main objectives of the Reserve Bank of India (RBI) are as follows:
    a) To manage the monetary and credit functioning within the country

b) To stabilize the value of rupee

c) To have balanced and systematic development of banking in India

d) To effectively develop the money market in the country

e) To assist in providing agriculture and industrial finance

f) To properly manage public debts

8. The two main departments of RBI are Industrial and credit department and Exchange control department.

13.6 SUMMARY

- Banks have shifted their focus from traditional lending (to companies) to home loans, which is basically a retail sector.
- The interest rate and method of calculation are the most important factors that influence the borrowers in the selection of home loan lenders.
- Interest on home loans is critical as it has a significant financial impact on the process of borrowing and repayment.
- The floating interest rate on housing loans is a pattern where the rate of interest is not stable during the total loan period. The interest rate fluctuates with the change in the rates in the economy.
- Fixed rate loans have a stable rate of interest during the loan's tenure. Here, the rate of interest is unaffected by the changing market scenario.
- A hybrid structure is a combination of a fixed interest rate for an initial period and a floating interest rate for the balance period.
- A hybrid interest rate is a better option for home loan seekers as it provides a fixed commitment for a specified period and a floating rate structure commences only after the stipulated period.
- SBI was the first to introduce teaser home loans and RBI has banned introduction teaser interest rates on home loans.
- With rising competition in the home loan market, banks are offering a number of innovative products to lure customers, meeting their specific and unique requirements.
- A bridge home loan is a short-term loan when the owner of an existing house wants to sell it and buy another, without waiting for the sale proceeds of the existing house.
- The balloon mortgage loan is similar to a fixed-rate mortgage scheme and has a much shorter payment term.
- The main feature of the Indian balloon mortgage loan is payment of a hefty amount (i.e., balloon amount) at the end of the loan's term. The monthly payment structure is also smaller than the fixed-rate mortgage.

- The National Housing Bank (NHB) is an apex level financial institution catering to the housing sector in the country.
- The Indian economy is marked by a number of institutions favouring growth of the export sector. To enhance and develop the export sector, it is important to make available the finance schemes as an incentive.
- In India, short- or medium-term finance is provided by members of Foreign Exchange Dealers Association of India (FEDAI). FEDAI is an association of banks dealing in foreign exchange and its members are commercial banks and other financial institutions.
- The Reserve Bank acts as an institution which refinances the short- and medium-term loans provided by commercial banks to exporters or importers.
- Export Credit Guarantee Corporation of India (ECGC) plays a major role in enhancing export from the country by underwriting various risks involved in exports.
- RBI has its headquarters in Mumbai and several regional offices. It authorizes and extends export credits. It also monitors transactions related to foreign exchange but does not interact directly with the exporters.
- The EXIM Bank has taken over the operations of the International Finance Wing of the Industrial Development Bank of India (IDBI).
- The Small and Medium Enterprise (SME) sector contributes significantly to the socio-economic growth of the country.
- The EXIM Bank in order to develop a strong background for provided export assistance to agricultural units has built strong linkages with various other prominent stakeholders in this sector.

13.7 KEY WORDS

- **Bridge Home Loan**: It refers to a short-term loan when the owner of an existing house wants to sell it and buy another, without waiting for the sale proceeds of the existing house.
- **Fixed Rate Loans**: It refers to a rate on housing loans which have a stable rate of interest during the loan's tenure. Here, the rate of interest is unaffected by the changing market scenario.
- **Floating Interest Rate**: It refers to a rate on housing loans in which the rate of interest is not stable during the total loan period.
- **Hybrid structure**: It refers to a combination of a fixed interest rate for an initial period and a floating interest rate for the balance period.

13.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

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Short Answer Questions

1. Why does bank lend in the housing sector?
2. How does interest rate fluctuate?
3. Write a short note on hybrid interest rate structure.
4. What is balloon mortgage loan?
5. Name the institutions which offer export finance.
6. How does Export Credit Guarantee Corporation of India (ECGC) play an important role in enhancing exports from the country.

Long Answer Questions

1. Explain in detail the advantages of house financing.
2. Discuss the methods related to house financing.
3. What are the main types of interest rates of house financing? Explain any two in detail.
4. Analyse the functions of National Housing Bank (NHB).
5. Discuss the schemes introduced by RBI to improve lending of credit for import and export.
6. Explain the functions of EXIM bank.

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UNIT 14 OVERVIEW OF NON-BANKING FINANCIAL COMPANIES

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Structure

14.0 Introduction
14.1 Objectives
14.2 Non-Banking Financial Companies (NBFCS): Regulation and Role
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14.8 Further Readings

14.0 INTRODUCTION

A non-banking financial company (NBFC) is registered under the Companies Act, 1956 of India. It is engaged in the business of loans and advances, acquisition of bonds, shares and stocks, or chit-fund business. However, it does not include any institution whose principal business includes agriculture, the sale, purchase or construction of immovable property and industrial activity.

The working and operations of NBFCs are regulated by the Reserve Bank of India (RBI) within the framework of the Reserve Bank of India Act, 1934 and the directions issued by it.

In this unit, the working of NBFCs and its various categories have been discussed. The unit will also explain the concept of chit fund companies and the functions of chit fund companies and finance companies.

14.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss the concept and working of non-banking financial services (NBFCs)
- Identify the categories of NBFCs
- Explain the role of chit fund companies
- Analyze the functions of chit fund and finance companies

14.2 NON-BANKING FINANCIAL COMPANIES (NBFCS): REGULATION AND ROLE

NOTES

Non-banking finance companies (NBFCs) which are heterogeneous in nature in terms of activity, organizational structure, portfolio mix, are important financial intermediaries and an integral part of the Indian financial system. The main advantages of NBFCs lie in the lower transaction costs, quick decision-making, and customer orientation and prompt provision of services. They have been able to carve out a niche for themselves in meeting the credit needs of unorganized sector and small borrowers at the local level. Their number has gone up from 7,063 in 1981 to 51,929 in 1996. Of these, only 20 per cent used to submit returns to the RBI. In 1996, the regulated deposits of NBFCs amounted to ₹ 38,110 crore. Aggregate public deposits of 1,547 NBFCs holding public deposits, amounted to ₹ 20,428.93 crore as on 31 March 1999; and as a proportion to deposits with commercial banks they constituted 2.9 per cent.

Non-banking deposits as a proportion of household savings in gross financial assets rose from 3.1 per cent in 1980-81 to 7.4 per cent in 1998-99. NBFCs attracted a large number of small investors since the rate of return on deposits with them was relatively high. NBFCs are quite flexible in meeting the credit needs of specific sectors like equipment leasing, hire-purchase, housing finance and consumer finance, where gaps between the demand and supply of funds have been high and where established financial entities are not easily accessible to borrowers. The growth in the number of NBFCs was facilitated by the ease of entry, limited fixed assets and absence of any need to hold inventories. While their functions and the services they render are different, the common feature is acceptance of deposits from the public, borrowing from banks and in the case of companies organized as public limited companies, accessing the capital market.

The number of NBFCs registered with the RBI was 12,809. NBFCs consist of NBFC–D (deposit taking NBFCs), RNBCs, and mutual benefit companies, miscellaneous non-banking companies (MNBCs) and Nidhi companies. The deposit taking NBFCD are 364 and RNBC two (former IFCI and TFCI).

According to the Reserve Bank (Amendment Act), 1997, 'A Non-banking Finance Company' (NBFC) means:

(i) A financial institution which is a company.

(ii) A non-banking institution which is a company and which has, as its principal business, the receiving of deposits under any scheme or arrangement or in any other manner or lending in any manner.

(iii) Such other non-banking institution or class of such institutions as the bank may with the previous approval of the Central government specify.

The definition excludes financial institutions besides institutions which carry on agricultural operations as their principal business.

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Categories of Non-finance Companies

Non-banking finance companies consist mainly of finance companies which carry on hire-purchase finance, housing finance, investment, loan, equipment leasing or mutual benefit financial companies but do not include insurance or stock exchanges or stockbroking companies.

The non-bank finance companies are categorized as follows:

- An equipment leasing company (EL)
- A hire-purchase company (HP)
- A housing finance company (HFC)
- An investment company (IC)
- A loan company (LC)
- A mutual benefit financial company (MBFC), *i.e.*, Nidhi companies
- A miscellaneous non-banking company, *i.e.*, chit fund companies

RNBCs: Residuary Non-banking Company (RNBC) is a company which receives any deposit under any scheme or arrangement, by whatever name called, in one lump-sum or in installments or in any other manner and which does not fall into any of the above categories.

Non-banking or non-financial company is defined as an industrial concern or a company whose principal activity is agricultural operations or trading in goods and services or real estate and which is not classified as a financial, miscellaneous or a residuary non-banking company.

Check Your Progress

1. What are the main advantages of non-banking finance companies?
2. How was the growth in number of NBFCs facilitated?

14.3 CHIT FUND COMPANIES AND THEIR FUNCTIONS

A chit fund is a type of rotating savings and credit association system. Chit fund schemes may be organized by financial institutions, or informally among friends, relatives, or neighbours. In some variations of chit funds, the savings are for a specific purpose. According to Section 2(b) of the Chit Funds Act, 1982, a chit is ‘a transaction whether called chit, chit fund, chitty, kuree or by any other name by or under which a person enters into an agreement with a specified number of persons that every one of them shall subscribe a certain sum of money (or a certain quantity of grain instead) by way of periodical instalments over a definite period and that each such subscriber shall, in his turn, as determined by lot or by auction or by tender or in such other manner as may be specified in the chit agreement, be entitled to the prize amount'. Chit fund companies are regulated by the respective State Governments, although some RBI regulations exist on them.

A chit fund company is classified as a Miscellaneous Non-banking Company (MNBC). It means it is a company that manages, conducts or supervises as a promoter, foreman or agent of any transaction or arrangement by which the company enters into an agreement with a specified number of subscribers that every one of them shall subscribe a certain sum in instalments over a definite period and that every one of such subscribers shall in turn, as determined by lot or by auction or by tender or in such manner as may be provided for in the agreement, be entitled to the prize amount.

Functions of Chit Fund Companies

In a chit fund scheme, the first and second month chit amount will be taken over by the organizations concerned conducting the chit. From the 3rd month onward, auction will be held among the members for the chit amount. The member who gives the highest bid will be allotted the chit amount less the amount that has been bid. The discount amount that has been decided in the auction through the bidding will be distributed among the members.

Functions of Finance Companies

A finance company finances the activities of other businesses and individuals. They lend money to those interested in pursuing such funding. However, unlike banks, these finance companies do not accept deposits the way that banks do. They base their loans on the value of the assets that borrowers pledge as security.

Check Your Progress

3. How are chit fund schemes organized?
4. How are chit fund companies regulated?

14.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. The main advantages of non-banking finance companies are lower transaction costs, quick decision-making, and customer orientation and prompt provision of services.
2. The growth in the number of NBFCs was facilitated by the ease of entry, limited fixed assets and absence of any need to hold inventories.
3. Chit fund schemes may be organized by financial institutions, or informally among friends, relatives, or neighbours.

4. Chit fund companies are regulated by the respective State Governments, although some RBI regulations exist on them.

14.5 SUMMARY

- Non-banking finance companies (NBFCs) which are heterogeneous in nature in terms of activity, organizational structure, portfolio mix, are important financial intermediaries and an integral part of the Indian financial system.
- The main advantages of NBFCs lie in the lower transaction costs, quick decision-making, and customer orientation and prompt provision of services.
- NBFCs attracted a large number of small investors since the rate of return on deposits with them was relatively high.
- NBFCs are quite flexible in meeting the credit needs of specific sectors like equipment leasing, hire-purchase, housing finance and consumer finance, where gaps between the demand and supply of funds have been high and where established financial entities are not easily accessible to borrowers.
- The growth in the number of NBFCs was facilitated by the ease of entry, limited fixed assets and absence of any need to hold inventories.
- The number of NBFCs registered with the RBI was 12,809. NBFCs consist of NBFC–D (deposit taking NBFCs), RNBCs, and mutual benefit companies, miscellaneous non-banking companies (MNBCs) and Nidhi companies.
- A non-banking institution which is a company and which has, as its principal business, the receiving of deposits under any scheme or arrangement or in any other manner or lending in any manner.
- Non-banking finance companies consist mainly of finance companies which carry on hire-purchase finance, housing finance, investment, loan, equipment leasing or mutual benefit financial companies but do not include insurance or stock exchanges or stock broking companies.
- Residuary Non-banking Company (RNBC) is a company which receives any deposit under any scheme or arrangement, by whatever name called, in one lump-sum or in installments or in any other manner and which does not fall into any of the above categories.
- Non-banking or non-financial company is defined as an industrial concern or a company whose principal activity is agricultural operations or trading in goods and services or real estate and which is not classified as a financial, miscellaneous or a residuary non-banking company.
- A chit fund is a type of rotating savings and credit association system. Chit fund schemes may be organized by financial institutions, or informally among friends, relatives, or neighbours.

NOTES

- Chit fund companies are regulated by the respective State Governments, although some RBI regulations exist on them.
- In a chit fund scheme, the first and second month chit amount will be taken over by the organizations concerned conducting the chit.
- A finance company finances the activities of other businesses and individuals. They lend money to those interested in pursuing such funding.
- However, unlike banks, these finance companies do not accept deposits the way that banks do. They base their loans on the value of the assets that borrowers pledge as security.

14.6 KEY WORDS

- **Equipment Leasing Company:** It refers to a non-banking finance company that is engaged in the business of leasing of equipment or provides finance for any such activities.
- **Non-Banking Company**: It refers to an industrial concern or a company whose principal activity is agricultural operations or trading in goods and services or real estate and which is not classified as a financial, miscellaneous or a residuary non-banking company.
- **Non-Banking Institution**: It refers to a company and which has, as its principal business, the receiving of deposits under any scheme or arrangement or in any other manner or lending in any manner.
- **Residuary Non-Banking Company (RNBC)**: It refers to a company which receives any deposit under any scheme or arrangement, by whatever name called, in one lump-sum or in installments or in any other manner and which does not fall into any of the above categories.

14.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. What are the functions of finance companies?
2. How has the Chit Funds Act defined ‘chit’?
3. What are the various categories of non-bank finance companies?
4. How does the Reserve Bank Amendment Act define NBFCs?
5. State the most common feature of NBFCs.

Long Answer Questions

1. Discuss the functions of chit fund companies.
2. Explain the growth of NBFCs and its working.
3. Why is a chit fund company classified as a Miscellaneous Non-banking Company? Explain in detail.
4. Why is it said that NBFCs provide financial needs flexibly to people? Discuss in detail.

NOTES

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