DR.BABASAHEB AMBEDKAR OPEN UNIVERSITY

BBA

BACHELOR OF BUSINESS ADMINISTRATION

BBAR-601

Financial Services

Financial Services

Editorial Panel

Author
Dr. Nitin M. Verma
B.Com, M.Com, GSET, PGDRM, Ph.D.
Adhyapak sahayak in Commerce and Accountancy at
H.L. College of Commerce
Ahmedabad.

Editor
Dr. Kandarp Chavda
M.Com., B.Ed., M.Phil., UGC NET, Ph.D.
Adyapak Sahayak in Commerce and Accountancy at
S.L.U. Arts and H.& P. Thakore Commerce College for Women

Language Editor
Dr. Bhupesh Gupta
M.A., M.Phil., Ph. D.
Assistant Professor,
Lokmanya College of Commerce
Ahmedabad

Edition : 2022

Copyright © 2022 Knowledge Management and Research Organisation.
All rights reserved. No part of this book may be reproduced, transmitted or utilized in any form or by a means, electronic or mechanical, including photo copying, recording or by any information storage or retrieval system without written permission from us.

Acknowledgment
Every attempt has been made to trace the copyright holders of material re–produced in this book. Should an infringement have occurred, we apologize for the same and will be pleased to make necessary correction/amendment in future edition of this book.
The content is developed by taking reference of online and print publications that are mentioned in Bibliography. The content developed represents the breadth of research excellence in this multidisciplinary academic field. Some of the information, illustrations and examples are taken "as is" and as available in the references mentioned in Bibliography for academic purpose and better understanding by learner.

ROLE OF SELF INSTRUCTIONAL MATERIAL IN DISTANCE LEARNING

The need to plan effective instruction is imperative for a successful distance teaching repertoire. This is due to the fact that the instructional designer, the tutor, the author (s) and the student are often separated by distance and may never meet in person. This is an increasingly common scenario in distance education instruction. As much as possible, teaching by distance should stimulate the student's intellectual involvement and contain all the necessary learning instructional activities that are capable of guiding the student through the course objectives. Therefore, the course / self–instructional material are completely equipped with everything that the syllabus prescribes.

To ensure effective instruction, a number of instructional design ideas are used and these help students to acquire knowledge, intellectual skills, motor skills and necessary attitudinal changes. In this respect, students' assessment and course evaluation are incorporated in the text.

The nature of instructional activities used in distance education self–instructional materials depends on the domain of learning that they reinforce in the text, that is, the cognitive, psychomotor and affective. These are further interpreted in the acquisition of knowledge, intellectual skills and motor skills. Students may be encouraged to gain, apply and communicate (orally or in writing) the knowledge acquired. Intellectual– skills objectives may be met by designing instructions that make use of students'prior knowledge and experiences in the discourse as the foundation on which newly acquired knowledge is built.

The provision of exercises in the form of assignments, projects and tutorial feedback is necessary. Instructional activities that teach motor skills need to be graphically demonstrated and the correct practices provided during tutorials. Instructional activities for inculcating change in attitude and behavior should create interest and demonstrate need and benefits gained by adopting the required change. Information on the adoption and procedures for practice of new attitudes may then be introduced.

Teaching and learning at a distance eliminates interactive communication cues, such as pauses, intonation and gestures, associated with the face–to–face method of teaching. This is particularly so with the exclusive use of print media. Instructional activities built into the instructional repertoire provide this missing interaction between the student and the teacher. Therefore, the use of instructional activities to affect better distance teaching is not optional, but mandatory.

Our team of successful writers and authors has tried to reduce this. Divide and to bring this Self Instructional Material as the best teaching and communication tool. Instructional activities are varied in order to assess the different facets of the domains of learning.

Distance education teaching repertoire involves extensive use of self–instructional materials, be they print or otherwise. These materials are designed to achieve certain pre–determined learning outcomes, namely goals and objectives that are contained in an instructional plan. Since the teaching process is affected over a distance, there is need to ensure that students actively participate in their learning by performing specific tasks that help them to understand the relevant concepts. Therefore, a set of exercises is built into the teaching repertoire in order to link what students and tutors do in the framework of the course outline. These could be in the form of students' assignments, a research project or a science practical exercise. Examples of instructional activities in distance education are too numerous to list. Instructional activities, when used in this context, help to motivate students, guide and measure student's performance (continuous assessment).

PREFACE

We have put in lots of hard work to make this book as user–friendly as possible, but we have not sacrificed quality. Experts were involved in preparing the materials. However, concepts are explained in easy language for you. We have included many tables and examples for easy understanding.

We sincerely hope this book will help you in every way you expect.

All the best for your studies from our team!

Financial Services

Contents

BLOCK 1 : BUSINESS ETHICS–INTRODUCTION

Unit 1 : Introduction to Financial Services

Introduction, Meaning and Concept of Financial Services, Characteristics of Financial Services, Different types of Financial Services, Objectives of Financial Services, Functions of Financial Services, Importance of Financial Services, Evolution and Growth of Financial Services, Regulatory Framework of Financial Services, Merchant Banking : Meaning, Origin and Development of Merchant Banking, Functions of Merchant Banking, Regulations of Merchant Banking

Unit 2 : Mutual Funds

Introduction, Meaning of Mutual Fund, Origin and Growth of Mutual Fund, Structure of Mutual Fund, Guidelines of Mutual Fund by SEBI, Types of Mutual Fund, Advantages of Mutual Fund, Disadvantages of Mutual Fund, ELSS Mutual Fund, Regulations of Mutual Fund

Unit 3 : Insurance Services

Introduction of Insurance, Concept of Insurance, Principles of Insurance : (a) Utmost Good Faith (b) Insurable Interest (c) Compensation (d) Subrogation (e) Contribution (f) Loss Mitigation (g) Cause Proxima, Classification of Insurance : (I)

Life Insurance : (a) Whole Life Plan (b) Endowment Plan (c) Joint Life Policy (d) Term Plan (e) Annuity (f) Pension Plan (g) Child Plan (h) Female Marriage Plan, (II) Non–Life Insurance (General Insurance) : (a) Health Insurance (b) Motor Insurance (c) Marine Insurance (d) Insurance of Stock (e) Loss of Profit (f) Protection During Foreign Tour, Insurance Regulatory Framework : (a) Insurance Act : (i) Insured (ii) TPA (iii) Agent/ Broker (iv) Insurance Companies, (b) IRDA Guidelines, Different Types of Life Insurance, Operations of General Insurance (Explanation with "fire" insurance), Health Insurance : – Meaning – Importance – Process – Claim – TPA, Difference between Life Insurance and General Insurance, Importance of General Insurance to Different Sectors of Economy, History of Insurance at Nutshell, Insurance Sector Analysis (IBEF)

Unit 4 : Investment Banking and Merchant Banking

Introduction, Investment Banking in India, Meaning of Investment Banks, Characteristics of Investment Banks, Investment Banking Services, Recent Development and Challenges in Investment Banking, Merchant Banking Services, Institutional Structure of Merchant Banking, Definition of Merchant Banking, Characteristics of Merchant Banking, Functions of Merchant Banker, SEBI Guidelines for Merchant Banker, Appointment of Lead Merchant Banker, Responsibilities of Lead Merchant Banker

BLOCK 2 : NEW FINANCIAL PRODUCTS AND SERVICES

Unit 1 : Leasing

Introduction, Definition of Leasing, Feature of Leasing, Indian Leasing Industry Structure, Types of Leasing, Advantages of Leasing from the Viewpoint of Lessor, Disadvantages of Leasing from the Viewpoint of Lessor, Advantages of Leasing from

the Viewpoint of Lessee, Disadvantages of Leasing from the Viewpoint of Lessee, Difference between Leasing and Hire Purchase, Direct Lease, Sales and Lease Back

Unit 2 : Hire Purchase

Introduction, Meaning of Hire Purchase, Features of Hire Purchase Agreement, Legal Status, Hire Purchase Agreement, Hire Purchase Interest and Instalments, Choice Criteria between leasing and Hire Purchase, Factoring and Forfeiting

Unit 3 : Housing Finance and Venture Capital

Introduction, Meaning of Housing Finance, Rise of Housing Finance in India, Fixing Amount of Loan, Floating vs. Fixed Rate, Venture Capital : Concept, Characteristics of Venture Capital, Stages of Investment/Financing, Venture Capital Regulatory Framework, Eligibility and Investment Criteria for Venture Capital Funds

Unit 4 : Factoring

Introduction, Factoring–Meaning, Parties Involved, Mechanism of Factoring, Types of Factoring, Advantages and Dis–Advantages of Factoring, Factoring v/s Bill Discounting, Indian Scenario of Factoring

---

BLOCK 3 : CONSUMER BEHAVIOUR AND BANKING PRODUCTS

Unit 1 : Consumer Behaviour for Financial Services

Introduction, The Complexity of Consumer Buying Decisions, Individual Influences on Consumer Behaviour, Needs and Motives, Individual Perception, Learning and Habit Development, Family Influences on Buying Behaviour, Behavioural Models for Analysing Buyers, Consumer Behaviour Some Learning Points for Financial Service

Unit 2 : Banking Products and Services

Introduction, Nature of Product, Products and Services in Banking, Elements of Product Mix, Product Life Cycle and Product Strategies, Using Product Life Cycle to Manage Marketing of Banking Products, New Product Development , Branding in Bank Marketing, Process and Product Development Cycle for Banking Services, Product Development

BLOCK 4 : RATINGS AND SECURITIZATION

Unit 1 : Credit Ratings

Introduction, Meaning, Origin, Types of Credit Rating, Advantages of Credit Ratings, Disadvantages of Credit Ratings, Credit Rating Agencies, Credit Rating Methodology, International Credit Rating Practices, Top Three Credit Rating Institutions of World

Unit 2 : Plastic Money

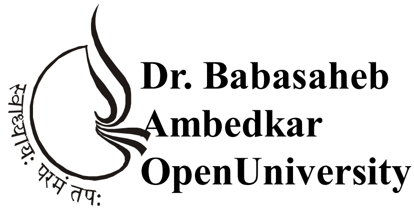
Introduction, Concept and Different Forms of Plastic Money, Details of Debit Cards and Credit Cards, Credit Card Cycle, Credit Card Advantages, Credit Card Disadvantages, Future Perspective of Cards

Unit 3 : Securitization

Introduction, Concept of Securitization, Securitization as a Funding Mechanism, Utility of Securitization, Forms of Securitization, Advantages of Securitization, Disadvantages of Securitization, Concept of Mortgage, Traditional Morgtage, Non–Traditional Mortgage, Graduated Payment Mortages (GPMs), Pledged Account Mortagages (PAMs), Collateralized Mortgage Obligations (CMOs), Securitization of Non–Mortgage Assets, Securitization in India, Latest Innovations and Technological Integration in Financial Services

Unit 4 : Depository

Introduction, Definition, Depository System, Advantages/ Benefits of Depository System, Features of Depository System, SEBI (Depositories and Participants) Regulations, 1996, Dematerialization of Shares, Re–Materialization of Shares, Difference Between Dematerialization and Re–Materialization of Shares, Market Settlement of Trade, Process/Procedure of Market Settlement, Participants Involved in The Process, Clearing and Stock Trade Settlement Process (Diagrammatic Presentation), Commonly Asked Questions



BBAR-601

Financial Services

BLOCK-1 BUSINESS ETHICS–INTRODUCTION

UNIT 1
INTRODUCTION TO FINANCIAL SERVICES

UNIT 2
MUTUAL FUNDS

UNIT 3
INSURANCE SERVICES

UNIT 4
AN OVERVIEW OF INDIAN FINANCIAL SYSTEM

BLOCK 1 : BASICS OF FINANCIAL SERVICES

Block Introduction

Since 1990, the financial services sector in India has changed significantly. Before to its entry, the Indian industry's financial needs were covered by the commercial banks and other leading financial organisations. The financial services sector didn't really take off until after economic liberalisation. This area has now grown into a separate industry. In fact, one of the biggest sectors in the world now is financial services. An integral part of the financial system is financial services. Modern economies are built on the backbone of financial services. The financial services industry is essential to a country's prosperity.

Block Objectives

- To help students comprehend the function & responsibility of regulatory authorities in the financial sector
- It improves knowledge of how investment and portfolio theories are used in real–world situations.
- To work as a financial analyst or consultant with in–depth knowledge of insurance, risk management, portfolio theory, and financial analysis, among other things.
- Provide students the skills they need to work in banks and insurance firms.

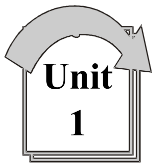
Block Structure

Unit 1 : Introduction to Financial Services

Unit 2 : Mutual Funds

Unit 3 : Insurance Services

Unit 4 : An overview of Indian Financial System



INTRODUCTION TO FINANCIAL SERVICES

: UNIT STRUCTURE :

1.0 Learning Objectives

1.1 Introduction

1.2 Meaning and Concept of Financial Services

1.3 Characteristics of Financial Services

1.4 Different types of Financial Services

1.5 Objectives of Financial Services

1.6 Functions of Financial Services

1.7 Importance of Financial Services

1.8 Evolution and Growth of Financial Services

1.9 Regulatory Framework of Financial Services

1.10 Merchant Banking : Meaning

1.11 Origin and Development of Merchant Banking

1.12 Functions of Merchant Banking

1.13 Regulations of Merchant Banking

1.14 Let Us Sum Up

1.15 Answers for Check Your Progress

1.16 Glossary

1.17 Assignment

1.18 Activities

1.19 Case Study

1.20 Further Readings

1.0 Learning Objectives :

- To disseminate information about financial services.
- To offer a thorough grasp of financial services, including those linked to banking, insurance, mutual funds, and capital markets.
- To provide the students with the knowledge and abilities needed to thrive in the service industry's cutthroat climate.

1.1 Introduction :

Financial services are a component of the financial system, which offers numerous forms of financing through different credit instruments, financial goods, and financial services. The following also make up the financial system : (i) Financial Markets, including the capital market for

long–term investments and money markets for short–term investments. (ii) Financial Institutions, such as banks and non–banks; (iii) Financial Instruments, such as Treasury Bills, Commercial Papers, Certificates of Deposit, Commercial Bills, etc. as Short–Term Instruments; and (iv) Financial Institutions, such as banks and non–banks.

Several sorts of assets can be purchased through services such as leasing, factoring, hire buy finance, etc., either for ownership or on a lease. Both factoring and leasing come in a variety of forms. Financial services thus allow the consumer to purchase any asset online.

1.2 Meaning and Concept of Financial Services :

"Financial services can be defined as the products and services offered by institutions like banks of various kinds for the facilitation of various financial transactions and other related activities in the world of finance like loans, insurance, credit cards, investment opportunities and money management as well as providing information on the stock market and other issues like market trends."

Financial Services

As per section 65(10) of the Finance Act, 1994, "banking and financial services" means the following services provided by a banking company or a financial institution including a non–banking financial company, namely;

(i)	*financial leasing services including equipment leasing and hire–purchase by a body corporate;*
(ii)	*credit card services;*
(iii)	*merchant banking services;*
(iv)	*securities and foreign exchange (forex) broking;*

(v)	*asset management including portfolio management, all forms of fund management, pension fund management, custodial depository and trust services, but does not include cash management;*
(vi)	*advisory and other auxiliary financial services including investment and portfolio research and advice, advice on mergers and acquisition and advice on corporate restructuring and strategy; and*
(vii)	*provision and transfer of information and data processing.*

"Financial services refer to services provided by the finance industry. The finance industry encompasses a broad range of organizations that deal with the management of money. Among these organizations are banks, credit card companies, insurance companies, consumer finance companies, stock brokerages, investment funds and some government sponsored enterprises."

1.3 Characteristics of Financial Services :

(I) Customer–Specific : Financial services are usually customer focused. The firms providing these services, study the needs of their customers in detail before deciding their financial strategy, giving due regard to costs, liquidity and maturity considerations. Financial services firms continuously remain in touch with their customers, so that they can design products which can cater to the specific needs of their customers. The providers of financial services constantly carry out market surveys, so they can offer new products much ahead of need and impending legislation. Newer technologies are being used to introduce innovative, customer friendly products and services which clearly indicate that the concentration of the providers of financial services is on generating firm/customer specific services.

(II) Intangibility : In a highly competitive global environment brand image is very crucial. Unless the financial institutions providing financial products and services have good image, enjoying the confidence of their clients, they may not be successful. Thus institutions have to focus on the quality and innovativeness of their services to build up their credibility.

(III) Concomitant : Production of financial services and supply of these services have to be concomitant. Both these functions i.e. production of new and innovative financial services and supplying of these services are to be performed simultaneously.

Tendency to Perish : Unlike any other service, financial services do tend to perish and hence cannot be stored. They have to be supplied as required by the customers. Hence financial institutions have to ensure a proper synchronization of demand and supply.

(IV) People Based Services : Marketing of financial services has to be people intensive and hence it's subjected to variability of

performance or quality of service. The personnel in financial services organisation need to be selected on the basis of their suitability and trained properly, so that they can perform their activities efficiently and effectively.

(V) Market Dynamics : The market dynamics depends to a great extent, on socioeconomic changes such as disposable income, standard of living and educational changes related to the various classes of customers. Therefore, financial services have to be constantly redefined and refined taking into consideration the market dynamics. The institutions providing financial services, while evolving new services could be proactive in visualizing in advance what the market wants, or being reactive to the needs and wants of their customers.

1.4 Different types of Financial Services :

(I) Banking Services : Banking is the process of accepting the deposits from public and converting them as assets by giving loans to the public.

- Rate of interest is offered on deposits and charged on loans.
- The difference between the offer rate and loan rate is the profit for a bank.
- Deposits are the liabilities and loans are the assets for a bank.
- Asset liability Management is more important to a bank.

(II) Insurance Services : Insurance is the contract between two parties i.e. insurer who protects from the risk and insured (policy holder) who is protected for a service charge paid by the insured to the insurer.

- It is a risk management tool for financial loss.
- It is used to hedge against risk of contingent loss or loss due to uncertainty.
- It has both underwriting and investing depending on the policy contract.
- Insurance regulatory and Development Authority of India (IRDAI) is the body regulating and promoting insurance and reinsurance industry in India.
- There are 90 insurance companies registered with IRDA.

(III) Investment Management Services :

(A) Mutual Funds : It is a fund established in the form of a trust by a sponsor to raise monies by the Trustees through the sale of units to the public under one or more schemes for investing in securities in accordance with these regulations – The SEBI (Mutual Funds) Regulations 1993. A mutual fund comprises of four separate entities, namely

1. Sponsor
2. Mutual fund trust
3. Asset Management Company (AMC)
4. Custodian

(B) Portfolio Management Services :

- It is a personalised portfolio management service where there is no pooling of assets like a mutual fund.
- This is more of an equity portfolio.
- This is not a common fund but investment on one name.
- Every trade transaction by the fund manager is taxable in the on the investor.
- According to SEBI, the minimum investment in PMS is Rs. 25 lakh. Best performing portfolio managers may increase this limit due to increasing demand.
- There are 354 registered Portfolio managers with SEBI.

(C) Wealth Management Services :

- It is similar to Portfolio Management Services (PMS) in terms of customization and personalised management.
- It varies from PMS as it is not limited to equity securities but diversified into variety of investment products.
- Wealth Products comprises of equity, debt, derivatives, real estate, bullion, antiques, arts and any other investment avenue.
- In India ASK Wealth Management is the first WMS company.

(D) Investment Advisory Services : SEBI has put the following in the list of Investment advisory services related to tax, insurance, investments, lending, borrowing, etc.

- Financial Planning
- Tax Planning
- Investment Advisory
- Real Estate planning.

(IV) Capital Market Services :

- These are the services offered by various financial institutions to companies, financial institutions and governments in the process of raising capital and maintaining the liquidity for the same.
- The type and cost of services depends on the volume, technology, urgency and risk associated with respective process or product.

(A) Primary Market Services : Primary Market refers to the market for fresh issue of securities by companies, financial institutions and governments. They can be classified as follows :

1. Public Issue Services

2. Credit Evaluation Services
3. Underwriting Services
4. Registrar Services

1. Public Issue Services : These are the services offered by various financial institutions to variety of investors in private or public in the process of issuing financial instruments or securities. They are a kind of New security issue services. The issues are as below.

- Equity
- Debt
- Mutual fund units
- Gold equivalents

2. Credit Evaluation Services : Credit evaluation is the process of assessing and affirming the credit risk associated with a person, firm or government as required by the stake holders like investors, regulators, suppliers and shareholders.

- It considers the following parameters
- Credit history
- Borrowing capacity
- Ability to repay
- Promptness in repayment
- Optimum utilization of borrowed funds

3. Underwriting : It is an agreement with or without conditions to subscribe to the securities of a body corporate when the existing shareholders of such body corporate or the public do not subscribe to the securities offered to them.

- Underwriter means a person who engages in the business of underwriting of an issue of securities of a body corporate.
- The issue should get 90% subscription to be successful. Failure to do so will result in refund.

  This is where underwriter's plugin to the need of the issuer guaranteeing the success.

4. Registrar : Registrars are the institutions that register and maintain detailed records of the transactions of investors or applicants or securities holders for the convenience of

- Companies: issuing bonds, shares and convertible securities.
- Governments: Issuing bonds.
- Mutual Funds: issuing closed ended and open–ended units.

(B) Secondary Market Services : Secondary markets are the markets for trading of issued financial securities and related services. Broadly they can be classified as follows :

1. Stock Exchange Services
2. Index Services
3. Stock Broking Services
4. Depository Services
5. Depository Participant's Services
6. Clearing Services

(V) Non–Banking Financial Services : These services are provided by Non–Banking Financial companies (NBFCs) which are registered with RBI and SEBI to do lending, investment and related activities. They are like banks but differ as follows as the NBFC

- Provides banking services but doesn't hold bank license.
- Don't do payment and settlement.
- Cannot issue cheques drawn on itself
- Cannot accept demand deposits.
- Not required to maintain Reserve Ratios with RBI
- Depositors cannot avail Deposit insurance facility of
- Deposit Insurance
- Credit Guarantee Corporation
- Cannot indulge Primarily in agricultural, industrial activity, sale purchase, construction of Immovable Property has 100% FDI.

(VI) Corporate Services : Accounting, auditing, book keeping, treasury investment management are internal to a company. Apart from these financial services they demand need–based services which required specialized focus and efforts. Following are some of specialized corporate services:

i. Factoring
ii. Forfaiting
iii. M&A Services
iv. Offshore Bundled Services

(VII) Merchant Banking Services :

- These are the services offered to companies in manufacturing, services, financial markets and other areas where a specialized service is required.
- Merchant Banks is often referred to Investment banks which is not real. In India we don't have specialized investment banks like in USA, Europe and Japan which was root cause of 2008 recession.

(VIII) Global Financial Services : Global Financial Services are the financial services provided at the global level. Following are the various kind of global financial services :

- Investment Banking

- Savings and loan associations
- Mutual savings banks
- Credit unions
- Pension Funds

1.5 Objectives of Financial Services :

(I) For Raising Fund : Financial services serve as an efficient tool for raising funds in an economy. It provides various financial instruments to individuals, investors, corporations, and institutions where they can invest their money thereby raising funds from them.

(II) To Promotes Savings : These services provide different types of convenient investment options that can grow people's savings. A mutual fund is one such good option where people can invest and earn reasonable returns without much risk.

(III) Deployment of Funds : Financial services enable the proper deployment of financial resources into productive means. There are numerous investment avenues and instruments available in the financial market where people can invest their funds for earning income.

(IV) For Minimizes Risk : Risk minimization is an important role played by financial services. These services help in diversifying the risk and protect people against damages by providing insurance policies.

(V) For Economic Growth : Financial services help the government in attaining the overall growth of the economy. The government can easily raise both short–term and long term funds for its various needs. It helps in improving overall infrastructural facilities and employment opportunities in a country.

1.6 Functions of Financial Services :

(I) Enables payment system : Financial services have a key role in the proper movement of funds among peoples. It enables peoples to successfully do their payments without any difficulty. Credit cards, debit cards, bill of exchange, and cheque are such financial instruments which facilitate financial transactions.

(II) Proper Utilization of Funds : These intangible services help in efficient allocation of funds. Financial services serve as a means through which peoples invest their ideal lying resources into better investment plans for generating incomes.

(III) Maintains Liquidity : Financial services helps in maintaining sufficient funds in an economy. It links the one who is in need of funds and those who can supply funds as they have sufficient savings. Various services like loans and credit cards enable people to acquire needed funds easily.

(IV) Raises Standard of living : These services play a crucial role in improving the living standards of people. Customers are easily able to purchase costly goods on hire purchase system availing these services. People are able to enjoy the benefits of quality and luxury items.

(V) Promotes trade : Financial services promote both domestic and foreign trade in a country. Forfaiting and factoring companies in the financial market promote the export of goods to foreign markets and also the sales of products in the domestic market. In addition to this insurance and banking facilities also support trade activities in–country.

(VI) Improve Employment Opportunities : Generation of employment opportunities is another important function of financial services. Different financial institutions employ a large number of peoples for selling these services. They pay remunerations to their employees out of the profit earned by selling these financial services.

(VII) Balanced Regional Development : Financial services helps in the balanced regional development of the country. All the key sectors of the economy such as the primary sector, secondary sector, and tertiary sector are able to acquire the required funds through these services. This results in regional disparities and brings balanced development in a country.

1.7 Importance of Financial Services :

(I) Facilitates Transactions : Financial services facilitate the smooth functioning of transactions in an economy. Various financial instruments such as debit cards, credit cards, cheque, bill of exchanges and many more assist people in doing payments.

(II) Ensures Liquidity : These services ensure proper liquidity by facilitating free movement of funds among people. Financial services enable people to easily acquire the required funds through credit cards or loan facilities.

(III) Mobilizes Savings : Mobilization of people's savings is another important role played by financial services. It brings together those who have excess ideal lying resources and one who are in need of funds for investing into productive means.

(IV) Risk Minimization : Financial services reduce the effect of risk to customers through diversification. Insurance policies offered by companies provide protection to people against various losses.

(V) Allocates Capital Funds : It enables people to allocate their fund into efficient sources. Financial services provide various investment options to customers like mutual funds, stocks, saving and fixed deposits which can generate income for them.

(VI) Generates Employment : Financial services helps in creating more employment opportunities in a country. There are large numbers of people who are associated with financial institutions selling these services. Such institutions via selling financial services generate their income and pay remuneration to their employees.

(VII) Economic Growth : These services enable the overall development of all sectors of the economy. Financial services provide sufficient funds to all key sectors that is a primary sector, secondary sector and tertiary sector. It results in a balanced growth of the whole economy.

1.8 Evolution and Growth of Financial Services :

History :

- Since historic time period India has always been an agrarian country which is mainly because of its geographic conditions and its resources which has been the interests of various people who have tried to take hold of it. The financial sector India dates back with the establishment of British rule in India. The first stock exchange was established in Mumbai in 1875, then in Ahmedabad in 1894, Calcutta 1908 and then in Madras in 1937. Though Britishers looted our country and left us in a miserable state, they established a financial system which had "clearly defined rules governing listing, trading and settlements, a well–developed equity culture if only among the urban rich, a banking system with clear lending norms and recovery procedures, and better corporate laws than most other erstwhile colonies. The 1956 Indian Companies Act, as well as other corporate laws and laws protecting the investors' rights, were built on this foundation."
- Though the above mentioned positives stand true the aforementioned negatives share the same spotlight. "A semi organized and narrow industrial securities market, devoid of issuing institutions and the virtual absence of participation by intermediary financial institutions in the long term financing of the industry, was the state of financial system prior to independence. As a result, the industry had very restricted access to outside savings. It simply means that the financial system was not responsive to opportunities for industrial investment. Such a financial system was clearly incapable of sustaining a high rate of industrial growth, particularly growth of new and innovating enterprises."
- After the independence the policy makers adopted for a 'socialist' economy to be practiced in order to drive India to the path of development. 'Socialist' economy meant that though the private sector will be present but public sector will be the major player in the economy. "The Indian financial system remained a relatively free but unsophisticated market system till the seventies. This included a private banking sector, fragmented but active stock markets, active

commodity spot and futures markets. The first milestone of India's socialism was in the 1950s with the closing of the capital account. More changes came in the 1960s and 1970s, with the nationalization of financial service providers. This changed the structure of the financial services industry from a fairly competitive sector to one dominated by large public sector monopolies. This period also saw the closure of commodity derivatives markets. This took place in the latter part of the 1960s, when these markets saw a large number of trader defaults during a period of three consecutive drought years. At the end of the seventies, the equity market was the only component of Indian finance that retained a relatively private sector character. Even here, the State is believed to have used UTI, the only mutual fund in the country, to influence stock prices. Also, while secondary market price discovery was relatively free, the Controller of Capital Issues (CCI) dictated whether, and at what price, firms could sell shares to the public." [4]

- Due to the presence of stringencies in the system the cross–check or self–adjustment mechanism which could have been provided by global capital markets was absent. The regulatory norms did not provide any room for such measures. There were huge flaws in the financial system at that point of time. "Most banks were state owned and had negligible equity capital. Basic concepts of accounting, asset classification, and provisioning were absent. The largest of the local stock exchanges, Bombay Stock Exchange (BSE), was a closed market. The exchange focused on the interests of broker members, did not have outreach across the country, and did not have appropriate structures for governance and regulation. Financial transactions were controlled by the RBI (setting interest rates on various products) and the Ministry of Finance (controlling the price at which securities were issued), with a plethora of price and quantity restrictions. The financial industry was riddled with entry barriers in every sub–industry. It was extremely difficult to start a bank, a mutual fund, a brokerage firm, an insurance company, a pension fund, a securities exchange or a broking firm. Apart from banking, foreign firms could not operate in any of these areas. A comprehensive system of capital controls was in place, which ensured that domestic households and domestic firms had to go to the domestic financial system, in order to access financial services. Few areas of the Indian economy were as dominated by the State as was finance." Trying to raise capital through the means of financial market was not at all feasible due to the complexities involved.
- Apart from the financial sector other sector seemed to be equally constrained due to the economic policies. The public sector grew very large and the irony was that it couldn't generate enough income to meet the requirements of the country as a result we had large

borrowings. By the time the people in the power came to know about the implication of their decisions, it was too late. The deficits were huge, the public sector industries were turning out to be unprofitable and at a point of time the foreign reserves of the country were so less that it could only have supported countries needs for near about 2 more weeks. In this case the 'lender of the last resort', World bank and IMF were approached which granted 7 billion dollars as a loan but on the terms that India would reforms its stringent economic policies and liberalize its economy.

Evolution :

- The new economic policy was adopted which focused on three main aspects: liberalization, privatization and globalization. From being a more socialist than capitalists it tilted to being majorly capitalists and less socialists. There was a complete drift in economic policies i.e. basis on which the economic policies were earlier drafted were no longer in existence and liberal policies were adopted. This also brought about a sea change in the financial system of the country. Narsimhan committee was also established which looked at the major areas in the financial sector which needed reforms such as; reduction in statutory liquidity ratio and cash reserve ratio (they were astoundingly high which was also one of the major reasons that few commercial banks were in existence), the determination of interests rate should be according to the market forces, the public sector banks should have autonomy.
- Due to ease of operation more private players entered the market. There was no more 'license raj' which acted as a stimulus for foreign direct investment. More and more commercial banks and asset management institutions started emerging and also utilized the opportunity to raise debt with the backing of insurance sector. And due to stiff competition in the market there was check and balance mechanism prevailing with relation to the interests rates. "In addition, foreign institutional investors (FIIs) were allowed, beginning in 1992; and Indian firms were allowed to issue global depository rights (GDRs) offshore. These additional resources provided finance for India's private sector–led growth in the mid–1990s, and contributed to a stock market boom."
- MRTP act was abolished which increased the net quantity of imports and exports. "Reforms in the stock market were accelerated by a stock market scam in 1992 that revealed serious weaknesses in the regulatory mechanism. Reforms implemented include establishment of a statutory regulator; promulgation of rules and regulations governing various types of participants in the capital market and also activities like insider trading and takeover bids; introduction of electronic trading to improve transparency in establishing prices; and dematerialization of shares to eliminate the need for physical movement and storage of paper securities. Effective regulation of

stock markets requires the development of institutional expertise, which necessarily requires time, but a good start has been made and India's stock market is much better regulated today than in the past. This is to some extent reflected in the fact that foreign institutional investors have invested a cumulative $21 billion in Indian stocks since 1993, when this avenue for investment was opened."

- To keep a check on the functioning of the stock market and also due to the scam of 1992, in 1992 SEBI (securities exchange board of India) was established. Though it was established in 1988 but in 1992 it became a separate body. Establishment of SEBI had put a check on illicit activities such as insider trading etc. and also provided a sense of security among investors. It provided a uniform code of discipline to be followed by the exchanges. It was a major transformation that took place because of the reform. SEBI also abolished 'badla' system which was unique to Indian stock market which was a way of settlement among traders.

1.9 Regulatory Framework of Financial Services :

(I) Institutional Regulations :

- These regulations are also known as institutional regulations.
- Each institution's activities are regulated by one regulator.
- These regulation call for a clear demarcation of activities of financial institution.
- The apex agencies associated are SEBI and RBI.
- SEBI regulates the functioning of mutual funds, stock exchanges and stock broking companies.

(II) Prudential Regulations :

- These are the regulations associated with the internal management of the financial institution and financial services.
- The aim of regulation is to prevent the entry of firms without adequate resources into the market and ensure the proper functioning of firms within market.

(III) Investor Regulations :

- They ensure protection for investors. E.g.: SEBI issues guidelines to protect the interest of investors from time to time.

(IV) Legislative Regulations :

- Government enacted such regulations for overall development of financial service industry.
- E.g.: Banking Regulation Act, Security Regulation Act.

1.10 Merchant Banking – Meaning :

"Merchant banking can be defined as a skill–oriented professional service provided by merchant banks to their clients, concerning their financial needs, for adequate consideration, in the form of fee."

"The term merchant bank refers to a financial institution that conducts underwriting, loan services, financial advising, and fundraising services for large corporations and high–net–worth individuals (HWNIs). Merchant banks are experts in international trade, which makes them specialists in dealing with multinational corporations."

1.11 Origin and Development of Merchant Banking :

- The origin of merchant banking can be traced back to 13th century when a few family owned and managed firms engaged in sale and purchase of commodities were also found to be engaged in banking activity. These firms not only acted as bankers to the kings of European States, financed coastal trade but also borne exchange risk.
- In order to earn profits, they invested their funds where they expected higher returns despite high degree of risk involved. They charged very high rates of interest for financing highly risky projects. In turn, they suffered heavy losses and had to close down. Some of them restarted the same activity after gaining financial strength. Thus, merchant Banking survived and continued during the 13th century.
- Later, merchant Bankers were known as "commission agents" who handled the coastal trade on commission basis and provided finance to the owners or supplier of goods. They made investments in goods manufactured by sellers and made huge profits. They also financed continental wars. The sole objective of these merchant bankers was profit maximisation by making investments in risky projects.
- During the early nineteenth century, merchants indulged in overseas trade and earned good reputation. They accepted bills of the lesser reputed traders by guaranteeing the holder to receive full payment on due date. This practice of accepting bills has grown over the years with expansion in trade and has become part of the merchant banking activity.
- The merchant banks then extended their activity to the domestic business of loan syndication both for short–term as well as long–term purposes.
- Today, these banks provide a variety of services, such as issue management, portfolio management, asset management, underwriting of new issues, act as registrars, share transfer agents, trustees, and provide leasing, project consultation, advice on mergers and amalgamations, Euro credits, etc.

- In USA, investment banking is concerned with 'garnering savings and directing the flow of funds to business enterprises. 'Investment bankers are primarily the intermediaries who provide specialised service in the marketing of securities. These banks do not invest their own funds in securities for a long–term.
- In India, merchant banking services were started only in 1967 by National Grindlays Bank followed by Citi Bank in 1970. The State Bank of India was the first Indian commercial bank having set up a separate merchant banking Division in 1972. Since then, a number of other banks, financial institutions and other organisations are also engaged in providing merchant banking services.
- But merchant banks in India have been primarily operating as issue houses than full–fledged merchant banks as in other countries.
- In view of the above, we can define merchant bank as an institution or an organisation which provides a number of services including management of securities issues, portfolio services, underwriting of capital issues, insurance, credit syndication, financial advices and project counseling, etc.
- It would also be necessary to make a distinction between merchant banking and commercial banking for a better understanding of the nature of merchant–banking. The merchant banks mainly offer financial services for a fee, while commercial banks accept deposits and grant loans.
- The merchants do not act as repositories for savings of the individuals. Even when merchant banks engage themselves in fund–based activities and act as commercial banks, they function only as whole–sale bankers for a few selected industrial houses and not as retail banks for the general public.
- The merchant banks are also different from the dealers, traders and brokers of securities. The merchant banks mainly deal in new issues while the dealers, traders and brokers deal mainly in secondary market.

Evolution of Merchant Banking:

- It was in 1813, when merchants came from European countries to trade with India. Agency houses were set up by merchant bankers based at London.
- These agency houses raised deposits at cheaper rates of interest viz. 4% to 5% from their home and made advances to native merchants at 10% to 12% and in addition they charged high commissions on every kind of service provided to the clients.
- Easy availability of money at the spot from the agency houses had completely eliminated the role of acceptance house or the merchant banking in India. It was only with the entrance of East India Company that restrictions were put on operation of agency houses.

- During 19th century, foreign merchant bankers operated in India through 'East India House'. East India House members moved into real estate business viz. tea and rubber plantation, cotton mills etc. They faced tough competition from Persian finance houses who were willing to grant credit to the trade with India.
- It was in 1860 when the merchant's interest in joint stock banking started growing and with their own investments they floated joint stock banks. Some new banks were founded which included Orient Bank in 1845, Chartered Bank of India and Asia in 1853, Chartered Merchantile Bank of India, London & China in 1857 and so on.

1.12 Functions of Merchant Banking :

(I) Raising finance : Merchant bankers support their customers to collect funding through debenture issuances, stocks, bank loans, etc. Both domestic and foreign markets are filmed. The funds generated by this strategy increasing be used to launch a new project or company, or also to extend and modernize the current enterprise.

(II) Promotional activities : Merchant bankers perform the role of industrial business promoters. They allow developers to create innovations, define ventures, produce feasibility studies, receive permits from public bodies, and opportunities. At times, merchant bankers may also assist with political, technological, and joint projects.

(III) Brokers in stock exchanges : On behalf of the consumers, they purchase and sell stock in the stock market. They often carry out surveys of equities, remind consumers of the share to be purchased, the date of purchasing, the amount of such acquisition, and the period that these shares will be exchanged.

(IV) Project management : In the project management cycle, they assist consumers in a variety of areas. They guide the position of the plant, the writing of the plant study, feasibility reports, and the project finance preparation, sources of support, policy benefits, and concessions.

(V) Advice on modernization and expansion : Advice on amalgamation, mergers, partnerships, partnerships, international alliances, market diversification, up–gradation of technologies, joint ventures, etc.

(VI) Managing public issue : They serve as consultants on the terminology, form, and timing of corporate securities issues and helps them to be tailored to customers and provides the issuing companies with transparency and versatility.

(VII) Credit syndication : They offer professional services during project planning, loan applications required to collect short– and long–term credit from various institutions and companies, etc.

(VIII) Handling government consent for industrial projects : They complete all formalities for their client and allow the government to extend and modernize their businesses and launch new companies

(IX) Special assistance to entrepreneurs and small companies : They offer guidance and resources for market prospects for start–ups and small businesses, discounts, grants, and government policy, and help them make the best of this opportunity open to them.

(X) The revival of sick units : They help to restore disabled manufacturing units. They meet with various long–term financing institutions and the Industrial and Financial Restoration Council.

(XI) Portfolio management of sick units : They give guidance on investment choices to customers, typically institutional investors. They purchase and sell shares and offer fund investment services and them.

(XII) Corporate restructuring : They help mergers acquisitions, selling and disinvestment comprise them. Such protocols include careful discussions, detailed planning, and delivery of various documentation and lengthy legal formalities.

1.13 Regulations of Merchant Banking :

SEBI has laid the following conditions on the merchant bankers, for conducting their operations. The conditions are as follows:

1. SEBI will give authorization for a merchant banker to operate for 3 years only. Without SEBI's authorization, merchant bankers cannot operate.
2. The minimum net worth of merchant banker should be Rs. 1 crore.
3. Merchant banker has to pay authorization fee, annual fee and renewal fee.
4. All issue of shares must be managed by one authorized merchant banker. It should be the lead manager.
5. The responsibility of the lead manager will be clearly indicated by SEBI.
6. Lead managers are responsible for allotment of securities, refunds, etc.
7. Merchant banker will submit to SEBI all returns and send reports regarding the issue of shares.
8. A code of conduct for merchant bankers will be given by SEBI, which has to be followed by them.
9. Any violation by the merchant banker will lead to the revocation of authorization by SEBI.

Check Your Progress :

1. A merchant bank is a financial institution conducting money market activities and :

   a. Lending

   b. Underwriting and financial advice

   c. Investment service.

   d. All of the above

2. Formal merchant banking activity in India was originated in _________.

   a. 1978 b. 1969 c. 1769 d. 1987

3. The early growth of merchant banking in the country is assigned to the _________.

   a. FEMA

   b. Foreign Exchange Regulation Act, 1973

   c. Securities Contracts Act

   d. Income–tax Act

4. The term 'Merchant Bank' is used in :

   a. United States b. United Kingdom

   c. America d. India

5. Banks implement the RBI's _________ policies.

   a. Monetary b. Credit c. Commercial d. Both a and b

6. Financial services through the network of elements such as _________, serve the needs of individuals, institutions and Corporate.

   a. Financial institutions b. Financial markets

   c. Financial instruments d. All of the above

7. Role of merchant bankers _________.

   a. Mobilization of funds b. Promotional function

   c. Innovation d. All of these.

8. Which of the following is not a fee–based financial service ?

   a. Corporate counselling b. Lease financing

   c. Profit management d. Issue management.

9. Functions of financial services exclude _________.

   a. Mobilization of savings b. Allocation of fund

   c. Specialized services d. Collection of tax.

10. Financial service companies exclude _________.

    a. Commercial banks b. Insurance companies

    c. Sole proprietorship d. Crepitating agencies.

1.14 Let Us Sum Up :

An essential part of the financial system are financial services. Via a network of components, financial services meet the needs of businesses, institutions, and individuals. The Indian Financial Services Industry was characterised by a number of obstacles that slowed its expansion before economic liberalisation. A vast number of activities are covered by financial services, and they can be roughly divided into traditional and modern activities. Many financial intermediaries have begun expanding their operations in the financial services sector by providing a variety of new products in response to the altered economic environment. So, the industry with the fastest rate of growth to emerge is the financial services sector. To meet the economy's increasing need for financial services, the financial services sector must overcome numerous obstacles.

1.15 Answers for Check Your Progress :

1. d	**2.** b	**3.** b	**4.** b	**5.** d
6. d	**7.** d	**8.** b	**9.** d	**10.** c

1.16 Glossary :

1. **Financial Services :** Financial Services are a broad category of activities and products that financial firms in the financial system offer.
2. **Securitization :** It's a process by which a financial institution turns its high–value, non–negotiable, illiquid financial assets into tradable, transferable securities of lower value.
3. **Treasury Bill :** The Central Government issues treasury bills, which are money market instruments.
4. **Convertible Bond :** A convertible bond is one that can be entirely or partially converted into equity shares at a certain time.

1.17 Assignment :

1. Describe the different services provided by the financial services business and define it.
2. In order to meet the rapidly shifting demands of the economy, financial intermediaries must carry out the role of financial innovation. Discuss.
3. Write a note on merchant banking.
4. What is Financial Service ? Explain the different types of financial services.
5. Explain the importance of financial services in detail.

1.18 Activities :

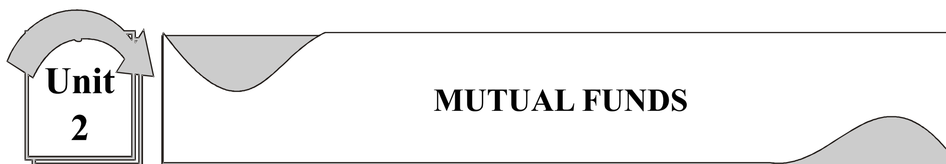
1. Talk about a few of the cutting–edge financial tools that have recently been adopted by the financial services industry.

1.19 Case Study :

1. Critically assess the current situation of the Indian financial services industry and list the difficulties it will have to overcome in the future.

1.20 Further Readings :

1. Indian Financial System, M.Y.Khan, Vikas Publishing House.
2. Management of Indian Financial Institutions, R.M. Srivastava, Himalaya Publishing House.
3. Financial Markets and Institutions, L.M.Bhole, Tata McGraw Hill.
4. Financial Markets and Services, Gordan and Natrajan, Himalaya Publishing House.



Unit 2

MUTUAL FUNDS

: UNIT STRUCTURE :

2.0 Learning Objectives
2.1 Introduction
2.2 Meaning of Mutual Fund
2.3 Origin and Growth of Mutual Fund
2.4 Structure of Mutual Fund
2.5 Guidelines of Mutual Fund by SEBI
2.6 Types of Mutual Fund
2.7 Advantages of Mutual Fund
2.8 Disadvantages of Mutual Fund
2.9 ELSS Mutual Fund
2.10 Regulations of Mutual Fund
2.11 Let Us Sum Up
2.12 Answers for Check Your Progress
2.13 Glossary
2.14 Assignment
2.15 Activities
2.16 Case Study
2.17 Further Readings

2.0 Learning Objectives :

After reading this lesson, you should be able to :

(a) Describe the definition of a mutual fund and its many subtypes.

(b) Talk about the value of and dangers involved with mutual funds.

(c) Describe the broad principles for investor protection put forth by the Indian government.

(d) Describe an Indian mutual fund scenario.

2.1 Introduction :

Simply put, a mutual fund gathers small participants' funds, invests them in government and other corporate assets, and generates income through interest and dividends in addition to capital gains. According to the axiom "little drops of water make a big ocean," it operates. For instance, if one invests Rs. 1000, it might not yield much on its own. Nevertheless, if it were combined with the Rs. 1000 that many other individuals contributed, one could establish a "great fund" that would

be sufficient to make commanding investments in a variety of shares and debentures and thereby benefit from the economies of scale. A mutual fund is just a type of collective investment as a result. It is created when a number of investors band together and transfer their extra money to a management company with the necessary expertise.

The fund uses a straightforward strategy to obtain investor surplus funds. Each fund is split up into a tiny fraction known as "units" that have equal value. According to the amount of each investor's investment, units are distributed to them. As a result, any investor, large or little, will own a portion of the fund and be able to benefit from the diverse array of investments the fund holds. Hence, mutual funds make it possible for millions of small and major investors to take part in and profit from the expansion of the capital market. It has become a well–liked method of wealth development because of its high return, low cost, and diversified risk.

A mutual fund is defined as "a fund established in the form of a trust by a sponsor, to raise funds 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" in the Securities and Exchange Board of India (Mutual Funds) Regulations, 1993.

These mutual funds are known as open end investment firms in the United States and unit trusts in the United Kingdom. Therefore, an open end investment company is "an organisation formed for the investment of funds obtained from individuals and institutional investors who in exchange for the funds receive shares which are convertible into cash at any time at the value of their underlying assets.

2.2 Meaning of Mutual Fund :

A small retail investor is playing key role in the economy of country. Retail investor would like to invest in stock exchange but hesitate for the same due to fluctuations in market. Small invest would like to take an advantage of but due to lack of stock market knowledge and inability of timely decisions of entering into the market they keep themselves away.

Mutual Fund is a solution for the same. Mutual fund is an arrangement or system under which fund from small investor is being invested in stock exchange by experts. Thus, funds of general public at large is brought into the circulation through Mutual Fund. It is a vehicle through which small investors can get benefit of fluctuations of market and earning of companies, in the form of appreciation in the Net Annual Value as well as dividend on mutual fund.

A collective insurance vehicle that pools (obtains) the money of investors and invest pooled money in specific script or investment options.

Thus, small investors can invest in stock market indirectly through Mutual Fund. Through mutual fund small investors can enjoy facility of portfolio management. Mutual Fund is managed by professionals or

experts of market. Hence, level of risk in mutual fund is relatively less as compared to individual investor.

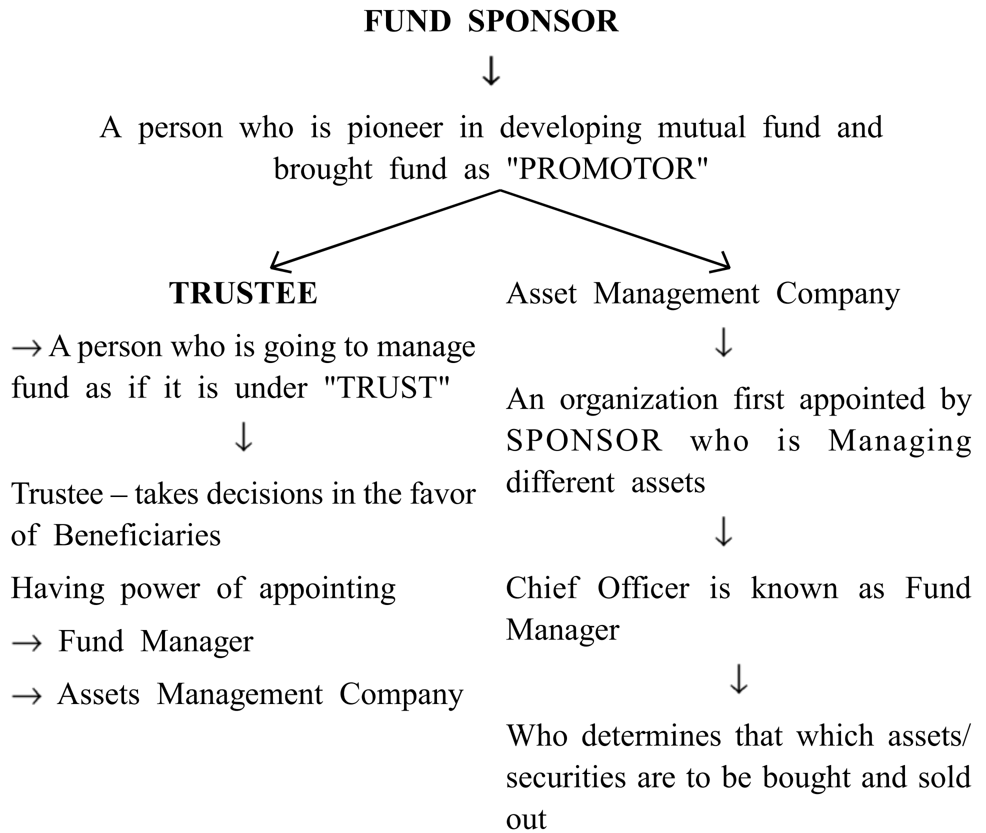
In India initially mutual funds are allowed to invest in physical assets only. Since 2006 Mutual Funds are allowed to invest in gold–by–gold exchange traded fund schemes. Later on mutual funds are permitted to invest in real estate also.

2.3 Origin and Growth of Mutual Fund :

Time line of Mutual Fund in India :

1. Bill of establishment of Unit Trust of India had been passed in 1963 and Unit Trust of India came into existence.
2. Unit Trust of India was functioned under Reserve Bank of India upto 1978.
3. After 1978 Industrial Development Bank of India comes in the existence and UTI functions under it.
4. UTI had launched its first mutual fund scheme under the name of UNIT–64. The scheme was very successful and lower and upper middle class had invested in stock market through that scheme to great extent.
5. UTI was very lucrative for investors as in UNIT–64, investors get dividend in decent proportion for a long period of time.
6. SBI has entered in Mutual Fund market through its existing banking network in 1987.
7. After SBI various State / Central Government organisations had entered the market slowly and gradually.
8. Private sector has entered in the mutual fund market in 1993. Kothari Pioneers was the first private mutual fund in the market.
9. After entry of private sector in the mutual fund foreign funds had diverted their fund in Indian market. After 1995 many Indian firm has entered into Mutual Fund market with the help of foreign fund and foreign technology also.
10. After 2003 stock market regulator has issued guidelines for mutual fund and made an attempts to make the industry more regularize and transparent one.

2.4 Structure of Mutual Fund :



- **Structure of Mutual Fund :**

→ **CUSTODIAN :** An organisation established for safe keeping of "Securities" and other assets of Mutual Fund.

→ **ASSET MANAGEMENT COMPANY :** An asset management company (AMC) is a firm that invests pooled funds from clients, putting the capital to work through different investments including stocks, bonds, real estate, master limited partnerships, and more.

→ **REGISTER AND TRANSFER AGENT :** An organisation which maintains records of unit holders for mutual fund.

Such entire work can be assigned to third party which is eligible for it as per "SEBI" guidelines.

Communication point for mutual fund holder for every type of question.

2.5 Guidelines of Mutual Fund by SEBI :

1. Every mutual fund should get a certificate of registration from SEBI by fulfilling due requirements.
2. Sponsor of mutual fund should have proper (good) track record of the past performance and with fairness and integrity. Sponsor should contribute at least 40% of the fund.
3. Mutual Fund should be started in the form of Trust and one should prepare Trust deed for the same and register with SEBI.

4. Sponsor or Trustee should appoint Assets Management Company to manage fund of mutual fund but such mutual.
5. Assets Management company should be approved by the SEBI.
6. The Capital of Assets Management company should not be less than Rs. 10/– crores.
7. Any director of any one Assets Management Company should not be director of any other Assets Management Company.
8. AMC should follow all due diligence and care in all investment decisions. One should examine conflict of interest of directors of company.
9. AMC should not purchase or sale more than 5% of total assets under management.
10. AMC should not invest in any security for more than 5% of Net Assets Value of scheme. If such investment has been made, then AMC should inform to the trust for the same indicating level of risk.
11. AMC should appoint a custodian to carryout custodial services for schemes of the fund and send information about appointment of such to SEBI.
12. Every scheme of mutual fund should be approved by Trustee of Mutual Fund. As well as its. offer documents / prospectus should be approved by the SEBI.
13. Every close ended scheme should be listed on the stock exchange and should reflect its NAV to general public at large. (If such scheme offering purchasing of fund scheme to general public at large).
14. A scheme of mutual fund may be wound up after paying any debt and dues. The scheme can be wound up only if 75% or more– unit holders are agreeing for the same. If SEBI is of the opinion that respective mutual fund scheme should be wound up, then only such wound up process may be executed.
15. Every mutual fund shall compute the NAV of each scheme by dividing the net assets of the scheme by number of units outstanding on the valuation date.
16. Total expenses of scheme excluding issue or redemption expenses whether initially borne by the mutual fund or AMC but including management and advisory fees shall be subject to following limits.
17. On the first ?100/– crore of the average weekly net assets 2.5%.
18. On the next ?300/– crore of the average weekly net assets 2.25%.
19. On the next ?300/– crore of the average weekly net assets 2.00%.
20. On the balance of the assets 1.75%.

21. AMC may charge the mutual fund investment management and advisory fees, which should have been disclosed fully in proposal with following ceiling
22. 1.25% of the weekly average net assets outstanding in current year if net assets is not more than ?1 billion.
23. 1% of the weekly average net assets outstanding in current year if net asset is more than ?1 billion.

2.6 Types of Mutual Fund :

1. Close–end–funds :

Units of this fund is offered to investor at a specific rate. The subscription to such fund is predetermined. Hence, once such subscription has been reached then fund stops accepting fund from new investors.

Under this scheme size of fund and number of units to be issued to the general public at large is predetermined. Hence, the name of fund is "close fund". Such funds are opened for certain period of Time only and price at which fund is known as New Fund offer price.

2. Open–end–funds :

As the name suggest you, it is an open fund. Investor can invest in the fund at any point of time. One can even exit at any point of time. (With some stipulations). The size of fund and number of units to be issued to general public at large is not fixed at all. Thus, investors make investment in this fund based on performance. Thus, movement of investors can be found very higher in such type of fund.

3. Income Funds :

The funds which are generating income for the investor is known as income fund. Fund which having objective of distributing their income in the form of Dividend every year is known as income fund. As the income of such fund is distributed amongst unit holders its NAV is always lower as compared to other funds.

4. **Growth Funds :**

A funds which invest its earning in the stock market on regular interval of time. Net Assets Value of such fund is significantly higher. These funds offer substantial increase in the wealth of investor. Generally, such funds are profitable for long period of time. However, fluctuations in the beneficial net annual value of such fund is highly volatile.

5. **Balanced Funds :**

A fund which invest in equity, preference, bonds and other securities of market to generate income on fund invested as well as to appreciate their NAV at lower risk. As the name suggest one fund manager invest in debt and equity fund both. These funds are more in demand since last five years.

The fund is balancing between Risk and Return and Growth and Income. Conservative investors are preferring such funds.

6. **Money Market Fund :**

Fund Manager of these funds invest in Money Market instruments. These funds are earning in the form of interest of such instruments only. These funds are highly influenced by changes in interest rates, repo rates, reverse reported and liquidity in market.

These funds are safe and secure. The liquidity elements in these funds are higher. In India money market is not fully developed. Hence investors are not much interested in such funds.

7. **Sector Mutual Fund :**

A fund which restricts its investment to particular sector of economy is called sector fund. The sector specific fund can gain income through purchase and sale of securities of such organisation / companies. This is known as focused portfolio.

Under this fund (demand of particular sector in which investment has made) growing sector or demanding sector investment can be done very easily. Growth of other industry will also affect growth of other industry.

8. **Index Fund :**

A type of mutual fund that invests in stocks that are part of particular index and the performance of such fund is a replica of particular index also. Thus, value of fund is depended upon that particular index. We have index based on particular sector also. There are funds based on Mid Cap Index and Small Capital Index securities. Under this BSE sensex fund is benchmark fund as index is considered to be Bench Mark one.

9. **Funds of Fund :**

A mutual fund which invests in other mutual funds. Such funds are designed to diversify fund more and more as compared to conventional funds. Fund Manager of funds of fund makes an investment in other

mutual funds. But such investment is subject to certain limit only. NAV of funds of fund is less volatile as compared to other funds.

10. Debt Funds :

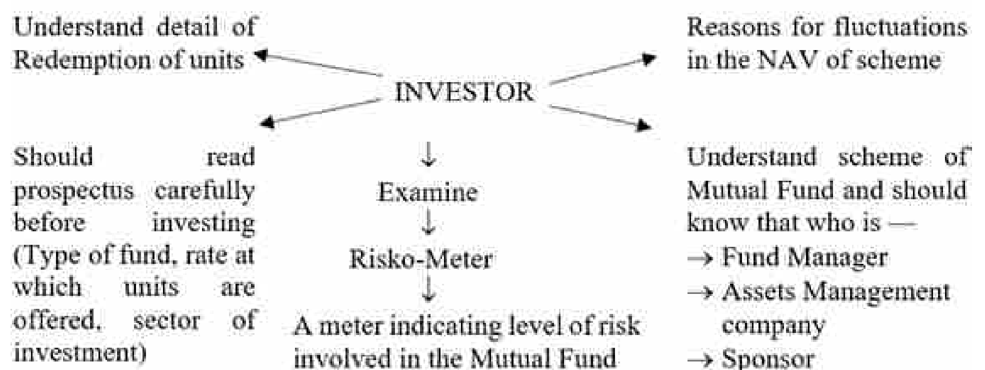
This is a funds which invest fund in the different "debt securities" or "debt market". Generally speaking mutual funds are making investment in debentures, (Secured or unsecured) Bonds (government or issued by private companies) or any other debt market. Return under this fund remain low but level of risk is also lower.

11. Offshore Funds :

These funds are considered to be most diversified one as these funds provides an opportunity to make an investment outside the country. These funds make an investment in foreign / international market. If fund manager is able to understand global financial risk and portfolio then one can get good return from such fund. Foreign market's fluctuations are required to be considered while investing in this way.

Over and above such fund can make investment in varieties of securities in the international market. This is an added advantage as compared to other funds.

PRE–CAUTIONS IN INVESTING MUTUAL FUND :



2.7 Advantages of Mutual Fund :

The mutual fund sector has recently experienced extraordinary growth. Given the mutual fund industry's significance to investors generally and the national economy in general, a revolution may be taking place in this sector. One of the key benefits of mutual funds is as follows:

(I) Using saved money for investments :

Mutual funds serve as a catalyst for the public's savings by providing a range of programmes suited to different consumer demographics and the growth of the economy as a whole. Savings are put towards capital because MFs offer a variety of programmes to satisfy the diverse needs of the populace. Direct investment. These savings would have remained dormant without MFs. As a result, the economy as a whole benefit from the effective and optimal allocation of limited financial and real resources for the economy's rapid expansion.

(II) Providing a diverse portfolio of investments :

With relatively little investments, small and medium investors used to burn their fingers during stock exchange activities. Some of their shares might even disappear completely if they invest in only a few, never to rise again. These investors can now benefit from the mutual fund's diverse investment holdings.

By investing in a wide variety of shares and bonds that small and medium investors cannot purchase, the fund diversifies its risks. In keeping with the adage "Don't put all your eggs in one basket," this is. These funds have substantial resources at their disposal, which gives them influence over stock exchange transactions. They are in a position to have a risk–free, well–balanced portfolio. Thus, MFs offer immediate portfolio diversification. Savings from a single investor cannot provide the risk diversification that a mutual fund pool of investors' resources provides.

(III) Providing better Yields :

The fund can access a sizable amount of money thanks to the pooling of cash from numerous users. Mutual funds are able to buy cheaper and sell dearer than small and medium investors because of these big sums. They can therefore demand higher market rates and reduced brokerage fees. As a result, they offer their clients higher yields. Also, they benefit from scale economies and can lower the cost of capital market participation. Large investments have unquestionably lower transaction costs than small investments. Actually, all of a mutual fund's gains are distributed to the investors in the form of dividends and capital growth.

Only the costs associated with a specific plan are billed to that scheme. The majority of the mutual funds that have been put on the market so far have distributed dividends at rates between 12% and 17% annually. It has a decent yield. For individuals who are interested in long–term capital growth, it is the perfect investment option.

(IV) Providing Investing Services with Expertise at a Discount :

Typically, experts with proper training and investment expertise are given the responsibility of managing the fund. These experts always base their financial choices on sound judgement and expertise. Investors may be guaranteed that the services they receive are of the highest calibre. A single investor cannot perform all these tasks by himself or resort to a professional manager who manages individual portfolios due to the complexity of the securities market. He might levie a large management fee in this situation. In the case of a mutual fund, the intermediation cost is the lowest at 1%.

(V) Providing research services :

A mutual fund has access to enormous resources, making it possible for it to do a thorough analysis and research on business securities. Each

fund keeps a sizable research staff that continuously studies the businesses and industries and advises the fund whether to buy or sell a particular share. As a result, investments are only made after conducting extensive study. An individual investor cannot undertake research because it requires a significant amount of time, energy, and money. The investor benefits from the fund's research by making a mutual fund investment.

(VI) Providing Tax Advantages :

Certain funds provide their clients with tax advantages. So, in addition to receiving dividends, interest, and capital gains, investors may also profit from tax breaks. For instance, a payment of Rs. 10,000 paid as a dividend (Rs. 13,000 to UTI) from an MF is deductible from the gross total income under section 80L of the Income Tax Act. Investments in mutual funds are exempt up to Rs. 5 lakhs under the wealth tax act.

Taxes on any investment–related income do not apply to mutual funds themselves. Yet, all other businesses are required to pay taxes, and they can only declare dividends from their post–tax income. But, mutual funds do not deduct dividend tax at source. It's a good idea to have a backup plan just in case.

(VII) Introducing Flexible Investment Schedule :

Investors greatly benefit from the flexibility provided by some mutual funds that allow unit exchanges from one scheme to another. Depending on the performance of the funds, income units may be exchanged for growth units. Such flexibility cannot be found in any other investments.

(VIII) Increasing Accessibility and Liquidity :

Mutual funds are accessible to investors of all sizes. They give an attractive and cost effective alternative to direct acquisition of shares. Little investors cannot imagine participating in multiple ventures with such a tiny sum in the absence of MFs. More liquidity is present once more. Quick access to liquid cash is ensured by the ability to sell units to the fund at any moment for the Net Asset Value. Also, the sponsoring bank's branches are constantly prepared to offer lending facilities secured by unit certificates.

BENEFITS OF MUTUAL FUND :

2.8 Disadvantages of Mutual Fund :

1. Dependency of Fund Manager. Investment decision of any fund is made by Fund Manager. Such decision is crucial and important for generating return and reducing risk. Once the Fund Manager has been changed assurance of consistent return get doubtful.
2. Overall performance of fund is based on stock exchanges fluctuations. In high volatile market mutual fund owners cannot get return equal to fixed deposit even sometimes.
3. Mutual Fund charges account for like management fees, brokerages, commission etc. and many more. Thus, effective Net Assets Value is lower after such charges, which leads to loss to the unit holders.
4. Close ended funds are not advisable for small investors of the society in case of volatile market.

2.9 ELSS Mutual Fund :

Those funds which are investing in equity of specific industry / securities of specified companies. The objective of creating this fund is to provide an opportunity to the middle–class service income person to invest in stock market and obtain tax benefit for the same. The full form of scheme is Equity Linked Savings Scheme. There is a lock in period of 3 years. (One cannot sale out such mutual fund for 3 years from date of investment for obtaining benefit of savings).

2.10 Regulations of Mutual Fund :

(I) Investment Limitations :

- Mutual funds can invest only in transferable securities either in money market or security market including privately placed securities.
- Mutual fund can invest in privately placed such debt instrument to the extent of 40% in case of income debt and 10% in case of Growth Fund.
- No individual scheme of a mutual fund should invest more than 5% of the corpus in any one company's share.
- No mutual fund under all its scheme should own more than 5% of any company's paid up capital carrying voting rights (and not more than 10% of any company's debt and equity shares together).

(II) Accounting Requirements :

- Should segregate their earnings as current income, short–term capital gains and long term capital gains for each scheme of mutual fund AMC manager.
- For all quoted investments mutual fund must calculate the weekly NAV at the last available closing market price.
- Every unit holder should have received financial statement of respective scheme either electronic form or physical form.
- One should mention all the expenses of fund and allowable / ceiling of expenses in percentage by SEBI.

(III) Assets Management Company :

- AMC shall be authorized by SEBI.
- Directors of AMC should be with 10 years' experience in the profession.
- At least 50% of directors should be independent director.
- AMC can be changed by Trustees or by request of 75% or more– unit holders of respective scheme.
- Minimum net worth of AMC at any point of time should be ?50 million.

Check Your Progress :

1. In which year did the mutual fund industry started in India ?

   a. 1965 b. 1960 c. 1963 d. 1962

2. Who is a pioneer in developing mutual fund scheme ?

   a. Promoter b. Sponsor c. Trustee d. None

3. AMC shall not purchase or sell more than _________ of total assets under management ?

   a. 5% b. 3% c. 1% d. 2.5%

4. Under which kind of fund, investors can invest at any point of time ?

   a. Close–end–fund b. Open–end–fund

   c. Off shore fund d. None of these

5. Which of the following fund is designed with an objective to diversify fund as compared to conventional funds ?

   a. Sector Funds b. Index Funds

   c. Fund of funds d. Open–end–fund

6. Mutual Fund should be started in the form of ?

   a. Trust b. Company c. LLP d. Proprietorship

7. Which of the following is not the disadvantage of mutual fund ?

   a. Dependency on fund manager b. Processing charges

   c. Volatile return d. High disclosure

8. What is the lock in period of ELSS Mutual Fund ?

   a. 3 years   b. 2 years   c. 1–year   d. 5 years

9. A mutual fund under its all schemes cannot own more than _________ of company's paid up capital ?

   a. 3%   b. 5%   c. 1%   d. 2%

10. What are the minimum net worth requirements of AMC at any point of time ?

   a. ₹ 50 million   b. ₹ 30 million

   c. ₹ 10 million   d. ₹ 5 million

2.11 Let Us Sum Up :

Mutual Funds are trusts that combine the savings of numerous small investors in order to invest in different financial instruments, including capital market and money market investments, with the goal of generating a respectable return. Mutual funds have the benefit of being a convenient way to save and a great place to invest small sums of money. Mutual funds offer expert management in addition to a variety of investment options. Also, mutual funds provide a wide choice of products to meet the needs of different types of investors. Open and closed ended plans, income and growth funds, equities and bond funds, gilt funds, index funds, and other types are significant among them. The NAV of a mutual fund can be used to assess its operational effectiveness.

2.12 Answers for Check Your Progress :

1. c	**2.** a	**3.** a	**4.** b	**5.** c
6. a	**7.** d	**8.** a	**9.** b	**10.** a

2.13 Glossary :

1. **Mutual Fund :** A mutual fund is a trust that combines the savings of investors who have similar financial objectives.

2. **Open–Ended Scheme :** An open–ended scheme is one in which a mutual fund management continuously accepts and liquidates funds.

3. **Net Asset Value :** The Net Asset Value of a certain scheme is the intrinsic value of each unit under that plan.

4. **Growth Fund :** A mutual fund with a focus on long–term capital growth.

5. **Index Fund :** An index fund is a type of mutual fund that aims to replicate the performance of the overall stock market by matching its holdings to a wide index.

2.14 Assignment :

1. Difference between Close–end and Open–end mutual funds
2. Benefits and Disadvantages of investing in mutual funds

3. Precautions while investing in mutual funds
4. ELSS Mutual Funds
5. Structure of Mutual fund
6. Define Mutual Fund. Explain the origin and development of mutual fund industry in India.

2.15 Activities :

1. Discuss in detail about origin and development of mutual fund industry in India.

2.16 Case Study :

1. Diagrammatically, enlist the various kinds of mutual funds and explain them in detail.

2.17 Further Readings :

1. Bhatia, B.S., and Batra, G.S., Financial Services, Deep & Deep Publishers, New Delhi.
2. Bansal, L.K., Merchant Banking and Financial Services, Unistar Books Pvt. Ltd., Chandigarh.
3. Bhole, L.M., Financial Institutions and Markets, Tata McGraw Hill, New Delhi.
4. Chandra, P., Financial Management, Tata McGraw Hill, New Delhi.
5. Khan, M.Y., Financial Services, Tata McGraw Hill, New Delhi.
6. Kothari, C.R., Investment Banking and Customer Service, Arihand Publishers, Jaipur.

Unit 3

INSURANCE SERVICES

: UNIT STRUCTURE :

3.0 Learning Objectives

3.1 Introduction of Insurance

3.2 Concept of Insurance

3.3 Principles of Insurance

- (a) Utmost Good Faith
- (b) Insurable Interest
- (c) Compensation
- (d) Subrogation
- (e) Contribution
- (f) Loss Mitigation
- (g) Cause Proxima

3.4 Classification of Insurance

- (I) Life Insurance
  - (a) Whole Life Plan
  - (b) Endowment Plan
  - (c) Joint Life Policy
  - (d) Term Plan
  - (e) Annuity
  - (f) Pension Plan
  - (g) Child Plan
  - (h) Female Marriage Plan
- (II) Non–Life Insurance (General Insurance)
  - (a) Health Insurance
  - (b) Motor Insurance
  - (c) Marine Insurance
  - (d) Insurance of Stock
  - (e) Loss of Profit
  - (f) Protection During Foreign Tour

3.5 Insurance Regulatory Framework

- (a) Insurance Act
  - (i) Insured
  - (ii) TPA

(iii) Agent/Broker

(iv) Insurance Companies

(b) IRDA Guidelines

3.6 Different Types of Life Insurance

3.7 Operations of General Insurance

(Explanation with "fire" insurance)

3.8 Health Insurance

– Meaning

– Importance

– Process

– Claim

– TPA

3.9 Difference between Life Insurance and General Insurance

3.10 Importance of General Insurance to Different Sectors of Economy

3.11 History of Insurance at Nutshell

3.12 Insurance Sector Analysis (IBEF)

3.13 Let Us Sum Up

3.14 Answers for Check Your Progress

3.15 Glossary

3.16 Assignment

3.17 Activities

3.18 Case Study

3.19 Further Readings

3.0 Learning Objectives :

You ought to be able to: after reading this lesson.

(a) Describe the meaning of insurance and its components.

(b) Go over how insurance is categorised.

(c) Outline the fundamentals of insurance.

3.1 Introduction of Insurance :

Life in full of unexpected events and mishaps. In current scenario life becomes complex and clumsy also. Human being is passing through an era of "risk" in 21st century. To protect oneself from such unexpected risk – an insurance is only available option. Protection from every unexpected events (Natural / Manmade) and mishaps (executed by others and affecting to us).

Technically spiralising insurance is a proximate contract in which one party protect other party in case of loss. Insurance can be treated

as contract of indemnity also. Insurance is the only solution to provide protection against 'Loss" due to specific reasons / situation / event.

The level of awareness of insurance or sense of security of life and livelihood arrangement has been increased phenomenally in last 10 years.

Government's initiatives of covering each and every Indian in insurance has covered 34–35% of population in the protection net of insurance at bare minimum cost of premium. Government's initiative of pension plan with insurance can provide post–retirement benefits to organised sector employees / workers as well as unorganised sector employees / workers.

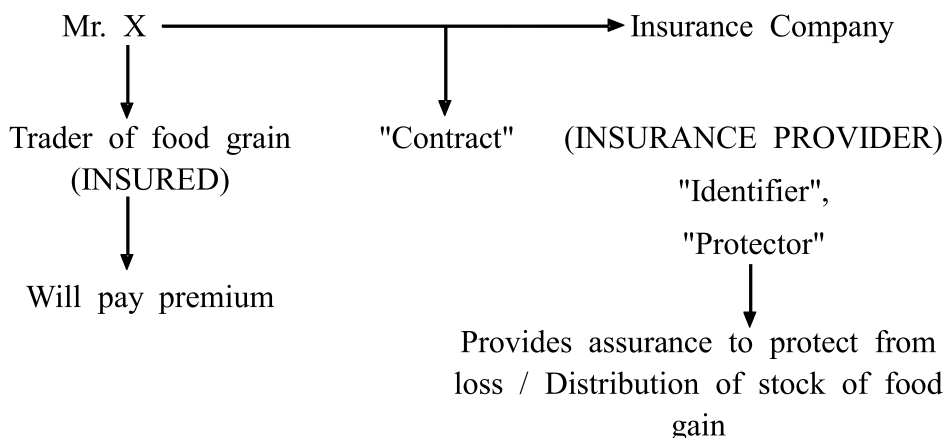
Insurance sector in India is in the growing stage. After liberalization Indian insurance companies need to get their counter part from foreign (because of technical support and distribution of risk). However, sector is growing at 15–20%.

Earlier it was believed that insurance is a need of regular income persons only our need of upper class only. However, need recognition about insurance amongst young one's has been started from just after getting employment. Life insurance was started in India in 1818 to provide insurance for English. Widows when Oriental Insurance Company was incorporated at Kolkata, first comprehensive legislative came in force in 1938.

3.2 Concept of Insurance :

A contract

- Where in one party (insurer)
- Agrees to pay to the other party (insured)
- or his beneficiary
- a certain sum of money
- upon a given contingency / risk event



What have been exchanged

→ Premium

← Protection from "Risk" (if any)

3.3 Principles of Insurance :

Insurance is a contract. But such contract have specific features or charters or principles. Each and every principles should be present in the contract of every insurance (Either life or Non–life). Absence of anyone of the principle of insurance can be considered to be breach of contract and makes insurance company from any liability. In the actual contract of insurance such principles are not mentioned or clarified directly but indirectly as part of usual terms and conditions.

It is advisable for every insured person to have proper understanding of each principles of insurance. Otherwise one may be away from protection even after payment of premium.

Contract of Insurance is a contract of indemnity. Every contract of indemnity needs to be written form only.

(a) Utmost Good Faith :

A contract of insurance is founded on the principle of utmost good faith. Hence both parties should provide / disclose all material facts. That means insured person should provide all the important facts to the insurance company. If insured person hide any information and later on insurance company come to know about such fact then it is called breach of utmost good faith.

Non disclose of fact by insured person leads to utmost good faith.

(b) Insurable Interest :

The insurance taker or insured person should have insurable interest on the object on which the insurance policy has taken. Insurable interest means insurable interest should be present at the time of taking policy as well as at the time of maturity of policy / loss insurable interest means pecuniary or financial interest possessed by beneficiary.

The loss or damage caused to such an object would cause financial loss to the insured party. e.g. Mr. A is a trader of Readymade garments. He has sold out 200 track pants to Mr. B. But B has not taken delivery of such and entire ordered stock is laying at Godown of Mr. A. Mr. A cannot take insurance of such 200 track pants. As ownership of such track pant has been transferred from Mr. A, we can say that insurable interest of Mr. A is no more in such 200 track pants.

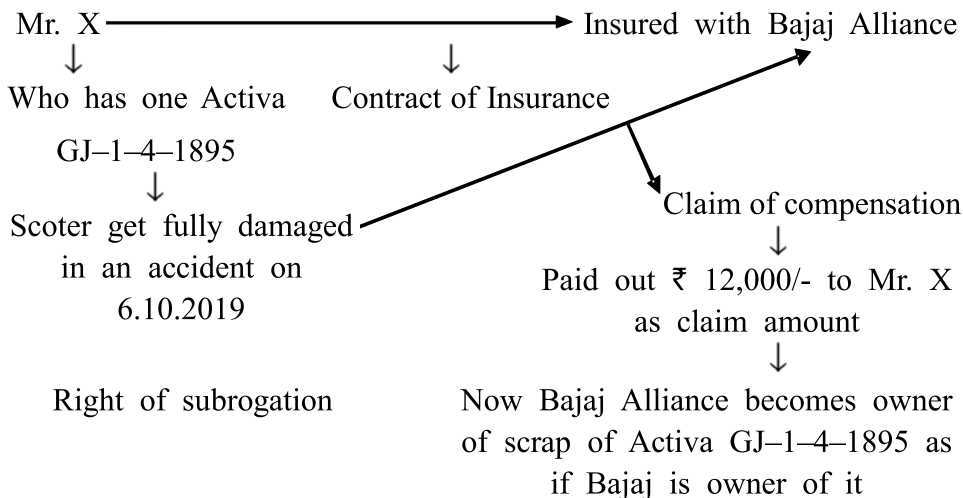
(c) Compensation :

Under the principle of insurance insured person should receive compensation from insurance company in case of loss suffered by insured person. The compensation means an amount paid out to recover loss. This principle is applicable to the general insurance sector only. In case of life insurance compensation for death of insured is invaluable. As per this principle one need to find out amount of loss suffered by the insured in terms of money and such amount need to be compensated.

The amount of compensation depends upon sum insured or policy amount or not value of object insured.

(d) Subrogation :

Once insurance company accept the claim then insurance company stepping into shoes of insured person. After that insurance company can enjoy all rights of insured person. Lets understand the rule with following chart.



Right of subrogation

Now Bajaj Alliance becomes owner of scrap of Activa GJ–1–4–1895 as if Bajaj is owner of it

Under this right / doctrine the property in the object will pass on to the insurance company after payment of insurance claim.

(e) Contribution :

According to this principle amount of compensation from insurance company is depending upon the amount of contribution given by insured person. Such contribution is also known as "Premium" of insurance contract.

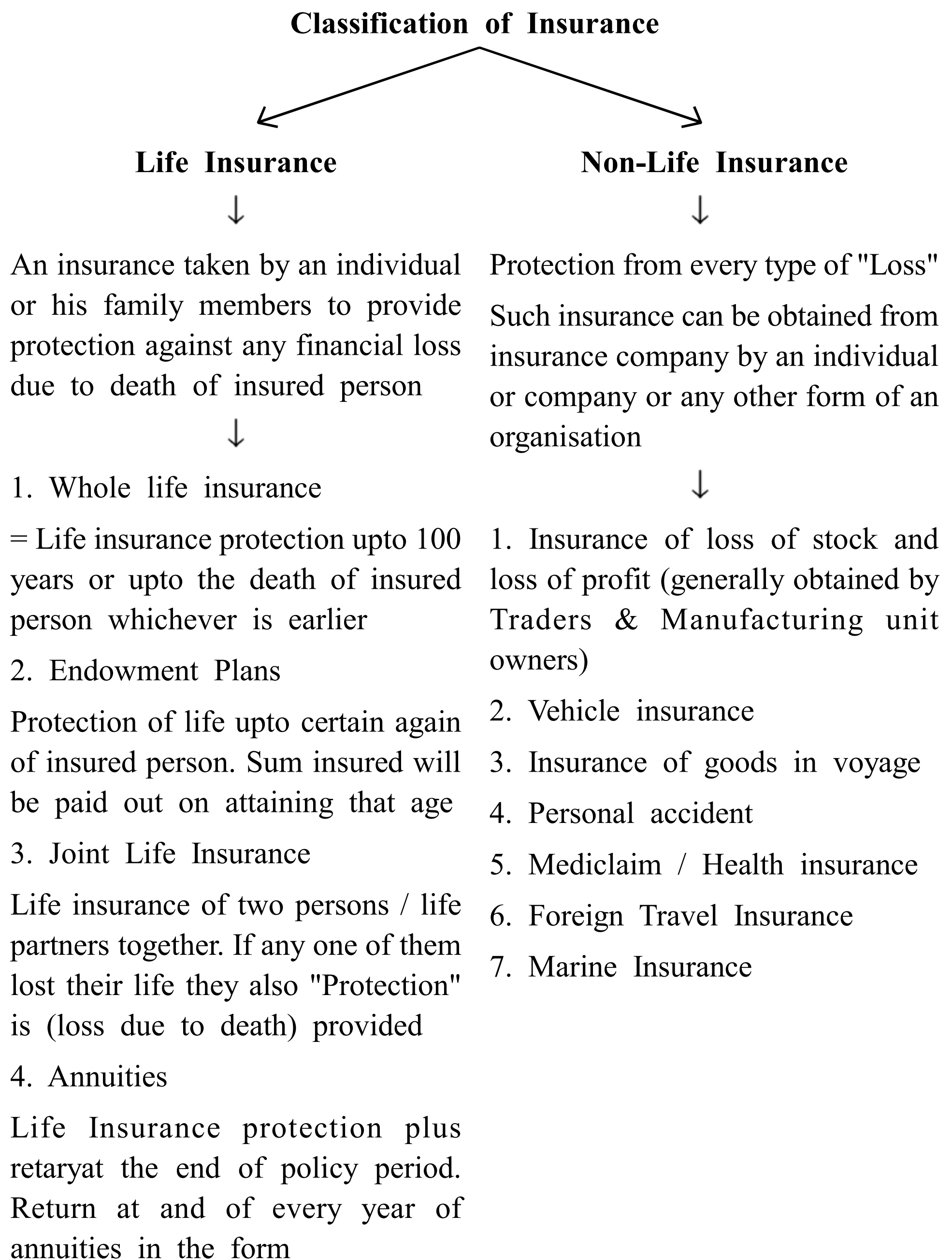
(f) Loss mitigation :

The insured person should act as prudent person. In case of contingency / mishap or any other event an insured person should make an attempt of preventing loss. One should mitigate such loss / risk. For example, a trader who has taken a loss of stock policy should make all reasonable efforts to protect such stock from risk. If owner of stock/ goods does not take such step they it will be reach of contract of insurance.

(g) Cause Proxima :

As per this principal insurance company is responsible for compensating loss of insured person from predetermined situation. If insured person does face any loss, then insurance company is not liable to pay anything. Liability of insurance company is highly depended upon loss to insured and reasons for loss.

3.4 Classification of Insurance :



3.5 Insurance Regulatory Framework :

Insurance sector was in the hand of government of India. After liberalisation also foreign players were hesitating to enter into Indian market. Approach of other industries toward insurance was very pathetic and insurance was considered to be "Burden" as compared to "Protection Provider". In India main legislative acts that deal with insurance in India are :

1. Insurance Act 1938
2. Insurance Regulatory and Development Authority Act, 1999.

Post liberalisation effect had increased flow of fund in Indian economy from foreign and also from citizen of country. This flow of money had created new business enterprises and large plants and

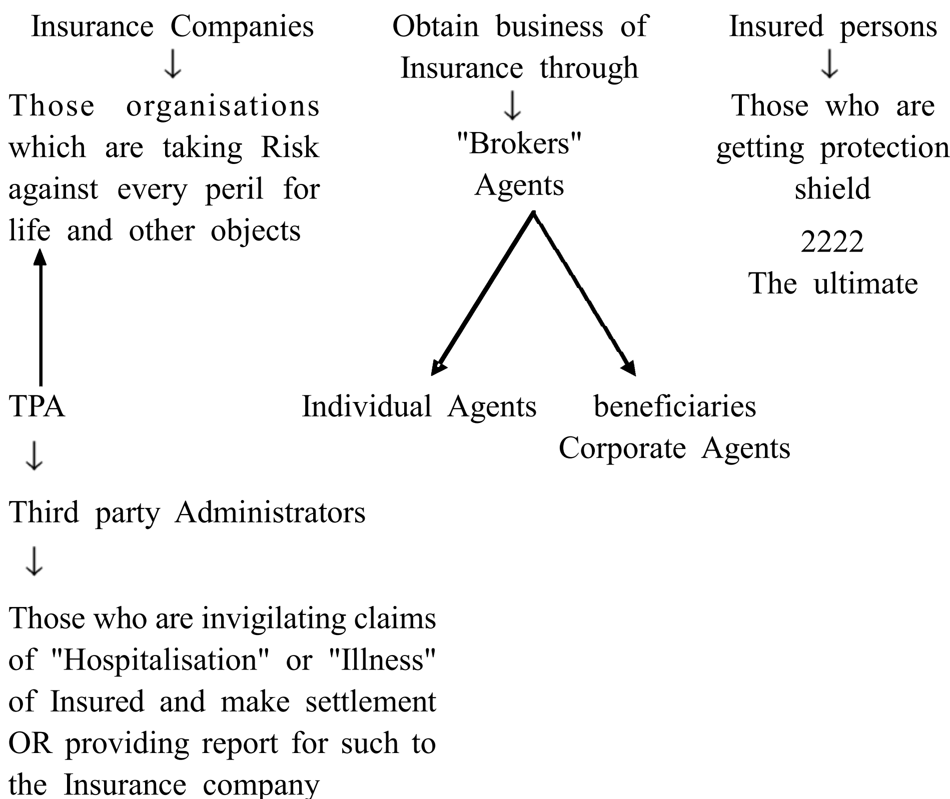
machineries. These all actions required "Protection" from possible / probable loss from natural as well as man–made casualties.

India's insurance sector ways under full control of central government at that time. Slowly and gradually market share of another new entrant has been raised. Thus, government feel a need of a regulator of the sector. They a regulating authority has been created to regulate every market player in the country. The industry was passing through nascent stage and new entrants we interested in innovative products, development product for specific industry, development of unique distribution system etc. These all initiative leads to high level of competition. The opening of sector for private had flooded with new players in life insurance as well as in non–life insurance.

To regulate market effectively regulator IRDA has obtained powers through act. Thus, IRDA has issued guidelines for every participant of the sector via.

1. Unit Linked Insurance Products
2. Third Party Administrator (Health Service)
3. Policy Holders
4. Insurance Brokers

Major Insurance Market Player Regulated by IRDA



b. Irda Regulartions for Potection of Policy Holders :

1. Prospectus of every insurance should be precise and should provide information about benefits of policy, insurance cover, warranties, exclusions. In case of life insurance, one should mention policy with profit participation or not.

2. Insurer or Agent of Insurance company should provide all material information to the insured person.
3. If insured person has not filled up all the documents of proposal as well as other documents in support of proposal then prospect consumer should sign out certificate. It must indicate that full explanation about insurance policy has been received.
4. Wherever it is being necessary one should draw an attention towards nomination of policy.
5. Proposal should be processed by insurance companies in given period of time. (Specific time has been determined by IRDA at regular interval of time).
6. Following matter should be included in the life insurance policy.
   a. Name and Plan governing entire policy.
   b. Bonus will be available or not and if bonus is given / entitled they method of its calculation.
   a. Details of Rider if any.
   c. Premium payable, frequency of payment, grace period the date of last instalment of insurance.
   d. Contingencies executed from insurance to be specified clearly.
   e. Any special clauses or conditions such as pregnancy clause, suicide clause
   f. Date of commence of risk and date of maturity.

IRDA Third Party Administrator – Health Services Regulations :

1. Only Registered company with capital can becomes third party administrator.
2. The objective of the organisation / company shall be to carry on business in India as Third–Party Administration.
3. Minimum paid up capital of TPA company should be ?1 crore.
4. One of the directors of company should be doctor and should be registered with medical council of India.
5. TPA should obtain a licence from IRDA for working as TPA.
6. TPA should file a contract with insurance company with a Regulatory Authority in period of 15 days from date of execution.
7. Insurance company can appoint more than one TPA for managing claim similarly only one TPA can work for more than one insurance company.
8. Every TPA should settle down claim of the insured in given stipulated time only.
9. Third party administrator should inform insured about passing / rejection of claim. TPA should also inform insured person about reasons for rejections of claim.

10. License of TPA should be renewed every 3 years with IRDA.
11. It is duty of insurance company to inform insured about procedure of claim and address (contact details) of applicable TPA.

3.6 Different Types of Life Insurance :

(1) Endowment Policy :

An endowment policy is a life policy designed to pay a lump sum after a specific term on its 'maturity' or on death. Typically, maturities are ten, fifteen or twenty years up to a certain age limit. Some policies also pay out in the case of critical illness.

(2) Whole Life Policy :

Whole life insurance, or whole of life assurance, sometimes called "straight life" or "ordinary life," is a life insurance policy which is guaranteed to remain in force for the insured's entire lifetime, provided required premiums are paid, or to the maturity date.

(3) Joint Life Policy :

A life insurance policy taken for life of two or more persons of the family jointly. Under this policy if any one of the insured died then remaining / survived insured person can get claim of insurance.

(4) Children's Education :

Many insurance companies are offering children's educational plan under life insurance policy. Here life of insured or bread winner have been insured but beneficiary of policy is child and to protect educational expenses. This facility is very useful to the children of middle class who have lost their parents in an accident / sudden death.

(5) Girl Child Policy :

In India marriage of a girl is considered to be a very expensive occasion. Hence, parents of girl child start saving since her birth. Hence many life insurance companies are offering a life insurance cum marriage expenses baring insurance. One should make an estimation of marriage expenses and then should determine policy amount.

(6) Pension Plan :

A plan under which after retirement age or after specific age of insured person certain sum of money is to be paid out as premium. After certain period of time, one should stop the premium but risk cover continues. After certain age automatic pension starts. At that time an option may be available to the insured to get lumpsum amount of sum insured on the date of maturity and remaining amount in the form of pension / to be paid out on monthly basis.

(7) Annuity Policy :

As the name suggest insured person get return in the form of annuity. Every year certain fixed amount will be available to thee survival of the policy. If insured died before maturity date then one can get sum insured plus bonus to the legal heir. This policy is very useful for retirement planning and particularly for those whose income is irregular and fluctuating. This policy is generally offered with Bonus.

(8) Term Plans :

This is an insurance policy without Bonus. Under this policy great amount of insurance is available at very low rate. This policy is available on–line also. Under this policy insured need to pay premium only once and insurance will be available for entire year. Meanwhile IRDA has allowed to take 3 years term plan. On the death of insured person insurance company provides sum insured only. Generally, term plan can be treated as additional cover at low expenses / cost.

Higher income individuals are preferring such plans a life insurance premium for such is significantly higher. One of the important disadvantages of term plan is no bonus or no repayment. Once the insured has paid out premium and by grace of god survived they on competition of term he can get any amount.

Losing Bread winner :

One of the unavoidable risk in the life of every one is losing breadwinner of the family. Life Insurance companies provide protection against such risk / peril / mishap. Generally, after losing breadwinner one's daily expenses and other family responsibilities will be there as it. To meet such amount of sum insured (either with bonus or without bonus) is generally paid out. One cannot bring dead bread winner back but life insurance can assure same life style of family after proper life insurance.

Different Life Cycle stages required different types of expenses :

At different ages of life, one need to meet different types of expenses. Just after marriage on need to arrange for the house and at the time of retirement one need steady and handsome income. For all these need and post–retirement need (to do expenses to grandchildren) life insurance help a lot.

Situation Post Pandemic :

- After COVID–19 period all of sudden importance of health insurance has been sport–up and general public at large is seeking health insurance packing offering COVID–19 hospitalization expenses.
- Even after COVID–19 protection offered by insurance companies through special coverage, now COVID–19 cover is essential in all renewals and new policy also.
- COVID–19 has created job loss for various sectors and employees. Due to that reason Personal Accident – protection against loss of income has created great demand and claim both. This lead to manage life expenses to certain extent.

Protection to Industrial Risk :

Industrial perils like

- Loss of stock due to fire/rain/other reason
- Loss of building due to heavy rain
- Loss due to lockdown/strikes.
- Loss of plants or other assets
- Loss of foreign exchange in case of foreign trade.

Need of Insurance :

(1) Different Needs different Policies

In case of life insurance, insurance companies are designing their policies for various needs of the family as well as of an individual member also.

Generally following needs are taken care of by insurance company through various policies.

- Education expenses at the time of graduation expenses (children plan)
- Marriage expenses of the daughter (Sukanya Policy)
- Foreign travelling expenses after the age of 55 (fixed term plan).
- Post–retirement settlement at another city. (Fixed Term Insurance)
- Pension after retirement life (pension plan)
- Purchase of any appliance / assets at regular interval of time (Money Back Policy)
- Contingency requirement of fund (Loan facility against policy taken)
- Compensating loss of life partner (Jeevan Sathi Policy)

(2) Insurance is a backbone in case of emergency :

- Life insurance is one of the most important ways of safe guarding financial interest of family. Life insurance is a weapon which can be useful for every type of emergency in life ranging from death of family member to requirement of cash to mitigate health expenses.
- In case of emergency every insurance policy holder can get loan up to certain percentage of surrender value of the insurance policy. At the time of obtaining loan policy remain intake and protection from risk.
- Interest on such loan is absolutely reasonable and lower to personal loan interest rate of any bank.
- Over and above obtaining loan from LIC at surrender value is very easy and absolutely less time consuming. As LIC has very wide branch network across the country even a rural consumer can enjoy such family.

3.7 Operations of General Insurance :

General or non life insurance is very important. It provides protections to an individual as well as to industries. Over and above in case of general insurance there are many insurances to offer (depending upon need of insured person). General insurance sector provides protection to every manufacturing concern, vehicle owners, to every individuals from health care expenses. Operational aspects in all such different insurance contracts are absolutely different and complex too. As compared to life insurance but these non life insurance are following complex and lengthy process in getting insures as well to get claim even.

Central Government had found a fraud in had found a fraud in insurance claim of several medical policies of private companies and public companies. This fraud had changed the industry norms to certain extent. To reduce such fraud and keep a third eye in the operations of insurance, third party administrator authority has been created. Thus almost all claims are passed through vigilance of third party administrator.

Following is a graphical presentation of operational aspects of General Insurance. (This process is adopted by and large in every general insurance).

Step–1	Step–2	Step–3
Offer / Request of an Insurance from proposed insured person	After evaluation of the request insurance company issued insurance cover note / acceptance of premium	Effect of Step-2 insurance protection cover starts

Step–4	Step–5	Step–6
In case of claim .... with respective evidence of loss based by insured person .... one should file a claim with TPA / (Third Party Administrator) Insurance company	After Evaluation at TPA / Insurance company claim will be passed / rejected and amount will be credited to the account of insured person	At the time of Renewal Adjustment of "No claim Bonus" if claim is not made

3.8 Health Insurance :

(a) Meaning of Health Insurance :

An insurance contract in which insurance company provides a protection against financial loss to the insured person due to sickness, hospitalization or accident injury. The amount of protection is highly depend upon sum insured or policy amount. In current situation health expenses are keep on increasing and for ordinary person. It is not possible to get medical treatment. In such situation health insurance is the only option available for protection against healthcare cost.

In last decade awareness and importance of health insurance has been increased predominantly. Over above health insurance providers are / have been increased to great extent. Protection from conventional deceases as well as cancer has been sought through Health Protection Policy. Family health protection and extra are / protection to senior citizen is in demand since corporatization of the entire health care has been taken place in India need of "Cashless" insurance facility has been felt by insurance providers.

(b) Protection under Health Insurance Cover :

Generally speaking, under health insurance plan protection from following expenses is provided.

1. Room, Boarding charges
2. Nursing Expenses
3. Fees of surgeon, Anesthetist, Physician, Specialist
4. Anesthesia, Oxygen, operation theatre charges, surgical appliances, machines, x–rays, dialysis, artificial parts.
5. Attendant charges
6. Ambulance charges
7. Post Hospitalisation Medicine Cost
8. Post Hospitalisation Physiotherapist treatment
9. Post Hospitalisation Reports
10. Other aspects / cost (post hospitalization)

(c) Risk Covered :

One of the most important aspect in the health insurance is coverage of risk, or protection from specific types of deceases. In the policy of health insurance itself one mention specifies deceases for which protection is not going to be available. Such clarification is also known as exclusion from policy. Conventionally following treatments are not covered in the health insurance policy.

1. Pre–existing diseases. (Those diseases which were there before taking policy)
2. Under first year of policy any claim during first 30 days.
3. Cost of specs, contact lenses, hearing aids.
4. Dental treatment / surgery under requires hospitalization.

There are several deceases which require long treatment as well chances of re–occurrence of deceases are very high after first detection. Insurance company may provide protection from such deceases but with some extra premium.

Extra precautions are necessary in the current situation. Hence, insurance companies are providing different types of additional protection earners of family as well as to the family members of insured. Such extra benefits / options are known as "Ridas". Along with main protection such riders provide additional protection also. Different insurance companies are providing different riders at different rates.

Hence, at the time of taking insurance agent of insurance company as well as insured family members should know all riders. Selection of appropriate rider is also important as well as crucial. With the help of agent one must understand technical aspects of "riders".

Some insurance companies also know this facility as "Add ons" Insurance companies are also offering special policies like "Hospital Cash", "Critical illness in benefits, "Surgical Expenses Benefits" etc. These policies can either be taken separately or in addition to hospitalization policy one.

Cost of health check–ups also included in the health insurance policy. Some insurance companies are also providing health check–up plan in association with specific hospitals in their routine OPD.

Minimum Period of Stay in Hospital :

24 hours stay is necessary for becoming eligible to make a claim under the policy of health care. This time limit is not applicable for injury or accident treatment.

Pre and Post Hospitalisation Expenses :

Expenses incurred (in the form of medical check–up, pharmaceutical / drugs need etc.) before and after hospitalization from the date of discharge can be considered as part of claim. One need to be extra careful for such provisions.

- Treatment relating to pregnancy or child birth including caesarean section.
- Naturopathy Treatment.

(Above are general exclusions. Different insurance companies are providing different risk cover package and different exclusions also).

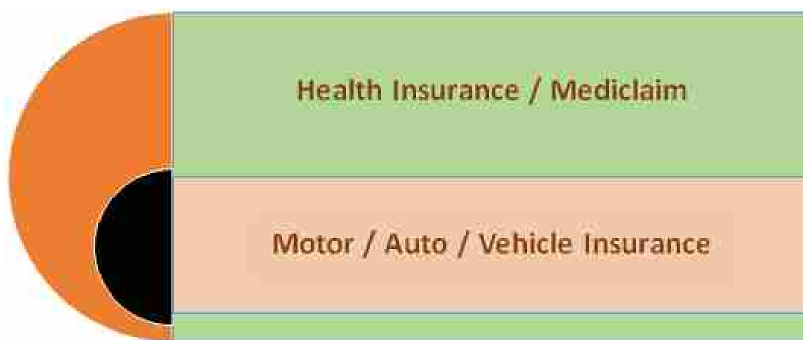
Cashless Facility :

Many insurance companies are providing cashless facilities to the insured as well as his/her family members for claim settlement in Mediclaim. Cashless facility means and include an arrangement under which insured person get all medical treatment from recognised medical centre without paying any cash. Insurance company/ third party administrator will later on pay to medical treatment providing centre after due examination. Du to this facility insured can have following advantages.

(1) No need of liquidity at all at the time of hospitalization.

(2) Saving of time and efforts from filling claim with TPA/Insurance company.

Different Types of Non–Life Insurance :



(1) Health Insurance / Mediclaim :

A policy which provides protection against hospitalization expenses of insured against pre–determined deceases / illness. In last several years medical treatment becomes costly and, in some cases, out of reach of middle–class family. Hence the policy of health insurance proven to be most protective in nature. Specially after COVID–19 pandemic the importance of policy has been increased phenomenally.

Health insurance protection can be provided to entire family under family plan. Every member of family can be covered. Over and above cashless facility of the policy gives assurance of no requirement of liquidity for the hospitalization or for medical treatment. Awareness to this policy has been increased but still penetration in the country is lower. To make Indian family protected indirectly Indian government has allowed Mediclaim / health insurance premium as deductions from income tax.

(2) Motor / Auto / Vehicle Insurance :

Auto insurance is second most important insurance one must have on individual capacity. Motor / Auto insurance is an insurance which

provides protection against loss / theft of vehicle or even against damage of vehicle. This insurance also provides protection against any type of financial loss to the driver of vehicle as well as third party.

When any person carries out any vehicle on the road then such person carries out risk for others. To protect general public at large one should take third party insurance. Thus, even if accident took place and third party get injured insurance protection for financial loss to him (third party) will be available.

The sum insured under this policy is highly dependent upon remaining life of vehicle or age of vehicle and value of life of driver (determined by insurer himself). This policy provides protection against fire, lost, burglary, riots, floods, cyclone, to car etc.

The vehicle insurance is also very useful for transporters, truck operators, Government / State owned transportation organisations also. In India third party insurance is compulsory for every type of vehicles.

Personal Accident Insurance :

Human life is unpredictable. Number of people died in accidents are higher than number of people died in World War–II. Death toll of accidental death is significantly higher as compared to other countries. Personal accident is one of the important health insurance policy who provides protection to the insured person against financial loss to the insured person / died in an accident.

Over and above personal accident policy also covers disability / loss of income protection to the insured. If insured person suffered from loss of any body part which reduced earning capacity of the insured then insurance company compensate for the same on the basis of expected loss of income.

This policy is also available for entire family at discount. Here policy protection is against loss of income. Hence, person who is earning only eligible for the protection.

Travel Insurance :

Travel insurance provides protection against financial loss due to

- Medical emergency during travelling
- Trip delay
- Personal Accident
- Loss of Passport or Luggage
- Trip cancellation
- Other allied financial loss during travel

Travel insurance is very important when any individual or family is on foreign tour (As level of risk is significantly higher). Indian Railways and Domestic airlines includes insurance in the ticket price itself. Now–a–days student travel insurance and senior citizen travel insurance are in demand to great extent.

Marine Insurance :

Marine insurance covers the loss or damage of

– Ship
– Cargo
– Terminals and
– Transport cargo

by which property is transferred, acquired or held between the point of origin and final destination.

Marine insurance is an insurance which provides protection against perils of sea (Natural and Manmade both). Marine insurance also include risk from

– Theft
– Pilferage
– Rain damage
– Shortage
– Breakage
– War
– Strike etc.

In case of marine insurance there are two types of insurance coverage i.e.

(1) Cargo (Goods shipped)

(2) Ship (Vessel which is used for transportation)

IN international business such insurance is compulsory.

3.9 Difference between Life Insurance and General Insurance :

Sr. No.	Basis of comparison	Life Insurance	General Insurance
1.	**Meaning**	Life insurance is an insurance contract, wherein the insurance company promises to compensate the insured individual for uncertainties of life that are death. Life insurance provides protection against life risk.	General insurance is an insurance contract, wherein the insurance company promises to compensate the insured individual or entity for the financial loss or damage caused due to an unfortunate event. General insurance gives protection for all the valuable things that are important to you.

2.	**Term of contract**	Long-term contract	Short-term contract
3.	**Nature of contract**	Life insurance is not a contract of indemnity. It is considered as an investment	General insurance is a contract of indemnity.
4.	**Insurable interest**	Life insurance requires the beneficiary to have an insurance interest in the person who is being insured. That means, insurable interest needs to be present at the time of underwriting.	In general insurance policies, insurance interest is expected to exist both at the time of underwriting and at the time of loss.
5.	**Payment of claim**	Benefits under the policy are paid on the occurrence of an insured event or on maturity.	Financial loss caused due to the insured event is remembered on the occurrence of the particular event.
6.	**Compensation value**	The compensation value is dependent on the premium payable under the policy.	The compensation value is the actual loss incurred in the insured event (maximum amount payable is subjected to the policy limit).
7.	**Premium payment**	Premiums need to be paid periodically over the years for a specified term.	Premium is paid in a lump sum as the policy is purchased for short-term and plans need to be renewed on expiry.
8.	**Savings**	Many life insurance plans come with a savings element which helps the insured to build corpus or create wealth for future.	General insurance plans have no savings component as it's an indemnity contract wherein you incur the premium cost to avail the protection.

3.10 Importance of General Insurance to Different Sectors of Economy :

1. Provide safety and security :

Insurance provides financial support and reduce uncertainties in business and human life. It provides safety and security against particular event. There is always a fear of sudden loss. Insurance provides a cover

against any sudden loss. For example, in case of life insurance financial assistance is provided to the family of the insured on his death. In case of other insurance security is provided against the loss due to fire, marine, accidents etc.

2. Generates financial resources :

Insurance generates funds by collecting premium. These funds are invested in government securities and stock. These funds are gainfully employed in industrial development of a country for generating more funds and utilised for the economic development of the country. Employment opportunities are increased by big investments leading to capital formation.

3. Promotes economic growth :

Insurance generates significant impact on the economy by mobilizing domestic savings. Insurance turn accumulated capital into productive investments. Insurance enables to mitigate loss, financial stability and promotes trade and commerce activities those results into economic growth and development. Thus, insurance plays a crucial role in sustainable growth of an economy.

4. Medical support :

A medical insurance considered essential in managing risk in health. Anyone can be a victim of critical illness unexpectedly. And rising medical expense is of great concern. Medical Insurance is one of the insurance policies that cater for different type of health risks. The insured gets a medical support in case of medical insurance policy.

5. Spreading of risk :

Insurance facilitates spreading of risk from the insured to the insurer. The basic principle of insurance is to spread risk among a large number of people. A large number of persons get insurance policies and pay premium to the insurer. Whenever a loss occurs, it is compensated out of funds of the insurer.

6. Source of collecting funds :

Large funds are collected by the way of premium. These funds are utilised in the industrial development of a country, which accelerates the economic growth. Employment opportunities are increased by such big investments. Thus, insurance has become an important source of capital formation.

3.11 History of Insurance at Nutshell :

In India, insurance has a deep–rooted history. It finds mention in the writings of Manu (Manusmrithi), Yagnavalkya (Dharmasastra) and Kautilya (Arthasastra). The writings talk in terms of pooling of resources that could be re–distributed in times of calamities such as fire, floods, epidemics and famine. This was probably a pre–cursor to modern day insurance. Ancient Indian history has preserved the earliest traces of

insurance in the form of marine trade loans and carriers' contracts. Insurance in India has evolved over time heavily drawing from other countries, England in particular.

1818 saw the advent of life insurance business in India with the establishment of the Oriental Life Insurance Company in Calcutta. This Company however failed in 1834. In 1829, the Madras Equitable had begun transacting life insurance business in the Madras Presidency. 1870 saw the enactment of the British Insurance Act and in the last three decades of the nineteenth century, the Bombay Mutual (1871), Oriental (1874) and Empire of India (1897) were started in the Bombay Residency. This era, however, was dominated by foreign insurance offices which did good business in India, namely Albert Life Assurance, Royal Insurance, Liverpool and London Globe Insurance and the Indian offices were up for hard competition from the foreign companies.

In 1914, the Government of India started publishing returns of Insurance Companies in India. The Indian Life Assurance Companies Act, 1912 was the first statutory measure to regulate life business. In 1928, the Indian Insurance Companies Act was enacted to enable the Government to collect statistical information about both life and non–life business transacted in India by Indian and foreign insurers including provident insurance societies. In 1938, with a view to protecting the interest of the Insurance public, the earlier legislation was consolidated and amended by the Insurance Act, 1938 with comprehensive provisions for effective control over the activities of insurers.

The Insurance Amendment Act of 1950 abolished Principal Agencies. However, there were a large number of insurance companies and the level of competition was high. There were also allegations of unfair trade practices. The Government of India, therefore, decided to nationalize insurance business.

An Ordinance was issued on 19th January, 1956 nationalising the Life Insurance sector and Life Insurance Corporation came into existence in the same year.

The history of general insurance dates back to the Industrial Revolution in the west and the consequent growth of sea–faring trade and commerce in the 17th century. It came to India as a legacy of British occupation. General Insurance in India has its roots in the establishment of Triton Insurance Company Ltd., in the year 1850 in Calcutta by the British. In 1907, the Indian Mercantile Insurance Ltd, was set up. This was the first company to transact all classes of general insurance business.

In 1968, the Insurance Act was amended to regulate investments and set minimum solvency margins. The Tariff Advisory Committee was also set up then.

In 1972 with the passing of the General Insurance Business (Nationalisation) Act, general insurance business was nationalized with effect from 1st January, 1973. The General Insurance Corporation of India

was incorporated as a company in 1971 and it commence business on January 1sst 1973.

This millennium has seen insurance come a full circle in a journey extending to nearly 200 years. The process of re–opening of the sector had begun in the early 1990s and the last decade and more has seen it been opened up substantially. In 1993, the Government set up a committee under the chairmanship of RN Malhotra, former Governor of RBI, to propose recommendations for reforms in the insurance sector.

Following the recommendations of the Malhotra Committee report, in 1999, the Insurance Regulatory and Development Authority (IRDA) was constituted as an autonomous body to regulate and develop the insurance industry. The IRDA was incorporated as a statutory body in April, 2000. The key objectives of the IRDA include promotion of competition so as to enhance customer satisfaction through increased consumer choice and lower premiums, while ensuring the financial security of the insurance market.

The IRDA opened up the market in August 2000 with the invitation for application for registrations. Foreign companies were allowed ownership of up to 26%.

In December, 2000, the subsidiaries of the General Insurance Corporation of India were restructured as independent companies and at the same time GIC was converted into a national re–insurer. Parliament passed a bill de–linking the four subsidiaries from GIC in July, 2002.

3.12 Insurance Sector Analysis (IBEF) :

- After Post–liberalisation, India's insurance industry has recorded a significant growth.
- There are 24 life insurance and 33 non–life insurance companies in the Indian market who compete on price and services to attract customers, whereas, there are two reinsurance companies.
- Over 53.8 million farmers benefitted under the Pradhan Mantri Fasal Bima Yojana (PMFBY) during FY 2020. National Health Protection Scheme was announced under Union Budget 2018–19 as part of Ayushman Bharat. The scheme provided insurance cover up to Rs. 500,000 (US$ 7,723) to more than 100 million vulnerable families in India.
- Pradhan Mantri Jan Arogya Yojna (PMJAY), the world's largest social health scheme, is expected to provide coverage to around 50 crore people. Fund of Rs. 6,400 crore (US$ 887 million) has been allocated for FY21, which is thrice that of last year.
- Life insurers reported 14% Year on Year growth in individual annualised premium equivalent (APE) in October 2020, compared with 4% Year on Year in September 2020.

- On July 09, 2020, Union Cabinet approved capital infusion of Rs. 12,450 crore (US$ 1.77 billion), including Rs. 2,500 crore (US$ 354.66 million) infused in FY20, in three public sector general insurance companies – Oriental Insurance Company Limited, National Insurance Company Limited (NICL) and United India Insurance Company Limited.

Check Your Progress :

1. In which year, life insurance business was started ?

   a. 1818 b. 1830 c. 1881 d. 1960

2. Which of the following life insurance policy is guaranteed to remain in force for the insured's entire lifetime ?

   a. Endowment b. Join life c. Pension d. Whole life

3. Which of the following insurance can be provided to entire family under family plan ?

   a. Health b. Vehicle

   c. Travel d. Personal Accident

4. Which of the following expenses is not covered under Health Insurance ?

   a. X–ray charges b. Dialysis

   c. Anaesthesia d. Syringe

5. The TPA license should renewed after every ?

   a. 1 year b. 3 years c. 2 years d. 5 years

6. Tenure of general insurance contract is ?

   a. long term b. short term

   c. medium term d. Not Applicable

7. How much should be the minimum stay in hospital in order to become eligible for reimbursing health insurance cover ?

   a. 24 hours b. 12 hours c. 48 hours d. 10 hours

8. How many life insurance companies are prevailing in the Indian market ?

   a. 33 b. 22 c. 24 d. 28

9. Marine Insurance covers which of the following ?

   a. Ship b. Cargo c. Terminals d. All of the above

10. The minimum paid up capital of TPA should be ?

    a. ₹ 50 lakhs b. ₹ 2 crore c. ₹ 1 crore d. ₹ 5 crore

3.13 Let Us Sum Up :

Insurance is a contract that guarantees payment for losses or damages incurred by the insured upon the occurrence of specific events. For the duration of the insurance, a premium is required. A contract for insurance

is based on a number of concepts, including good faith, insurable interest, compensation, subrogation, contribution, and others. Both investment contracts and life insurance policies have the same protective function. It is a protection contract since it pays the assured's entire sum assured in the event of death, protecting the assured. Because it offers the assured the benefit of receiving their money back with interest and bonuses at the conclusion of the policy, it is also an investment contract.

A general insurance contract only functions as a contract of protection, not as an investment, and only on the occurrence of certain specified events will the premium money paid be returned to the insured in the form of claims.

3.14 Answers for Check Your Progress :

1. a	**2.** d	**3.** a	**4.** d	**5.** b
6. b	**7.** a	**8.** c	**9.** d	**10.** c

3.15 Glossary :

1. **Insurance :** An agreement in which one party agrees to reimburse the other for any loss or damage sustained by the latter in exchange for the payment of a premium for a set period of time is referred to as an insurance.
2. **Life Insurance :** It is a type of contract where the insurer agrees to pay the insured a predetermined amount of money upon the expiration of a predetermined period or upon the insured's death in exchange for a predetermined number of premium payments.
3. **General Insurance :** A contract whereby the insurer agrees to compensate the insured in the case of any specific loss or loss incurred by the latter is known as general insurance.
4. **Fire Insurance :** In the case of a fire mishap, the insurance provider agrees to compensate the insured party for any losses they may have incurred.
5. **Marine Insurance :** A marine insurance contract is one that covers the risks of loss associated with maritime activities.

3.16 Assignment :

1. Travel and Marine Insurance
2. Classification of Insurance
3. IRDA regulations for policy holder
4. Insurance sector analysis (IBEF)
5. Difference between Life insurance and General insurance
6. Define Insurance. Discuss various types of insurance and non–life insurance policies.

3.17 Activities :

1. Explain the various principles of insurance in detail.

3.18 Case Study :

1. Explain the importance of general insurance in various sectors of economy.

3.19 Further Readings :

1. Gupta, P.K., Insurance and Risk Management, Himalaya Publishing House, New Delhi.
2. Mathew, M.J., Insurance, RBSA Publishers, Jaipur.
3. Ganguly, Anand, Insurance Management, New Age Publishers, New Delhi.
4. Mishra, M.N., Insurance, S. Chand and Sons, New Delhi.

Unit 4

INVESTMENT BANKING AND MERCHANT BANKING

: UNIT STRUCTURE :

4.0 Learning Objective
4.1 Introduction
4.2 Investment Banking in India
4.3 Meaning of Investment Banks
4.4 Characteristics of Investment Banks
4.5 Investment Banking Services
4.6 Recent Development and Challenges in Investment Banking
4.7 Merchant Banking Services
4.8 Institutional Structure of Merchant Banking
4.9 Definition of Merchant Banking
4.10 Characteristics of Merchant Banking
4.11 Functions of Merchant Banker
4.12 SEBI Guidelines for Merchant Banker
4.13 Appointment of Lead Merchant Banker
4.14 Responsibilities of Lead Merchant Banker
4.15 Let Us Sum Up
4.16 Answers for Check Your Progress
4.17 Glossary
4.18 Assignment
4.19 Activities
4.20 Case Study
4.21 Further Readings

4.0 Learning Objectives :

You should be able to :

(a) Understand the idea of Investment and merchant banking after reading this lesson.

(b) Describe the responsibilities of merchant bankers.

(c) Review the main characteristics of Indian merchant banking.

(d) Understand the recent development and challenges in investment banking.

4.1 Introduction :

The financial system is a natural culmination of the monetary system which converts physical resources into currencies or monetary units. The monetary system evolved to eliminate the limitations of the barter system which exchanged the physical assets (i.e., goods and services) without the use of money. The monetary system has substantially facilitated the exchange of monetary units in terms of the business buying and selling and the system of banking through lending and borrowing. The financial system has not only contributed to the growth of business and banking enormously but it has also contributed to the domestic and international economy. Several types of financial services developed correspondingly to enhance the efficiency and effectiveness of the financial system.

As the complexities and challenges have increased, the financial system has been made more systematic and it has been brought under the control and regulation of the government. As the unit of wealth generation and transfer, either physical or monetary, is individual, the entire financial system is not amendable to be brought under the government regulation. Thus, the financial system of different countries is broadly classified into two categories: Organized and Unorganized sector.

The growth of the organized and systematic financial system is conducive to the economic growth of a nation. The developed financial system encourages the motivation to organize economic activities; it promotes savings and its profitable investments. It also facilitates the disinvestments from ill–performing economic units and transfer to higher productive units.

A well–developed financial system :

(i) provides the payment system for goods and services

(ii) pools smaller funds to finance large scale investments

(iii) manages the mismatches between the short–term and long–term savings and investments

(iv) helps in managing the risk and uncertainties in dealing with financial assets

(v) scans, analyses and disseminates the relevant information and facilitates appropriate price discovery of the financial assets

(vi) provides pre–matured liquidity to long–term financial system

(vii) facilitates price stability for mispriced instruments in two markets at same time or mispricing occurring between two periods

(viii) facilitates risk management on financial assets through risk transfer, risk sharing and risk spreading

(ix) encourages the international financial co–operation.

4.2 Investment Banking in India :

The term 'Investment Banking' is a specialized financial service which helps the corporates in merger and acquisition, financial restructuring, etc. The commercial banks keep the inventories of cash which is raised through mobilizing the savings of the surplus household sector and provide such mobilized funds to the deficit sectors like corporate and government. Thus, commercial banks are financial intermediaries which provides – fund–based and non–fund based financial services.

On the other hand, the investment banking is mostly focusing on the non–fund based financial services and their fund–based services are negligible. They act as a financial intermediary which connect the selling of financial securities issued by the deficit sectors like corporates and government and the buyers of the financial securities like individual and institutional investors.

Well–known investment banking companies which provide global investment banking services are : Merill Lynch, Morgan Stanley, Lehman Brothers, J P Morgan, Goldman Sachs, etc. Some Indian investment banks providing investment banking services like securities issue management, underwriting of securities, etc. are : DSP Merill Lynch, J P Morgan Stanley, SBI Capital Markets, ICICI Securities, etc.

4.3 Meaning of Investment Banks :

"Investment banks are the banks that act as the financial intermediary which connects the selling of securities by the corporates with the individuals and institutions which are interested in the buying of such security issue related services."

4.4 Characteristics of Investment Banks :

Some of the important characteristics of the investment banks are as under :

(1) The investment banks act as a link connecting the company issuing securities and the buyers of securities like individuals and investors.

(2) Like commercial banks which provide fund based and non–fund based financial services, the investment banks provide the non–fund based financial services related to the securities issue.

(3) Investment banks provide services such as issue of securities, underwriting, etc. Other services include corporate advisory services like merger and acquisitions (M&A) deals, financial restructuring, issue of securities related to foreign currency, etc.

(4) Investment banks also provide other important services like trading of securities in the secondary markets as block deals, research relating to appropriate valuation of the financial securities traded in the stock market.

4.5 Investment Banking Services :

(1) Pre–investment studies :

On the basis of the environmental scanning, they conduct the feasibility studies on behalf of the clients.

(2) Project counselling :

The investment/merchant bankers prepare the detailed project report on the proposed investments involving huge investments of a unique nature like infrastructure or similar projects.

(3) Vetting of offer documents :

Security issue related services like drafting of the offer document (or the prospectus) and vetting the offer document with regulatory authorities like SEBI are provided by investment/merchant bankers. The offer document for the Initial Public Offers (IPOs) and Subsequent Public Offers (SPOs) are to be vetted with the SEBI. While the right offer, private placement and pure debt issues, the SEBI has authorized the merchant bankers to perform the vetting by themselves.

(4) Issue management :

The investment/merchant bankers perform the services like the issuer of securities, registrar to an issue, management and subscription and allotment of securities in case of oversubscriptions, underwriting services in case of under subscriptions of the issue of securities, etc.

(5) Security Trading Services :

Trading of the securities in the secondary markets like management of block deals (i.e. large volume of securities from one or limited parties), private equity management services, etc.

(6) Corporate advisory services :

The corporate advisory services such as Merger and Acquisitions (M&A) deals and also the financial restructuring services for the overcapitalized companies (i.e., excess funding companies) and undercapitalized companies (i.e., shortage of funding companies) are provided by the merchant bankers.

(7) Portfolio management services :

The investment/merchant bankers also provide the creation and reshuffling of the portfolios of wealthy and high net–worth individuals.

(8) Financial research services :

The investment/merchant bankers conduct researches like appropriate valuation of securities necessitated during diverse corporate events.

(9) Working capital financing :

The working capital involves the recycling of funds. Some new limits needing huge working capital needs are arranged through the merchant bankers either independently or through loan–syndication, the

merchant banks act as a lead manager in managing the huge working capital finance.

(10) Foreign currency financing :

The international business of large Indian firms and foreign multinational companies (MNCs) increased substantially after June 1991, economic liberalization in India. The merchant banks provide foreign currency funding for import–exports of goods, capital equipment, technology and fund transfer. They also provide the services in foreign currency risk management through options, futures and swaps.

4.6 Recent Development and Challenges in Investment Banking :

(1) The Challenges of Transforming Regulatory Modifications :

Investment banking firms in India are facing challenges in terms of dealing with transforming regulatory changes. Things have also changed the way banking bodies operate in the nation. On the other hand, the fresh rules have brought most of the prime functionalities of the investment banking under rigorous process check.

(2) Addressing the Challenge of Lowered Equity Rate :

Different investment banking types, as mentioned above, are all abided by or have to follow a certain set of rules. It also takes the aspect of expenses as well as meeting the regulatory needs. Also, there remains the compliance associated with technology as well. The overall equity return has indeed dropped. Hence, it is suggested that investment banking functions should be regulated in such a way that the capital cost is ensured to get recovered.

(3) Real–time Analysis and Challenge of Risk Management :

Through the course of risk management analysis, some finance experts recommend analyzing eligibility for investment bankers in India. However, instead of attempting to modify or change the entire infrastructure, it would be wiser to address the challenge of trades with a greater margin.

(4) Maintaining Transparency :

Be it about the investment banks or those of traditional forms, the challenges of any bank can be addressed with a greater customer base. In a scenario where most people don't understand how to get into investment banking in India, one should not expect much; rather should be accomplished about whatever achieved.

Most importantly, there should be proper transparency maintained within and out. There is no meaning of optimizing technology and process without maintaining the transparency within the procedure. Investment banking roles towards providing the ground level coverage is massive, specifically with a transforming banking arena.

(5) Challenges of Regulatory Deadlines :

The scope of investment banking in India is indeed huge. But, as discussed, it is true at the same time that there is no scarcity of challenges

either. One of the prime challenges that banks are dealing with is meeting the regulatory deadlines. The main reason behind this is said to be the confines of the technology they have to deal with.

It won't be too difficult to understand this aspect upon observing the structure of investment banking in India. Also, the level of investment associated is comparatively huge as well. In short, the entire process is in search of a proper creative model to address the challenges of such.

(6) Automation Testing :

The scope of investment banking in India has always been encouraging. Upon going through the history of investment banking in India, the same things have been stated. However, the level of advancement is indeed not as expected. It has advanced, but as discussed above, there is no shortage of challenges as well. Any kind of challenge could be addressed by improving the productivity level.

And, in an era of technology, automation is considered the most effective and critical way of advancing or staying ahead of the competitors. To be specific, automated testing has moreover appeared like the need of the hour. One may claim that through the course of evolution of investment banking in India, greater application of automated testing is not something impossible.

(7) Maintaining Overall Flexibility in the System :

Everyone talks about risk management and better practical analysis. However, there should be proper resource management to ensure that better trade volume is maintained. In this regard, flexibility in the overall system is highly essential. In simple terms, the banks should possess the flexibility of controlling the trading volume as desired.

As stated above, automation of processes is highly important to ensure that effectiveness is maintained to cover–up the expenses and get enabled to deliver better profit. Not just the investment banks on the whole, but the individual banks should emphasize this matter to enjoy competitive benefits over the others. The future of investment banking in India is hugely dependent upon the thorough regulation of policies to maintain flexibility.

(8) Security Challenges :

Investment banking should not be distinguished too much from traditional banking from an operational point of view. As the entire banking industry or ecosystem is expected to get transformed from technological perspectives, similar things can be expected in the case of investment banking as well. Hence, just like the mainstream banks, investment banks are also obvious to confront similar challenges.

To be specific, the compatibility issues should be immediately addressed as hackers often aim at the vulnerabilities of such. At the same time, having proper arrangements for avoiding the threats of such, it is equally important to have a reliable arrangement for the safety of data

as well. The concerned IT agency in–charge specifically should take responsibility for assuring the utmost complacency to the clients.

4.7 Merchant Banking Services :

Merchant bankers are the financial intermediaries which mostly provide non–fund based financial in securities issue management. They occasionally provide fund–based services but their major focus is on non–fund based activities relating to the securities issues like drafting of offer documents from SEBI, registrar to the issues, underwriting services, management subscriptions and allotment of shares, etc. Some other non–fund based financial services include the pre–investment feasibility studies of the project, preparation of the detailed project reports, arrangement of project financing, etc.

They also conduct the corporate advisory services for mergers and acquisitions and the valuation of outstanding securities and the financial restructuring of healthy as well as sick units.

4.8 Institutional Structure of Merchant Banking :

The merchant banking services are generally performed by the commercial banks, financial institutions, securities broking firms, independent financial consultants, etc. as under:

(i) Commercial Banks :

Some banks in India provide the merchant banking services either through creating a separate strategic business unit (SBU) or through establishing the wholly owned subsidiary companies. The State Bank of India, Canara Bank and Bank of Baroda have established specialized subsidiary companies .i.e., SBI Capital Markets Ltd., Canbank Financial Services Ltd. And BOB Fiscal Services Ltd. respectively and Foreign Greenlays Bank in providing merchant banking services through a separate division.

(ii) Financial Institutions :

The All–India Financial Institutions like IDBI, IFCI and ICICI Corporation (ICICI Bank) are also providing merchant banking services through their separate division.

(iii) Securities Broking Firms :

Some large sized broking firms like DSP Financial Consultants, J M Financial and Investment Services Ltd., Credit Capital Finance Corporation, etc. also provide merchant banking services.

(iv) Independent Financial Consultancy Firms :

The technical consultancy organizations are operating in different states like Mitcon in Maharashtra, GITCO in Gujarat, etc. Some of the professionally managed consultancy organizations also provide merchant banking services.

SEBI has advised that merchant bankers shall undertake only those activities which relate to securities market.

These activities are :

(a) Managing of public issue of securities;

(b) Underwriting connected with the aforesaid public issue management business;

(c) Managing/Advising on international offerings of debt/equity i.e. GDR, ADR, bonds and other instruments;

(d) Private placement of securities;

(e) Primary or satellite dealership of government securities;

(f) Corporate advisory services related to securities market including takeovers, acquisition and disinvestment;

(g) Stock broking;

(h) Advisory services for projects;

(i) Syndication of rupee term loans;

(j) International financial advisory services.

The activities of the Merchant Bankers in the Indian capital market are regulated by SEBI (Merchant Bankers) Regulations, 1992.

4.9 Definition of Merchant Banking :

"Merchant Banking is a specialized financial intermediary services focusing of securities issues management, underwriting, corporate advisory and counselling services like establishment of ventures, mergers and acquisition deals, etc."

"A merchant banker has been defined as any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities or acting as manager, consultant, advisor or rendering corporate advisory services in relation to such issue management."

'Merchant Banker' means any person engaged in the business of issue management by making arrangements regarding selling buying or subscribing to securities or acting as manager/consultant/advisor or rendering corporate advisory services in relation to such issue management.

4.10 Characteristics of Merchant Banking :

(1) The merchant bankers are financial intermediaries which render services to varied individual and corporate clients.

(2) Their major focus is on buying and selling of securities in primary market like public issues and private issues management and also in the secondary markets like block deals of large size, private equity deals, etc.

(3) Mostly they provide non–fund based services like issue management, portfolio management, corporate counselling, etc. They also provide fund–based financial services like underwriting of public issues. But, as compared to non–fund based activities, the proportion of fund–based activities is marginal.

(4) Merchant banks in India are established by banks, financial institutions, large stock–broking houses and private consultancy firms.

(5) Only those merchant banking firms which are authorized by SEBI can only provide the merchant banking services in India. They are subject to SEBI (Merchant Bankers) Rules, 1992. In India, along with the merchant bankers of India, foreign multi–national merchant banking firms authorized by SEBI area also providing merchant banking services to Indian companies.

(6) The merchant banking services in India are classified in four categories – Category I, II, III and IV in terms of financial resources and the area of activities.

4.11 Functions of Merchant Banker :

The organized banking business in India is broadly classified into banking finance companies (BFCs) and non–banking finance companies (NBFCs). The merchant banking is classified under the NBFCs.

Some important functions and services of the merchant bankers are as under:

(1) Pre–investment studies :

The pre–investment studies are the feasibility studies for new projects and alternative avenues of investments for existing companies for expansion and diversification activities.

(2) Project management :

The merchant banking firms also provide the advisory services for large sized multi–purpose turnkey projects on domestic and global basis. They also provide advisory services for preparation of detailed project report and its financial, economic and technical appraisal.

(3) Issue management :

The management of securities issues are the core services of merchant bankers. The issue services include drafting of offer document, vetting it from SEBI, its publication, registrar to the issues and related services like subscription, allotment and refunding of securities underwriting services, listing of securities in domestic and global stock markets, etc.

(4) Project counselling :

The project counselling services include identification of project ideas, preparation of project report, registration and clearance procedure for project implementation, identification of partners in joint venture, loan syndication in case of huge funding, working capital financing, etc.

(5) Corporate counselling :

The corporate counselling is required by corporate clients for the critical events occurring during the life span of companies. They include value–based management (VBM), valuation of securities at the time of whole or partial sell of business, mergers and acquisition (M&A) deals, block deals, private equity management, loan syndication, listing of securities in foreign stock markets, foreign currency fund raising in equities like GDRs (Global Depository Receipts) and ADRs (American Depository Receipts) and issue of debt instruments like NRIs (Non–Resident Indians' Deposits), issue of foreign bonds, foreign currency convertible bonds (FCCBs), etc.

(6) Capital restructuring and rehabilitation of sick units :

A fair capitalized firm turns into overcapitalized firms (i.e. firms with excess funds) and undercapitalized firms (i.e. firms facing financial shortages). The financial restructuring of equity and debt bases of funding are required to revert the companies to fair capitalization state. Moreover, due to the consistent loss–making, the equity–base of the company gets eroded and when the accumulated losses are more than 50% of net–worth or equity–base, they are treated as sick units in India. The sick units are brought out from sickness through framing the turnaround strategies. Merchant bankers provide important services for the revival of the sick units.

(7) Loan syndication :

The merchant bankers provide services a lead manager in case of huge project financing through developing joint deals with financiers, domestic and global banks and financial institutions. The merchant banks act as a lead manager in determining the proportion and terms of the syndicated loans. They also provide the services for viability gap financing and bridge financing in the huge infrastructure projects.

(8) Working capital finance :

The working capital financing involves recycling of funds in the form of procurement of inputs like raw–materials and cash inflows in the form of sales of outputs. The merchant bankers provide the services in the form of management of operating cycle, assessment of working capital requirements, arrangements of working capital from various sources of working capital including banking sector.

(9) Bill discounting, factoring and forfaiting services :

In case of credit sales, bills receivables or trade receivables are created. The realization from credit sales are made at the end of the credit period. There are chances of bad debt losses also in case of defaults by the buyers at the time of maturity period. The merchant bankers provide pre–matured fund–based financing through discounting of receivables, factoring of domestic book–debts and forfaiting of global book–debts arising from import–export business. They also provide the service of collection of book debts and management of bad debt losses.

(10) Lease financing :

The merchant bankers also provide the long–term capital lease financing for the purchase of costly equipment. The international merchant bankers also provide foreign currency lease financing. This is a long–term fund–based financial services.

(11) Venture financing :

The venture financing is required for high–risk, huge project investment having uncertainty of success. But, once succeeds, the project provides wind–fall gains. The merchant bankers also act as venture financiers. They become the partner in the joint venture and exit from it once it is commissioned successfully. This is a fund–based financial services of the merchant bankers.

(12) Share broking and mutual fund activities :

As merchant bankers are mostly connected with the buying and selling of financial securities in primary market and secondary market they also act as registered brokers at stock exchanges. They also act as a mutual funds through raising funds in the form of sell of units and creating a portfolio from their investments.

4.12 SEBI Guidelines for Merchant Banker :

The activities of the merchant bankers in the Indian capital market are regulated by SEBI (Merchant Bankers) Regulations, 1992.

Regulation 3 of SEBI (Merchant Bankers) Regulations, 1992 lays down that an application by a person desiring to become merchant banker shall be made to SEBI in the prescribed form (Form A) seeking grant of a certificate of registration along with a non–refundable application fee as specified in Schedule II of these Regulations.

The aforesaid application shall be made for any one of the following categories of the merchant banker namely:–

(a) Category I, that is –

- To carry on any activity of the issue management, which will, inter alia, consist of preparation of prospectus and other information relating to the issue, determining financial structure, tie up of financiers and final allotment and refund of the subscriptions; and
- To act as adviser, consultant, manager, underwriter, portfolio manager;

(b) Category II, that is to act as adviser, consultant, co–manager, underwriter, portfolio manager;

(c) Category III, that is to act as underwriter, adviser, consultant to an issue;

(d) Category IV, that is to act only as adviser or consultant to an issue.

Regulation 4 and 5 deal with the methodology for application and furnishing of information, clarification and personal representation by the applicant. Incomplete or non–conforming applications shall be rejected

after giving an opportunity to remove the deficiencies within a time specified by SEBI and the applicant shall furnish further information or clarification to SEBI regarding matters relevant to the activity of a merchant banker for the purpose of disposal of the application.

Regulation 6 lists out the following considerations for being taken into account by SEBI to grant the certificate of registration.

(a) the applicant shall be a body corporate other than a non–banking financial company as defined under clause(f) of section 45–I of the RBI Act, 1934; However, the Merchant Banker who has been granted registration by the RBI to act as a primary or satellite dealer may carry on such activity subject to the condition that it shall not accept or hold public deposit;

(aa) the applicant has the necessary infrastructure like adequate office space equipment, and manpower to effectively discharge his activities.

(b) the applicant has in his employment a minimum of two persons who have the experience to conduct the business of the merchant banker;

(c) a person directly or indirectly connected with the applicant has not been granted registration by SEBI;

(Here the expression "directly or indirectly connected" means any person being an associate, subsidiary or interconnected or group company of the applicant in case of the applicant being a body corporate)

(d) the applicant fulfils the capital adequacy requirement;

(e) the applicant, his partner, director or principal officer is not involved in any litigation connected with the securities market which has an adverse bearing on the business of the applicant;

(f) the applicant, his director, partner or principal officer has not at any time been convicted for any offence involving moral turpitude or has been found guilty of any offence;

(g) the applicant has the professional qualification from an institution recognised by the Government in finance, law or business management;

(h) the applicant is a fit and proper person;

(i) grant of certificate to the applicant is in the interest of investors.

Regulation 7 prescribes that the capital adequacy requirement shall be a net worth of not less than five crore rupees.

('Net worth' means the sum of paid–up capital and free reserves of the applicant at the time of making application.)

Regulation 8 deals with grant of certificate of registration, where SEBI is satisfied that applicant is eligible, shall grant certificate of registration in Form B and intimate the same information to the applicant.

The certificate of registration granted shall be valid unless it is suspended or cancelled by SEBI.

Regulation 9A and 10 deals with conditions of registration for initial registration (granted under regulation 8) and procedure where registration is not granted.

Regulation 8, 9A and 10 deal with procedure for registration, renewal of certificate conditions of registration and procedure where registration is not granted.

However, SEBI may, in the interest of investors in the securities market, permit the merchant banker to carry on activities undertaken prior to the receipt of the intimation of refusal subject to such condition as the SEBI may specify.

Regulation 12 provides for payment of fees and consequences of failure to pay annual fees. It provides that SEBI may suspend the registration certificate if merchant banker fails to pay fees.

4.13 Appointment of Lead Merchant Banker :

1. All issues should be managed by at least one merchant banker functioning as the lead merchant banker:

   Provided that, in an issue of offer of rights to the existing members with or without the right of renunciation the amount of the issue of the body corporate does not exceed rupees fifty lakhs, the appointment of a lead merchant banker shall not be essential.

2. Every lead merchant banker shall before take up the assignment relating to an issue, enter into an agreement with such body corporate setting out their mutual rights, liabilities and obligations relating to such issue and in particular to disclosures, allotment and refund.

RESTRICTION ON APPOINTMENT OF LEAD MANAGERS :

The number of lead merchant bankers may not, exceed

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

4.14 Responsibilities of Lead Merchant Banker :

1. No lead manager shall agree to manage or be associated with any issue unless his responsibilities relating to the issue mainly, those of disclosures, allotment and refund are clearly defined, allocated and determined and a statement specifying such responsibilities is furnished to the Board at least one month before the opening of the issue for subscription:

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

2. No lead merchant banker shall, agree to manage the issue made by any body corporate if such body corporate is an associate of the lead merchant banker.

   Lead merchant banker not to associate with a merchant banker without registration.

3. A lead merchant banker shall not be associated with any issue if a merchant banker who is not holding a certificate is associated with the issue.

Underwriting obligations :

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

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

Submission of due diligence certificate :

The lead merchant banker, who is responsible for verification of the contents of a prospectus or the Letter of Offer in respect of an issue and the reasonableness of the views expressed therein, shall submit to the Board at least two weeks prior to the opening of the issue for subscription, a due diligence certificate in Form C.

Documents to be furnished to the Board :

1. The lead manager responsible for the issue shall furnish to the Board, the following documents, namely :–

   (i) particulars of the issue;

   (ii) draft prospectus or where there is an offer to the existing shareholders, the draft letter of offer;

(iii) any other literature intended to be circulated to the investors, including the shareholders; and

(iv) such other documents relating to prospectus or letter of offer as the case may be.

2. The documents referred to in sub–regulation (1) shall be furnished at least two weeks prior to date of filing of the draft prospectus or the letter of offer, as the case may be, with the Registrar of Companies or with the Regional Stock Exchanges, or with both.
3. The lead manager shall ensure that the modifications and suggestions, if any, made by the Board on the draft prospectus or the Letter of Offer as the case may be, with respect to information to be given to the investors are incorporated therein.

Check Your Progress :

1. Which of the following is not an advantage of a good financial system ?

   a. systematic payment system

   b. risk management

   c. international financial co–operation

   d. preserves funds

2. Investment banks mostly provide which kind of financial service ?

   a. fund–based b. non–fund–based

   c. both d. None

3. Which of the following is not the challenge faced by Investment bank ?

   a. portfolio management b. automation testing

   c. meeting regulatory deadlines d. flexibility

4. Under which category, a merchant banker can act as a co–manager ?

   a. III b. II c. IV d. I

5. For fulfilling the eligibility criteria to become merchant banker, the applicant must be ?

   a. a firm b. a body corporate

   c. an LLP d. a trust

6. How many lead merchant bankers are required to be appointed if the issue size is Rs. 45/– lakhs ?

   a. one b. three c. two d. zero

7. Which of the following service is not provided by a merchant banker ?

   a. lease financing b. consultancy on M & A

   c. issue management d. custodial

8. The minimum capital adequacy requirement for registration of merchant banker shall be net worth not less than ?

   a. Rs. 2 crores b. Rs. 5 crores c. Rs. 1 crore d. Rs. 3 crores

9. SEBI shall grant a certificate of registration to merchant banker after satisfying various conditions under ?

   a. Form B b. Form D c. Form A d. Form E

10. The minimum underwriting obligation, a lead merchant banker has to accept for an issue is how much percent of the total underwriting commitment/issue ?

   a. 5 b. 2.5 c. 1 d. 1.5

4.15 Let Us Sum Up :

A form of financial service called merchant banking entails problem solving and other related tasks. The organisations involved in offering corporate entities merchant banking services are known as merchant bankers. Merchant bankers offer many different sorts of services. They include bill discounting, leasing, factoring, underwriting, project counselling, credit syndication, corporate counselling, portfolio management, stock broking, and venture capital. On merchant banking, SEBI has published the SEBI (Merchant Banking) Regulation. Only a small number of merchant banker operations are covered by the regulations. In addition, merchant bankers must carry out their obligations in accordance with operational standards. As part of issue management, they have pre– and post–issue responsibilities.

4.16 Answers for Check Your Progress :

1. d	**2.** b	**3.** d	**4.** b	**5.** b
6. d	**7.** d	**8.** b	**9.** a	**10.** a

4.17 Glossary :

1. **Merchant Bank :** It's a company that underwrites corporate securities and provides clients with guidance on a range of matters related to business venture ownership.
2. **Corporate Counselling :** Services that ensure a corporate enterprise is handled effectively are referred to as corporate counselling.
3. **Credit Syndication :** It deals with providing credit on a consortium basis in both Indian rupees and foreign money.
4. **Underwriter :** An investment and banking company known as an underwriter enters into an agreement with a company that issues new securities to distribute those securities to the investing public.

4.18 Assignment :

1. Discuss the code of conduct laid down for merchant bankers by SEBI. What is its need ?

3. Discuss the activities specified by SEBI for merchant banker
4. Explain the Characteristics of investment banks
5. Discuss in detail the authorized activities of merchant bankers as per SEBI.
6. Define Merchant Banker. Discuss the services rendered by merchant bankers.
7. Define Investment Banks. Explain various services provided by investment banks.
8. Write a note on recent developments and challenges in investment banking
9. Explain the Institutional structure of merchant banking

4.19 Activities :

1. Explain the role of SEBI in regulating the merchant banking operations in India.

4.20 Case Study :

1. Who is a lead merchant banker ? Explain various SEBI regulations, restrictions and responsibilities of the lead merchant banker.

4.21 Further Readings :

1. Sundharam, K.P.M., and Varshney, P.N., Banking and Financial System, Sultan Chand and Sons, New Delhi.
2. Meir, Kohn, Financial Institutions and Markets, Tata McGraw Hill, New Delhi.
3. Maheshwari, S.N., Banking Law and Practice, Kalyani Publishers, Ludhiana.
4. Sundharam, Money Banking and International Trade, Sultan Chand & Sons, New Delhi.
5. Bedi, Suresh, Business Environment, Excel Books, New Delhi.

BLOCK SUMMARY

This block gives detailed about functions of finance and financial services that are rendered in market which shows importance to customer. The idea of financial services and problems related to it are well detailed with features and characteristics. The block gives information about Merchant Banking and its various aspects along some basic's information of financial services in first unit.

In second unit focus is on to explore the concept of mutual fund and its various types. Third unit relates to principles and classifications of Insurance services and IRDA guidelines. Last unit includes investment banking services and merchant banking functions and its guidelines by SEBI.

BLOCK ASSIGNMENT

Short Questions :

1. List few financial services ?
2. Difference between Life Insurance and General Insurance.
3. Importance of General Insurance to different sectors of economy
3. Describe briefly the structure of a mutual fund.
4. How financial services plays important role in economy ?
5. Recent Development and Challenges in Investment Banking
6. Discuss the Responsibilities of Lead Merchant Banker

Long Questions :

1. What are financial services in India ?
2. What are the financial services that arise in India after independence ?
3. Compare financial instruments and financial services ?
4. Explain the different types of Life Insurances.
5. Explain the guidelines of mutual funds given by SEBI.
6. Explain SEBI guidelines for Merchant Banker.

❖ **Enrolment No. :** [ ]

1. How many hours did you need for studying the units ?

Unit No.	1	2	3	4
No. of Hrs.				

2. Please give your reactions to the following items based on your reading of the block :

Items	Excellent	Very Good	Good	Poor	Give specific example if any
Presentation Quality	☐	☐	☐	☐	________
Language and Style	☐	☐	☐	☐	________
Illustration used (Diagram, tables etc)	☐	☐	☐	☐	________
Conceptual Clarity	☐	☐	☐	☐	________
Check your progress Quest	☐	☐	☐	☐	________
Feed back to CYP Question	☐	☐	☐	☐	________

3. Any other Comments

....

....

....

....

....

....

....

....

BBAR-601

Financial Services

BLOCK-2 NEW FINANCIAL PRODUCTS AND SERVICES

UNIT 1
LEASING

UNIT 2
HIRE PURCHASE

UNIT 3
HOUSING FINANCE

UNIT 4
FACTORING

BLOCK 2 : NEW FINANCIAL PRODUCTS AND SERVICES

Block Introduction

The relevance of financial services is currently spreading around the globe. People expect a financial service company to perform a very dynamic role in today's complex financial world, acting both as a department shop and a provider of financing. The free market idea has gained a lot of relevance with the introduction of the economic emancipation strategy and the openness of the economy to multinationals. Due to this exposure to volatility and unpredictability, both corporate and individual clients expect the financial services industry to invent new products and services to satisfy their various needs.

Innovations have led to the emergence of new goods and tools in the capital market. The money market and the capital market are expanding and deepening. In addition, the advent of new products and cutting–edge methods of capital market operation has caused a fundamental change in the global capital market. By introducing a variety of new products, several financial intermediaries, including banks, have already begun to increase their activity in the financial services sector. As a result, the world of financial intermediation has become more sophisticated and innovative. Below is a discussion of a few of them :

One of a person's basic needs is a place to live, yet the cost of a home is so high that few people can afford it out of their own savings. So, there is a huge demand and opportunity for the creation of plans for the provision of loans or financing for the purpose of house construction. But for whatever reason, up until the end of the 1980s, the shelter sector of the Indian financial system remained entirely underdeveloped. A major gap in India's financial development process has been highlighted as the absence of an appropriate institutional supply of credit for home construction. The authorities have recently started taking some actions to close this gap.

New businesses are growing thanks to venture money. Investments in new and tested businesses without a track record of consistent growth are meant by this phrase. Venture money is a form of long–term risk financing used to finance high–tech businesses with risk and significant growth potential.

Block Objectives

After finishing this lesson, you ought to be able to :

(a) Describe the definition and range of a financial service.

(b) Go over the numerous cutting–edge financial instruments.

(c) Explain the difficulties the financial services industry is currently facing.

(d) Describe the current state of the Indian financial services industry.

Block Structure

Unit 1 : Leasing

Unit 2 : Hire Purchase

Unit 3 : Housing Finance

Unit 4 : Factoring

LEASING

: UNIT STRUCTURE :

1.0 Learning Objective

1.1 Introduction

1.2 Definition of Leasing

1.3 Feature of Leasing

1.4 Indian Leasing Industry Structure

1.5 Types of Leasing

1.6 Advantages of Leasing from the Viewpoint of Lessor

1.7 Disadvantages of Leasing from the Viewpoint of Lessor

1.8 Advantages of Leasing from the Viewpoint of Lessee

1.9 Disadvantages of Leasing from the Viewpoint of Lessee

1.10 Difference between Leasing and Hire Purchase

1.11 Direct Lease

1.12 Sales and Lease Back

1.13 Let Us Sum Up

1.14 Answers to Check Your Progress

1.15 Glossary

1.16 Assignment

1.17 Activity

1.18 Case Study

1.19 Further Readings

1.0 Learning Objectives :

After finishing this lesson, you should be able to :

(a) Describe the basics of leasing.

(b) Go over the benefits, restrictions, and types of leasing.

(c) Describe the different legal facts of leasing.

(d) Describe what hire buy is and how it works.

1.1 Introduction :

Firms typically buy useful assets and use them as owners. A company can obtain funding for asset acquisition from both internal and external sources. Due to poor profitability, there has been a downward tendency in the internally generated resources over time. The financial institutions struggle to raise enough money to meet the growing demands

of borrowers. Also, the corporate world of today is getting more and more complicated. The businesses want growth that is stable in order to succeed in the environment. Businesses must embark on a significant expansion, diversification, and modernization programme to achieve this goal. In essence, these initiatives demand a significant financial commitment. Several businesses were compelled to explore for other methods of project financing due to factors such as high rates of inflation, rapid cost growth, onerous taxation, and limited internal resources. As a new method of financing capital assets, leasing has emerged.

1.2 Definition of Leasing :

"A lease represents a contractual arrangement whereby the lessor grants the lessee the right to use an asset in return for periodic lease rental payments. While leasing of land, buildings, and animals has been known from times immemorial, the leasing of industrial equipment is a relatively recent phenomenon, particularly on the Indian scene."

"A lease is a contractual arrangement calling for the lessee (user) to pay the lessor (owner) for use of an asset. Property, buildings and vehicles are common assets that are leased. Industrial or business equipment is also leased."

To put up broadly, a lease agreement is a contract between two parties, the lessor and the lessee. The lessor is the legal owner of the asset, while the lessee obtains the right to use the asset in return for regular rental payments. The lessee also agrees to abide by various conditions regarding their use of the property or equipment. For example, a person leasing a car may agree to the condition that the car will only be used for personal use.

1.3 Feature of Leasing :

The key features of lease finance in India :

– Most leases in India are finance leases not operating leases.
– Lease finance is available for identifiable performing assets.
– Lease finance is available in small volume.
– There is a great deal of flexibility in structuring lease finance.
– Lease of immovable assets is not possible by banks.
– Lease tenors up to eight years is available.

1.4 Indian Leasing Industry Structure :

Private sector leasing and public sector leasing make up the current structure of the leasing market in India.

Leasing in the private sector includes :

(i) Businesses that only lease.
(ii) Businesses that offer hire–purchase and financing
(iii) Businesses with Manufacturing Group Subsidiaries.

The following groups make up the public sector leasing organisation :

(i) Financial institutions' leasing departments.

(ii) Public sector banks' subsidiaries.

(iii) More public sector leasing companies.

LEASING IN THE PRIVATE SECTOR

(i) Pure leasing businesses :

These businesses run on their own, with no ties to or affiliations with any other organisations or groups of organisations. This group includes the Grover Leasing Limited, the Twentieth Century Financial Corporation Ltd, and the First Leasing Company of India Limited.

(ii) Businesses that offer hire–purchase and financing :

The businesses that had previously specialised in automobile finance and hire purchase added leasing to their offerings in 1980. Some of them engage in leasing as a primary activity, while others engage in it sparingly as a tool for tax planning. This group includes Sundaram Finance Limited and Motor and General Finance Ltd.

(iii) Manufacturing group companies' subsidiaries :

These businesses fall under the vendor leasing and internal leasing categories.

(a) **Vendor Leasing :** These businesses were created to increase and promote the sale of their parent company's products by providing leasing services.

(b) **In–house leasing :** In–house leasing or capture leasing businesses are created to satisfy capital needs or reduce group corporations' income tax obligations.

LEASING IN THE PUBLIC SECTOR

(i) Financial institutions :

Financial Institutions including IFCI, ICICI, IRBI, and NSIC, have established leasing subsidiaries or divisions to do leasing activity. The Shipping Finance and Investment Corporation of India provides its customers with lease options for ships, deep sea fishing vessels, and related equipment in foreign currencies.

(ii) Subsidiaries of Banks :

May be established to conduct leasing activities in accordance with section 19(1) of the Banking Regulation Act of 1949. In 1986, the SBI became the first bank to establish a subsidiary for the leasing industry.

In SBI, leasing is handled by the bank's Strategic Business Unit (SBU). Each SBU is staffed with properly qualified personnel and furnished with the newest technology tools to cater to the requirements of prestigious corporate customers. Leasing is viewed by the bank as a whole as having strong growth potential. The bank is currently mainly focusing on "Large Ticket Leasing," which typically costs Rs. 5 crore or more. SBI has so

far provided more than Rs. 300 billion through lease with the average size of deal being Rs. 25crores.

(iii) Other public sector organisations :

A handful of the manufacturing firms that are part of the public sector, like Bharat Electronics Limited, Hindustan Packaging Company Limited, and Electronic Corporation of India Limited, have begun to offer their equipment through leasing.

1.5 Types of Leasing :

I. Financial Lease :

A finance lease or capital lease is essentially a form of borrowing. Its salient features are :

1. It is an intermediate term to a long–term non–cancellable arrangement. During the initial lease period, referred to as the 'primary lease period'. Which is usually three years or five years or eight years, the lease cannot be cancelled.
2. The lease is more or less fully amortised during the primary lease period. This means that during this period, the lessor recovers, through the lease rentals, his investment in the equipment along with an acceptable rate of return. Thus, a finance lease transfers substantially all the risks and rewards incident to ownership to the lessee.
3. The lessee is responsible for maintenance, insurance, and taxes.
4. The lessee usually enjoys the option for renewing the lease for further periods at substantially reduced lease rentals.

II. Operating Lease :

An operating lease can be defined as any lease other than a finance lease. The salient features of an operating lease are :

1. The lease term is significantly less than the economic life of the equipment.
2. The lessee enjoys the right to terminate the lease at a short notice without any significant penalty.
3. The lessor usually provides the operating know–how and the related services and undertakes the responsibility of insuring and maintaining the equipment. Such an operating lease is called a 'wet lease'. An operating lease where the lessee bears the costs of insuring and maintaining the leased equipment is called a 'dry lease'.

From the above features of an operating lease it is evident that this form of a lease does not result in a substantial transfer of the risks and rewards of ownership from the lessor to the lessee. The lessor structuring an operating lease transaction has to depend upon multiple leases or on the realisation of a substantial resale value (on expiry of the first lease)

to recover the investment cost plus a reasonable rate of return thereon. Therefore, specialising in operating lease calls for an in–depth knowledge of the equipment and the secondary (resale) market for such equipment. Of course, the prerequisite is the existence of a resale market. Given the fact that the resale market for most of the used capital equipment in our country lacks breadth, operating leases are not in popular use. In recent years there have been attempts to structure car lease and computer lease transactions in the operating lease format.

1.6 Advantages of Leasing from the Viewpoint of Lessor :

(i) Higher Profits :

The lessor acting prudently can make high profits from leasing of the asset. The profits will take care of his cost of capital as well as the risk involved.

(ii) Tax Benefits :

The lessor being the owner of the asset can claim various tax benefits such as depreciation, investment allowance, etc. In fact, leasing has been successfully employed by the leasing companies to reduce their tax liabilities.

(iii) Quick Returns :

The lessor gets quick returns in the form of lease rentals as compared to investment in other projects which have a longer gestation period.

(iv) Increased Sales :

Lease financing through third parties has helped manufacturers to increase their sales. The lessors are also in position to demand certain concessions from the manufacturers.

1.7 Disadvantages of Leasing from the Viewpoint of Lessor :

(i) High Risk of Obsolescence :

The lessor has to bear the risk of obsolescence especially in the present era of rapid technology developments.

(ii) Competitive Market :

As a number of leasing companies have emerged in recent years in India, the lessor has to face a tough competition from Indian as well as foreign companies. Due to this competition, the lessor may not be able to obtain sufficient lease rentals to recover the cost of the asset and his expected profit on investment as well as taking the risk.

(iii) Price–Level Changes :

In spite of the increase in prices of assets due to inflation, the lessor gets only fixed rentals based on previous costs.

(iv) Management of Cashflows :

The success of a leasing business depends to a large extent upon efficient use of cashflows which are very difficult to manage because of unexpected market fluctuations.

(v) Increased Cost due to Loss of User Benefits :

The lessor is not entitled to certain benefits available to buyers who are actual users of the assets such as concession in sales tax, duties, etc. This increases the cost of the asset and compels the lessor to charge higher lease rentals.

1.8 Advantages of Leasing from the Viewpoint of Lessee :

(i) Avoidance of Initial Cash Outlay :

Leasing enables a firm to acquire the use of an asset without making capital investment in buying the asset. The lessee may avail 100% finance from lease financing and avoid even initial investment in margin money as required under loan financing. However, some leasing companies demand that first lease rent should be paid in advance.

(ii) Minimum Delay :

Usually, leasing companies take much lessor time in processing the lease proposal as compared to the lengthy procedure involved in the term–loan financing. Thus, a firm can avoid delay in the use of an asset by taking it on lease.

(iii) Easy Source of Finance :

Leasing provides one of the easiest sources of intermediate and long– term financing. It does not require any mortgage of the assets because the ownership of asset leased remains with the lessor and is not transferred to the lessee.

(iv) Shifting the Risk of Obsolescence :

In the present era of rapid changing technologies, a firm has to bear the risk of obsolescence if it purchases the asset. The firm (lessee) can easily shift this risk upon the lessor by acquiring the use of the asset on lease rather than buying the same.

(v) Enhanced Liquidity :

Sale and leaseback arrangement enables a firm to improve its liquidity position by realising cash from the sale of fixed assets and retaining the economic use of the same. Thus, the lessee can salvage its working capital crisis through lease financing.

(vi) Conserving Borrowing Capacity :

Leasing is a form of financing that does not reduce or affect the borrowing capacity of the lessee firm. It is considered to be a hidden form of debt which does not appear as a liability in the balance sheet of the lessee. Thus, it does not affect the debt equity ratio of the firm acquiring use of an asset through leasing.

(vii) Tax Planning and Differential Tax Advantage :

As lease rentals are considered as a revenue expense while determining taxable profits, it is advantageous for the lessee in minimising tax liabilities. Moreover, the lessor who is usually in the higher tax bracket passes on the benefit of depreciation advantage to the lessee in the form of reduced lease payments.

The lessee can also arrange to adjust lease rentals in such a way that it reduces his tax liability and thus helps him in tax planning.

(viii) Higher Return on Capital Employed :

Since the lessee acquires only the right to use the asset without owning it, such asset does not appear on the asset side of the balance sheet. This implies higher earnings against capital employed and higher rate of return on capital employed.

(ix) Convenience and Flexibility :

Operating or service leases are usually cancellable enabling the lessee firm to terminate the lease if it does not require the use of the asset, any more. Hence, it is very convenient and flexible mode of financing fixed assets.

(x) Lesser Administrative and Maintenance Costs :

Under a 'gross lease' arrangement, the lessee can avail the specialised services of the lessor for maintenance of the asset leased. Even in case of operating lease agreement there could be a provision of maintaining the asset by the lessor.

Although, the lessor charges for such maintenance and service costs by way of higher rentals, the lessee's overall administrative and service costs are reduced because of specialised services of the lessor.

1.9 Disadvantages of Leasing from the Viewpoint of Lessee :

(i) Higher Cost :

The lease rentals include a margin for the lessor as also the cost of risk of obsolescence; it is, thus, regarded as a form of financing at higher cost.

(ii) Loss of Moratorium Period :

The lease rentals do not take care of the gestation period. It usually takes a long time before the asset generates funds to pay it back. The term loan provides certain moratorium period in repayments for that reason. But no such moratorium is permitted under lease' arrangements.

(iii) Risk of Being Deprived of the Use of Asset :

The lessee may be deprived of the use of the asset due to the deterioration in the financial position of the lessor or winding up of the leasing company.

(iv) No Alteration or Change in Asset :

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 Ownership Incentives :

There are certain advantages of owning the assets, such as depreciation and investment allowance, In case of lease; the lessee is not entitled to such benefits.

(vi) Penalties on Termination of Lease :

The lessee is usually required to pay certain penalties if he terminates the lease before the expiry of the lease period.

(vii) Loss of Salvage Value of the Asset :

An asset generally has certain salvage value at the expiry of the useful life. As the lessee does not become the owner of the asset, he cannot realise the salvage value at the expiry of the lease rather he has to return the asset to the lessor.

1.10 Difference between Leasing and Hire Purchase :

Sr. No.	Points of Comparison	Leasing	Hire Purchase
1.	**Meaning**	Leasing is an agreement where one party buys the asset and allows the other party to use it by paying consideration over a specified period is known as Leasing.	The deal in which one party can use the asset of the other party for the payment of equal monthly instalments is known as Hire Purchasing.
2.	**Governing Ind. Accounting standard**	Leasing is governed by any Ind. AS - 17.	Hire-purchase is not governed by any specific accounting standard.
3.	**Requirement of down payment**	No requirement to give down payment.	Down payment is obligatory under hire purchase.
4.	**Duration**	Leasing is comparatively for long-term purpose.	Hire purchase is for short-term purpose.
5.	**Ownership**	Transfer of ownership depends upon the type of lease.	Ownership is transferred to the hirer purchaser on the payment of the last instalment.

6.	**Responsibility for Repairs & Maintenance**	Depends upon the type of lease.	Responsibility for repairs and maintenance is of hire purchaser.
7.	**Assets covered**	Land, Building, Plant & Machinery, etc.	Cars, trucks, tempos, vans, etc.

1.11 Direct Lease :

The direct lease is a simple form of a lease agreement where the lessor and the lessee are two separate entities and may have either the operating or a finance lease agreement. There can be two types of direct lease : **Bipartite Lease and the Tripartite Lease.**

In a bipartite lease, there are two parties to the lease agreement; one is the lessor, and the other is the lessee. Whereas in the case of a tripartite lease agreement, there are three parties to the agreement, one is the supplier of the equipment; the other is the lessor, and the third one is the lessee.

1.12 Sales and Lease Back :

Under this kind of lease agreement, the vendor of the asset sells his asset to the leasing company and leases it back in order to enjoy the uninterrupted use of the leased asset in his business operations. Generally, this kind of lease agreement is used by the entrepreneurs who want to free their money blocked on the assets or equipment and use that money for some other purpose.

The sale & lease back arrangement could pose problems for the leasing company because it is quite difficult to establish a fair market value of the asset being acquired. This is because, the secondary market for the asset may not exist and also the depreciation value claimed for the tax purposes could not be more than the value claimed earlier, by the vendor.

Check Your Progress :

1. Which of the following clearly define the Leasing services ?

   a. One party agrees to rent property own by another party

   b. It guarantees the lessee, also known as the tenant, use of an asset.

   c. It guarantees the lessor, regular payment from the lessee.

   d. All of the above

2. The type of lease that includes a third party, a lender, is called as which of the following ?

   a. Sale and leaseback   b. Leveraged lease

   c. Direct leasing agreement   d. Operating lease

3. A Direct lease, a sale and leaseback, and a Leveraged lease are all examples of which of the following ?

   a. Operating lease

   b. Financial lease

   c. Full – services leases

   d. Off–balance sheet method of financing

4. What are the benefits of leasing to other companies ?

   a. Interest revenue b. High residual values

   c. Tax incentives d. All of the above

5. Which of the following clearly defines Price Checking ?

   a. A prospect calls on the phone and ask for the rental rates.

   b. A supervisor checks your knowledge of rental rates.

   c. Both a & b

   d. None of the above

6. In case of Sub–lease royalty earned by the lessor is credited to ________

   a. Sub–lease account b. Profit and loss account

   c. Short working account d. Royalty receivable account

7. A 'sale and lease back' arrangement is more suitable for a lessee having

   a. Liquidity crisis b. Surplus fund

   c. High fund d. No–profit no–loss

1.13 Let Us Sum Up :

Leasing is a type of financial arrangement that allows a company to use an asset without purchasing it. There are numerous kinds of leases. The lessor and lessee are both parties to a lease. The lessor offers the parties to a lease agreement a number of advantages. The benefits of leasing are enormous for both the lessor and the lessee. Leasing promotes quicker production and sales of commodities, offers tax advantages to the lessee, boosts the capital market, offers a less expensive source of capital funds, and assists in avoiding capital outlay. Leasing, however, comes with a lot of disadvantages. In a hire buy agreement, the owner rents out his goods to the hirer and gives them the option to purchase them later. The hirer for making the contract–required purchases of the commodities.

1.14 Answers to Check Your Progress :

1. d **2.** b **3.** b **4.** d

5. a **6.** d **7.** a

1.15 Glossary :

1. **Lease :** A lease is a leasing contract that allows one person to use an item in exchange for reoccurring payments of rent.
2. **Lessor :** The term "lessor" refers to a person who grants another party the right to utilise an asset in exchange for a regular rental payment.
3. **Lessee :** A lessor grants a person the right to utilise an item in exchange for a regular rental payment over a predetermined period of time.
4. **Financial Lease :** A lease is deemed to be a financial lease if a significant portion of the risks and benefits of ownership are transferred from the lessor to the lessee.
5. **Operational Lease :** An operating lease is any type of lease that is not a financial lease.

1.16 Assignment :

1. Define leasing. Explain the different kinds of leasing.
2. Discuss the advantages and disadvantages of leasing.
3. Discuss the superiority of lease finance over other alternatives.
4. Discuss the status of income tax and sales tax in context of leasing in India.

1.17 Activity :

1. Study of leasing industry in India and also discuss about its accounting treatment.

1.18 Case Study :

1. According to you, which is a good option to adopt, Hire purchase or Lease ? Justify your answer by giving appropriate reasons.

1.19 Further Readings :

1. Varshney, P.N., and Mittal D.K., Indian Financial System, Sultan Chand & Sons, New Delhi.
2. Vinod Kothari, Lease Financing and Hire Purchase (Including Merchant Banking and Mutual Funds), Wadhwa and Co.(P). Ltd. Nagpur.
3. Sundharam, K.P.M., and Varshney, P.N., Banking and Financial System, Sultan Chand and Sons, New Delhi.
4. Meir, Kohn, Financial Institutions and Markets, Tata McGraw Hill, New Delhi.

: UNIT STRUCTURE :

2.0 Learning Objective

2.1 Introduction

2.2 Meaning of Hire Purchase

2.3 Features of Hire Purchase Agreement

2.4 Legal Status

2.5 Hire Purchase Agreement

2.6 Hire Purchase Interest and Instalments

2.7 Choice Criteria between leasing and Hire Purchase

2.8 Factoring and Forfeiting

2.9 Let Us Sum Up

2.10 Answers of Check Your Progress

2.11 Glossary

2.12 Assignment

2.13 Activity

2.14 Case Study

2.15 Further Readings

2.0 Learning Objective :

After studying this unit, you will be able to :

- Explain the concept of hire purchase
- Discuss legal framework
- Describe taxation of hire purchase

2.1 Introduction :

A method of financing the cost of the things that will be sold at a later time is through hire buy. In a hire purchase agreement, the products are rented out for a set period of time, the purchase price is divided into payments, and the hirer has the option to buy the things outright by making all of the instalments.

A method of selling items is through purchase. In a hire purchase transaction, a financial business (creditor) rents out the products to the hire purchase consumer (hirer). The customer is obligated to pay the agreed–upon sum in regular payments over the course of a certain term. After the final instalment is paid, the property's ownership transfers from the creditor to the hirer.

2.2 Meaning of Hire Purchase :

Hire purchase is an arrangement of purchasing any asset or goods by a person who can't pay price of such at a time. In other words, we can conclude that it's an arrangement of deferred payment system of purchase of assets or goods having relatively higher market value. Hire purchase is a financial transaction used by many industries or retailers to increase sales. Indian Middle class have lower purchasing power but regular income. Hence purchase of various movable assets like Refrigerator, Air–conditioner, Two–Wheeler etc. can be purchased through Hire purchase. This arrangement creates win–win situation for the buyer and seller also. From the seller's view point it increases sales of goods. And from buyer's view point one can purchase and get possession of such goods by paying significantly lower amount as to its price. Indian middle class can purchase many of home appliances and electronic equipment only through this way.

Hire purchase is has peculiar features under which ownership of assets or goods will be transferred to buyer only after payment of last instalment. This peculiar feature of the transaction indirectly compel buyer to pay all the amount and at same time it gives right to seller to recover possession of property.

Hire purchase agreement is an agreement in which

- Buyer one can get possession of property by
- Paying down payment (which is generally 10% of Purchase Price)
- And balance amount is paid out in either equal or unequal instalments with interest
- And ownership of such property or goods will be transferred to buyer after payment of last instalment.

Example of Hire Purchase :

Mr A has sold out Refrigerator of Rs. 25000 to Mr B on hire–purchase basis on 1–01–2019. Rs.5000 is to be paid out as down payment. Balance amount will be paid out in equal instalment with 12% interest rate.

Here in above transaction Mr A is seller. Owner of Refrigerator will be transferred to Mr B after last instalment payment. Similarly, Mr B gets the possession of Refrigerator after paying down–payment on 1–01–2019 itself. Buyer can start using assets immediately.

If buyer can't pay out down payment, then seller have right to recover property or goods given. Such seller can't be compelled to give back the amount of price paid. Seller can keep such price as rent for usage of the property.

In other words, we can say that hire purchase is a system through which seller provides financial liberty to buyer to make payment of high price goods or assets at convenience.

Banks and Non–banking financial companies are providing such financial assistance to the buyer of regular income. Generally speaking, such finance is provided against movable property or goods only. Banks and Nonbanking financial companies can create charge against such asset. Such charge is known as Hypothecation. Once payment has been made charge gets over. In case purchase of vehicle under this scheme RTO mentions such charge in RTO book or card. Hence such buyer can't sale out such property.

Here, most important and technical aspect is to be considered. The buyer of such property under hire purchase agreement can't sale out it before making payment of all instalments.

2.3 Features of Hire Purchase Agreement :

Hire purchase is the method of selling goods. In a hire purchase transaction, a financial business (creditor) rents out the products to the hire purchase consumer (hirer). The customer is obligated to pay the agreed–upon sum in regular payments over the course of a certain term. After the final instalment is paid, the property's ownership transfers from the creditor to the hirer. Characteristics of a hire–purchase agreement are as follows :

1. In a hire purchase system, the buyer agrees to pay the whole hire purchase amount in instalments and instantly receives possession of the products.
2. Each payment is regarded as a hire fee.
3. At completion of the final payment, the hirer becomes the owner of the goods.
4. The seller has the right to take back the items from the buyer and keep the money already paid, treating it as a hire fee, if the buyer defaults on paying any instalment.
5. Before the property passes, the hirer has the ability to end the contract at any moment. He has the choice to return the items, in which case he is exempt from making any further payments that become due. He is unable to get back the money already paid because it is technically a hire charge on the goods in question.

2.4 Legal Status :

A hire purchase agreement is described under the Hire Purchase Act of 1972 as "an arrangement whereby items are let on hire and whereby the hirer has the option to acquire them in accordance with the conditions of agreement under which :

1. Payment is to be made in instalments over a set period."
2. At the moment of signing a contract, the possession is given to the buyer.

3. Upon receipt of the final payment, the purpose becomes the owner of the items.
4. Because each instalment is recognised as a hiring fee, the seller has the right to remove the goods if any instalment is not paid on time.
5. The hirer or purchaser may return the products at any time without being obligated to pay any additional instalments that become due after the return.

2.5 Hire Purchase Agreement :

A hire purchase agreement must be in writing and be signed by both parties; there is no set format for such an arrangement.

The following information must be included in a hire purchase agreement :

(i) A sufficient description of the products to identify them.

(ii) The cost of the products for hire purchase.

(iii) The day the arrangement officially began.

(iv) The amount, due date, and number of instalments that must be paid towards the hire purchase price.

Credit Sale and Hire Purchase

Transactions involving higher prices are distinct from credit sales. When a property is actually sold, the title–that is, ownership and possession–are instantaneously transferred to the buyer; but, when a property is purchased through a hire–purchase agreement, ownership stays with the seller until the last payment is made.

Rental Agreements and Instalment Sales

A hire buy transaction is not an instalment agreement. While using an instalment plan, the buyer is immediately given both the right to use the products and their ownership at the time of the agreement. Also, the seller does not have the authority to take back the products when the buyer ceases paying their debts.

He is only allowed to return the products to the buyer in order to sue the customer for non–payment, but he is free to dispose of the things however he pleases. Since the risk is with the owner, any loss of the products should only be borne by the buyer.

Hire Purchase and Leasing

Leasing and hire purchase are also dissimilar for the reasons listed below :

1. Ownership :

Under a lease agreement, the lessor retains complete ownership of the commodities, while the lessee (hirer) has no right to acquire them.

2. **Method of Financing :**

Leasing is a way to finance commercial property, whereas hire purchase is a way to finance both commercial property and consumer goods.

3. **Depreciation :**

The lessee cannot claim depreciation or investment allowance when leasing. The hirer may claim depreciation and investment allowance in a hire purchase.

4. **Tax Advantages :**

Tax deductions are available for the total lease rental. Tax deductions for hire purchase instalments only apply to the interest portion.

5. **Value of Slavery :**

Since the lessee is not the asset's owner, they are not entitled to its salvage value. Being the asset's owner, the hirer benefits from the asset's salvage value during the purchase process.

6. **Payment :**

While a 20% deposit is necessary, the lessee is not obligated to pay any deposits in hire purchase.

7. **Rent – Purchase :**

When we buy the products with hire purchase, we rent with lease.

8. **Financial Resources :**

100% financing is always the case with lease financing. The lessee is not required to pay a down payment or margin money right away. A margin between 20 and 25 percent of the asset's cost must be paid by the hirer in a hire buy transaction.

9. **Maintenance :**

The hirer is responsible for covering the expense of maintaining the asset they have hired. Only in cases of financing lease is the lessee responsible for leasing asset upkeep.

10. **Reporting :**

The hirer's balance sheet displays the asset subject to hire purchase. The leased assets are simply mentioned in a footnote.

2.6 Hire Purchase Interest and Instalments :

In the hire–purchase agreement buyer get the possession of goods immediately. At the same time buyer need to pay amount of down payment immediately. After such down payment one need to make payment of purchase price instalments. Such instalment contains two elements. Viz. Principal amount and Interest amount both. Interest can be charges on the balance amount outstanding after down payment. Banks and Non–banking financial companies are earning in the form of interest charged to the borrower. Every instalment contains interest amount.

Amount of interest is highly depending upon rate of interest rate and balance amount to be paid out.

Sometime for ease in calculation and other aspects seller makes equal instalments of actual price of asset. And Interest amount will be added to such amount to get an amount of instalment.

Interest on outstanding amount of the instalment price is shown as interest in profit and loss account of respective Bank and Non–banking financial institutions. Balance amount of outstanding instalment is considered to be current assets.

Interest and other aspects if buyer become insolvent

If buyer could not pay out all instalments which he had been agreed at the time of agreement, then seller has several rights in such case. Following are such rights.

1. Seller can take possession of asset or goods sold on hire purchase method after giving written notice for payment of due instalments.
2. Whatever charges paid by buyer towards such property (interest and principle both) will not be refunded by the seller. It will be considered as charges for usage of property or goods given.
3. Seller has right to resale such property other person.
4. Rights of buyer towards such property get an end when seller gets possession of the property for non–payment.

2.7 Choice Criteria between leasing and Hire Purchase :

Lease is a form of transaction or agreement to increase revenue of an organisation having higher value. Under lease agreement owner of property gives right to use of assets to another person for specific period of time and obtain a lump sum amount as lease rent from the user of property. After completion of term of usage such asset either need to give back to its owner or to be destroyed. The treatment of asset or goods under lease agreement after completion of term is highly depending upon contract.

Those assets having higher price and highly technological base preferred to be obtained through lease rent. This situation is created due to two main reasons viz. lower purchasing power of buyer and such goods or assets becomes useless after change in technology. Though rental amount of such asset is higher buyers are ready to have such assets for certain period of time. Nowadays technology is changing constantly and faster way also. Hence, buyer would like to prefer to have latest assets or goods for the business. Such option is open only when obtain different assets on lease basis. One can get advantages of new asset at regular interval of time with relatively low investment.

2.8 Factoring and Forfeiting :

FACTORING :

Factoring, receivables factoring or debtor financing, is when a company buys a debt or invoice from another company. Factoring is also seen as a form of invoice discounting in many markets and is very similar but just within a different context. In this purchase, accounts receivable is discounted in order to allow the buyer to make a profit upon the settlement of the debt. Essentially factoring transfers, the ownership of accounts to another party that then chases up the debt.

Factoring therefore relieves the first party of a debt for less than the total amount providing them with working capital to continue trading, while the buyer, or factor, chases up the debt for the full amount and profits when it is paid. The factor is required to pay additional fees, typically a small percentage, once the debt has been settled. The factor may also offer a discount to the indebted party.

Factoring is a very common method used by exporters to help accelerate their cash flow. The process enables the exporter to draw up to 80% of the sales invoice's value at the point of delivery of the goods and when the sales invoice is raised.

FORFEITING :

Forfaiting is the purchase of an exporter's receivables – the amount that the importer owes the exporter – at a discount by paying cash. The purchaser of the receivables, or forfeiter, must now be paid by the importer to settle the debt. This is a common process used for speeding up the cash flow cycle and providing risk mitigation for the exporter on 100% of the debts value.

As the receivables are usually guaranteed by the importer's bank, the forfeiter frees the exporter from the risk of non–payment by the importer. When a forfeiter purchases the exporter's receivables directly from the exporter then it is referred to as a primary purchase. The receivables technically then become a form of debt instrument that can be sold on the secondary market as bills of exchange or promissory notes, this is known as a secondary purchase.

Check Your Progress :

1. Hire purchase is useful for which class of people ?

   a. Upper b. Lower c. Middle d. Lower–middle

2. Under which form, of agreement, ownership of assets is transferred only after payment of last instalment ?

   a. Hire purchase b. Mortgage c. Pledge d. Lease

3. Under hire purchase, finance is provided against which kind of property ?

   a. movable b. immovable c. both d. none

4. Under which of the following form, right to use assets is given for a specific period ?

   a. Hire purchase b. Mortgage c. Pledge d. Lease

5. Interest on outstanding amount of the instalment price is shown as _____ in profit and loss account of respective Bank/NBFC.

   a. expense b. interest c. BDR d. none

6. Which of the following form of agreement is generally selected by person having lower purchasing power to gain advantage of obtaining or utilizing costly assets ?

   a. Hire purchase b. Mortgage c. Pledge d. Lease

7. Which of the following form of agreement is formed in order to purchase exporter's receivables ?

   a. Factoring b. Forfeiting c. a & b d. none

8. Under hire purchase, buyer needs to pay a specific amount known as ________ at the time of purchase.

   a. stock payment b. advance payment

   c. down payment d. none

9. Generally companies which are facing difficulty for ______ takes decision for hire purchase.

   a. Cash b. Debt

   c. Equity d. Working Capital

10. Hire purchase agreement are generally made for ______.

    a. short–term b. medium–term

    c. long–term d. none

2.9 Let Us Sum Up :

There is no need for anything in a Hire Purchase agreement, the owner agrees to rent out his goods to the hirer in exchange for a purchase option that the hirer may exercise in line with the contract's terms. Hire purchase is the method of selling goods. In a hire purchase transaction, a financial business (creditor) rents out the products to the hire purchase consumer (hirer). The customer is obligated to pay the agreed–upon sum in regular payments over the course of a certain term. After the final instalment is paid, the property's ownership transfers from the creditor to the hirer.

The hirer always has the option to purchase the movable asset by paying the regular hire charges, and the property in the items goes to him upon payment of the last instalment, therefore the element of sale is inherent in a hire–purchase contract.

Three categories–Income Tax, Sales Tax, and Interest Tax–can be used to categorise the tax implications of hire buy transactions. Each sort of hire purchase agreement has a unique feature.

2.10 Answers of Check Your Progress :

1. c	**2.** a	**3.** a	**4.** d	**5.** b
6. d	**7.** b	**8.** c	**9.** b	**10.** a

2.11 Glossary :

1. **Hire Purchase :** Hire purchase is a type of financial transaction in which things are bought and sold according to a set of terms and conditions, such as the buyer receiving immediate ownership of the goods after purchase and the payment of monthly instalments.
2. **Salvage Value :** The book value of an asset after all depreciation has been fully expensed is known as the salvage value. An asset's salvage value is determined by what a business anticipates getting in return for selling or dividing it up after its useful life has passed.
3. **Stamp Duty :** State governments apply a charge known as stamp duty on the purchase and sale of real estate.
4. **A Document of Title to Goods :** It is one that permits and enables its legitimate bearer to conduct business with the goods it represents as though he were the owner.
5. **Goods :** The "goods" are the "subject matter" of a sales contract.
6. **Security Deposit :** In some contracts, the buyer is required to pay a sum up front as earnest money or as a security deposit to ensure that his portion of the deal would be carried out as agreed.

2.12 Assignment :

1. Meaning of Hire purchase with example.
2. Rights of seller under hire purchase in case buyer becomes insolvent. Explain the statement.
3. Advantages of Lease
4. Disadvantages of Lease
5. Define hire purchase. Discuss its features.
6. Explain Factoring and Forfeiting agreement in brief.

2.13 Activity :

1. Define Hire Purchase. Explain with example determination on interest and instalment under hire purchase for buying an asset.

2.14 Case Study :

1. According to you, which is a good option to adopt, Hire purchase or Lease ? Justify your answer by giving appropriate reasons.

2.15 Further Readings :

1. Varshney, P.N., and Mittal D.K., Indian Financial System, Sultan Chand & Sons, New Delhi.
2. Vinod Kothari, Lease Financing and Hire Purchase (Including Merchant Banking and Mutual Funds), Wadhwa and Co.(P). Ltd. Nagpur.
3. Sundharam, K.P.M., and Varshney, P.N., Banking and Financial System, Sultan Chand and Sons, New Delhi.
4. Meir, Kohn, Financial Institutions and Markets, Tata McGraw Hill, New Delhi.

: UNIT STRUCTURE :

3.0 Learning Objective
3.1 Introduction
3.2 Meaning of Housing Finance
3.3 Rise of Housing Finance in India
3.4 Fixing Amount of Loan
3.5 Floating vs. Fixed Rate
3.6 Venture Capital : Concept
3.7 Characteristics of Venture Capital
3.8 Stages of Investment/Financing
3.9 Venture Capital Regulatory Framework
3.10 Eligibility and Investment Criteria for Venture Capital Funds
3.11 Let Us Sum Up
3.12 Answers of Check Your Progress
3.13 Glossary
3.14 Assignment
3.15 Activity
3.16 Case Study
3.17 Further Readings

3.0 Learning Objective :

After reading this lesson, you will be able to :

(a) Trace the role being played by National Housing Bank

(b) Appreciate the institutional framework of housing finance.

(c) Discuss the new developments that have taken place in housing finance.

(d) Recognize the idea, application, and method of venture capital.

(e) Explain the significance of venture capital.

3.1 Introduction :

Financial resources are used to mobilise savings. These savings are typically produced by households and used by the commercial sector. Nonetheless, there are some instances where other household sector players need the funds made by households. The housing industry is the clearest illustration of this. There is a severe housing shortage in the

majority of nations. Because of this, housing costs in urban areas are soaring. This indicates that relatively few people can afford to pay the full price of a home up front. Many want to borrow money up front and pay it back in instalments, thus there is a high demand for housing finance.

Venture capitalists are a new breed of professional investors who specialise in combining risk money with entrepreneur management and using cutting–edge technology to introduce new goods and businesses to the market.

Unquestionably, what has drawn more participants into the market is the venture capitalist's exceptional talent and capacity to evaluate and handle large risks and extract from them tremendous gains.

3.2 Meaning of Housing Finance :

"Housing Finance is a business of financial intermediation wherein the money raised through various sources such as public deposits, borrowings, refinance from different institutions and their own capital is lent to borrowers for purchasing a house."

"Housing Finance is financing, for purchase/ construction/ reconstruction/ renovation/ repairs of residential dwelling unit."

3.3 Rise of Housing Finance in India :

- In the early years of independence, housing was through the self–construction route and later on emerged the concept of housing cooperatives which encouraged group housing.
- Housing cooperatives have a prominent place in the cooperative movement in the country. Today, it is estimated that there are over 92,000 primary housing cooperatives with over 6.5 million members.
- Also, the government/quasi–government entities, like housing boards and development authorities allotted land and housing sites to facilitate the development of this sector.
- In many cases, public–private partnerships in complex projects that take the shape of mini–cities, malls and multiplexes, information–technology parks and housing communities, specialized townships, special economic zones and even the concept of private towns is found.
- A noteworthy change has been in the financing opportunities for housing and real estate. It was difficult for builders/developers to find financiers for funding housing and real estate.
- Today, there are a number of options to finance housing and real–estate projects through initial public offerings (IPOs), foreign direct investment (FDI), venture capital, private equity, listings on alternative investment market, in addition to the traditional debt–financing options.

- In order to enable Housing Finance Corporations to finance big construction projects, they have been allowed to raise funds through foreign–currency bonds. They can mobilize resources by selling 15–year, upper–tier–II instruments, including foreign –currency bonds, which need the clearance of the RBI.
- These options would be cheaper source option to raise capital, boost housing–finance market and help maintain regulatory stipulations.

3.4 Fixing Amount of Loan :

- The amount of loan will depend on the market value of the residential property, as assessed by the PLI (Product Liability Insurance), age of borrower and the prevalent interest rate.
- The PLIs will have the discretion to determine the eligible quantum of loan reckoning the 'no negative–equity guarantee' being provided by the PLI.
- The methodology adopted for determining the quantum of loan, including the detailed tables of calculations, the rate of interest and assumptions (if any), shall be clearly disclosed to the borrower.
- The PLI may consider ensuring that the equity of the borrower in the residential property (equity–value ratio) EVR does not at any time, during the tenor of the loan fall below 10 per cent.
- The PLIs will need to re–value the property mortgaged to them at intervals that may be fixed by the PLI, depending upon the location of the property, its physical state and so on.
- Such revaluation must be done at least once every 5 years, the quantum of loan may undergo revisions based on such re–valuation of property, at the discretion of the lender.

3.5 Floating vs. Fixed Rate :

Sr. No.	Points of Comparison	Leasing	Hire Purchase
1.	**Interest rate**	Higher Interest Rate	Lower Interest Rate
2.	**Financial market conditions**	Not affected by financial market conditions	Affected by changes in the financial market
3.	**Change of EMIs**	Fixed EMIs	EMIs change as per interest rate or MCLR
4.	**Budget Planning**	Budget planning possible	Difficult to budget or manage financials
5.	**Security**	Sense of security	Generates savings
6.	**Tenure**	Suitable for short/medium term (3-10 years)	Suitable for long term (20-30 years)
7.	**Risk**	Lesser risk	Higher risk

3.6 Venture Capital : Concept :

Venture capital is growing business of recent origin. It refers to investment in new & tried enterprises that are lacking a stable record of growth. Venture capital is long–term risk capital to finance high technology projects which involve risk but at the same time has strong potential for growth.

Venture capital company can be defined as,

"A financial institution which joins an entrepreneur as a co–promoter in a project & shares the risk & rewards of the enterprise".

"It is a private or institutional investment made into early–stage / start–up companies (new ventures)".

3.7 Characteristics of Venture Capital :

1. Illiquid :

Venture capital investments are usually long–term investments and are fairly illiquid compared to market–traded investment instruments. Unlike, publicly traded investment instruments, VC investments don't offer the option of a short–term payout. Long–term returns from venture capital investing depend largely on the success of an IPO.

2. Long–term investment horizon :

Venture capital investments feature a structural time–lag between the initial investment and the final pay–out. The structural time–lag increases the liquidity risk. Therefore, VC investments tend to offer very high returns to compensate for this higher than normal liquidity risk.

3. Large discrepancy between private valuation and public valuation :

Unlike standard investment instruments that are traded on some organized exchange, VC investments are held by private funds. Thus, there is no way for any individual investor in the market to determine the value of the investment. The venture capitalist also does not know how the market values his investment. This causes IPOs to be the subject of widespread speculation from both the buy–side and the sell–side.

4. Entrepreneurs lack full information about the market :

The majority of venture capital investing is into innovative projects whose aim is to disrupt the market. Such projects offer potentially very high returns but also come with very high risks. As such, entrepreneurs and VC investors often work in the dark because no one else has done what they are trying to do.

5. Mismatch between entrepreneurs and VC investors :

An entrepreneur and an investor may have very different objectives with regards to a project. The entrepreneur may be concerned with the process (i.e., the means) whereas the investor may only be concerned with the return (i.e., the end).

6. Mismatch between VC investors and fund managers :

An investor and a fund manager may have different objectives regarding a particular project. The difference in interest depends largely on the contract signed by the fund manager. For instance, many fund managers are paid based on the size of the VC fund and not based on the returns generated. Such fund managers tend to take on excessive risk with regards to investments.

3.8 Stages of Investment/Financing :

1. Seed Stage :

At the seed stage, the company is only an idea for a product or service, and the entrepreneur must convince the venture capitalist that their idea is a viable investment opportunity. If the business shows potential for growth, the investor will provide funding to finance early product or service development, market research, business plan development, and setting up a management team. Seed–stage venture capitalists participate in other investment rounds alongside other investors.

2. Startup Stage :

The startup stage requires a significant cash infusion to help in advertising and marketing of new products or services to new customers. At this stage, the company has completed market research, has a business plan in place, and a prototype of their products to show investors. The company brings in other investors at this stage to provide additional financing.

3. First Stage :

The company is now ready to go into actual manufacturing and sales, and this requires a higher amount of capital than the previous stages. Most first–stage businesses are generally young and have a commercially viable product or service.

4. Expansion Stage :

The business has already started selling its products or services and needs additional capital to support the demand. It requires this funding to support market expansion or start another line of business. The funding may also be used for product improvement and plant expansion.

5. Bridge Stage :

The bridge stage represents the transition to a public company. The business has reached maturity, and it requires financing to support acquisitions, mergers, and IPOs. The venture capitalist can exit the company at this stage, sell off his shares, and earn a huge return on his investments in the company. The exit of the venture capitalist allows other investors to come in, hoping to gain from the IPO.

3.9 Venture Capital Regulatory Framework :

Venture Capital in India governs by the SEBI Act, 1992 and SEBI (Venture Capital Fund) Regulations, 1996. According to which, any company or trust proposing to carry on activity of a Venture Capital Fund shall get a grant of certificate from SEBI. However, registration of Foreign Venture Capital Investors (FVCI) is not obligatory under the FVCI regulations. Venture Capital funds and Foreign Venture Capital Investors are also covered by Securities Contract (Regulation) Act, 1956, SEBI (Substantial Acquisition of Shares & Takeover) Regulations, 1997, SEBI (Disclosure of Investor Protection) Guidelines, 2000.

Constitution of Venture Capital Funds :

There are three layers of structured or institutional venture capital funds i.e. venture capital funds set up by high net worth individual investors, venture capital subsidiaries of corporations and private venture capital firms/ funds. Venture funds in India can be divided on the basis of the type of promoters.

1. Venture Capital Funds promoted by the Central government controlled development financial institutions such as ICICI, Risk capital and Technology Finance Corporation Limited (RCTFC) by the Industrial Finance Corporation of India (IFCI) and Risk Capital Fund by IDBI.
2. It is promoted by the state government–controlled development finance institutions such as Andhra Pradesh Venture Capital Limited (APVCL) by Andhra Pradesh State Finance Corporation (APSFC) and Gujarat Venture Finance Company Limited (GVCFL) by Gujarat Industrial Investment Corporation (GIIC)
3. Also, promoted by Public Sector banks such as Canfina and SBI–Cap.
4. Venture Capital Funds promoted by the foreign banks or private sector companies and financial institutions such as Indus Venture Fund and Grindlay's India Development Fund.

3.10 Eligibility and Investment Criteria for Venture Capital Funds :

- For Venture Capital Funds it is required that Memorandum of Association or Trust Deed must have main objective to carry on action of Venture Capital Fund including prohibition by Memorandum of Association & Article of Association for making an invitation to the public to subscribe to its securities.
- Further, it is required that Director or Principal Officer or Employee or Trustee is not caught up in any litigation connected with the securities market and has not at any time been convicted of any offence involving moral turpitude or any economic offence.
- Also, in case of, body corporate, it must have been set up under Central or State legislations and applicant has not been refused certificate by SEBI.

- A Venture Capital Funds may generate investment from any investor (Indian, Foreign or Non–resident Indian) by means of issue of units and no Venture Capital Fund shall admit any investment from any investor which is less than five Lakhs.
- Employees or principal officer or directors or trustee of the VCF or the employees of the fund manager or Asset Management Company (AMC) are only exempted. It is also mandatory that VCF shall have firm commitment of at least five Crores from the Investors before the start of functions by the VCF.
- Disclosure of investment strategy to SEBI before registration, no investment in associated companies and duration of the life cycle of the fund is compulsorily being done.
- It shall not invest more than twenty five percent of the funds in one Venture Capital Undertaking. Also, minimum 66.67% of the investible funds shall be utilized in unlisted equity shares or equity linked instruments of Venture Capital Undertaking.
- It is also mandatory that not more than 33.33% of the investible funds may be invested by way of following as stated below :–

1. Subscription to IPO of a Venture Capital Undertaking (VCU)
2. Debt or debt instrument of a VCU in which VCF has already made an investment by way of equity
3. Preferential allotment of equity shares of a listed company subject to lock in period of one year
4. The equity shares or equity linked instruments of a monetarily weak company or a sick industrial company whose shares are listed.
5. SPV (special purpose vehicles) which are created by VCF for the purpose of making possible investment.

RBI and Investment Criteria :

A foreign venture capital investor proposing to carry on venture capital activity in India may register with the Securities and Exchange Board of India ("SEBI"), subject to fulfilling the eligibility criteria and other requirements contained in the SEBI Foreign Venture Capital Investor Regulations. The SEBI Foreign Venture Capital Investor Regulations prescribe the following investment guidelines, which can impact overall financing plans of foreign venture capital funds.

(a) The foreign venture capital investor must disclose its investment strategy and life cycle to SEBI, and it must achieve the investment conditions by the end of its life cycle.

(b) At least 66.67 per cent of the investible funds must be invested in unlisted equity shares or equity linked instruments.

(c) Not more than 33.33 per cent of the investible funds may be invested by way of :

- Subscription to initial public offer of a venture capital undertaking, whose shares are proposed to be listed.
- Debt or debt instrument of a venture capital undertaking in which the foreign venture capital investor has already made an investment, by way of equity.
- Preferential allotment of equity shares of a listed company, subject to a lock–in period of one year.
- The equity shares or equity linked instruments of a financially weak or a sick industrial company (as explained in the SEBI FVCI Regulations) whose shares are listed.

A foreign venture capital investor may invest its total corpus into one venture capital fund

Check Your Progress :

1. Which of the following are the characteristics of a Mortgage Loan ?

   a. It is secured against, immovable or fixed property.

   b. It is long term loan in nature.

   c. It is repaid in small monthly instalments along with interest.

   d. All of the above

2. Who of the following plays the vital role in setting up of National Housing Bank ?

   a. K .R. Puri   b. Dr. Minoan Singh

   c. C. Rangrajan   d. None of the above

3. HFC stands for which of the following ?

   a. Housing Finance Company

   b. Housing Finance corporation

   c. Housing Federation of commerce

   d. None of the above

4. National Housing Bank is wholly owned by which of the following institutions ?

   a. RBI   b. SEBI

   c. SBI   d. None of the above

5. National Housing Bank was set up on July 9, 1988 under which among the following acts ?

   a. National Housing Bank Act, 1985

   b. National Housing Bank Act, 1986

   c. National Housing Bank Act, 1987

   d. None of the above

6. NHB has been established with an objective to
   a. Operate as a principal agency to promote housing finance institutions
   b. Promote housing finance institutions both at local and regional levels
   c. Provide financial and other support incidental to such institutions and for matters connected therewith
   d. All of The Above
7. The Head Office of National Housing Bank is at
   a. Kolkata b. Bangalore c. New Delhi d. Mumbai
8. _______ is an apex financial institution for housing
   a. RBI b. SBI
   c. NHB d. None of The Above
9. The loan which is made available for businesses or individuals to buy land, home or other property is classified as
   a. Secondary loan b. Primary loan
   c. Mortgages d. Swapped mortgages
10. The mortgages used to purchase the townhouses and apartment complexes are classified as
    a. Multi mortgages
    b. Multifamily dwelling mortgages
    c. Sovereign dwelling mortgages
    d. Primary dwelling mortgages

3.11 Let Us Sum Up :

A basic human requirement is housing. Hence, as long as there are people in the globe, there will be a need for homes. In this competition, home financing is essential in supplying the money required for housing construction, additions, and modifications. One of the top concerns for emerging nations has been the provision of basic housing facilities. Foreign financial institutions like the World Bank are offering these nations all the resources and help they need to build their housing markets. The expansion of home finance in India has been influenced by numerous causes.

Budgetary assistance for housing supplied by the government in the form of tax advantages, comparably higher staff compensation packages, new heightened rivalry among the HFCs, etc. are crucial in this regard. Before opting to offer home finance assistance, housing finance businesses take into account variables including the loan amount, the term, the cost of the loan, etc. NHB, LIC, HDFC, and other organisations that offer housing finance facilities. Since they provide more than 80% of the finance needed for home building in India, HUDCO, etc., are significant.

Venture capital is a type of financial service that focuses on offering financial and other support to high–tech, high–risk, and high–return companies. The high expectations of entrepreneurs for huge profits are catered for in the architecture of venture capital. The granting of equity or seed capital is the typical method of venture financing. The defining characteristic of venture financing is financing high–risk projects. Venture capital offers value–added services to investee companies in addition to money, such as business expertise. To determine whether their investments in new enterprises are desirable, venture capitalists use certain approaches.

Moreover, venture capital is highly popular in India, where both public and private sector businesses have established venture capital funds. Several types of finance, including R&D financing, startup financing, expansion financing, replacement financing, turnaround financing, etc., are provided by venture capitalists. Together with their own capital, venture capitalists can also borrow money from banks and other financial organisations. 'Buy–out deals,' in which a venture capitalist purchases the managerial holding of a firm, are a common method of venture funding. In order to maximise the advantages of venture capital investments, venture capitalists offer investment–nurturing services as a part of their attempts to establish strong relationships with the investee companies.

3.12 Answers of Check Your Progress :

1. d	**2.** c	**3.** a	**4.** a	**5.** c
6. d	**7.** c	**8.** c	**9.** c	**10.** b

3.13 Glossary :

1. **Housing Finance :** A collection of all financing options provided by Housing Finance Companies (HFCs) to suit housing construction needs.
2. **Housing Initiatives :** a collection of houses or apartments created using public funds for low–income households.
3. **Estate of Houses :** A big group of dwellings that are purposefully constructed next to one another.
4. **Venture Capital :** A high–risk, high–return capital vehicle, typically in the form of equity financing, for high–tech businesses.
5. **Venture Capital Fund :** A fund established by venture capitalists to provide high–risk finance to businesses.
6. **Start–up Financing :** Financing is required for the creation of product facilities, beginning marketing, and product development.

3.14 Assignment :

1. What kinds of business can be transacted by National Housing Bank ?
2. Discuss the recent developments that have taken place in the field of housing finance in India.

3. What is venture capital ? Discuss the scope of venture capital in India.
4. Discuss the strategic role of venture capital in the development of a country.

3.15 Activity :

1. Make suggestions for the success of venture capital in India.

3.16 Case Study :

1. Give a brief overview of various institution/agencies involved in housing finance system

3.17 Further Readings :

1. Bansal, L.K., Merchant Banking and Financial Services, Unistar Books Pvt. Ltd., Chandigarh.
2. Bhole, L.M. (2004). Financial Institutions and Markets.
3. Tata McGraw Hill Publishing Co. Ltd. Khan, M.Y. (2004).
4. Financial Services. Tata McGraw Hill Publishing Co., Ltd. Report on Trend and Progress of Housing in India, June, 2002 (NHB).
5. Varshney, P.N. and D.K. Mittal (2005). Indian Financial System. Sultan Chand & Sons, New Delhi.
6. Pandey, I.M., Financial Management, Vikas Publishing House, New Delhi.

Unit 4

FACTORING

: UNIT STRUCTURE :

4.0 Learning Objective
4.1 Introduction
4.2 Factoring–Meaning, Parties Involved
4.3 Mechanism of Factoring
4.4 Types of Factoring
4.5 Advantages and Dis–Advantages of Factoring
4.6 Factoring v/s Bill Discounting
4.7 Indian Scenario of Factoring
4.8 Let Us Sum Up
4.9 Answers of Check Your Progress
4.10 Glossary
4.11 Assignment
4.12 Activity
4.13 Case Study
4.14 Further Readings

4.0 Learning Objectives :

You ought to be able to :

(a) Comprehend the ideas of factoring after reading this lesson.

(b) Describe how factoring works.

(c) List the many forms and types of factoring.

(e) Go over the advantages and disadvantages of forfeiting.

(f) Describe a scenario involving factoring in India.

4.1 Introduction :

A sizeable share of the company's current assets is made up of receivables. Yet, a company must pay some expenses, such as those associated with financing receivables and recovering debt from them, in order to invest in receivables. Moreover, there is a chance of bad loans. Thus, having adequate control and management of receivables is crucial. Indeed, keeping track of receivables creates two different kinds of issues :

First, there is the issue of finding the money to finance the receivables, and second, there are issues with the collection, timeliness, and default of the receivables.

A small business may be able to manage its receivables issues on its own, but a large business may not be able to do so effectively due to the risk of accumulating more and more bad debts. In this situation, a company may use the services of specialized organizations known as factoring firms that manage receivables.

In 1988, a committee led by Shri C. S. Kalyan Sundaram investigated the implications of factoring services in India at the request of the RBI. This investigation served as the foundation for the introduction of factoring services in India. SBI created a subsidiary called SBI Factors Limited in 1991 with a 25 crore authorized capital to provide factoring services for the western zone.

4.2 Meaning of Factoring :

Bills receivable comprise an important component of current assets of any company. Bills receivables and debtors represent the credit sales of a business and it is an important strategy to boost sales volume. However, it is a double–edged sword. On one hand, increased sales results in more bills receivables and debtors and on the other hand, it increases the cost of managing the bills receivables in the form of collection cost, financing cost and the default rate risk due to possibility of non–payment by debtors. The small businesses can manage the receivables in more efficient manner but it is not the same case for a large business houses. The business of the large business/ companies extends to national and international borders and therefore the management of receivables is an extremely challenging task. Hence they need the services of some specialized institutions that have expertise in the receivable management. These specialized institutions are called factor and the services provided by them is called Factoring.

The word factoring has its origin from the Latin verb *'facere'* which means 'to do' or 'to make'. *Factoring is defined as a specialized service provided by financial institution in which financial institutions buy (through an agreement) receivables from the seller of goods/ services and manage seller's receivables. The specialized institution is called the factor.* Factoring service is not confined to the financing of receivables of client but also includes other services of the client like :

1. Maintenance of books of accounts of client's debtors
2. Collection of debts on behalf of client
3. Protection of client against any default risk or non– payment of receivables

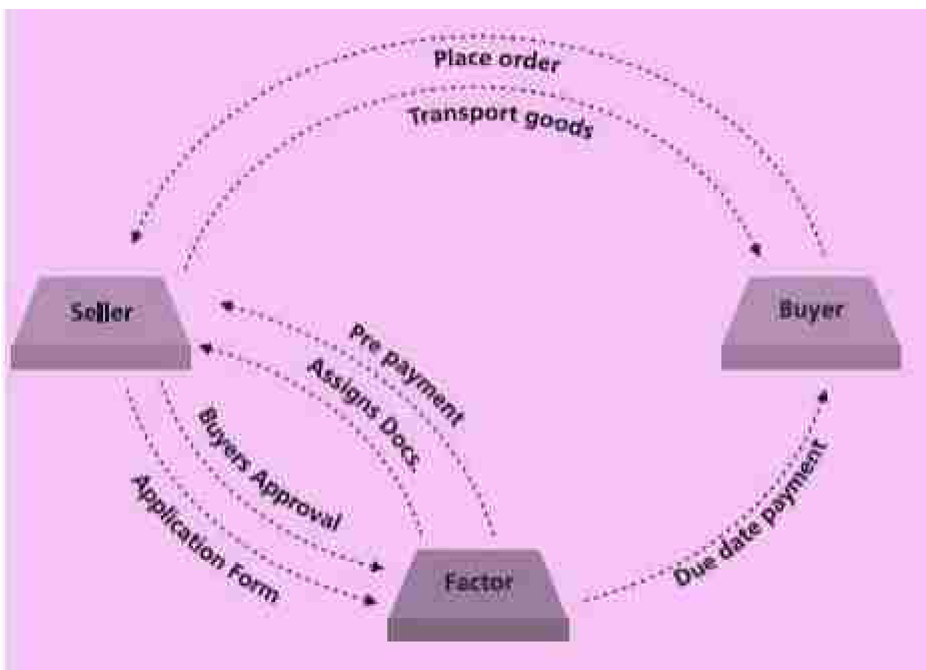
In other words, factoring is a receivables management and financing mechanism which is designed to improve cash flows and cover the credit risk of the seller.

Parties involved in Factoring : There are three parties involved in a factoring contract.

1. **Seller of goods (Client) :** The seller is the person who sells goods on credit and avails factoring services from factor. The seller receives approximately 80% of the amount (depending upon the type of factoring service availed by seller and negotiations between the factor and seller) of receivables. Once the seller enters into a legal contract with the factor, seller sends instructions to its debtors to make payments to factor at the expiry of the time period.
2. **Buyer of goods (debtor) :** The buyer is the person who buys goods/services from the client/seller and makes an agreement to pay for these goods on some future date. He receives instructions from the seller to pay money for the goods bought on credit directly to the factor. In case the buyer is not able to pay the money due to the factor, then the factor has the right to take legal actions against the buyer.
3. **Factor (financial institution) :** The factor discounts the bills of the seller and gives him money on the promise that the debtor of the seller will pay him (factor) on some future date. For this, factor charges some percentage as commission from the seller.

4.3 Mechanism of Factoring :

The factoring is the mechanism of providing financial services to the clients but the role of the factor is not confined to financing function only. It also provides other services like receivables management, administration of sales ledger, risk protection and other advisory services. The mechanism of factoring can be summarized in the figure below :



1. The seller and the factor enter into an agreement of factoring. In this agreement, they decide the terms and conditions of factoring. The factor asks for the financial statements (last three years) of the seller.

2. After the seller submits the financial documents, the factor verifies the documents and carries out the client appraisal by conducting credit assessment on the basis of quantitative and qualitative parameters.
3. The seller sells goods to the buyer on credit
4. The seller sends invoice to the factor and discounts his bills after payment of commission to the factor. Usually, the amount of bills discounted is approximately 80% or more of the final payment expected to be received from the buyer of goods at the future date.
5. Now the factor waits till the due date and on the due date, he receives money from the buyer of the goods
6. Factor makes the final payment to the seller of the goods after deducting fees and commission or charges for providing this service to the seller.

4.4 Types of Factoring :

There are several forms of factoring. The important ones as as follows :

1. Recourse and Non–recourse factoring

In recourse factoring, the factor buys the receivables of the client firm on the condition that the loss arising due to bad debts will be borne by the client firm. That is, the factor does not provide protection against the bad debts. This is less risky from the factor's viewpoint but from the client's viewpoint, there is no protection against the risk of bad debts. Recourse factoring is the most common type of factoring and is often used when a firm has high–risk customers and credit information is scarce.

Under Non–recourse factoring, the factor provides a safety net to its client against the default rate risk associated with the buyers of goods/services. The factor bears the risk of bad debts arising from the non–payment of dues by the customers. For bearing this risk, the factor charges additional commission which is called del credere commission. The factor also assumes the responsibility of maintaining the sales ledger. Although non–recourse factoring is expensive for the client firm, it is used when the firm has a large number of customers and it is difficult to monitor and control the credit collection. Moreover, non–recourse factoring provides 100 percent financing of receivables. However, the factor might set credit limits for customers while undertaking non–recourse factoring.

2. Advance factoring and Maturity factoring

Under advance factoring agreement, the factor gives a specific percentage of total receivables in advance to the client. Generally, this percentage varies from 75 percent to 95 percent. The balance amount is paid on the collection of factored receivables or on a date specified in the agreement. Various aspects affect the value of discount rate under

advance factoring, namely, creditworthiness of buyers, total volume of sales, rates offered by competitors and duration of factoring agreement.

Under Maturity factoring, the factor does not pay any amount upfront (advance). Instead, the factor pays the amount to the client on a specified date in future, regardless of whether customers have settled their dues, or on the collection of receivables. Here the role of the factor is like an agent of the client and he performs the function of collection of receivables on behalf of his client.

3. Conventional/Full Factoring :

Under this form of factoring service, the factor executes majority of the factoring functions of the client. It includes maintenance of sales ledger, maintenance of books of accounts of client, credit collections and advisory functions for the client. This type of factoring service is more popular in developed countries in comparison to India. In India, SBI offers such services to its clients with recourse and having sound track record of the financial performance and has good credit rating or creditworthiness of buyers of goods and services produced by them.

4. Bank participation factoring :

This is the form of factoring wherein bank can participate to the extent of financing the receivables of a client against the reserves maintained by the factor. For example, suppose the factor has advanced 80 percent of the invoice value. The bank can provide finance to the client firm against the remaining 20 percent of the value of factored receivables.

5. Limiting :

Under limiting factoring services, the facility of bill discounting is available to some specific categories of receivable only and not for all types of bills receivable

6. Domestic and Export Factoring :

These two categorizations are made on the basis of parties involved in a factoring contract.

In case of domestic factoring, the three parties involved are client, customer and factor and all three parties are from the same country.

Export factoring also called international factoring or cross border factoring involves four parties in the factoring contract. The four parties are exporter, importer, export factor and import factor. In export factoring, two agreements are made – one agreement is made between the importer and the import factor and other one is made between exporter and export factor. The import factor acts as a link between export factor and the importer and serves to solve the international barriers like language problems, legal formalities and so on. He also underwrites customer trade credit risk, collects receivables and transfers funds to the export factor in the currency of the invoice This type of factoring is of non–recourse in nature.

7. **Selected Seller and Selected Buyer based factoring**

Under the selected seller factoring services, the seller of the goods /services sells all its receivables to factor and factor manages all functions related to the credit collection, management of accounts of the seller and advisory functions too. In addition to this, the seller needs approval of factor before entering into any contract or agreement related to receivables.

Under the Selected Buyer factoring, the factor prepares a comprehensive list of creditworthiness of buyers. Now this selected buyer list will be accepted by the factor for providing bills discounting services. Now these approved buyers can approach the factor to discount their purchases from the client or seller of goods. And this payment is made to the seller. In case of selected buyer service, the nature of agreement of factoring service is without recourse to seller

8. **Disclosed and Undisclosed Factoring**

In case of disclosed factoring services, the seller of goods/services mentions the name of the factor in the invoice and the buyers are asked to make payment to factor only. The risk of any default or non–payment by buyer of goods /services is absorbed by the seller of the goods.

In case of undisclosed factoring, the name of the factor is not disclosed in the invoice. But the factor has control on the receivables and all functions related to cash collection, maintaining the sales ledger and other related and advisory functions are performed by the factor.

4.5 Advantages of Factoring :

The client or the seller can transfer major responsibility of collection and management of receivables to a factor and can focus on more strategic decisions of the business. The factoring provides the following financial and non–financial benefits :

1. Since the seller transfers the administration of receivables to the factor, the seller has sufficient time to focus on the other aspects of the business to attain competence
2. Factor provides cash upto almost 75% to 95% of the amount of receivables which provides sufficient liquidity to the seller for the credit period granted to the debtors. With this increased liquidity, the client/ seller can meet the day to day expenses on time. It results in enhanced creditworthiness of client among suppliers, lenders, bankers and competitors
3. A client gets a financial back up with the help of the factor. It increases the bargaining power of client and client can claim more cash discount from suppliers too
4. The factor can provide sufficient information regarding the creditworthiness of client's buyers. It helps the client in making good credit policy and setting credit limits for various buyers

5. Since factor is a professional and specialized agency, it can reduce the expenditure on sales ledger administration and collection of debts. It can even pass on a part of savings to the client in the form of lower factoring costs.
6. The incidence of bad debts comes down due to more accurate credit limits. With the involvement of the factor in the credit granting process, credit risk is reduced. Firms utilizing factoring services are likely to have a healthier customer portfolio.
7. In case of international factoring, the exporter needs to deal with only one factor (the export factor) regardless of the location of his/her sales. This saves a lot of factoring costs and delays. Moreover, in international factoring, the factor bears the currency risk and interest rate risk besides credit risk. In addition, the import factors in different countries can provide customer information to the exporter. Such information enables the client firm to design appropriate marketing strategies.

Disadvantages of Factoring

1. Careless selection of the factor by the client may result in many difficulties in the future.
2. The performance of the factor may not be up to the desired level. Sometimes the factor may cause unpleasant relationship between the client and the debtor.
3. The client may give a fake invoice (duplicate invoice/ invoice written at some previous date, invoice written for goods non–existing or invoicing before actually dispatching the goods– pre invoicing) to the factor which may cause increase in the forged activities in the market.
4. The client may behave casual in credit sales and managing the sales policies because of the financial support provided by the factor.
5. The factoring may not be a suitable course of actions for companies
    - having small business operations
    - a few numbers of debtors or buyers
    - companies having a very large number of buyers and debtors
    - companies with large variety of products across the domestic and international boundaries
    - companies involved in speculative business
6. The rights of the factor are a result of buying the invoices which is quite uncertain in nature. Many a times, these bills are required to be settled for various discounts and allowance which weaken the hold of the factor on debtors.
7. There is lack of professionalism, competence and expertise in the factoring business. Resistance to change is also one of the problems faced by the factoring industry.

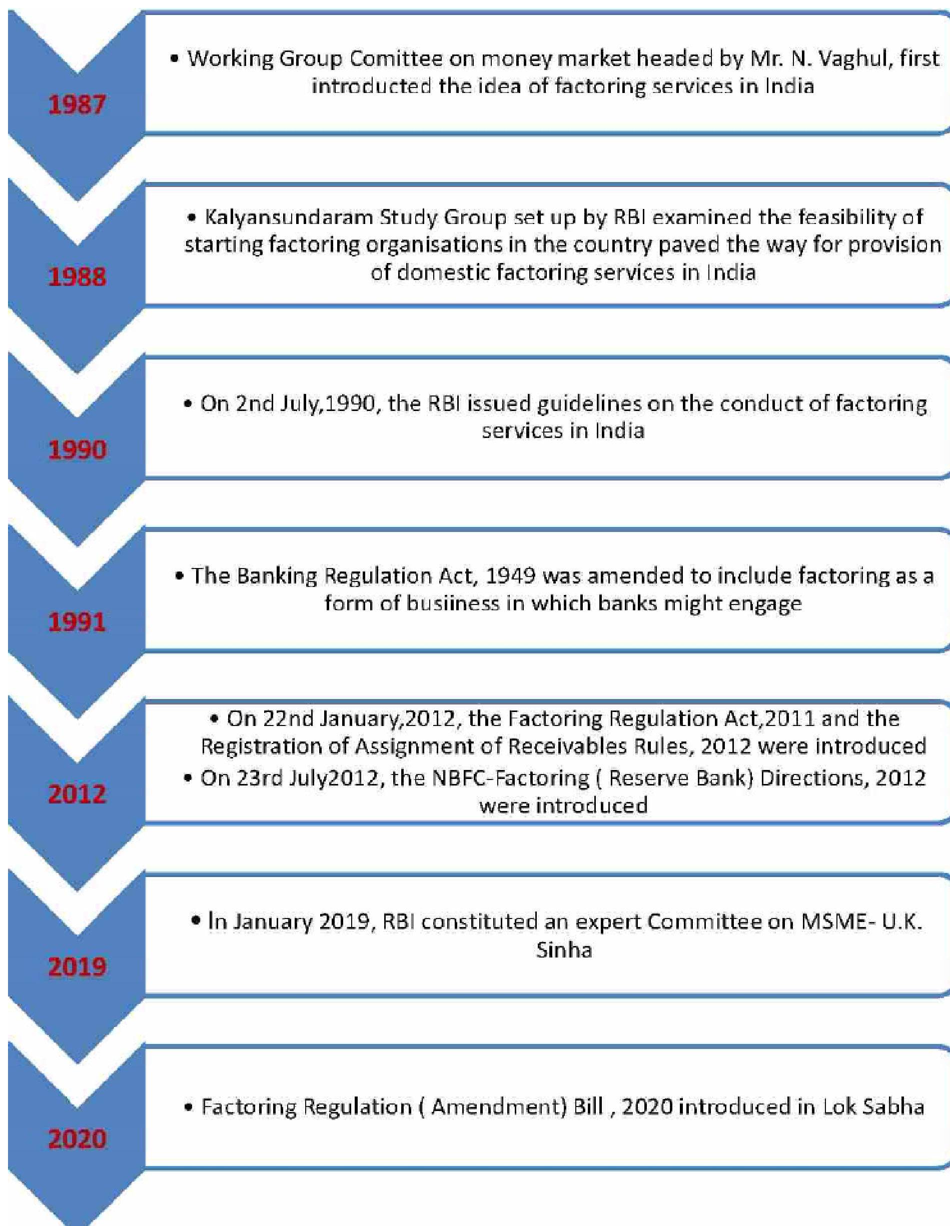
4.6 Factoring v/s Bill Discounting :

Point of Difference	Factoring	Bill Discounting
Meaning	It is a source of financing. In addition to providing short term finance, it provides many other services like maintenance of sales ledger, credit collection, advisory services to the client	It involves providing funds against the bills receivables. It is a kind of loan and allied services are not provided by bank/ financing agency as these are available in factoring
Collection of Debtors	The factor makes collection of credit sales from the debtors of the client	The bills discounting firm collects the money from debtors of client and receipt of the same is forwarded to the financing agency
Multiple Discounting	Multiple discounting (Re-discounting) of bills is not possible in case of factoring	Bills discounted can be re discounted many times before the maturity
With/Without Recourse	Factoring can be with/ without recourse depending upon the agreement between the client & factor	Bill discounting is always of recourse type which means that if the buyer/ debtor does not make the payment on the maturity, then client will have to bear this default risk
Total / Individual Basis of Discounting	Factoring is provided for the bulk of receivables and not for individual receivable. Factor just fixes the credit limit or receivable for which he is ready to provide financing client	In case of bills discounting, individual transaction is reviewed separately and a decision is made for that individual transaction only
Effect on Balance Sheet	Factoring has no effect on the balance sheet of the client (in case of full factoring) as it is an off balance sheet transaction	Bill discounting is of recourse in nature. Therefore it is a part of balance sheet, i.e. shown as receivables and bank credit as current asset and current liability, respectively

Knowledge	Generally in factoring, debtors of the client have full knowledge about factor	In bill discounting, debtors have no knowledge about the bill discounting
Stamp Duty	There is no stamp duty on factoring services, therefore, it is less expensive than bills discounting	In case of certain usages, stamp duty is levied on bills discounting in addition to bank charges. It makes this form of financing costlier than factoring

4.7 Indian Scenario of Factoring :

Factoring is becoming an effective method of working capital financing, as entities move away from asset centric models to operation–centric businesses. The journey of factoring in India can be viewed as follows :



Major players of factoring services in India :

1. **SBI Global Factors Ltd.** was the first factoring company in India which started its operations in April 1991. It is the only provider of international factoring, domestic factoring and forfaiting services under one roof in India.
2. **IFCI Factors,** the subsidiary of IFCI was incorporated in February 1996. It provides services related to Domestic Sales Bill Factoring, Purchase Bill Factoring, Export Sales Bill Factoring and Corporate Loan.
3. **Canbank Factors Ltd** is a non–banking financial company and one of the leading factoring company in India. It is a subsidiary of Canara Bank. It was incorporated in 1991. Domestic factoring and invoice discounting are the two key services provided by the Canbank Factors.
4. **India Factoring and Finance Solutions Pvt. Ltd.** was established in 2009. The main objective of the company is to provide factoring and forfaiting services to business entities in India.
5. **Export Credit Guarantee Corporation of India Ltd** is a Government of India Enterprise which provides export credit insurance facilities to exporters and banks in India. It functions under the administrative control of Ministry of Commerce and Industry and is managed by Board of Directors comprising representatives of the Government, Reserve Bank of India, banking and insurance and exporting community. Buyer's Credit Cover, Line of Credit, Overseas Investment Insurance and Customer Specific Covers are few factoring services which are provided by ECGC Ltd.
6. **Siemens Factoring Private Limited** is an unlisted private company. It was incorporated in 2017.
7. **Bibby Financial Services (India) Pvt. Ltd.** specializes in providing cash flow solutions for SMEs. The parent company is in the United Kingdom and is the largest independent invoice provider in that country With the establishment of independent factoring organizations, the factoring market in India has grown phenomenally over the last 10 years. However, only a minuscule proportion of firms in India have access to factoring facilities. Bills of Exchange and letters of credit continue to play a dominant role in the credit market. The problem with the domestic factoring is that, unlike international factoring, no due diligence is performed on the buyer and no default insurance is provided. If a customer delays payment beyond the due date, the client firm is required to pay off the accumulated debt to the factor. Moreover, factoring in India also works out to be expensive because of additional stamp duty. Factoring charges in addition to interest include a fee that is calculated on the agreed volume of trade which can be quite significant.

Check Your Progress :

1. The word factoring has its origin from the ________ verb 'facere which means 'to do' or 'to make'

   a. Latin b. French c. German d. English

2. How many parties are involved in a factoring transaction ?

   a. Two b. Three c. Four d. Five

3. The 'client' in the factoring transaction is the

   a. Seller of goods b. Buyer of goods

   c. Factor d. None of the above

4. Which of the following is not covered under the factoring service ?

   a. Receivables collection

   c. Risk Protection

   b. Administration of sales ledger

   d. Preparing financial statements of client's

5. Under _______ factoring, factor provides a safety net to its clients against the default risk associated with the buyers

   a. Recourse b. Non–recourse c. Limiting d. Maturity

6. Working Group Committee on money market headed by______, first introduced the idea of factoring services in India

   a. Mr. N. Vaghul b. Mr. Aditya Birla

   c. Mr. Kalyansundaram d. None of the above

7. Under ________ type of factoring, the factor carries out the function of sales ledger administration, risk protection besides receivables collection

   a. Conventional b. Limiting c. Recourse d. Non–recourse

8. Factoring Regulation (Amendment) Bill was introduced in Lok Sabha in the year

   a. 2012 b. 2017 c. 2019 d. 2020

9. The 'del credere' commission, charged by the factor to cover the buyer's default risk is under

   a. Recourse factoring b. Non–recourse factoring

   c. Conventional factoring d. Limiting factoring

10. Which of the following is the first factoring service provider in India ?

    a. IFCI Factors Ltd.

    b. SBI Global Factors Ltd.

    c. Canbank Factors Limited

    d. Export Credit Guarantee Corporation

4.8 Let Us Sum Up :

The relationship established by a contract between the provider of products or services and a financial institution is known as factoring. Trade finance provided by a forfeiter to an exporter seller for an export/ sale transaction containing long–term deferred payment terms at a fixed rate of discount is known as forfeiting.

Banks and other financial organizations offer clients financing in addition to factoring services by way of bill discounting capabilities. The bill of exchange is a written document with a maker's signature that commands a specific person to pay a specific amount of money exclusively to, or at the request of, a specific person or to the bearer of that document.

4.9 Answers of Check Your Progress :

1. a	**2.** b	**3.** a	**4.** d	**5.** b
6. a	**7.** a	**8.** d	**9.** b	**10.** b

4.10 Glossary :

1. **Account Receivables :** Any trade debt that results from a client's sale of products or services to a customer on credit is known as an account receivable.
2. **Client :** He also goes by the name of supplier. It might be a company that uses factoring arrangements to supply goods or services on credit.
3. **Customer :** A natural person or legal entity to whose products or services have been provided on credit. Another name for him is a debtor.
4. **Eligible Debt :** Debts that the factor has allowed for prepayment are considered eligible debt.
5. **Open Account Sales :** When products or services are provided by a client to a customer on credit without the use of a bill of exchange or promissory note, this is known as a "open account transaction."
6. **Prepayment :** The factor paying the client a portion of the acceptable bills in advance, up to a particular debt.
7. **Retention :** Margin maintained by the factor.

4.11 Assignment :

1. Meaning and benefits of factoring
2. Limitations of factoring
3. Domestic and International factoring
4. Recourse and Non–recourse factoring
5. Disclosed and Undisclosed factoring
6. Explain the meaning and mechanism of factoring

4.12 Activity :

1. Explain the meaning and mechanism of factoring

4.13 Case Study :

1. Discuss the impact of factoring on bank's business.

4.14 Further Readings :

1. Bateson, John E. G. and K. Douglas Hoffman (1999), Managing Services Marketing Text and Readings (Fourth ed.). Fort Worth : The Dryden Press. (471 Pages; I.S.B.N. Number = 0–03–022519–1).
2. Cooper, Robert G. and Scott J. Edgett (1999), Product Development for the Service Sector : Lessons for Market Leaders. Cambridge, MA : Perseus Books. (256 Pages; I.S.B.N. Number = 07382–0105–7).
3. www.forfeiting.com
4. www.forfeiting.com
5. www.languages.ind.in

BLOCK SUMMARY

We discovered in this lesson that financial services are those offered by the financial sector, which includes businesses dealing with the administration of money including banks, insurance companies, credit card companies, and brokerage firms. As they take care of the requirements of financial institutions, financial markets, and financial instruments that serve individual and institutional investors, financial services play a significant role in the financial system.

Financial services have been discovered to include offerings from both asset management and liability management firms. Lease firms, mutual funds, merchant bankers, and issue/portfolio managers are examples of asset management firms.

According to research, India has a strong financial system that performs a variety of purposes and exhibits efficiency and adaptability, which are key goals of a competitive, market–driven economy. Financial services, financial markets, financial instruments, and financial institutions make up this industry.

Financial services are found to play a significant role in supporting the economy both directly and indirectly. Directly, they do so by creating highly rewarding employment opportunities for people, and indirectly, they do so by providing services to other important economic sectors like real estate and tourism. Analysis shows that some financial services, such as banking, the stock market, mutual funds, and non–banking finance businesses, emerged in India after independence and expanded following the nationalisation of banks in 1969.

BLOCK ASSIGNMENT

Short Questions :

1. Define lease. Explain the main features of lease.
2. Hire purchase interest and instalment.
3. Discuss the main characteristics of Hire Purchase.
4. Explain the various stages of venture capital financing.
5. Explain the types of factoring
6. Distinguish between Factoring and Bill discounting.
7. Discuss the various Parties involved in factoring.

Long Questions :

1. Discuss the superiority of lease finance over other alternatives.
2. According to you, which is a good option to adopt, Hire purchase or Lease ?
3. Justify your answer by giving appropriate reasons.
4. Write a note on Hire Purchase Agreement.
5. Write a brief note on the National Housing Bank as the apex housing finance institution in India.
6. Write a note on Factoring business in India.

❖ **Enrolment No. :** [ ]

1. How many hours did you need for studying the units ?

Unit No.	1	2	3	4
No. of Hrs.				

2. Please give your reactions to the following items based on your reading of the block :

Items	Excellent	Very Good	Good	Poor	Give specific example if any
Presentation Quality	☐	☐	☐	☐	____________
Language and Style	☐	☐	☐	☐	____________
Illustration used (Diagram, tables etc)	☐	☐	☐	☐	____________
Conceptual Clarity	☐	☐	☐	☐	____________
Check your progress Quest	☐	☐	☐	☐	____________
Feed back to CYP Question	☐	☐	☐	☐	____________

3. Any other Comments

....

....

....

....

....

....

....

....

BBAR-601

Financial Services

BLOCK-3 CONSUMER BEHAVIOUR AND BANKING PRODUCTS

UNIT 1
CONSUMER BEHAVIOUR FOR FINANCIAL SERVICES

UNIT 2
BANKING PRODUCTS AND SERVICES

BLOCK 3 : CONSUMER BEHAVIOUR AND BANKING PRODUCTS

Block Introduction

One of the difficult ideas in marketing is customer behaviour, which calls for a comprehensive evaluation of consumer behaviour. It is advantageous for marketers to have a solid understanding of consumer behaviour since it will assist them to comprehend what matters to customers and identify significant impacts on their decision–making. You will learn about the roles that consumer behaviour plays and the services that marketing provides to help customers recognise their relevance in this block. With the help of features and qualities, the idea of contemporary marketing management and consumer issues in the area of consuming are clearly presented. The block will go into detail regarding bank deposits, including such products' benefits and drawbacks. Examples of these products include savings accounts, current accounts, and term deposit accounts.

You will be able to accurately grasp the many sorts of bank accounts and their characteristics after studying this block, along with information regarding brand awareness. Student knowledge that will help them understand the behavioural nature of consumers is provided by the notion of consumer behaviour for obtaining customer behaviour. Information about new product development is provided through product development technique principles and understanding of the designing, producing, and marketing of new goods and services.

Block Objectives

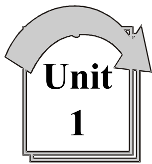
After learning this block, you will be able to understand :

- Consumer behaviour.
- Features of modern marketing management.
- Study the needs of consumer behaviour.
- The impact of consumer behaviour on family.
- Knowledge about various banking products.
- Brand awareness.
- Idea about Saving and Current Bank Accounts.
- Qualities of product development.

Block Structure

Unit 1 : Consumer Behaviour for Financial Services

Unit 2 : Banking Products and Services



CONSUMER BEHAVIOUR FOR FINANCIAL SERVICES

: UNIT STRUCTURE :

1.0 Learning Objective

1.1 Introduction

1.2 The Complexity of Consumer Buying Decisions

1.3 Individual Influences on Consumer Behaviour

1.4 Needs and Motives

1.5 Individual Perception

1.6 Learning and Habit Development

1.7 Family Influences on Buying Behaviour

1.8 Behavioural Models for Analysing Buyers

1.9 Consumer Behaviour Some Learning Points for Financial Service

1.10 Let Us Sum Up

1.11 Answers of Check Your Progress

1.12 Glossary

1.13 Assignment

1.14 Activities

1.15 Case Study

1.16 Further Readings

1.0 Learning Objectives :

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

- Consumer Decision Process.
- Meaning of buying motives.
- Importance of study of buyer behaviour.

1.1 Introduction :

Customer behaviour is acknowledged as the most difficult marketing concept. It is concerned with a thorough understanding of consumer behaviour. Such knowledge is crucial for marketers to have a solid understanding of consumer behaviour since it will help them understand what matters to customers and identify the key factors that impact their decisions. Marketers can create marketing campaigns to pique customers' interest using this data.

The decision–making processes of clients are regulated by a myriad of intricate psychological and sociological factors. There are no universally applicable simple rules that could be used to describe how people make

judgements about what to buy. But experts who have analysed consumer behaviour for a long time have given us helpful pointers on how people decide whether or not to buy something. The actions taken throughout the selection, purchase, use, and disposal of products and services are referred to as customer behaviour. Customers act in a certain way whenever they buy new trousers, read a book or recycle soda cans. User buying behaviour refers directly to the steps customers take when determining what to buy and when making the actual purchase.

1.2 The Complexity of Consumer Buying Decisions :

By constantly innovating and gaining a grasp of the most recent consumer requirements and tastes, current marketing management aims to address the fundamental difficulties that customers face in the domain of consuming. It will be very helpful in creating marketing possibilities and overcoming problems presented by the Indian market. Because of the following factors, understanding consumer behaviour is crucial for marketers. For marketers, understanding consumer behaviour for any product is crucial to determining the success of their businesses.

Because it is important for controlling commodities consumption and preserving economic stability. Because it helps create strategies for the more effective use of marketing resources. Also, it facilitates more efficient problem–solving for marketing management issues.

Consumers today place a higher value on environmentally friendly goods. They are more focused on exercise, hygiene, and health. They favour organic stuff. So, a thorough analysis of potential consumer groups is crucial for any company.

Understanding how customers choose what to buy and consume has become increasingly important as the consumer protection movement has grown.

It creates the possibility of a product's influence on consumers' identity, tastes, and propensities. Customers are constantly evolving. Consumer behaviour research provides knowledge on the colours, designs, and other preferences of consumers. Production policy is created in part using consumer behaviour.

Consumers and their behavioural patterns must be taken into account for efficient market segmentation and target marketing.

1.3 Individual Influences on Consumer Behaviour :

Organizations use studies to identify the strategies that are most likely to be successful because buyer behaviour dictates the type of marketing approach they choose. The methods listed below can be used to obtain customer information and subsequently develop a marketing plan. Sales Predictions Businesses examine consumer behaviour from the past to forecast future sales. Sales projections assess the anticipated sales for a particular market over a given time frame. Sales projections cannot

exceed the market's potential. Study Surveys These polls are carried out in order to research consumer behaviour. They assist businesses in discovering what customers desire and how they react to advertising. They also aid in identifying potential issues.

Web–based research Businesses, even small enterprises, conduct a large portion of their research online while keeping track on consumer web usage. Organizations make precise decisions on the features, specifications, and marketing campaigns for their products based on their results. Also, they make known the best locations and market conditions for selling. The Internet is an economical tool for marketing research since it can identify target markets and is adaptable enough to meet changing consumer demands. market awareness By using various resources to research consumer behaviour and processing that data into a marketing and management information database, or market sensing in layman's terms, these methods can assist organisations in gaining a competitive advantage.

1.4 Needs and Motives :

The need for and reasons behind consumer behaviour may include :

Analyse Market Opportunities : Study customer behaviour to identify unmet consumer requirements while analysing market opportunities. In order to do this, it is necessary to look at the market's trends and conditions, consumer lifestyles, income levels, and new influences. This could indicate unmet needs and desires. There is an increasing demand for household gadgets like childcare centres due to the trend towards an increase in dual income households and a focus on appropriateness and leisure. A legitimate and unmet consumer need has led to the marketing of mosquito repellents.

Choosing a Target Market : Reviewing market opportunities frequently aids in the discovery of discrete client categories with incredibly specific wants and demands. While using a questionnaire method, customer replies are very important because they vary and non–responses cause significant issues. The marketer can create and offer goods and services that are especially suited to these groups' requirements and goals by identifying them, learning how they behave, and understanding how they make purchasing decisions. Consumer surveys, for instance, showed that many current and potential consumers preferred low–cost sachets providing enough shampoo for one or two washes over shampoo packs costing Rs. 60 or more. The discovery prompted businesses to release the sachet, which was well received.

Choosing the right marketing mix : Unmet needs and demands must be discovered before the marketer can decide on a product, price, distribution strategy, and advertising plan. Target groups are crucial because they have a thorough understanding of the issues involved in consumer decisions, which helps us make informed decisions.

Social and non–profit Marketing : Organisations can employ customer behaviour research to build marketing tactics that will help their family planning, AIDS awareness, crime against women, safe driving, environmental concerns, and other programmes become more active. In order to promote their products and services and to persuade people to support these organisations, UNICEF, Red Cross, and CRY, among other organisations, use an understanding of customer behaviour.

1.5 Individual Perception :

The analysis of consumer behaviour will enable management of the kind of marketing plan to research and choose the most suitable ones. Businesses examine consumer behaviour from the past to forecast future sales. Sales predictions predict the anticipated sales for a specific market over a given time frame. Research surveys are carried out purely to examine customer behaviour. They assist businesses in discovering what customers desire and how they react to advertising. They also aid in spotting future issues.

It has been noted that businesses use the Internet to monitor customer web behaviour while doing research. Organizations must choose the appropriate prices, features, and sales promotions for their products based on the results of their study. Due to its ability to pinpoint target markets and its adaptability to changing customer demands, the Internet is a cost–effective instrument for marketing research.

Finally, it is important to note that motivation research involves the study of psychological causes. It encompasses the reasons why people respond favourably to certain forms of advertising or why they choose to purchase particular goods.

1.6 Learning and Habit Development :

Consumer behaviour is described as the actions that consumers take when looking for, selecting, utilising, assessing, and discarding goods and services that they believe will meet their needs. User behaviour focuses on how people choose to spend their available resources (time, money, and effort) on things that are connected to consuming. Customer segmentation should be carried out in order to group clients with similar wants for the sale and consumption of any goods. Preferences and needs are crucial for segmentation. People behave and buy in accordance with their age, although this is not always the case in terms of demographics. Similar to this, the market needs to be divided into segments based on socioeconomic position, demographics, and psychographic representation.

A product is evaluated by consumers on various levels. Its fundamental qualities–which are outlined as the core benefits it can provide to a customer–are intrinsic to the generic version of the product. Generic products stand out by providing value through additional characteristics, such performance or quality improvements. Amplified properties, which provide less obvious benefits like customer support, maintenance services,

training, or enticing payment choices, represent the highest level of consumer perception.

1.7 Family Influences on Buying Behaviour :

It is clear that there are many aspects that affect buying. One of the most important influences on a consumer's beliefs and behaviours is their family. Finding the person who made the decision to make that specific purchase appears to be the key to understanding how family influences consumer behaviour. As stated, a spouse, wife, or child may also make a buying decision. Decisions are frequently made in conjunction with others. Also, it has been observed that the decision–maker changes depending on the kind or volume of the transaction.

Family Impact on Consumer Behaviour : Additional evidence suggests that families have a variety of influences on buying. At the beginning, parental influence plays a significant role in demonstrating how parents assist their children in developing political and religious ideas, lifestyle preferences, and dietary habits. It is common knowledge that parents, including those of spouses and children, exert tremendous pressure on consumers to make purchases. The number and ages of children as well as how well–off each spouse is influence purchasing decisions. Compared to most other social factors, these family impacts have a more immediate impact on how consumers view purchases.

Features :

- Finding the purchasing decision maker is one technique to study family consumer behaviour.
- Parents' crucial roles in families' influencing purchasing patterns demonstrate how much spouses and kids matter.
- Individuals go through a family life cycle that is made up of many buying stages.

1.8 Behavioural Models for Analysing Buyers :

According to the behavioural definition, an organisation is a group of rights, privileges, duties, and obligations that must be carefully balanced over time through conflict and conflict resolution. This concept emphasises the individuals who make up the organisation, their methods of operation, and their interactions. Many decision–makers are no longer in direct contact with customers due to the expansion of marketplaces and enterprises. Decision makers are now investing more money than ever before in an effort to better understand their customers, turning more and more to summary statistics and behavioural theory. The biggest determinants of consumer behaviour include cultural, sociological, psychological, and personal factors.

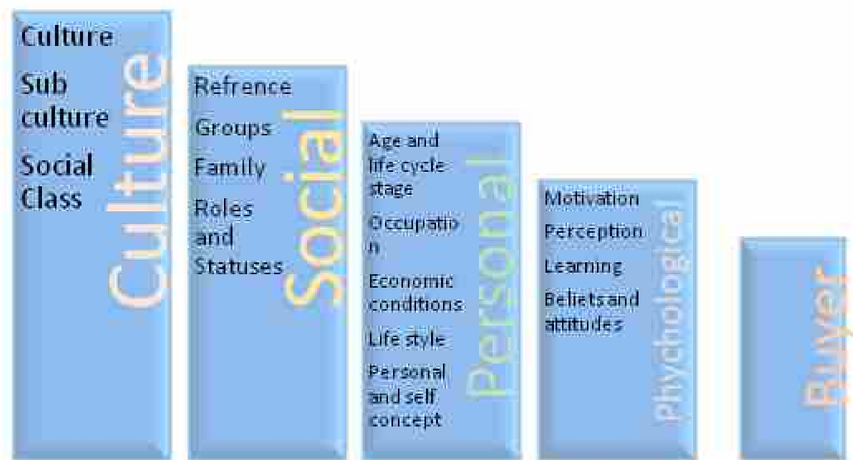


Figure : Buyers Factor

The buyer may often be located fairly easily for many things. Such products frequently incorporate a multi–person decision–making unit. Five roles that individuals may play in a purchase decision.

1. **An initiator :** Is someone who initially raises the notion of acquiring a specific good or service.
2. **Influencer :** A person whose opinions or counsel are taken into consideration when a decision is made.
3. **Decider :** A person who makes a choice regarding any aspect of a purchasing decision, including whether or not to buy something as well as what, how, and where to acquire it.
4. **Buyer :** The individual who really makes the purchase.
5. **User :** An individual who makes use of the commodity or service.

1.9 Consumer Behaviour Some Learning Points for Financial Service :

Given that products and services are not polar opposites, it is clear that services are typically differentiated from them on the basis of their intangibility, inseparability, heterogeneity, and perishability. This makes selling services more challenging. The qualities of services, especially financial services, will also have a significant impact on buyer behaviour, even though this is less explicitly acknowledged in the research. Many professional or specialised services will also have a high degree of belief qualities, which are characteristics that cannot even be determined after the service has been consumed. Due to their intangibility, services are likely to be appraised differently from products, especially during the pre–purchase stage, hence this topic has to be explored more to better understand consumer behaviour for services.

In addition to this, services differ from things that cannot be separated. Services must essentially be produced and consumed simultaneously since they are experiences or processes. It demonstrates the effect of perishability, wherein services cannot be preserved for a future time period, leading to the requirement for quick distribution routes. Production and marketing are interactive activities since the production

and consumption of services are inseparable. Both the customers themselves in their capacity as partly employees and the front–line service staff play a crucial boundary–crossing role in the creation of services. Consequently, it will be crucial to take into account how the customer and supplier interact while trying to understand buyer behaviour. The quality of the service output is greatly influenced by the nature of the interpersonal relationships between these parties because services require input from both service providers and customers in order to be produced.

Check Your Progress :

1. As per the marketing theory the two types of buyers are :

   a. Consumer buyers b. Industrial buyers

   c. None of this d. Both a & b

2. Which of the following statements best describes the concept of involvement in the context of buyer behaviour ?

   a. The length of time involved in the buying process.

   b. The potential impact of a product on an individual's self–identity.

   c. The number of people involved in the decision–making unit.

   d. The complexity of an order.

3. Organizations study past consumer behaviours to determine :

   a. current sales b. previous sales

   c. future sales d. all of above

4. Consumer behaviour helps in studying :

   a. stock evaluation b. market behaviour

   c. loan requirement d. none of above

5. The final level of consumer perception is to amplified properties that offers :

   a. customer assistance b. maintenance services

   c. training option d. all of above

6. A Consumer's family helps in shaping individual :

   a. attitudes b. behaviour

   c. both a and b d. neither a nor b

7. Behavioural model of an organization is a collection of :

   a. Rights b. Privileges c. Obligations d. All of above

8. To understand buyers behaviour :

   a. supplier needs to interact

   b. buyers need to interact

   c. both supplier and buyer needs to interact

   d. none of above

1.10 Let Us Sum Up :

We have discovered that consumer behaviour is a difficult concept in marketing that requires careful appreciation of consumer behaviour. It is helpful for marketers to have a good understanding of consumer behaviour because it will help them to understand importance to customers, which further suggests important influences on client decision–making. By constantly inventing and recognising the most recent customer demands and tastes, current marketing management is able to address several consumer issues related to consuming.

Also, the type of marketing strategy that businesses use to undertake research to identify specific strategies that are most likely to succeed is influenced by consumer behaviour. The study of consumer behaviour will aid in identifying unmet consumer requirements, which necessitates looking at market trends and conditions, consumer lifestyles, income levels, and new influences. As can be observed, customer behaviour demonstrates the behaviour that clients exhibit when looking for, buying, utilising, assessing, and discarding goods and services that can be anticipated by meeting all needs.

It has been highlighted that the best method to comprehend how a family affects consumer behaviour is to identify the person who made the decision for a specific purchase. This person may have been the husband, wife, or child. According to the behavioural definition, an organisation is a group of rights, privileges, duties, and obligations that must be carefully balanced over time through conflict and conflict resolution.

1.11 Answers of Check Your Progress :

1. d	**2.** b	**3.** d	**4.** b
5. d	**6.** c	**7.** d	**8.** c

1.12 Glossary :

1. **Consumer :** The final user of products, concepts, or services. The customer is also the one who makes the purchase or decision; an example would be a parent choosing children's books.
2. **Consumer Behaviour :** How a customer or decision–maker acts in a market for goods and services.
3. **Customer Characteristics :** The consumer's demographic, lifestyle, and personality traits.
4. **Customer Satisfaction :** The extent to which a product meets or exceeds a customer's expectations.

1.13 Assignment :

1. What do you understand by buyer behaviour ?
2. Is Buyer Behaviour does make any impact on Financial Services ?

1.14 Activities :

1. What external factors can influence buyer behaviour ? Explain with examples.

1.15 Case Study :

1. What are the ways to gather information about consumer for planning a marketing strategy ?

1.16 Further Readings :

1. Marketing Management, Philip Kotler, Kevin Lane Keller, Mairead Brad, Pearson, 2008.
2. Principles and Practice of Marketing, John Frain, Pitman Publishing, 1996.
3. Basic Marketing : Principles and Practice, Tom Cannon, Thomson Learning, 1995.
4. Essentials of Marketing, Geoff Lancaster, Lester Massingham, Ruth Ashford, Mcgraw–hill Professional, 2001.
5. Global Marketing, Hollensen, Pearson, 2007.

: UNIT STRUCTURE :

2.0 Learning Objectives
2.1 Introduction
2.2 Nature of Product
2.3 Products and Services in Banking
2.4 Elements of Product Mix
2.5 Product Life Cycle and Product Strategies
2.6 Using Product Life Cycle to Manage Marketing of Banking Products
2.7 New Product Development
2.8 Branding in Bank Marketing
2.9 Process and Product Development Cycle for Banking Services
2.10 Product Development
2.11 Let Us Sum Up
2.12 Answers for Check Your Progress
2.13 Glossary
2.14 Assignment
2.15 Activities
2.16 Case Study
2.17 Further Readings

2.0 Learning Objective :

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

- Elements of Product Mix.
- Product Life Cycle.
- New Product Development.

2.1 Introduction :

Banks in India provide a range of banking services, including deposit products like :

- Term deposit accounts,
- Savings accounts,
- Current accounts,

And other lending products like :

- Cash,
- Credit.
- Term Loans

According to Reserve Bank of India regulations, banks perform other things besides accept deposits at a fixed rate of interest set by the RBI and loan money using a formula set forth by the Reserve Bank of India. The standard for interest on lending products was the PLR (prime lending rate). Remittance products are believed to have only included the issuing of :

- Draft
- Telephonic transfers
- Bankers cheque
- Internal Fund Transfers

It is evident that clients, who can be both individuals and corporations, are today demanding better services with surplus products from banks as a result of exposure to worldwide trends following the Internet's information boom.

2.2 Nature of Product :

Banks not only offer safekeeping for cash but also accounts and other products that let you pay your expenses and give you income with the goal of compounding. Using the bank account, you can :

- Prevent losing your money through theft or fire.
- Increase your savings while earning interest.
- Directly deposit your pay check
- Pay payments quickly and affordably.
- Keep tabs on your spending and handle your money
- Get credit
- Access to a variety of products, including mortgage and auto loans

Banks come in a variety of shapes and sizes, including big financial services firms with local, regional, or global reach, savings and loan institutions, and credit unions with online banking. The majority provide a wide range of goods and services, including loans, consumer checking and savings accounts, and business–specific services.

2.3 Products and Services in Banking :

Banks provide the following products :

- Credit card
- Debit card
- Mortgage

- Individual retirement account (IRA)
- Money market account
- Certificate of deposit (CD)
- Saving Account
- Mutual Fund
- Personal loan
- Time deposits
- ATM card
- Current accounts
- Cheque books

Apart from these, there are certain general banking services like :

- Domestic Transfers
- Banker payments
- Credit transfers
- Standing orders instruction
- Cheques
- Bank–to–bank transfers
- Direct debits

International Transfers

- EFT transfers
- International cheques
- Bank drafts

Commercial Credits

- Import & Export credits
- Documentary credits
- Clean credits

2.4 Elements of Product Mix :

The entire number of product lines that a business can provide to its clients is shown by product mix, also known as product assortment. According to research, a product mix will consist of the following :

- Height
- Weight
- Depth
- Consistency

Width : The number of product lines that a corporation sell is indicated by the width of its product mix. In the event that a corporation

has five product lines, its product mix will have a breadth of five. The product mix of tiny and newly established enterprises won't be diverse.

Length : It has been observed that the length of a product mix indicates the number of total products or items in a certain company's product mix.

Length : The product mix length of a corporation is 20 if there are four product lines and five brands within each product line. Businesses that have numerous product lines occasionally keep note of the typical length for each product line. Here, we can observe that a company's product line, on average, is five lines long.

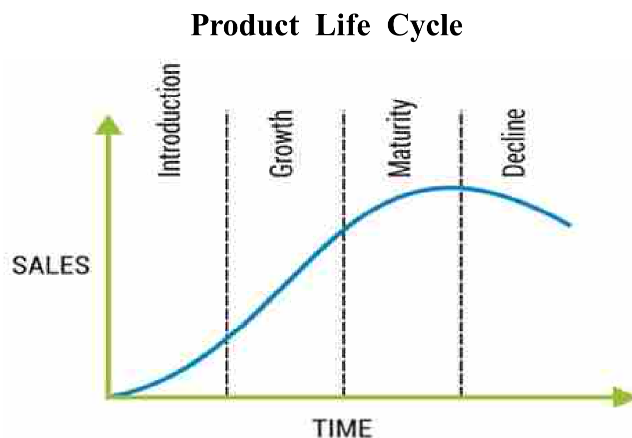
Depth : The depth of the product mix reveals the total number of variations in each product's size, flavour, and other identifying features. If a corporation sells gum paste in five sizes and five flavours, we can observe that the brand in question has a depth of 10.

Consistency : A product mix's consistency demonstrates the close connections between its product lines in terms of use, production, and distribution.

2.5 Product Life Cycle and Product Strategies :

Product life cycle contains four parts as shown in following figure :

Product Life Cycle



The product is introduced in the initial stage, which is followed by the growth stage, the maturation stage, and the declination stage. With the introduction of new products, the value of the existing product completely declines. According to the life of the product, the product strategies are separated into four stages :

Stage 1 : Introduction phase of the product life cycle

A product's development and introduction into the market are known as the first stage of the product lifecycle. Marketing is necessary because the product isn't yet on the market and isn't therefore well known to consumers. Consumers must be informed of the advantages and cutting–edge features of the product by the marketer. Marketers can seize the market using a marketing penetration plan or a marketing skimming strategy during the launch phase of a new product. Another aspect of this stage is the minimal likelihood of a company sale.

Stage 2 : Growth stage of Product life cycle

Consumers frequently have preconceived notions about new products in the second stage of the product life cycle because of prior experiences they may have had after making an initial purchase. With this, sales will rise, and it will be up to the business to raise prices to cover increased marketing and advertising expenses. The company's earnings will increase at this point.

Stage 3 : Maturity

When the product becomes widely available on the market in the third stage of the product life cycle, sales of new products reach their peak level, as shown in fig. 2.1. At this point, the corporation will cut the price to outbid rivals on the market in order to maximise profit on the goods. For selling the goods quickly before it reaches the decreasing stage, the company may grant the dealer a special discount.

Stage 4 : Decline Stage

The fourth stage of a product's lifetime is when sales plummet because no new buyers are showing any interest in purchasing the product. The corporation may now encourage customers to switch to his new, improved product.

2.6 Using Product Life Cycle to Manage Marketing of Banking Products :

The creation and introduction of several goods in the financial services sector occurred in the last part of the 20th century as a result of market globalisation, shifting investment tendencies, etc.

As can be seen, risk diversification plays a significant role in the creation of a range of financial products. Since rate of return is correlated with inherent risk and financial products available on the global market can be clearly separated based on risk–reward ratio, return on investment serves as the underlying principle of all financial products. Due to the fact that risk is correlated with a variety of dynamic environmental elements that are brought about by geopolitical and economic circumstances, financial products are always altering to reflect shifting risk characteristics. Individual risk tolerance and even the notion of risk have seen significant change over the past 50 years. Each of these changes has provided an opportunity to design a new financial product, which in the present day, is achieved through financial engineering.

In addition to this, economic reform is the main driver behind the creation of new financial products. The development of novel items with broad appeal also pushes existing ones towards maturity. As can be seen, the demand for fixed deposits increased when interest rates reached a low point at the beginning of the century. But, occasionally, shifting economic conditions might save a product that is about to decline. So, it is admirable that a financial product might change course at different periods of its existence.

2.7 New Product Development :

Since ideas for long–term product planning are derived from concepts produced by the preparatory process, it is evident that product development is not usually acknowledged as a formal stage in the product life cycle. Product development offers updated or new items to be present in the existing market, acting as a tool for growth. Product development often focuses on translating conceptual products into physical products to ensure that an idea may be realised through each step of development. Costs appear to be accruing during the product development stage as a result of investment in specific concepts and ideas.

The following eight steps of new product development must be completed before a product may be introduced to the market : idea creation, idea screening, concept development, marketing strategy, business analysis, product development, test marketing, and commercialization.

The organization's internal sources are typically where ideas are generated. For the purpose of creating workable product Banking Products and Service concepts, company staff will create fresh ideas. A business may also examine the new products being offered by its rivals with the goal of differentiating from them and enhancing current designs.

This involves screening the concepts to remove the unrealistic ones and concentrate on notions that are reasonable and attainable. A product concept is created from a single idea. The attraction of a product to consumers in the predicted target market is then assessed using concept models. From focus groups to random surveys, testing may be used.

A marketing plan is required to specify how the product will be positioned in the market following concept testing. At this point, it is also decided on the product's predicted target market, expected sales, distribution methods, and price strategy.

If the product will be profitable to manufacture is determined by business analysis, which includes sales projections. While evaluating the expected profitability of a product, many aspects are taken into account. While selecting whether to move further with development, managers will take the time it takes for the product to be profitable, the cost of capital, and other financial factors into account. A prototype is made from the product concept if the concept is accepted.

After creating a successful prototype, businesses test market the product. A business would typically carry out formal research on a product concept to determine whether the suggested idea has validity with the intended audience. Once more, customer surveys and focus groups are held with the goal of evaluating the product on a representative sample of the intended market. Following testing, consumer response to the product is evaluated through analysis. High commercialization expenses are incurred once all the information is available and the company decides to launch the product.

2.8 Branding in Bank Marketing :

The consumer–packaged goods sector gave rise to the current idea of branding, and branding now encompasses much more than merely coming up with a technique to distinguish a product or business. Hence, it's safe to say that branding is now employed to foster a sense of emotional connection between consumers and brands. The brand name, mark, or symbol is surrounded by an aura of intangible qualities that evokes feelings of engagement, higher quality, and prestige.

Brand recall, which measures consumers' capacity to name your brand when given the product category, category need, or another comparable cue, is a component of brand awareness. Brand recall is the ability of consumers to affirm that they have previously been exposed to your brand. Assisted awareness occurs when a person exhibits familiarity with your brand only after hearing or seeing it mentioned or shown in a list of other brands. Top–of–mind awareness occurs when your brand is the first to come to mind when a consumer is asked to name brands within a particular product category.

The key research question is how branding affects marketing in the retail banking sector, notably for retail goods and services, as well as how it affects other outcomes like growing customer loyalty. The two fundamental parts of the brand knowledge framework are building brand awareness and building brand image. Brands have the power to increase the value of marketing services and products, which is what increases client loyalty. Retail banking is currently faced with a great deal of difficulties, such as customer concerns about the bank's integrity about the investments they make there or the need to streamline the financing options that banks provide to their clients. The peace of mind that comes with knowing that damage to their house caused by unforeseeable disasters may be quickly and affordably repaired is not the only benefit that prudential insurance policy buyers receive. Also, they purchase the company's emblem, the face of Prudence, which serves as a constant reminder of the additional benefits of heritage, size, and public awareness while also evoking trust and credibility.

Therefore, branding is an effective marketing concept that does not just concentrate on one component of the marketing mix but rather is the outcome of a carefully planned array of marketing across the marketing mix spectrum, with the goal of getting the buyer to recognise pertinent added values that are distinctive when compared to competing products and services and that are challenging for competitors to imitate. The goal of branding is to make it easier for an organisation to attract and keep a loyal consumer base while minimising costs to maximise return on investment. Retail banking uses a variety of cutting–edge transaction methods, including non–cash transactions, internet banking, e–banking, and mobile banking. These contemporary transaction technologies are anticipated to replace the previous teller–based banking system in the near future.

2.9 Process and Product Development Cycle for Banking Services :

It has been discovered that banks are much like any other industry that produces goods and services for clients. There are many life cycle stages in banks that should include :

Demand Deposit Accounts (DDAs) or checks : This will monitor rapidly dropping usage that was supposed to be replaced by electronic bill payment and debit cards.

Online banking and electronic bills : are in a development phase as a result of the increasing number of clients who use these services instead of checks.

Cards for debt or checks : It serves as a stage of development when acceptance from almost everyone is situated.

Apart from this as discussed above, there are 6 key tactics typically utilized by special operation teams :

Purpose : It has a purpose for developing financial services and products. The entire product development team should agree on a project charter since it can serve as both a statement of purpose and a set of rules for your team to refer to in the event that information is unclear or contradictory.

Simplicity : Although creating products with plenty of bells and whistles is entertaining and will keep your call centres busy with client inquiries, they are not necessarily the ideal solution for your bank or your customers. It's too difficult if a platform banker can't describe an account or product in three phrases or less. Yet, this does not imply that each bank should only provide its own brand of free services. But this does not imply that each bank should just provide its own version of free checking and the 30–year fixed–rate mortgage.

The only approach to maintain the profitability of checking accounts is to influence client behaviour through customised incentives that are unique to your customer base and your bank. For banks to compete with non–bank loan providers like Lending Club and Kabbage, they will need to develop creative lending strategies that address the demands of millennials. While you preserve profitability, you may let your clients bank how they want by using behaviour–driven pricing and product strategy.

Instead of concentrating on developing one product that treats their clients differently depending on what they do, many banks have a variety of products that all treat customers the same. The greatest banks, or those that pay attention to and act upon customer feedback, consider customer behaviour and offer flexible solutions for each client's unique financial needs without adding needless complexity.

Speed : In a conflict zone, speed and surprise are clearly advantageous. The quick creation of new products enables your bank to seize possibilities as they arise in the market.

Security : By keeping the specifics of action plans hidden until execution, adversaries are kept wondering about the next step.

For bankers who want to learn how to manage compliance, configure network servers, or underwrite credit, there are many schools and training programmes available, but there are incredibly few for those who want to learn how to deliver a good product on time. Using a third party with substantial experience in the product you are launching can help you avoid costly mistakes that could take years to fix. Trial and error can be painful.

If you want your team to function as a unit efficiently, repetition in training and processes is essential. Starting with a well–documented strategy that enables all team members to contribute ideas while keeping the project moving forward is the first step in developing a repeatable, scalable process for product development.

When well–meaning team members create obstacles because of a lack of resources, misinterpret the goal of a project, or fail to see the commercial potential of the new items, projects can stall. Following a pre–established process helps prevent small issues from derailing a project that is already underway and severe issues from Banking Products and Services Products from leading to a botched product launch.

To make sure that everyone in the team is on board with the new framework, it is tremendously beneficial to have a senior bank executive champion the creation of the process documentation.

Surprise : Providing unanticipated advantages in a new product or service to your customer's increases engagement and adoption. The surprise can be as straightforward as a banker calling to confirm the delivery of a new debit card as requested or as complex as a tiered cash incentives scheme for an advanced checking account.

The surprise element should initiate a positive feedback cycle in which new customers tell their friends and family about your new product, who then open new accounts and spread the word to other people. The most effective and affordable marketing your bank can do is through a feedback loop that begins with a surprise.

2.10 Product Development :

The process of designing, producing, and selling new goods or services that benefit consumers is known as product development. As it focuses on creating systematic procedures to direct all activities involved in bringing new products to market, it is also known as new product development. The appreciation of the asset allocation idea by investors is one of the shifts that is observed in Indian private banking in the current volatile and unpredictable environment. With this, an investor has begun to comprehend better, demonstrating the advantages of viewing portfolios from a wider and longer–term perspective. The idea of portfolio diversity can be challenging to implement in India at times because there aren't as many assets being displayed by the market.

The benefit of this is that private bankers frequently struggle to convince customers of excessive diversity at the proper price when product makers appear to be having trouble creating the market owing to lack of scale. Some of the top asset management firms and other product producers in the Indian wealth management business expressed these and other ideas.

Product manufacturers place a strong emphasis on straightforward items that are combined with education to create a solid foundation for the market's potential to advance in the following six to twelve months.

It is considered that product producers experience difficulties when it comes to determining and controlling investors' return expectations, which ultimately reduces not only the aim but also risk mitigation, which is a key element of the product. The idea of a longer term is also being re–examined in light of the fact that investors are increasingly becoming short term due to the abundance of information available to them nowadays.

Check Your Progress :

1. Bank account allows you to :

   a. Transacts   b. Opens an account

   c. Transfers an account   d. All of above

2. Which is not associated with banking ?

   a. Savings account   b. Certificate of deposit

   c. Mutual Fund Deposit   d. Individual retirement account

3. If a company has five product lines, with five brands in each product, then what will be the product mix length of that company ?

   a. 20   b. 10   c. 25   d. None of these

4. Which of the following is stage of Product Life Cycle ?

   a. Introduction Stage   b. Growth stage

   c. Decline stage   d. All of the above

5. Risk diversity involves aspect for development of :

   a. Economic products   b. Financial products

   c. Deposit Products   d. None of the above

6. Product development works as a tool for :

   a. Growth of product   b. Modification of product

   c. Generation of new product   d. All of above

7. Branding makes the product :

   a. Cost effective   b. Cheap

   c. Famous   d. Easy to develop

8. _________ is the systematic search for new–product ideas.
   a. Idea generation
   b. Idea screening
   c. Concept development and testing
   d. Marketing strategy development
9. In case of product concept stage of new product development, the product is ___________.
   a. word description   b. crude mock–up
   c. drawing   d. all of the above

2.11 Let Us Sum Up :

We discovered in this lesson that an Indian bank provides a range of financial services, including deposit products like savings accounts, current accounts, and term deposit accounts. Banks not only offer safekeeping for cash but also accounts and other products that let you pay your expenses and give you income with the goal of compounding. Brand recall, which measures consumers' capacity to name your brand when given the product category, category need, or another comparable cue, is a component of brand awareness. Brand recall is the ability of consumers to affirm that they have previously been exposed to your brand.

It is found that banks are like any other business where goods and services are produced for customers. Product development is a technique with which designing, creating and marketing of new products or services arise which shows benefit to their customers. It is also called as new product development as it focusses on developing systematic methods which will guide all processes which are used in getting new product to market.

2.12 Answers for Check Your Progress :

1. a	**2.** c	**3.** c	**4.** d	5. b
6. d	**7.** c	**8.** a	**9.** d	

2.13 Glossary :

1. **Checks or Demand Deposit Accounts (DDAs) :** This will stop the usage from rapidly falling because debit cards and electronic bill pay were set to replace them.
2. **Security :** A financial product that takes the form of a document (such as stock certificate or bond) that serves as proof of ownership

2.14 Assignment :

1. Explain the concept related to product development.
2. How to Using Product Life Cycle to Manage Marketing of Banking Products
3. Explain the concept of Branding in Bank Marketing

2.15 Activities :

1. Why are brands important ? What relationship does a brand share with a consumer ?

2.16 Case Study :

1. Look around you and describe clearly personality profiles of five brands.

2.17 Further Readings :

1. Marketing Management (Twelfth Edition) – Philip Kotler.
2. The Brand Mindset – Duanne E Knapp. Tata McGraw Hill edition.
3. The 22 Immutable Laws of Branding – Al Ries and Laura Ries.
4. Positioning : The Battle for Your Mind – Al Ries and Laura Ries.

BLOCK SUMMARY

The provides extensive information on consumer behaviour functions and marketing offerings that demonstrate value to customers. The concept of contemporary marketing management and consumer issues in the domain of consumption are thoroughly explained with features and characteristics. Information regarding bank deposits such savings accounts, current accounts, and term deposit accounts is provided in the block.

After studying this block, you get knowledge of various bank account kinds, their features, and brand recognition. Student knowledge that will help them understand the behavioural nature of consumers is provided by the notion of consumer behaviour for obtaining customer behaviour.

The information on product development methodology along with expertise in the planning, production, and marketing of new goods or services reveals relevant data on new product development.

BLOCK ASSIGNMENT

Short Questions :

1. What do you mean by product development ?
2. What is consumer behaviour ?
3. Compare Saving Bank Account with Current Bank Account ?
4. How consumer behaviour satisfies the needs of consumers ?
5. What do you understand by Brand awareness ?

Long Questions :

1. List certain banking products ?
2. Explain features of modern marketing management ?
3. What will be the impact of consumer behaviour on family ?
4. Explain the advantages of Mobile Banking.
5. Explain the elements of Product Mix.

❖ **Enrolment No. :** [ ]

1. How many hours did you need for studying the units ?

Unit No.	1	2
No. of Hrs.		

2. Please give your reactions to the following items based on your reading of the block :

Items	Excellent	Very Good	Good	Poor	Give specific example if any
Presentation Quality	☐	☐	☐	☐	______
Language and Style	☐	☐	☐	☐	______
Illustration used (Diagram, tables etc)	☐	☐	☐	☐	______
Conceptual Clarity	☐	☐	☐	☐	______
Check your progress Quest	☐	☐	☐	☐	______
Feed back to CYP Question	☐	☐	☐	☐	______

3. Any other Comments

....

....

....

....

....

....

....

....

BBAR-601

Financial Services

BLOCK-4 RATINGS AND SECURITIZATION

UNIT 1
CREDIT RATINGS

UNIT 2
PLASTIC MONEY

UNIT 3
SECURITIZATION

UNIT 4
DEPOSITORY SERVICES

BLOCK 4 : RATINGS AND SECURITIZATION

Block Introduction

Financial Services has been incorporated into all management and finance–related curricula since services are seen as one of the most crucial parts of any company unit, whether it is little or large scale. Every firm needs to focus on service aspect and cannot sustain longer without it.

You will learn about financial services and its different facets, as well as their parts and components, in this block. With the help of traits and characteristics, the idea and operation of various firms and related financial organisations are clearly explained. The section will go into detail regarding how financial services are marketed as well as how exchange relationships are approached. Rating and Securitization plays an important role in Financial services. In this block you will be able to understand the detail concept of credit rating, plastic money, securitization and depository services.

Block Objectives

After learning this block you will be able to understand :

- The concept of credit rating and its various types.
- The evolution of plastic money and its use.
- Role of securitization and its process.
- Depository services and its functions.

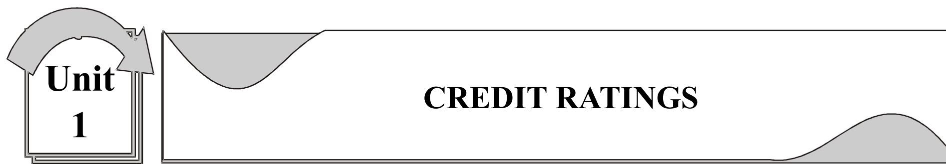
Block Structure

Unit 1 : Credit Ratings

Unit 2 : Plastic Money

Unit 3 : Securitization

Unit 4 : Depository Services



Unit 1 CREDIT RATINGS

: UNIT STRUCTURE :

1.0 Learning Objective
1.1 Introduction
1.2 Meaning
1.3 Origin
1.4 Types of Credit Rating
1.5 Advantages of Credit Ratings
1.6 Disadvantages of Credit Ratings
1.7 Credit Rating Agencies
1.8 Credit Rating Methodology
1.9 International Credit Rating Practices
1.10 Top Three Credit Rating Institutions of World
1.11 Let Us Sum Up
1.12 Answers for Check Your Progress
1.13 Glossary
1.14 Assignment
1.15 Activity
1.16 Case Study
1.17 Further Readings

1.0 Learning Objectives :

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

- What is the credit rating regulatory framework **?**
- Explain the credit rating procedure.
- Name the credit rating organizations.

1.1 Introduction :

There are various types of investors in the market. Some of them are : Investors having money but no skills, Investors having both money and skills, Investors having more skills but less money and Investors with less money and investment skills.

These who do not have enough of money but are equipped with enough of skill there are many individuals and institutions to help them by procuring funds as per need. But those who have money to invest (either from their own resources or from borrowed ones) need guidance

and advice with expert opinion as to where to invest ? What forms safer outlet both from income and get back point of view, Credit Rating Agencies (CRAs) serve this cause.

What is Credit ?

Provision of resources by one party to another party. The other party does not reimburse the first party immediately, and instead arranges either to repay or return the resources at a later date. It is any form of deferred payment. The first party is called a creditor, also known as a lender, while the second party is called a debtor, also known as a borrower. Credit is important since Individuals and Corporations with poor credit will have difficulty finding financing and will most likely have to pay more due to the risk of default.

1.2 Meaning :

A credit rating estimates the credit worthiness of an individual, corporation, or even a country. It is an evaluation made by credit bureaus of a borrower's overall credit history. Credit ratings are based on financial history and current assets and liabilities. Credit ratings are determined by credit ratings agencies. The credit rating represents the credit rating agency's evaluation of qualitative and quantitative information for a company or government; including non–public information obtained by the credit rating agencies analysts.

Credit ratings are not based on mathematical formulas. Instead, credit rating agencies use their judgment and experience in determining what public and private information should be considered in giving a rating to a particular company or government.

The credit rating is used by individuals and entities that purchase the bonds issued by companies and governments to determine the likelihood that the company/government will pay its bond obligations.

A poor credit rating indicates a credit rating agency's opinion that the company or government has a high risk of defaulting, based on the agency's analysis of the entity's history and analysis of long term economic prospects.

1.3 Origin :

The first mercantile credit agency was set up in New York in 1841 to rate the ability of merchants to pay their financial obligations. 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 first agency to form Dun & Bradstreet in 1933, which became the owner of Moody's Investor's Service in 1962. The history of Moody's can be traced back about a 100 years ago. In 1900, John Moody laid stone of Moody's Investors Service and published his 'Manual of Railroad Securities'.

Early 1920's saw the expansion of 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. Poor and Standard merged together in 1941 to form Standard and Poor's which was subsequently taken over by McGraw Hill in 1966. Between 1924 and 1970, no major new rating agencies were set up. But since 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 setup in 1987 as the first rating agency followed by ICRA Ltd. (formerly known as Investment Information & Credit Rating Agency of India 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. The rating agencies have established their creditability through their independence, professionalism, continuous research, consistent efforts and confidentiality of information. Duff and Phelps has tied up with two Indian NBFCs to set up Duff and Phelps Credit Rating India (P) Ltd.in 1996.

1.4 Types of Credit Rating :

SOVEREIGN CREDIT RATING

A sovereign credit rating is the credit rating of a sovereign entity, i.e., a national government. The sovereign credit rating indicates the risk level of the investing environment of a country and is used by investors looking to invest abroad. It takes political risk into account (Country risk rankings).

SHORT TERM RATING

A short–term rating is a probability factor of an individual going into default within a year. This is in contrast to long–term rating which is evaluated over a long timeframe. In the past institutional investors preferred to consider long–term ratings. Nowadays, short–term ratings are commonly used.

CORPORATE CREDIT RATINGS

The credit rating of a corporation is a financial indicator to potential investors of debt securities such as bonds. Credit rating is usually of a financial instrument such as a bond, rather than the whole corporation and have letter designations such as A, B, C. The Standard & Poor's rating scale is as follows, from excellent to poor : AAA, AA+, AA, AA–, A+, A, A–, BBB+, BBB, BBB–, BB+, BB, BB–, B+, B, B–, CCC+, CCC, CCC–, CC, C, D. Anything lower than a BBB– rating is considered a speculative or junk bond.

The below table shows rating as well as meaning by various credit rating agencies :

Moody's	S&P	Fitch	Meaning
Aaa	AAA	AAA	(Highest quality; EXTREMELY STRONG capacity to meet financial obligations.)
Aa1	AA+	AA+	(High quality; VERY STRONG capacity
Aa2	AA	AA	to meet financial obligations. It differs from
Aa3	AA-	AA-	the top-line rating only in small degree.)
A1	A+	A+	(High quality; STRONG capacity to meet financial obligations
A2	A	A	but is somewhat more susceptible to the adverse effects
A3	A-	A-	of changes in circumstances and economic conditions.)
Baa1	BBB+	BBB+	(Medium grade; ADEQUATE capacity to meet financial obligations
Baa2	BBB	BBB	but adverse conditions or changing circumstances are more
Baa3	BBB-	BBB-	likely to lead to a weakened capacity to meet financial commitments.)
Ba1	BB+	BB+	(Lower medium grade; LESS VULNERABLE but faces major
Ba2	BB	BB	ongoing uncertainties and exposure to adverse conditions which
Ba3	BB-	BB-	could lead to inadequate capacity to meet financial commitments.)
B1	B+	B+	(Low grade; MORE VULNERABLE and adverse business,

1.5 Advantages of Credit Ratings :

TO THE INVESTORS :

Helps in Investment Decision : Credit rating gives an idea to the investors about the credibility of the issuer company, and the risk factor attached to a particular instrument. So the investors can decide whether to invest in such companies or not. Higher the rating, the more will be the willingness to invest in these instruments and visa–versa.

Benefits of Rating Reviews : The rating agency regularly reviews the rating given to a particular instrument. So, the present investors can decide whether to keep the instrument or to sell it. For e.g. if the instrument is downgraded, then the investor may decide to sell it and if the rating is maintained or upgraded, he may decide to keep the instrument until the next rating or maturity.

Assurance of Safety : High credit rating gives assurance to the investors about the safety of the instrument and minimum risk of bankruptcy. The companies which get a high rating for their instruments, will try to maintain healthy financial discipline. This will protect them from bankruptcy. So the investors will be safe.

Easy Understandability of Investment Proposal : The rating agencies gives rating symbols to the instrument, which can be easily understood by investors. This helps them to understand the investment proposal of an issuer company. For e.g. AAA (Triple A), given by CRISIL for debentures ensures highest safety, whereas debentures rated D are in default or expect to default on maturity.

Choice of Instruments : Credit rating enables an investor to select a particular instrument from many alternatives available. This choice depends upon the safety or risk of the instrument.

Saves Investor's Time and Effort : Credit ratings enable an investor to his save time and effort in analyzing the financial strength of an issuer company. This is because the investor can depend on the rating done by professional rating agency, in order to take an investment decision. He need not waste his time and effort to collect and analyse the financial information about the credit standing of the issuer company.

TO THE COMPANY :

Improves Corporate Image : Credit rating helps to improve the corporate image of a company. High credit rating creates confidence and trust in the minds of the investors about the company. Therefore, the company enjoys a good corporate image in the market.

Lowers Cost of Borrowing : Companies that have high credit rating for their debt instruments will get funds at lower costs from the market. High rating will enable the company to offer low interest rates on fixed deposits, debentures and other debt securities. The investors will accept low interest rates because they prefer low risk instruments. A company with high rating for its instruments can reduce the cost of public issue to raise funds, because it need not spend heavily on advertising for attracting investors.

Wider Audience for Borrowing : A company with high rating for its instruments can get a wider audience for borrowing. It can approach financial institutions, banks, investing companies. This is because the credit ratings are easily understood not only by the financial institutions and banks, but also by the general public.

Good for Non–Popular Companies : Credit rating is beneficial to the non–popular companies, such as closely–held companies. If the credit rating is good, the public will invest in these companies, even if they do not know these companies.

Act as a Marketing Tool : Credit rating not only helps to develop a good image of the company among the investors, but also among the customers, dealers, suppliers, etc. High credit rating can act as a marketing tool to develop confidence in the minds of customers, dealer, suppliers, etc.

Helps in Growth and Expansion : Credit rating enables a company to grow and expand. This is because better credit rating will enable a company to get finance easily for growth and expansion

1.6 Disadvantages of Credit Ratings :

Possibility of Bias Exist : The information collected by the rating agency may be subject to personal bias of the rating team. However, rating agencies try their best to provide an unbiased opinion of the credit quality of the company and/or instrument. If not, they will not be trusted.

Improper Disclosure May Happen : The company being rated may not disclose certain material facts to the investigating team of the rating agency. This can affect the quality of credit rating.

Impact of Changing Environment : Rating is done based on present and past data of the company. So, it will be difficult to predict the future financial position of the company. Many changes take place due to changes in economic, political, social, technological, legal and other environments. All this will affect the working of the company being rated. Therefore, rating is not a guarantee for financial soundness of the company.

Problems for New Companies : There may be problems for new companies to collect funds from the market. This is because, a new company may not be in a position to prove its financial soundness. Therefore, it may receive lower credit ratings. This will make it difficult to collect funds from the market.

Downgrading by Rating Agency : The credit–rating agencies periodically review the ratings given to a particular instrument. If the performance of a company is not as expected, then the rating agency will downgrade the instrument. This will affect the image of the company.

Difference in Rating : There are cases, where different ratings are provided by various rating agencies for the same instrument. These differences may be due to many reasons. This will create confusion in the minds of the investor.

1.7 Credit Rating Agencies :

Independent Agency who assesses the capacity of the issuer of the debt security to pay interest and repay the principal as per the terms and conditions.

They collect a fee from the Issuers for rating their Debt Securities. They rate an instrument based on parameters like :

- business risk
- market position
- operating efficiency
- adequacy of cash flows
- financial risk,
- financial flexibility, and
- management and industry environment

Credit Rating is not one time evaluation of Credit Risk. Agencies continuously monitor the Performance of the company till the maturity of Particular Security. This is known as SURVEILLANCE. Changes affecting the company are taken into account and the rating, if necessary, is changed, upwards or downwards. In other words, a rating is valid during the life of the instrument unless is changed.

CREDIT RATING AGENCIES OF INDIA :

CRISIL :

The first rating agency 'Credit Rating Information Services of India Ltd., CRISIL, was promoted jointly in 1987 by the ICICI and the UTI. Other shareholders included ADB, LIC, HDFC Ltd, General Insurance Corporation of India and several other foreign and Indian Banks. It pioneered the concept of credit rating in the country and since then has introduced new concepts in credit rating services and has diversified into related areas of information and advisory activities.

It became public in 1993. In 1996, it formed a strategic alliance with S&P rating group.

Service offered by CRISIL are as follows **:**

- Credit Rating Services
- Advisory Services
- Credibility first rating and evaluation Services
- Training Services
- **Functions of CRISIL :**

The principle function of CRISIL is to rate mandated debt obligations of Indian Companies chit fund, real estate developers, LPG Kerosene dealers, NBFC, Indian states and so on.

- **Rating of debt obligations :**

Debt obligation includes rupee denominated credit instruments like debentures, preference shares, deposits, CD's commercial papers and a structured obligation of manufacturing, finance companies, banks, financial institutions etc.

It ensures stable and healthy growth of capital market by offering credit rating which is widely acceptable. It provides increased disclosures, better accounting standards and improved financial information to the users.

It reduces cost of issue by direct mobilization of resources.

It protects the interest of investors by constantly monitoring the results of rated companies.

- **Rating of structured obligations :**

It reflects CRISIL opinion regarding the capacity and willingness of the company to make timely payments of financial obligations on rated instruments.

- **Rating of real estate's developers :**

CRISIL has developed framework for rating of real estate projects. Such rating helps investors to identify their investment options

The rating is expected to help developers mobilize funds for their projects.

The methodology assesses a project in terms of project risk factors and developer's risk factors.

- **Bond Fund ratings :**

The rating is an opinion of the quality of bond funds underlying portfolio holdings. They mainly focus on fixed income securities.

The rating methodology takes into account the following factors i.e., credit associated with the securities, the systems and procedures followed by the funds and management quality and expertise.

- **Bank loan rating :**

The creditworthiness of bank's borrower is assessed offering comments on the likelihood of repayment of loans.

The methodology considers the borrowers underlying assets liquidity and risk management initiative and for NBFC quality of assets, loans and investment.

- **Collective investment schemes :**

This covers rating of collective investment schemes offering opinion on the degree of certainty of the scheme to deliver the assured returns in terms of cash as mentioned in the offer document.

- **Grading of health care institutions :**

The grading for healthcare institutions is an opinion on the relative quality of health care delivered by the institutions to the patients. Grading is done taking into account facilities, quality, consistency in delivering the service etc. Flowing are the grades given Grade A (Very good quality), Grade B (Good Quality), Grade C (Average Quality) and Grade D (Poor Quality)

- **Banking and finance group :**

  CRISIL offers a wide range of services covering restructuring and business reengineering, credit management, investment management and portfolio insurance, equity valuation, resource mobilization studies and financial feasibility studies.

- **Capital Market Group :**

  This group provides customized research and advisory assistance to meet specific transactional and strategic requirements of clients. It offers services like diagnostic evaluation for valuation of Indian partner of a foreign asset management company, technical assistance to AMFI, portfolio evaluation and portfolio analysis for leading mutual funds, composite performance ranking of domestic mutual funds, assistance to government for the development of India's financial sector.

ICRA Ltd :

Information and Credit Rating Services (ICRA) has been promoted by IFCI Ltd as the main promoter and started operations in 1991. Other shareholders are UTI, Banks, LIC, GIC, Exim Bank, HDFC and ILFS.

- It provides Rating, Information and Advisory services ranging from strategic consulting to risk management and regulatory practice.
- The main objectives of ICRA are to assist investors both individual and institutional in making well informed decisions.
- To assist issuers in raising funds from a wider investor base.
- To enable banks, investment bankers, Brokers in placing debt with investors.
- To provide regulators with market driven systems to encourage the healthy growth of capital markets.
- It provides rating services, information services and advisory services.

Services provided by ICRA :

Rating services

- ICRA rates debt instruments issued by manufacturing companies, commercial banks, NBFCs, financial institutions, PSUs and municipalities.
- The instruments rated by it include bonds/ debentures, fixed deposits, commercial papers and certificate of deposit. It also rates structured obligations in accordance with the terms of the structure based on risk assessment of the instrument. It rates sector specific debt obligations issued by power, telecom and infrastructure companies.
- It also provides corporate governance rating, rating of claims paying ability of insurance companies, credit assessment of large medium and small–scale companies to obtain assistance from banks, FIs. It also provides services of general assessment of companies.

Information services

- The information services division of ICRA focuses on providing authentic data and value–added products used by intermediaries, financial institutions, banks, asset managers, institutions and investors.
- Value added services include equity grading providing a critical input on a company's earnings prospects and inherent risks in decision making process of equity investors and equity assessment.
- Other services include corporate reports, equity assessment, mandate based studies (customized research) and sector/industry specific publication.

Advisory services

- The advisory services division of ICRA offers wide ranging management advisory services. Under advisory services ICRA provides its understanding on the business processes and relevant organizational issues to different players of financial markets such as investors, issuers, regulators, intermediaries and media.
- The advisory services include 1. strategic consulting/ strategic practice 2. risk management (credit risk, market risk and operations risk) 3. regulatory practice 4 transaction practice 5. Information (content services).
- It focuses on sectors like banking and financial services, infrastructure sector, manufacturing and service sector, government and regulatory authorities.

CARE Ltd :

- Credit Analysis and Research Ltd or CARE is promoted by IDBI jointly with Financial Institutions, Public/Private Sector Banks and Private Finance Companies.
- It commenced its credit rating operations in October, 1993 and offers a wide range of products and Services in the field of Credit Information and Equity Research.
- It also provides advisory services in the areas of securitization of transactions and structuring Financial Instruments.
- It offers services like

1. Credit rating of debt instruments
2. Advisory services like securitization transactions, structuring financial instruments, financing infrastructure projects and municipal finances
3. Information services like providing information to companies, industry and businesses.
4. Equity research

1.8 Credit Rating Methodology :

The credit rating methodology consists of four parts which are as follows :

1. **Business analysis** – covers an analysis of industry risk, market position in the country, operating efficiency of the company and legal position.
2. **Financial Analysis** – analysis of accounting quality, earnings protection, cash flow adequacy and financial flexibility.
3. **Management Evaluation** – study of track record of the management's capacity to overcome adverse situations, goals, philosophy and strategies.
4. **Fundamental Analysis** – analysis of liquidity management, asset quality, profitability and interest and tax sensitivity.

Process of Credit rating methodology :

– Information is collected and then analyzed by a team of professionals in an agency.

– If necessary, meetings with top management suppliers and dealers and a visit to the plant of proposed sites are arranged to collect additional data. This team of professionals submit their recommendations to the rating committee.

– Committee discusses this report and then assigns rating.

– Rating assigned is then notified to the issuer and only on his acceptance, rating is published.

– Assures confidentiality of information.

– Once the issuer decides to use and publish the rating, agency has to continuously monitor it over the entire life of instrument, called surveillance.

Credit rating for financial service sector

When rating debt instruments of financial institutions, banks, NBFCs in addition to the financial analysis and management evaluation. The following factors are considered **:**

- Regulatory and competitive environment
- Fundamental analysis

- Capital adequacy
- Asset quality
- Liquidity management
- Profitability and financial position
- Interest and tax sensitivity

1.9 International Credit Rating Practices :

How does the Credit Rating Agency work :

When any company wants to issue any bonds or securities into the market, they tend to rate this debt instrument by any Credit Rating Agency so that they can attract more customers. Higher the rating of the debt lower is the risk associated with that debt and vice–versa. The intended buyer of the debt instrument often looks at the credit rating of the debt before investing their funds so that they can have a fair idea about the risk associated with their investments.

Once the companies approach the credit rating agencies to evaluate their debt and rate the same the credit ratings agencies check the following parameters **:**

- Subjective evaluation of the capacity of the company to repay the debt.
- Overall total debt of the company and its impact on the financial position.
- A thorough analysis of the finances of the company to ascertain the areas through which the principal and interest would be paid.
- Past debt repayment history of the company.
- A general study of the economy and industry in which the company is operating.
- The willingness of the company to repay its debt.

For example, Bank Loan Rating Process & Methodology – by Fitch Ratings (In India)

The rating process typically takes six to eight weeks, and the steps involved are :

Step – 1 : Initiate Rating Process

Step – 2 : Collect publicly available information

Step – 3 : Perform pre–analysis & request non–public information, if appropriate

Step – 4 : Prepare a detailed questionnaire

Step – 5 : Hold meetings with entity management and other Stakeholders

Step – 6 : Perform in–depth analysis

Step – 7 : Draft report

Step – 8 : Hold rating Committee

Step – 9 : Assign ratings, write & publish commentary

Step – 10 : Conduct ongoing surveillance

Repeat Step 2 to Step 10 (as required) before giving the final ratings

The above list is indicative and not exhaustive, and there are various other factors considered by credit rating agencies before giving a certificate on their credit rating.

While issuing the rating certificate they also give an annexure wherein details are provided as to what assumptions they have taken or the method they have chosen to arrive at the ratings.

Investment Grade by Credit Rating Agencies :

Ratings are divided into

1. High investment grade
2. Upper medium grade
3. Lower medium grade
4. Non–investment grade speculative
5. Highly speculative
6. Substantial credit risk or near default
7. In default

However, there can be another grading also adopted by the agencies that shall be given in detail in their report. But the basic fundamental remains the same – Highest – High – Moderate – Weak – Poor – Default.

In this article, we will cover a list of **credit rating agencies** sites in the world.

Credit rating is an important aspect of securities, especially bonds. There are several rating agencies in the world that analyse and give ratings to bonds and other securities. Let's see the credit rating agencies listed as per their country.

1.10 Top Three Credit Rating Institutions of World :

Fitch Ratings

Fitch is one of the world's top three credit rating agencies. It operates in New York and London, basing ratings on company debt and its sensitivity to changes like interest rates. When it comes to sovereign debt, countries request Fitch–and other agencies–to provide an evaluation of their financial situation along with the political and economic climates.

Investment grade ratings from Fitch range from AAA to BBB. These letter grades indicate no to low potential for default on debt. Non–investment grade ratings go from BB to D, the latter meaning the debtor has defaulted

History

John Knowles Fitch founded the Fitch Publishing Company in 1913, providing financial statistics for use in the investment industry via "The Fitch Stock and Bond Manual" and "The Fitch Bond Book." In 1923, Fitch introduced the AAA through D rating system that has become the basis for ratings throughout the industry. With plans to become a full–service global rating agency, in the late 1990s Fitch merged with IBCA of London, subsidiary of Fimalac, a French holding company. Fitch also acquired market competitors Thomson Bank Watch and Duff & Phelps Credit Ratings. Fitch began to develop operating subsidiaries specializing in enterprise risk management, data services, and finance–industry training starting in 2005 with the acquisition of a Canadian company, Algorithmics, and the creation of Fitch Solutions and Fitch Training (now Fitch Learning)

Moody's Investors Service

Moody's assigns countries and company debt letter grades, but in a slightly different way. Investment grade debt goes from Aaa–the highest grade that can be assigned–to Baa3, which indicates that the debtor is able to pay back short–term debt. Below investment grade is speculative grade debt, which are often referred to as high–yield or junk. These grades range from Ba1 to C, with the likelihood of repayment dropping as the letter grade goes down.8

History

John Moody and Company first published "Moody's Manual" in 1900. The manual published basic statistics and general information about stocks and bonds of various industries. From 1903 until the stock market crash of 1907, "Moody's Manual" was a national publication. In 1909, Moody began publishing "Moody's Analyses of Railroad Investments," which added analytical information about the value of securities. Expanding this idea led to the 1914 creation of Moody's Investors Service, which, in the following 10 years, would provide ratings for nearly all of the government bond markets at the time. By the 1970s Moody's began rating commercial paper and bank deposits, becoming the full–scale rating agency it is today.

Standard & Poor's

S&P has a total of 17 ratings it can assign to corporate and sovereign debt. Anything rated AAA to BBB– is considered investment grade, meaning it has the ability to repay debt with no concern. Debt rated BB+ to D is considered speculative, with an uncertain future. The lower the rating, the more potential it has to default, with a D–rating being the worst.

History

Henry Varnum Poor first published the "History of Railroads and Canals in the United States" in 1860, the forerunner of securities analysis

and reporting that would be developed over the next century. Standard Statistics formed in 1906, which published corporate bond, sovereign debt, and municipal bond ratings. Standard Statistics merged with Poor's Publishing in 1941 to form Standard and Poor's Corporation, which was acquired by The McGraw–Hill Companies in 1966. Standard and Poor's has become best known by indexes such as the S&P 500, a stock market index that is both a tool for investor analysis and decision–making, and a U.S. economic indicator.

Check Your Progress :

1. Where does the headquarters of CRISIL situated ?

   a. Mumbai b. Delhi c. Haryana d. Calcutta

2. Which of the following is India's first Credit Information Company ?

   a. CRISIL b. ICRA c. SMERA d. CIBIL

3. SMERA has been registered under which of the following Acts ?

   a. Securities and exchange board of India act, 1992

   b. Reserve Bank of India act, 1934

   c. Banking regulation act, 1949

   d. Securities and exchange board of India (Credit Rating Agencies) Regulations, 1999

4. Who is the current head of Central Registry of Securitization Asset Reconstruction and Security Interest (CERSAI) ?

   a. Praveen Kumar Sharma b. Naveen Kumar Sharma

   c. Laxmi Nivas Mittal d. Nandan Nilekani

5. Where does the headquarters of Brickwork Ratings India Private Limited situated ?

   a. Bangalore b. Hyderabad c. Mumbai d. New Delhi

6. The Majority shareholder in CRISIL is _________ ?

   a. Standard and Poors' b. Fitch Ratings Inc.

   c. Moody's d. Dun and Bradstreet

7. Which is a full service credit rating agency exclusively set up for micro, small and medium enterprises ?

   a. CRISIL b. SMERA c. ICRA d. ONICRA

8. Which was the first exchange in the country to provide a modern, fully automated screen–based electronic trading system ?

   a. BSE b. NSE c. PSE d. CSE

9. Which of the following is merged with SEBI ?

   a. CRISIL b. FMC c. CIBIL d. SHCIL

10. Who is the present chairman of IRDA in India ?

    a. T. S. Vijayan b. J. Hari Narayan

    c. Nilesh Sathe d. D. D. Singh

1.11 Let Us Sum Up :

A credit rating determines how creditworthy a person, business, or even a nation is. It is a review of a borrower's overall credit history conducted by credit bureaus. Credit scores are computed using current assets and liabilities as well as financial history.

A company that gives credit ratings to both the issuers of specific kinds of debt obligations and the debt instruments themselves is known as a credit rating agency (CRA). In some circumstances, ratings are also provided to the servicers of the underlying debt. Companies, special purpose corporations, state and local governments, non–profit organisations, or national governments are the most common issuers of securities. These entities issue debt like securities (such as bonds) that can be sold on a secondary market. The interest rate charged on the specific instrument being issued depends on the issuer's credit rating, which considers the issuer's credit worthiness (i.e., its capacity to repay a loan).

The Securities and Exchange Board of India oversees the credit rating agencies. CRISIL, CARE, DCR India, and ONICRA are the nation's top credit rating agencies.

1.12 Answers for Check Your Progress :

1. a	**2.** d	**3.** d	**4.** a	**5.** a
6. a	**7.** b	**8.** b	**9.** b	**10.** a

1.13 Glossary :

1. **Credit Rating :** The process of creating a symbolic representation of the current assessment of the issuer's capacity to pay off its debts on schedule.
2. **CARE :** Credit Analysis and Research is a credit rating organization that, in addition to providing sector–specific industry research, assigns ratings to financial instruments.
3. **ICRA :** Investment Information and Credit Rating Agency of India Ltd, which provides investment information, consulting services, and rating services.
4. **Equity Rating :** The rating of equity issues is intended to improve the capital raising process.

1.14 Assignment :

1. What do you think is the advantage for an economy to have multiple credit rating agencies ?
2. What are the limitations of multiple credit rating agencies ?
3. Evaluate the working of :

   a. CRISIL b. CARE c. DCR India d. ONICRA

   as credit rating agencies in India.

1.15 Activity :

1. Explain the process of Credit Rating in detail.

1.16 Case Study :

1. A detailed case study on any one rating agencies of India.

1.17 Further Readings :

1. Bhatia, B.S., and Batra, G.S., Financial Services, Deep & Deep Publishers, New Delhi.
2. Bansal, L.K., Merchant Banking and Financial Services, Unistar Books Pvt. Ltd., Chandigarh.
3. Kothari, C.R., Investment Banking and Customer Service, Arihand Publishers, Jaipur.
4. Machiraju, H.R., Merchant Banking, New Age International Publishers, New Delhi.
5. Michael K. Ong, Credit Ratings : Methodologies, Rationale and Default Risk, Risk Books.
6. Online links www.indianembassy.org
7. www.onicra.com
8. www.sebi.com

Unit 2

PLASTIC MONEY

: UNIT STRUCTURE :

2.0 Learning Objective

2.1 Introduction

2.2 Concept and Different Forms of Plastic Money

2.3 Details of Debit Cards and Credit Cards

2.4 Credit Card Cycle

2.5 Credit Card Advantages

2.6 Credit Card Disadvantages

2.7 Future Perspective of Cards

2.8 Let Us Sum Up

2.9 Answers for Check Your Progress

2.10 Glossary

2.11 Assignment

2.12 Activity

2.13 Case Study

2.14 Further Readings

2.0 Learning Objective :

In this unit, You will :

- Read a text about crucial security measures and procedures for credit and debit cards.
- Learn how and why plastic currency is created.
- Learn more specific terms associated with plastic money.
- Analyse various modes of virtual payments used in commercial activities.
- Describe different types of E–payment systems used in commercial transactions

2.1 Introduction :

Plastic money was introduced in the 1950s and is now an essential form of ready money which reduces the risk of handling a huge amount of cash. In present era, it is impossible to imagine modern bank transactions, commercial transactions and other payments without using the plastic cards. Plastic currency is now gradually becoming a necessity across the globe as more and more developed countries are opting for plastic compared to paper as there are several inherent advantages.

Plastic money involves all types of cards made of plastic like debit card, debit card, etc. Plastic cards are one of the most popular forms of payment. In fact, Plastic cards are an inevitable part of our life. They allow cardholders to pay for goods and services easily and conveniently and provide an alternative to cash and cheques. As Credit Card, Debit card, ATM card etc are, used as the alternative to money such as cash or cheque, and are made of plastic, they are also called Plastic money. Credit cards or debit cards are called Plastic cards.

Plastic cards are issued to users by a variety of organisations (called as card issuers) such as banks, retailers such as Big Bazaar, Shopper Stop. There are various plastic card schemes such as MasterCard, Visa, Rupay Cards, American Express, Diners Club, Maestro etc. These operators work behind the scene to make sure that card works The types of cards issued and their levels of functionality vary from card issuer to card issuer and between the different card schemes under which the cards are issued.

2.2 Concept and Different Forms of Plastic Money :

There are basically two kinds of Plastic cards which are commonly used to buy goods and services : **Debit Card and Credit Card**

Debit Card

Debit card is linked to the account of the cardholder i.e one who owns the cards. They are usually issued by Banks and financial institutions. When ones use a debit card the money is immediately deducted directly from one's account associated with the card. One can buy things as long as there is money in account. ***A debit card is a way to "pay now"*** Say you have Rs 10,000 in your account. The amount you can spend, or withdraw, through your card cannot exceed this limit.

Credit Card

Credit Card is a small plastic card that is issued by financial institutions such as banks. As the name ***Credit*** when one buys using credit card, one is buying by taking loan. One needs to pay back later (there are no free lunches in life!). There is a limit to which one can buy on a credit card. So, even if you have only Rs 10,000 in your account but your credit limit is Rs 50,000, you are free to spend up to Rs 50,000. You could also have Rs 1,00,000 in your account, but your credit limit is only Rs 50,000. You need to repay the amount bought on credit by a due date.

Comparing Credit Card and Debit Card

Credit Card and Debit Cards are similar in appearance except on the front side "Debit card" is printed in small letters while for credit cards 'Credit Card' is printed. Credit is like buying money, goods, services now but paying for it in future. As in buying the two people or business involved are buyer and seller. In credit the person who agrees to provide money, goods, services etc is called as ***creditor or lender*** and one who

takes money, goods or services for the promise of future payment is called as ***debtor or borrower***.

Other Kinds of Cards

There are different types of plastic money available in the market today. Such as Credit cards, Debit cards, add–on cards, charge cards, co–branded cards, affinity cards or Diners Club cards. More and more Indians are using them as a convenient mode of payment. Let's check out these cards.

- ***Charge card*** carries all the features of credit cards. However, after using a charge card you will have to pay off the entire amount billed, by the due date. If you fail to do so, you are likely to be considered a defaulter and will usually have to pay up a steep late payment charge. In case of credit card, one can pay late payment fee if one misses the due date. Popular charge cards are American Express cards also called as Amex cards.
- ***Photo card*** If card holder photograph is imprinted on a card, then card is known as a photo card. This helps identify the user of the credit card and is therefore considered safer.
- ***Global cards*** allow one the flexibility and convenience of using a credit card rather than cash or travellers checks while travelling abroad for either business or personal reasons.
- ***Co–branded cards*** are credit cards issued by card companies that have tied up with a popular brand for the purpose of offering certain exclusive benefits to the consumer. For example, the Citi–Times card gives you all the benefits of a Citibank credit card along with a special discount on Times Music cassettes, free entry to Times Music events, etc.
- ***Affinity Card*** an affinity credit card program allows an organization to offer its members and supporters–those who have an "affinity" for that organization–a credit card that promotes the organization's brand and imagery each time a cardholder uses the card. When the card is used, a certain percentage is contributed to the organisation /institution by the card issuer.
- ***An add–on card*** allows you to apply for an additional credit card within the overall credit limit. You can apply for this card in the name of family members like your father/ mother/ spouse/ brother/ sister/ children above 18 years of age. You are liable to make good all the payments for the purchases made using the add–on card(s). Your billing statement would reflect the details of purchases made using the add–on card. Normally an issuing bank permits two add–on cards per credit card.

2.3 Details of Debit Cards and Credit Cards :

A plastic card (Debit Cards and Credit Cards) size is 85.60 X 53.98 mm (3.37 in) and, a thickness of 0.76 mm. Corners are rounded with

a radius of 3.18 mm. Specifications for credit card numbering have been drawn up by the International Standards Organization (ISO/IEC 7812–1:1993)

Details on the front of a typical plastic debit/credit card **:**

1. ***Issuing bank logo,***
2. ***Card number,***
3. ***Card brand logo such as VISA or MasterCard,***
4. ***Expiry date,***
5. ***Cardholder's name***

Details on the reverse of a typical plastic card such as debit or credit card are

Back side of debit or credit card

Magnetic stripe : The stripe on the back of a credit card is a magnetic stripe, often called a magstripe. Information such as name of card holder, expiry date of card, card number etc. is written in the magnetic strip. The magnetic stripe is read by swiping past a reading head and the information stored is sent to the acquirer's bank.

Signature strip : The card holder signs on the Signature strip. The merchant needs to verify that the signature on the card matches the signature on the receipt.

Card Security Code or Credit card Validation (CCV) number : CCV is an authentication scheme. It consists of requiring a card holder to enter while doing credit card transaction.

Analysing Credit Card Number

Credit card number has a lot of information. The number of digits in credit card varies from 13 to 19 depending on the issuer. Note : *In the section first digit mean the leftmost digit and we read numbers left to right*

First six digits of the credit card represent the ***card issuer***. The first digit is called as the system number. It is the Major Industry Identifier (MII), which represents the type of institution that issued the card. For example, American Express, Diner's Club are in the travel and entertainment category, VISA, MasterCard are in the banking and financial category. Different MII are shown below

Major Industry Identifier of Credit Cards

Digits 7 to last but one digit of credit card number is for ***account number***

The last digit is the check digit. Credit cards numbers use check digits to guard against mistakes and to check for validity. A check digit in a credit card number is used as : It can determine if a person keys in a number incorrectly. If a credit card is scanned it can determine of the scanner made a mistake. The check digit is calculated based on some

pattern and it is verified with the check digit on the card. If the check digit calculated matches the check digit on the card, the card is valid.

As mentioned, the maximum length of a credit card number is 19 digits. Since the 7 digits are reserved, account number field is 19 – 7, or 12 digits. Each issuer therefore has a trillion (1,000,000,000,000) possible account numbers.

2.4 Credit Card Cycle :

Mr. Akhil wants to buy a Samsung T.V with Axis credit card with a MasterCard logo. The shopkeeper at Samsung Showroom swipes the Axis credit card on a machine provided by ICICI banks. In the example Mr. Akhil; is the ***cardholder***, Axis bank is the ***card issuer, the merchant*** is the shop or Samsung Showroom and ICICI Bank is the ***acquirer*** and MasterCard is the ***card association***.

Various parties involved when one uses Plastic cards as explained below.

The cardholder is an individual to whom a plastic card is issued. Typically, this individual is also responsible for payment of all charges made to that card.

- **Card Issuer** is an institution that issues cards to cardholders. This institution is also responsible for billing the cardholder for charges.
- **Credit Card association** – An association of card–issuing banks such as Visa, MasterCard, etc. that set transaction terms for merchants, card–issuing banks, and acquiring banks.
- **Merchant** – The individual or business accepting card payments for products or services sold to the cardholder also called as Card Accepter.
- **Acquirer** – an organization that collects (acquires) credit authorization requests from Card accepters and provides guarantees of payment. The merchant swipes the card on the acquirer's swipe machine. He submits all the signed slips to the acquirer and collects payments from the acquirer.

2.5 Credit Card Advantages :

– Credit cards enable you to make purchases even if you don't have the money on hand, allowing you to choose to pay them off at a later time.

– Credit cards eliminate the time and money spent ordering, writing, mailing and reconciling check payments.

– Credit cards eliminate the risk of loss and theft associated with carrying cash, and the time and money spent getting cash from ATMs and banks.

– Credit cards provide the opportunity to reverse a charge for goods or services that a consumer finds unsatisfactory. Chargebacks are

initiated by the consumer through the bank providing their card, in many cases, without requiring direct confrontation with merchants or service providers.

- Credit cards are a great tool for consumers who are trying to establish or improve their credit rating. Credit cards typically report account activity to at least one of the three major credit bureaus on a monthly basis. An attractive credit rating will improve a consumer's chances of obtaining favorable credit terms (low interest rates, low fees, etc.) for automobile loans, mortgages, personal loans and other major purchases.
- Many credit cards offer services and rewards for using them : Airline Miles Rewards, Cash Back Rewards, Zero Liability Protection for Lost & Stolen Cards, Satisfaction Guarantee, Identity Theft Resolution, Rental Car Insurance, Car Rental Collision Damage Insurance, Roadside Assistance, Lost or damaged Luggage Insurance, Travel Accident Insurance and Trip Cancellation Insurance.
- Consumers can earn interest on the money in their bank accounts before paying off their monthly credit card account balance.
- Credit cards allow consumers to make purchases when cash flow is tight, so they can get what they want when it's most valuable to them.
- Credit cards provide consumers with the ability to make an expensive and essential purchase on an emergency basis, (i.e. broken hot water heater, refrigerator, home or car repairs), and are often the most suitable and cost–effective means to make that purchase.
- Credit cards offer consumers the option to revolve their balances, giving them optional, easy access to short–term consumer credit.
- Credit cards provide "cash advances," giving consumers immediate access to cash.

2.6 Credit Card Disadvantages :

- The biggest risk associated with credit cards is that, because the process of borrowing money is so convenient and simple, people sometimes over–extend themselves and become saddled with debt and interest and other charges can build to high levels.
- Many credit cards have annual fees, especially if consumer rewards are a part of the product. Consumers should weigh the amount they need to spend to receive rewards against the amount they would need to spend on the annual fees.
- Just as credit cards offer a good chance to build up a good credit score, they also provide the chance to damage it–paying credit card balances late is a fast way to harm a credit score.
- Credit card fraud, with or without stealing the plastic card itself, is a risk with credit card accounts. Your liability for fraudulent credit card transactions is limited to $50 under federal law.

- If consumers do not accurately track their account balances, they can be caught off–guard and reach their credit limits, unable to make additional purchases.
- Cash advances include different fees, interest rates and terms than credit purchases, potentially making this type of borrowing more expensive for consumers.

2.7 Future Perspective of Cards :

- Since the 20th century, the banking sector is in boom. In the 21st century also, it has noticed various changes and has also developed modernized services such as internet banking, credit debit cards, etc.
- In addition, with the introduction of various schemes such as Jan Dhan Yojna, Gas Subsidy, etc. by government, the number of account holders in banks has also rose and so was there a rise in facilities used by these account holders.
- Among the facilities provided by the banks, card facility is used most frequently by the people due to its various advantages such as convenience, speed, ease to use, etc.
- Looking to the post pandemic scenario of COVID–19, the usage of cards has risen up to a maximum extent because there were many people who were note able to avail the facilities quickly due to the long lasting ques at the banks for availing physical facilities.
- Due to the usage of cards, one can avail the facility of withdrawal, online payments, deposits, etc. with ease and smoothly, anytime and anywhere.
- The difficulties faced during this pandemic could be removed with the usage of cards.

Check Your Progress :

1. Which of the following is known as plastic money ?

   a. Demand Draft　　b. Fixed Deposit

   c. Cheque　　d. Credit Card

2. A costumer desiring to do permitted banking transactions through ATM needs to have

   a. ATM Card　　b. Personal Identification Number

   c. Both a and b　　d. None of the above

3. The charge cardholder is given about _______ days' time to credit his account in case there are insufficient funds in his account at the time of debit ?

   a. 10 to 25　　b. 15 to 35　　c. 20 to 40　　d. 25 to 50

4. A card that is used repeatedly to borrow money or buy products and services on credit is called as

   a. Credit limit
   b. Credit analysis
   c. Credit rating
   d. Credit cards

5. The bank which pays the merchant for the transactions is called as

   a. Issue bank
   b. Clearance bank
   c. Acquiring bank
   d. None of the above

6. Disadvantage to credit card holders

   a. Overspending ending in debt trap
   b. Frauds due to loss or theft of card
   c. Forged signatures
   d. All of the above

7. Credit Risk to the bank is higher form

   a. Credit card holders
   b. Debit card holders
   c. Both of the above
   d. None of the above

8. RuPay card has been launched by

   a. Reserve bank of India (RBI)
   b. National Payment corporation of India (NPCI)
   c. State Bank of India (SBI)
   d. Punjab National Bank (PNB)

2.8 Let Us Sum Up :

Plastic money is a term that is mostly used in reference to the hard plastic cards we use every day in place of hard cash. They can come in many different forms such as cash cards, credit cards, debit cards, pre–paid cash cards etc.

The world is switching from cash or paper money to plastic money, such as credit and debit cards. People now have access to cheaper internet and smart phones thanks to the recent telecom revolution. Due to this, electronic wallet and mobile wallet systems have replaced traditional electronic payment methods. With support from the government's Digital India programme and rising awareness, consumers, particularly those in rural areas, are gaining confidence. Digital wallet user base has grown and maintained a steady foothold thanks to policies that encourage electronic payment, increased smart phone penetration (mobile phone subscriptions passed the 1 billion mark in 2016 and an estimated 371 million users are now subscribed to mobile internet), improved telecom and payment infrastructure, and promotions by wallet players.

2.9 Answers for Check Your Progress :

1. d	**2.** c	**3.** d	**4.** d
5. c	**6.** a	**7.** a	**8.** b

2.10 Glossary :

1. **Plastic Money :** Credit cards, debit cards, pre–paid cash cards, and store cards are all examples of plastic money, which is also used to describe money made of plastic or polymer.
2. **E–Wallet :** An electronic wallet, often known as an e–wallet, is used to conduct transactions online or through a smart phone. It needs to be connected to their bank account.
3. **Electronic Payment :** sometimes known as a "e–payment system," is a type of electronic payment that eliminates the need for cash or cheques by allowing customers to pay for goods and services electronically.
4. **Cardholder :** The buyer, or the owner of the card used to make the purchase.

2.11 Assignment :

1. Define Plastic Money.
2. What is the merit of debit card to banks. ?
3. What are the advantage and disadvantage of Plastic Money.

2.12 Activity :

1. Describe process credit card transactions.

2.13 Case Study :

1. How has the introduction of plastic money enhanced the convenience of both the depositor and the bank. Explain.

2.14 Further Readings :

1. Anupama Sharma (2012), "Plastic card frauds and the countermeasures : Towards safer payment mechanism", International Journal of Research in Commerce, It &Management, Vol. 2, No. 4.
2. Bansi Patel and Urvi Amin (2012), "Plastic Money : Road may Towards Cash Less Society", Paripex Indian Journal of Research, Vol. 1, No. 11, ISSN–2250– 1991.
3. http://www.rbi.org.in/scripts/BS_SpeechesView.aspx?Id=1375.
4. KhandelwalAni K (2006), "Doing Business in India : The Big Picture Bankers respective", USIndia Business Summit, Retrieved March 20, 2008 from www.buyusa.gov/india/en/327.ppt6.

: UNIT STRUCTURE :

3.0 Learning Objective
3.1 Introduction
3.2 Concept of Securitization
3.3 Securitization as a Funding Mechanism
3.4 Utility of Securitization
3.5 Forms of Securitization
3.6 Advantages of Securitization
3.7 Disadvantages of Securitization
3.8 Concept of Mortgage
3.9 Traditional Morgtage
3.10 Non–Traditional Mortgage
3.11 Graduated Payment Mortages (GPMs)
3.12 Pledged Account Mortagages (PAMs)
3.13 Collateralized Mortgage Obligations (CMOs)
3.14 Securitization of Non–Mortgage Assets
3.15 Securitization in India
3.16 Latest Innovations and Technological Integration in Financial Services
3.17 Let Us Sum Up
3.18 Answers for Check Your Progress
3.19 Glossary
3.20 Assignments
3.21 Activity
3.22 Case Study
3.23 Further Readings

3.0 Learning Objective :

You should be able to :

- Define securitization and distinguish it from factoring after reading this lesson.
- Go over the securitization process in detail.
- Describe the advantages of securitization and state the reasons why it is controversial in India.

- Follow the securitization market's evolution both internationally and domestically.

3.1 Introduction :

With the ever–changing environment and needs of business and markets, there have been a change in the financial markets also. And to make a perfect match with the requirements of changing business needs and markets, there is a change noticed under various forms of finance also. Structured finance is one such form which is mostly used by various business entities in order to meet their funding requirements.

One of the modern forms of structured finance is *'Securitization'*. While we move towards the concept of Securitization in this chapter, it would become clear that the result of a transaction is that a business entity can obtain proceeds by selling assets and not borrowing funds.

Securitization differs from traditional forms of financing. For example, in the traditional lending process, a bank makes a loan, maintaining it as an asset on its balance sheet, collecting principal and interest, and monitoring whether there is any deterioration in borrower's creditworthiness.

This requires bank to hold assets till repayment of loan. The funds of the bank are blocked in these loans and to meet its growing fund requirement a bank has to raise additional funds from the market. Securitization is a way of unlocking these blocked funds.

3.2 Concept of Securitization :

- Securitization is primarily concerned with monetizing financial assets in such a way that risks of the collateral are tied primarily to their repayment rather than to the performance of a particular entity.
- The assets used in a securitization process can be either existing assets/existing receivables in which case the transaction is referred to as an existing asset securitization or assets/receivables to arise in the future in which case the transaction is referred to as a future flow transaction.
- The parties to a securitization process are :

Primary Parties :

1. The originator (Banks/FIs/Seller who has lent loan against properties)
2. Special Purpose Vehicles (SPVs) (Asset Reconstruction Company) who are assignee or issuers
3. Investors (To whom securities are issued, which is a participative interest against the pool of receivables which is bought by the SPVs from the originator)

Secondary Parties :

1. The obligator (i.e., original borrower of the loan)
2. Rating Agency
3. Administrator etc.

DEFINITIONS :

"Securitization is the process of pooling and repackaging of homogeneous liquid financial assets into marketable securities that can be sold to investors."

"Securitization is a method of raising funds by way of selling receivables for money."

"Securitization means acquisition of financial assets by any asset reconstruction company (ARC) from any originator whether by raising of funds by such (ARC) from qualified buyers by issue of security receipts representing undivided interest in such financial assets or otherwise."

3.3 Securitization as a Funding Mechanism :

Securitization is a carefully structured process by which a pool of loans and other receivables are packaged and sold in the form of asset–backed securities to the investors to raise the required funds from them. Through this process relatively illiquid assets are converted into securities. Securitization falls under the broad category termed as structured finance transactions.

Structured finance refers to securities where the promise to repay the investors is backed by the value of the underlying financial asset or the credit support of a third party to the transaction or some combination of the two. Thus, securitization is nothing but liquefying assets comprising loans and receivables of an institution through systematic issuance of financial instruments.

In a securitized transaction, the burden of repayment on the bond shifts away from the issuer to a pool of assets or to a third party. The cash flows from the pools of assets which have been securitized provide the funds for repayment to the bond.

Securitized transaction is termed as structured transaction because through specific choices relating to the type and amount of assets in the pool and particular features of the transaction, these securities may be structured to achieve a desired level of risk and a desired level of rating.

Securitization is said to have taken place when a company's assets are removed in one way or the other form from its balance sheet and are funded instead by investors. The investors receive tradable financial instruments evidencing the investment without recourse to lending institution. The entire transaction, from the accounting point of view, is carried out on the asset side of the balance sheet, that is, one asset gets converted into another.

Mechanism of Securitization :

Typically, the mechanism of securitization is outlined below :

1. The process of securitization starts with identification by the company (the originator) the loans or bills receivable in its portfolio, to prepare a basket or pool of assets to be securitized. The package usually forms an optimum mix so as to ensure fair marketability of the instrument to be issued.

   Further, the maturities are also so chosen that the package represents one homogeneous lot. The pool of receivables is backed by the underlying securities held by the originator (in the form of mortgage, pledge, charge, etc.).

2. The pool of assets so identified is then sold to a specific purpose vehicle (SPV) or trust. Usually, an investment banker performs the task of an SPV, which is also called an issuer, as it ultimately issues the securities to investors.

3. Once the assets are acquired by SPV, the same are split into individual shares/securities which are reimbursed by selling them to investors. These securities are called 'Pay or Pass Through Certificates' (PTC) which are so structured as to synchronize for redemption with the maturity of the securitized loans or bills.

   A PTC thus represents a sale of an undivided interest to the extent of the face value of the PTC in the aggregate pool of assets acquired by the SPV from the originator.

4. Repayments under the securitized loans or bills keep on being received by the originator and passed on to the SPV. To this end, the contractual relationship between the originator and the borrowers/obligates is allowed to subsist in terms of the pass through transaction; alternatively a separate agency arrangement is made between the SPV (Principal) and the originator (agent).

5. Although a PTC could be with recourse to its originator, the usual practice has been to make it without recourse. Accordingly, a PTC holder takes recourse to the SPV and not the originator for payment to the principal and interest on the PTCs held by him. However, a part of the credit risk, as perceived (and not interest risk), can be absorbed by the originator, by transferring the assets at a discount, enabling the SPV to issue the PTCs at a discount to face value.

6. The debt to be securitized and the PTC issues are got rated by rating agencies on the eve of the securitization. The issues by the SPV could also be guaranteed by external guarantor–institutions to enhance creditability of the issues. The PTCs, before maturity, are tradable in a secondary market to ensure liquidity for the investors.

From the above, it is evident that the primary participants involved in the issuance of securitization transaction are the originator, obligors,

the SPV, the servicer and the credit enhancer. The originator has the assets which are sold or used as collateral for the assets backed securities. Originators are generally manufacturing companies, financial institutions, banks and non–banking finance companies.

The term obligors' refers to borrowers who have taken loans from the originators resulting in the creation of the underlying asset. The SPV or trust raises funds to buy assets from the originator by selling securities to investors. It uses the cash flow generated by the financial assets in the pool to pay interest and principal to investors and covers its own costs. The servicer/receiving and paying agent is responsible for collecting principal and interest payments on assets when due and for pursuing the collection from delinquent accounts.

The service is usually the originator or an associate of the originator. The credit enhancer provides the required amount of credit support to reduce the overall credit risk of a security issue. Credit enhancement is provided by the originator in the form of senior– subordinate structure over collaterisation or through a cash collateral. Third party credit enhancement generally takes the form of a letter of credit or a surety bond.

3.4 Utility of Securitization :

Securitization as a financial instrument is becoming extremely popular the world over with more and more issuers resorting to raising funds through this route. This is for this fact that it confers lot of benefits on the parties to the process.

Securitization serves as handmade to organization in raising additional funds to finance their growth programme. Companies with poor credit standing and therefore finding it difficult to procure resources from the market can obtain funds by issuing asset back securities at lower interest cost due to higher credit rating on such securities. Even if the issuer is not an AAA rated company, it can issue an AAA rated securitized asset.

This can be done by carefully selecting the portfolio on the basis of criteria stipulated by the rating agency. What is more useful is that relatively illiquid assets are converted into marketable securities providing liquidity and alternate funding sources. Another advantage to the company is economy in the use of funds and greater recycling of resources leads to higher business turnover and profitability.

Further, cost of raising funds by way of securitization is cheaper than that involved in funding by way of conventional fund–raising instruments like shares, bonds, debentures, and commercial papers. Through its novel mechanism of diversifying the risk factors, enhancing the credit and removing uncertainties for investors, structured securitization facilitates the originator to access the securities market at debt ratings higher than its overall corporate rating. As a result, the company can secure funds at lower cost.

The cost of raising funds against securitized assets depends essentially on quality of assets to be securitized and image of the issuer in the minds of investors. Obviously, the price at which an asset based securities is sold or the discount which the buyer gets differs from deal to deal. Further, bargaining powers of the negotiations bear upon the cost of acquiring funds through securitization.

Securitization also facilitates strengthening of capital adequacy of the originating company by isolating the loan–assets from the originator's balance sheet and by removing or replacing them. Securitization is equally useful to investors. It offers multiple new investment instruments for mutual funds, insurance companies, pension funds and general investors to cater to their needs and preferences. Besides widening the choice and availability, it also provides for higher return and liquidity for the instrument.

The unique benefit which investors derive from securitization is that they can look past the issuing entity to the collateral pool that the issue represents. This transparency reduces uncertainly for the investor as to the risk element. Being a structured asset backed security, the instrument provides higher protection against rating down–grades of the originator, as compared to traditional debt securities.

It also provides opportunity for matching cash flows and managing ALM since securitized instrument carries regular monthly cash flows and has varying maturities. The prevalence of secondary markets would offer liquidity.

As a product of raising funds against receivables, securitization is far superior to bills discounting or factoring. Bill discounting has emerged as a working capital product employed to raise funds out of short–term trade receivables. In contrast, securitization is a medium to long–term source.

Even in a mature bill market, the sheer quantum of paper work in raising money against bills of long maturities would be a deterrent. Although factoring appears to be similar to securitization as the factor buys the receivables of a company at a discount, there has traditionally been no intention to rate the portfolio or create a secondary market for the receivables.

Further, factoring has emerged as a trade financing tool rather than for medium or long–term financing. However, the securitization process, if not carried out prudentially, can leave risks with the originating bank without allocating capital to back them. While all banking activity entails operational and legal risks, these may be greater under more complex activity.

It is felt that the main risk a bank may face in a securitization scheme arises if a true sale has not been achieved and the selling institution is forced to recognize some or all of the losses if the assets subsequently cease to perform. Also, funding risks and constraints on liquidity may arise if assets designed to be securitized have been originated, but because of disturbances in the market, the securities cannot be placed.

3.5 Forms of Securitization :

Securitization can be classified into two categories :

1. ASSET BACKED SECURITIZATION (ABS) :

Asset–backed securities (ABS) are bonds that are created from consumer debt. When consumers borrow money from the bank to fund a new car, student loan or credit cards, the loans become assets in the books of the entity (usually a bank) that is offering them this credit. The assets are then sold to a trust whose sole purpose is to issue bonds that are backed by such securities. The payments made on the loan flow through the trust to the investors who invest in these asset–backed securities.

An ABS is similar to a mortgage–backed security, except that the underlying securities are not mortgage–based. For investors, asset–backed securities can be an alternative to corporate debt.

Asset–backed securities allow issuers to generate cash, which can be used for more lending, while giving investors in the ABS the opportunity to participate in a wide variety of income–generating assets. The underlying assets of an ABS are often illiquid and can't be sold on their own. So, pooling assets together and creating an ABS financial security–a process called securitization–allows the owner of the assets to make illiquid assets marketable to investors.

The underlying assets of these pools may be home equity loans, automobile loans, credit card receivables, student loans, or other expected cash flows. Issuers of ABS can be as creative as they desire. For example, asset–backed securities have been created based on cash flows from movie revenues, royalty payments, aircraft leases, and solar photovoltaics. Just about any cash–producing situation can be securitized into an ABS.

2. MORTGAGED BACKED SECURTITIZATION (MBS) :

In Mortgage–backed securities (MBS), the lender requires that the borrowing firm commit specific assets of the firm as a security or collateral for a lending arrangement. The assets that are used as collateral may be short–term assets such as accounts receivables or long–term assets such as equipment. For example, In accounts receivable financing, the lender looks first to the accounts receivable of the borrower to fulfil the financial obligations of the lending arrangement. The amount advanced by the lender to the client firm depends on **:**

- What the lender deems acceptable based on the quality and nature of the receivables
- The type of customer the client firm sells to and the terms of the sale
- The historical performance of the client firm's accounts receivables.

3.6 Advantages of Securitization :

The major advantages of securitization are as follows :

1. There is typically **lower funding** cost when a securitization is used.
2. Securitization **turns illiquid assets into liquid ones**.
3. The **originator can free up its capital** through securitization.
4. Securitization converts non–performing assets (NPA) into Performing assets resulting into higher liquidity and ultimately improving the market position.
5. Securitization is the means through which it is possible to **transfer risks** from a business entity who does not want to bear it, to one that does.

3.7 Disadvantages of Securitization :

The major disadvantages of securitization are as follows :

1. Securitizations is **expensive** due to management and system costs, legal fees, underwriting fees, rating fees and ongoing administration.
2. Securitization is **not useful and cost–efficient** for micro/small and medium level transactions as it often requires large scale structuring.
3. There is a **risk of default** on underlying loans under Securitization.
4. As under securitization, receivables get matured early, it **damages investors returns**.

3.8 Concept of Mortgage :

"Mortgage" is the transfer of an interest in specific immoveable 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.

The transferor is called a mortgagor, the transferee a mortgagee. The principal money and interest the payment of which is secured for the time being are called the mortgage money.

3.9 Traditional Morgtage :

Traditional mortgages are simply structured, where a mortgagor borrows on a fixed or variable interest rate, making payments until the loan is completely paid off. They offer borrowers predictability, so there are no surprises in terms of the amount of the monthly payment or when the loan ends.

Traditional mortgages typically have a fixed rate of interest, which means that the interest rate does not change throughout the life of the loan.

3.10 Non–Traditional Mortgage :

A non–traditional mortgage broadly describes mortgages that do not have standard conventional characteristics. These can refer to any type

of mortgage that do not conform to a standard amortization schedule or have standard instalment payments.

Non–traditional mortgages often come with higher interest rates because of the higher payment risks associated with the loan.

These types of mortgages often come with a higher risk. That is because there is a higher risk for default. any of these mortgages require less asset and income requirements.

3.11 Graduated Payment Mortages (GPMs) :

GPM stands for a graduated mortgage loan. In this type of loan, the borrower has low initial monthly payments. The payments gradually increase over the mortgage's life.

A graduated payment mortgage (GPM) is a type of fixed–rate mortgage in which the payments increase gradually from an initial low base level to a higher final level. Typically, the payments will grow between 7–12 percent annually from their initial base payment amount until the full monthly payment amount is reached.

A graduated payment mortgage is designed to start with the homeowner owing minimum payments. Then, over time, the payment amount increases. A low initial interest rate is used to qualify the buyer. This lower rate allows many, who might not otherwise qualify for a home mortgage, to be eligible because they can afford the low initial payments.

3.12 Pledged Account Mortagages (PAMs) :

Pledged Account Mortgage is a mortgage loan program in which money is placed in a savings account and the interest earned on the account is used to subsidize interest payments in the early years. It allows a borrower to buy property with much less equity while still enjoying a relatively low interest rate.

A pledged account mortgage is a type of a mortgage loan. The mortgage loan is supplemented through funds drawn from savings account, the interest income, or pledged as an additional collateral.

Pledged account mortgages can reduce the down payment that is typically required for a loan as well as reduces the interest rate charged. In PAMs, pledged assets can include cash, stocks, bonds, and other equity or securities.

The downside of PAMs is for the person who put up the pledged account because the money is at risk in the event of default, and it is not earning any interest for the investor.

The borrower will transfer a pledged asset to the lender, but the borrower still maintains ownership of the valuable possession. Should the borrower default, the lender has legal recourse to take ownership of the asset pledged. The borrower retains all dividends or other earnings from the asset during the time it is pledged.

The asset is merely collateral for the lender in the event of borrower default. However, for the borrower, the pledged asset could help considerably with gaining approval for the loan. Using the asset to secure the note may let the borrower demand a lower interest rate on the note then they would have had with an unsecured loan. Typically, pledged–asset loans provide borrowers with better interest rates than unsecured loans.

Once the loan is paid off and the debt is fully satisfied, the lender transfers the pledged asset back to the borrower. The type and value of pledged assets for a loan are usually negotiated between the lender and borrower.

Advantages of Pams :

1. A pledged–asset loan allows the borrower to **retain ownership** of the valuable possession.
2. Borrower **avoids tax penalties or capital gains taxes** from selling the assets
3. Pledging assets **avoids heavy down payments** and PMI, if applicable.
4. The **borrower may receive a lower interest rate** on the loan or mortgage.
5. The borrower continues to earn income and must report the gains from their investments.

Disadvantages of Pams :

1. The ability to trade the pledged securities might be limited if the investments are stocks or mutual funds.
2. The borrower could **lose** both the home and the securities **in the event of default**.
3. By not making a down payment, loan interest is paid on the full price of the property.
4. If the pledged securities **decline in value**, the lender **may demand additional funds**.
5. Pledging assets for the loans of a relative carries **default risk** since there is no control over the borrower's repayment.

3.13 Collateralized Mortgage Obligations (CMOs) :

A collateralized mortgage obligation (CMO) refers to a type of mortgage–backed security that contains a pool of mortgages bundled together and sold as an investment.

Organized by maturity and level of risk, CMOs receive cash flows as borrowers repay the mortgages that act as collateral on these securities. In turn, CMOs distribute principal and interest payments to their investors based on predetermined rules and agreements.

For example, Mr. A, an investor has a CMO made up of thousands of mortgages. His potential for profit is based on whether the mortgage

holders repay their mortgages. If only a few homeowners default on their mortgages and the rest make payments as expected, the investor recoups his principal as well as interest. In contrast, if thousands of people cannot make their mortgage payments and go into foreclosure, the CMO loses money and cannot pay the investor.

3.14 Securitization of Non–Mortgage Assets :

Securitization of Non–Mortgaged Assets is exactly opposite of Mortgage–Backed Securities. It means under non–mortgaged securitization; non–mortgaged assets are collateralized. Various examples of non–mortgaged securitization are credit card debt or auto loans, personal loans, commercial loans, etc. However, such kind of securitization are less popular as there is higher rate of credit risk. This kind of securitization is not guaranteed by a government or quasi–government entity.

3.15 Securitization in India :

Securitisation in India began in the early nineties. It has been of a recent origin. Initially it started as a device for bilateral acquisitions of portfolios of finance companies. These were forms of quasi–securitizations, with portfolios moving from the balance sheet of one originator to that of another. Originally these transactions included provisions that provided recourse to the originator as well as new loan sales through the direct assignment route, which was structured using the true sale concept. Through most of the 90s, securitisation of auto loans was the mainstay of the Indian markets.

It has been observed that Financial Institutions and Banks have made considerable progress in financing of projects in the housing and infrastructure sector. It is therefore necessary that securitisation and other allied systems get developed so that Financial Institutions and Banks can offload their initial exposure and make room for financing new projects. With the introduction of financial sector reforms in the early nineties, Financial Institutions and Banks, particularly the Non–Banking Financial Companies (NBFCs), have entered into the retail business in a big way, generating large volumes of homogeneous classes of assets such as auto loans, credit cards receivables, home loans. This has led to attempts being made by a few players to get into the Asset Backed Securities market as well. However, still a number of legal, regulatory, psychological and other issues need to be sorted out to facilitate the growth of securitisation. People of India have not yet welcomed this concept.

Securitization as a financial instrument has been in practice in India since the early1990's in the later part of 1990s, creation of transferable securities in the form of passthrough certificates (PTCs) became common. The word PTC has almost become synonymous with securitization in India and most market practitioners do not envisage issuance of notes or bonds as a securitized product. A typical Indian PTC does not abide by any specific structural features – there are PTCs which have a specific

coupon rate, there are structured PTCs and PTCs have different payback periods. Over time, the market has spread into several asset classes – while auto loans and residential housing loans are still the mainstay, there are corporate loans, commercial mortgage receivables, future flow, project receivables, toll revenues, etc that have been securitized. While it has been fully accepted that India has a huge potential for securitization, actual result was not encouraging. A few originators like ICICI, TELCO and Citibank have been actively pursuing securitization, almost all the transactions in the market so far have been privately placed with a majority of them being bilateral fully bought out deals.

The reasons for the slow pace of securitization growth in India include absence of appropriate legislation and legal ambiguity, lack of guidelines on accounting treatment, high rate of stamp duties making transactions costly, lack of knowledge and understanding of the product amongst investors, originators and, till recently, even rating agencies.

Considering the above scenario, the evolution of securitization in India can be classified into following three stages :

1. The Infancy Stage :

The period between 1992 and 2001 is considered as the infancy/ initial stage during which first securitization of auto loan securitization including property receivables was introduced. First MBS was transacted in the year 2000. In 2001 first offshore transaction backed by aircraft purchase receivables. Securitization began with the sale of consumer loans and originators directly sold loans to buyers and mostly the deals were on one to one basis. Originators acted as servicers and collected instalments due on the loans. Creation of transferable securities backed by pool receivables became common in late 1990s.

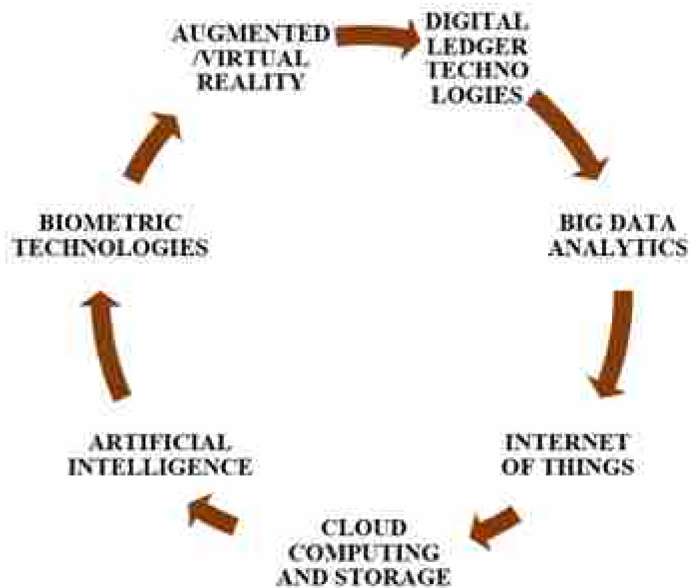
2. The Primary Stage :

During primary/pre take–off stage, there were approximately 75 issuances per year on an average and the average size of issue grew to Rs. 190 crore. The volume of issuances grew exponentially beginning in 2000. There was pressure on the resources of large originators due to continued growth in consumer credit. The period between 2002 and 2005 is considered as the growth phase during which first multi–asset CDO and Citibank completed the first revolving securitization involving working capital facilities for its small and medium enterprises. During this stage, the growth of debt funds and the largest investors in securitized papers supported the expansion of the market. Strong performance and higher yields also attracted investors.

3. The Growth Stage :

The period from 2006 is considered as the growth/take–off stage during which RBI issued guidelines on securitization.

3.16 Latest Innovations and Technological Integration in Financial Services :



The ongoing advances in telecommunications and computing technology have been an important force in the transformation of finance. Technological advances have greatly improved quality and processing speed and helped to lower information costs and other costs of transacting. These developments have had implications for both providers and users of financial products and services. The discussion that follows provides a brief overview of new and emerging technologies that are being applied to financial services. These include distributed ledger technology, Big Data, the Internet of Things (IoT), cloud computing, artificial intelligence, biometric technologies and augmented/virtual reality. While these technologies are discussed separately it should be noted that there are interdependencies among many of them. For example, AI is enabled by Big Data, cloud computing and increasingly the IoT.

DIGITAL LEDGER TECHNOLOGIES (DLT) :

Distributed ledger technology (DLT), also commonly referred to as blockchain technology, which is its most commonly used form, is a database technology that allows the creation, secure transfer (with finality) and storage of information. DLT is a protocol used to build a ledger system to store records, such as those relating to ownership, transactions or contract agreements. DLT is not centrally controlled by a single party, or intermediary, however, and instead shares the responsibility of adding to and maintaining the ledger with all participants.

DLT could also be used for a variety of recordkeeping tasks. Some applications have been to make compliance with Know Your Customer (KYC) requirements more efficient, or to streamline a mortgage application process where documents from numerous parties are required. The transparency of these records may also facilitate the supervision of financial institutions by authorities.

BIG DATA ANALYTICS :

The digitalisation of day–to–day activities has dramatically increased the amount of data available, creating extremely large and complex data sets commonly referred to as "Big Data". Such data are not only drawn from text or numeric forms, but also from images, video and audio clips as well as from data generated by communication and other devices (e.g. smartphones, Internet–connected PCs). The rapid advances in information technology are now allowing for the processing and analysis of such large data sets. Big Data can potentially be used at every point along the value chain of financial products, from conception to sale. Analysis of Big Data could be used to improve market research and inform product design. It could also be used for more granular price discrimination by allowing a more accurate assessment of a given individual's risk profile or willingness to pay. Profiling can also lead to targeted advertising, which in one application could tailor online promotions to an individual's characteristics inferred from their Internet use. Big Data could also potentially be used for internal risk management and outside monitoring of financial services and institutions and thus make supervision more efficient. For example, analysis of large data sets could improve fraud detection.

Three concepts closely connected to Big Data are the "Internet of Things", cloud computing and artificial intelligence. The Internet of Things is a source of Big Data, cloud computing facilitates the processing and storage of large datasets, and finally artificial intelligence is an advanced way of analysing and using Big Data. These concepts are discussed in turn.

INTERNET OF THINGS (IoT) :

The Internet of Things (IoT) refers to the numerous connected devices that capture information regarding movement and other sensing data of objects in the physical world, and is expected to represent an increasing source of Big Data. The IoT can provide rich information regarding individuals' behaviours; thereby, the resulting data can be used for increased tailoring of products, risk profiling and pricing.

CLOUD COMPUTING AND STORAGE :

Cloud–based services provide cost–efficient and relatively easily scalable on–demand processing and storage capacity for data. Cloud technology has greatly increased the capacity of financial institutions to collect and analyse data, thereby facilitating the growth in data analytics and their various applications.

ARTIFICIAL INTELLIGENCE (AI) :

The sub–fields of this science can focus on a range of different aspects of human intelligence, including recognition, understanding, learning, problem solving, reasoning and decision making.

Artificial Intelligence (AI) is often used in reference to machine learning, whereby machines are trained with historical data to recognise patterns and classify new data. Through advanced algorithms a machine can learn patterns with new experiences to improve its performance. However, the machine is not learning entirely on its own; rather, the learning process requires a significant level of human input to make sure the data is interpreted correctly.

Deep learning is a subset of machine learning. It takes a layered approach to calculations, starting from high–level abstractions and gradually moving to more specific features. As deep learning is able to tackle unstructured data such as text and images, it has many potential applications for the analysis of Big Data.

BIOMETRIC TECHNOLOGIES :

Biometric technologies rely on the recognition of physiological or behavioural characteristics, and can be used for identity authentication by detecting characteristics unique to individuals. Techniques that are now being used for verification include fingerprint scanning, voice authentication, face recognition, iris scanning, and gait recognition.

Biometric technologies represent a great improvement in security over verification by passwords, and could be used to increase the security of financial transactions, thereby reducing the risk of fraud or data theft. Nevertheless, these technologies are still in development and security is being improved to reduce the risk that biometric information is compromised.

AUGMENTED/VIRTUAL REALITY :

Augmented and virtual realities provide new ways for consumers to perceive or interact with their environment. The difference between the two is that augmented reality provides an enhanced view of the actual physical world in which individuals find themselves, whereas virtual reality creates a simulated world.

Check Your Progress :

1. Which of the following is one of the modern forms of structured finance ?

   a. IPO b. Equity

   c. Gilt Edged Securities d. Securitization

2. The process of securitization commences with identification of the loans or receivables in portfolio of ———— ?

   a. The originator b. The obligator

   c. SPVs d. Investors

3. Automobile Loan can be securitized under which of the following category of securitization ?

   a. Asset backed securitization b. Mortgage backed securitization

   c. Leverage backed securitization d. None of these

4. Under which of the category, it is mandatory to commit a specific set of assets a security or collateralized ?

   a. Asset backed securitization

   b. Mortgage backed securitization

   c. Leverage backed securitization

   d. None of these

5. Which of the following is not an advantage of Securitization ?

   a. damages investor returns

   b. originator frees up its capital

   c. turning of illiquid assets into liquid

   d. risk transfer

6. _______ refers to transfer of an interest in specific immovable property for the purpose of securing the payment of money advanced or to be advanced by way of loan or debt.

   a. Pledge b. Mortgage

   c. Actionable Claims d. Will

7. In which of the following mortgages, the borrower initially pays lower monthly instalments, and it increases over the period of time during the tenure of mortgage ?

   a. Graduated Payment Mortgages (GPMs)

   b. Pledged Account Mortgages (PAMs)

   c. Collateralized Mortgage Obligations (CMOs)

   d. None of these

8. In which year the concept of Securitization entered into the growth/ take off stage ?

   a. 2001 b. 2002 c. 2005 d. 2006

9. Which of the following technique includes fingerprint scanning, voice authentication, face recognition, etc. ?

   a. Artificial Intelligence b. Big Data Analytics

   c. Biometric Technologies d. Digital Ledger Technologies

10. ________ facilitates processing and storage of large datasets.

    a. Cloud Computing b. Augmented Reality

    c. Biometric Technologies d. Digital Leger Technologies

3.17 Let Us Sum Up :

Asset securitization is a method whereby assets are transformed into securities, which are then continuously transformed into cash, in order to enable an increase in business turnover and profit. To the benefit of both borrowers and lenders, the approach offers flexibility in yield,

pricing pattern, issue risk, and marketability of instruments. Securitization has a variety of characteristics, including marketability of financial claims, broad distribution, uniformity, etc. Financial instruments that have been securitized are beneficial because they provide liquidity for small investors. In order to facilitate communication between the originator of the receivables and the end–investors, a company known as "Special Purpose Vehicle" is involved. Additionally, it actively participates in reinvesting or restructuring the cash flows generated by the transferred assets.

Since it typically requires less capital to finance than conventional on–balance–sheet funding, it aids in increasing return on capital. In a similar way, it assists in raising capital when alternative sources of funding are not available, in addition to lowering credit exposure, etc. Securitization has various advantages. For example, it makes off–balance sheet funding easier. Additionally, it aids businesses in gaining access to the low–cost lending market. Nonetheless, the process can result in banks' role in financial intermediation becoming less significant. Similarly, by enabling the conversion of non–liquid loans into liquid securities, it may also lead to increased volatility in asset values. A strong capital market enables the securitization industry to expand smoothly.

3.18 Answers for Check Your Progress :

1. d	**2.** a	**3.** a	**4.** b	**5.** a
6. b	**7.** a	**8.** d	**9.** c	**10.** a

3.19 Glossary :

1. **Securitization :** Securitization is a strategy whereby assets are transformed into securities, which are then continuously converted into cash, in order to allow for rising business turnover and profit.
2. **Asset Backed Security :** Securitization is the process of turning risky, illiquid individual loans into safer, more liquid securities known as asset–backed securities.
3. **Special Purpose Vehicle :** A trust or a corporation could be the financial intermediary re–engineering the cash flow.

3.20 Assignments :

1. Process of Securitization as a funding mechanism.
2. Development of Securitization in India
3. Pros. And Cons. Of Securitization
4. Graduated Payment Mortgages (GPMs) and Pledged Account Mortgages (PAMs)
5. Asset Backed and Mortgage Backed Securities (ABS & MBS)

3.21 Activity :

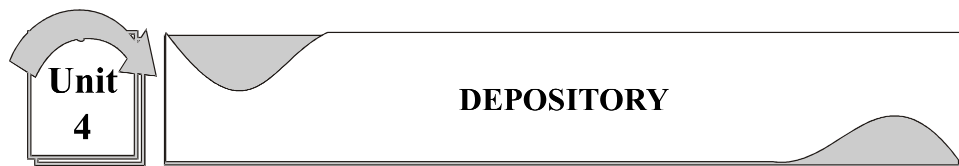
1. Define Mortgage. Explain various kind of mortgagees in brief. Explain in details concept of PAM's and CMO's.

3.22 Case Study :

1. Enlist the latest innovative technologies used in financial services. Explain any five in detail.

3.23 Further Readings :

1. Bansal, L.K., Merchant Banking and Financial Services, Unistar Books Pvt. Ltd., Chandigarh.
2. Bhole, L.M., Financial Institutions and Markets, Tata McGraw Hill, New Delhi.
3. Chandra, P., Financial Management, Tata McGraw Hill, New Delhi.
4. Khan, M.Y., Financial Services, Tata McGraw Hill, New Delhi.
5. Kothari, C.R., Investment Banking and Customer Service, Arihand Publishers, Jaipur.



: UNIT STRUCTURE :

4.0 Learning Objective
4.1 Introduction
4.2 Definition
4.3 Depository System
4.4 Advantages/Benefits of Depository System
4.5 Features of Depository System
4.6 SEBI (Depositories and Participants) Regulations, 1996
4.7 Dematerialization of Shares
4.8 Re–Materialization of Shares
4.9 Difference Between Dematerialization and Re–Materialization of Shares
4.10 Market Settlement of Trade
4.11 Process/Procedure of Market Settlement
4.12 Participants Involved in The Process
4.13 Clearing and Stock Trade Settlement Process (Diagrammatic Presentation)
4.14 Commonly Asked Questions
4.15 Let Us Sum Up
4.16 Answers for Check Your Progress
4.17 Glossary
4.18 Assignments
4.19 Activity
4.20 Case Study
4.21 Further Readings

4.0 Learning Objective :

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

- Explain the concept of depositories
- Discuss the relevance of depositories
- Clarify how depositories work
- Describe the method of dematerialization
- Comprehend the role that technology plays in depositories after completing this course.

4.1 Introduction :

The inception of depository system in the Indian Capital market has been during the 90's. The depositories are some important intermediaries in the securities market that is scrip–less or moving towards such a state. The erstwhile settlement system on Indian stock exchanges involved movement of paper securities to the issuer for registration, with the change of ownership being evidenced by an endorsement on the security certificate. Theft, forgery, mutilation of certificates and other irregularities provided the issuer right to refuse the transfer of a security. Added costs and delays in settlement, restricted liquidity and made investor grievance redressal time consuming.

This chapter is designed to enable the student to understand the basic concept of depository, depository participants, functions, rights and obligations of depositories, benefits of depositories, dematerialisation process, and the regulatory framework for depository in India.

A Depository is an organization like a Central Bank where the securities of a shareholder are held in the electronic form at the request of the shareholder through the medium of a Depository Participant. To utilize the services offered by a Depository, the investor has to open an account with the Depository through a Depository Participant.

A depository cannot act as a depository unless it obtains a certificate of commencement of business from SEBI. There are two Depositories functioning in India, namely the National Securities Depository Limited (NSDL) and the Central Depository Services (India) Limited (CDSL). Under the provisions of the Depositories Act, these Depositories provide various services to investors and other Participants in the capital market, such as, clearing members, stock exchanges, investment institutions, banks and issuing corporates. These include basic facilities like account opening, dematerialization, settlement of trades and advanced facilities like pledging, distribution of non–cash corporate actions, distribution of securities to allottees in case of public issues, etc. All the securities held by a depository shall be dematerialized and shall be in a fungible form. To utilize the services offered by a depository, the investor has to open an account with the depository through a participant, similar to the opening of an account with any of the bank branches to utilize services of that bank. Registration of the depository is required under SEBI (Depositories and Participants) Regulations, 1996 and is a precondition to the functioning of the depository. Depository and depository participant both are regulated by SEBI.

4.2 Definition :

"Depository is a place where financial securities are held in dematerialised form. It is responsible for maintenance of ownership records and facilitation of trading in dematerialised securities."

According to Section 2(e) of the Depositories Act, 1996. "Depository means a company formed and registered under the Companies Act, 2013 and which has been granted a certificate of registration under Section 12(1A) of the SEBI Act, 1992".

4.3 Depository System :

The Depository System functions very much like the banking system. A bank holds funds in accounts whereas a Depository holds securities in accounts for its clients. A Bank transfers funds between accounts whereas a Depository transfers securities between accounts. In both systems, the transfer of funds or securities happens without the actual handling of funds or securities. Both the Banks and the Depository are accountable for the safe keeping of funds and securities respectively.

In the depository system, share certificates belonging to the investors are to be dematerialized and their names are required to be entered in the records of depository as beneficial owners. Consequent to these changes, the investors' names in the companies' register are replaced by the name of depository as the registered owner of the securities. The depository, however, does not have any voting rights or other economic rights in respect of the shares as a registered owner. The beneficial owner continues to enjoy all the rights and benefits and is subject to all the liabilities in respect of the securities held by a depository. Shares in the depository mode are fungible and cease to have distinctive numbers. The transfer of ownership changes in the depository is done automatically on the basis of delivery vs. payment.

In the Depository mode, corporate actions such as IPOs, rights, conversions, bonus, mergers/amalgamations, subdivisions & consolidations are carried out without the movement of papers, saving both cost & time. Information of beneficiary owners is readily available. The issuer gets information on changes in shareholding pattern on a regular basis, which enables the issuer to efficiently monitor the changes in shareholdings.

The Depository system links the issuing corporates, Depository Participants (DPs), the Depositories and clearing corporation/ clearing house of stock exchanges. This network facilitates holding of securities in the soft form and effects transfers by means of account transfers.

KEY FEATURES OF THE DEPOSITORY SYSTEM IN INDIA :

1. Multi-Depository System
2. Depository services through depository participants
3. Dematerialisation
4. Fungibility
5. Registered Owner/ Beneficial Owner
6. Free Transferability of shares

1. **Multi–Depository System :** The depository model adopted in India provides for a competitive multi–depository system. There can be various entities providing depository services. A depository should be a company formed under the Companies Act, 2013 (erstwhile Companies Act, 1956) and should have been granted a certificate of registration under the Securities and Exchange Board of India Act, 1992. Presently, there are two depositories registered with SEBI, namely : – National Securities Depository Limited (NSDL), and – Central Depository Service Limited (CDSL)
2. **Depository services through depository participants :** The depositories can provide their services to investors through their agents called depository participants. These agents are appointed subject to the conditions prescribed under Securities and Exchange Board of India (Depositories and Participants) Regulations, 1996 and other applicable conditions.
3. **Dematerialisation :** The model adopted in India provides for dematerialisation of securities. This is a significant step in the direction of achieving a completely paper–free securities market. Dematerialization is a process by which physical certificates of an investor are converted into electronic form and credited to the account of the depository participant.
4. **Fungibility :** The securities held in dematerialized form do not bear any notable feature like distinctive number, folio number or certificate number. Once shares get dematerialized, they lose their identity in terms of share certificate, distinctive numbers and folio numbers. Thus all securities in the same class are identical and interchangeable. For example, all equity shares in the class of fully paid up shares are interchangeable.
5. **Registered Owner/ Beneficial Owner :** In the depository system, the ownership of securities dematerialized is bifurcated between Registered Owner and Beneficial Owner. According to the Depositories Act, 1996 'Registered Owner' means a depository whose name is entered as such in the register of the issuer. A 'Beneficial Owner' means a person whose name is recorded as such with the depository. Though the securities are registered in the name of the depository actually holding them, the rights, benefits and liabilities in respect of the securities held by the depository remain with the beneficial owner. For the securities dematerialized, NSDL/ CDSL is the Registered Owner in the books of the issuer; but ownership rights and liabilities rest with Beneficial Owner. All the rights, duties and liabilities underlying the security are on the beneficial owner of the security.
6. **Free Transferability of shares :** Transfer of shares held in dematerialized form takes place freely through electronic book–entry system.

4.4 Advantages/Benefits of Depository System :

In the depository system, the ownership and transfer of securities takes place by means of electronic book entries. At the outset, this system rids the capital market of the dangers related to handling of paper. The system provides numerous direct and indirect benefits, like :

Elimination of bad deliveries – In the depository environment, once holdings of an investor are dematerialised, the question of bad delivery does not arise i.e. they cannot be held "under objection". In the physical environment, buyer of shares was required to take the risk of transfer and face uncertainty of the quality of assets purchased. In a depository environment good money certainly begets good quality of assets.

Elimination of all risks associated with physical certificates – Dealing in physical securities have associated security risks of theft of stocks, mutilation of certificates, loss of certificates during movements through and from the registrars, thus exposing the investor to the cost of obtaining duplicate certificates and advertisements, etc. This problem does not arise in the depository environment.

Immediate transfer and registration of securities – In the depository environment, once the securities are credited to the investors account on pay out, he becomes the legal owner of the securities. There is no further need to send it to the company's registrar for registration. Having purchased securities in the physical environment, the investor has to send it to the company's registrar so that the change of ownership can be registered. This process usually takes around three to four months and is rarely completed within the statutory framework of two months thus exposing the investor to opportunity cost of delay in transfer and to risk of loss in transit. To overcome this, the normally accepted practice is to hold the securities in street names i.e. not to register the change of ownership. However, if the investors miss a book closure the securities are not good for delivery and the investor would also stand to lose his corporate entitlements.

Faster disbursement of non–cash corporate benefits like rights, bonus, etc. – Depository system provides for direct credit of non–cash corporate entitlements to an investors account, thereby ensuring faster disbursement and avoiding risk of loss of certificates in transit.

Reduction in brokerage by many brokers for trading in dematerialized securities – Brokers provide this benefit to investors as dealing in dematerialized securities reduces their back office cost of handling paper and also eliminates the risk of being the introducing broker. Reduction in handling of huge volumes of paper and periodic status reports to investors on their holdings and transactions, leading to better controls.

Elimination of problems related to change of address of investor, transmission, etc. – In case of change of address or transmission of demat

shares, investors are saved from undergoing the entire change procedure with each company or registrar. Investors have to only inform their DP with all relevant documents and the required changes are effected in the database of all the companies, where the investor is a registered holder of securities.

Elimination of problems related to selling securities on behalf of a minor – A natural guardian is not required to take court approval for selling demat securities on behalf of a minor.

Models Of Depository :

Immobilisation – Where physical share certificates are kept in vaults with the depository for safe custody. All subsequent transactions in these securities take place in book entry form. The actual owner has the right to withdraw his physical securities as and when desired. The immobilization of fresh issue may be achieved by issuing a jumbo certificate representing the entire issue in the name of depository, as nominee of the beneficial owners.

Dematerialisation – No Physical scrip in existence, only electronic records maintained by depository. This type of system is cost effective and simple and has been adopted in India.

4.5 Features of Depository System :

Dematerialization :

Dematerialization is a process by which the physical share certificates of an investor are taken back by the Company and an equivalent number of securities are credited his account in electronic form at the request of the investor. An investor will have to first open an account with a Depository Participant and then request for the dematerialization of his share certificates through the Depository Participant so that the dematerialized holdings can be credited into that account. This is very similar to opening a Bank Account.

Dematerialization of shares is optional and an investor can still hold shares in physical form. However, he/she has to demat the shares if he/she wishes to sell the same through the Stock Exchanges. Similarly, if an investor purchases shares from the Stock Exchange, he/she will get delivery of the shares in demat form. Odd lot share certificates can also be dematerialized.

Depository Functions :

- Account opening
- De–materialisation
- Re–materialisation
- Settlement
- Initial Public Offers (IPO's), corporate benefits
- Pledging

Depository Participant :

Just as a brokers act an agent of the investor at the Stock Exchange; a Depository Participant (DP) is the representative (agent) of the investor in the depository system providing the link between the Company and investor through the Depository. The Depository Participant maintains securities account balances and intimate the status of holding to the account holder from time to time. According to SEBI guidelines, Financial Institutions like banks, custodians, stockbrokers etc. can become participants in the depository. A DP is one with whom an investor needs to open an account to deal in shares in electronic form. While the Depository can be compared to a Bank, DP is like a branch of that bank with which an account can be opened. The main characteristics of a depository participant are as under :

- Acts as an Agent of Depository
- Customer interface of Depository
- Functions like Securities Bank
- Account opening
- Facilitates de–materialization
- Instant transfer on pay–out
- Credits to investor in IPO, rights, bonus
- Settles trades in electronic segment

Registrar/Issuer :

- De–materialization
- Confirmation of Beneficiary Holdings
- Corporate Actions
- Rights, Bonus, etc.
- Reconciliation of Depository Holdings
- Re–materialization

Dematerialisation :

- Investor opens account with DP
- Fills Dematerialization Request Form (DRF) for registered shares
- Investor lodges DRF and certificates with DP
- DP intimates the Depository
- Depository intimates Registrar/Issuer
- DP sends certificates and DRF to Registrar/Issuer
- Registrar/Issuer confirms demat to Depository
- Depository credits investor a/c

Re–materialisation :

- Client submits Re–materialization Request Form (RRF) to DP

- DP intimates Depository
- Depository intimates the Registrar/Issuer
- DP sends RRF to the Registrar/Issuer
- Registrar/Issuer prints certificates and sends to Investor
- Registrar/Issuer confirms demat to Depository
- Investor's account with DP debited

Electronic Credit in New Issues :

- Investor opens account with DP
- Submits application with option to hold securities in depository giving DP–Id and Client–Id
- Registrar uploads list of allottees to Depository
- Depository credits allottee's account with DP
- Refunds sent by Registrar as usual

Trading System :

- Separate quotes in Book Entry
- Trading Member to have Clearing Account with DP
- Settlement as per Settlement Calendar of Stock Exchange
- Trading can be introduced in any Stock exchange if settlement is guaranteed

Corporate Actions :

- Dividends/cash benefits – these benefits are directly forwarded to the investors by the company or its registrar and transfer agent.
- Non–cash benefits, viz. Bonus, Rights Issue, etc. – these benefits are electronically credited to the beneficial owner's account through Depository.

SEBI Guidelines :

The legal framework for depository system in the Depositories Act, 1996 provides for the establishment of single or multiple depositories. Anybody to be eligible for providing depository services must be formed and registered as a company under the Companies Act, 2013 and seek registration with SEBI and obtain a Certificate of Commencement of Business from SEBI on fulfilment of the prescribed conditions. The investors opting to join depository mode are required to enter into an agreement with depository through a participant who acts as an agent of depository. The agencies such as custodians, banks, financial institutions, large corporate brokerage firms, non–banking financial companies etc. act as participants of depositories. The companies issuing securities are also required to enter into an agreement with the Depository.

4.6 SEBI (Depositories and Participants) Regulations, 1996 :

SEBI had issued SEBI (Depositories and Participants) Regulations, 1996 on 16th May, 1996 which apply to depositories and its participants. These regulations also contain provisions for operations and functioning of depositories, form for application and certificates used and schedule of fees for participants, etc. It also contains provisions for registration of depository and depository participants, rights and obligations of various users and constituents, inspection and procedure for action in case of default.

Entities desiring to become depository participants must apply to the depository and are required to be recommended to SEBI by the depository. If approved and registered by SEBI, the depository participant can be admitted on the depository. The depository has to formulate its own set of criteria for selection of participants. Every participant holding a certificate is required at all times to abide by the specified Code of Conduct.

The regulations require the depository to list out, through its bye–laws, the securities which are eligible to be admitted to the depository for dematerialization. Equity shares, debentures, warrants, bonds, units of mutual funds, etc. are part of the list of eligible securities. The depository is empowered to set its own criteria for selection of securities and make securities eligible to be maintained in the form of electronic holdings on the depository.

Further, the regulations stipulate that agreements should be entered into by the following entities :

– Depository and every participant;

– Participant and every client; and

– Depository, issuer company and the Registrar.

The draft of these agreements are to be included in the bye–laws and to be approved by SEBI. The depository is required to ensure that sufficient safeguards are in place to protect the data available with it and with the participants. To reduce risk in operations, the regulations stipulate that adequate insurance cover be provided by the depository and by the depository participants as well. The regulations also require for reconciliation to be carried out on a daily basis. Further, the depository and the registrar will also reconcile balances on a daily and a periodic basis.

RIGHTS AND OBLIGATIONS OF DEPOSITORIES :

Every depository is required to maintain the following records and documents namely :

– Records of securities dematerialized and re–materialised;

– The names of the transferor, transferee, and the dates of transfer of securities;

– A register and an index of beneficial owners;

- Details of holding of the securities of the beneficial owners as at the end of each day;
- Records of instruction(s) received from and sent to participants, issuers, issuers' agents and beneficial owners;
- Records of approval, notice, entry and cancellation of pledge or hypothecation, as the case may be;
- Details of participants;
- Details of securities declared to be eligible for dematerialisation in the depository; and
- Such other records as may be specified by SEBI for carrying on the activities as a depository.

The participants are obliged to reconcile the records with every depository on a daily basis. Participants are required to maintain the following records for a period of five years–

- Records of all the transactions entered into with a depository and with a beneficial owner;
- Details of security dematerialised, rematerialized on behalf of beneficial owners with whom it has entered into an agreement;
- Records of instructions received from beneficial owners;
- Statements of account provided to beneficial owners; and
- Records of approval, notice, entry and cancellation of pledge or hypothecation as the case may be.

Governance of Depository :

Governing Board, Disclosures and Corporate Governance :

These regulations deal with the composition of Governing board of a Depository.

- The governing board of every depository is required to include :
  - a. shareholder directors;
  - b. public interest directors; and
  - c. managing director.
- Any employee of a depository may be appointed on the governing board in addition to the managing director, and such director shall be deemed to be a shareholder director.
- The chairperson shall be elected by the governing board from amongst the public interest directors Subject to prior approval of SEBI.
- The number of public interest directors shall not be less than the number of shareholder directors in a depository.
- The managing director shall be an ex–officio director on the governing board and shall not be included in either the category of public interest directors or shareholder directors.

The disclosure requirements and corporate governance norms as specified for listed companies shall mutatis mutandis apply to a depository.

Investor Protection Fund of Depositories :

Regulation 53C provides that every depository shall establish and maintain an Investor Protection Fund (IPF) for the protection of interest of beneficial owners. However, this fund shall not be used by the depository for the purpose of indemnifying the beneficial owner under section 16 of the Depositories Act, 1996. Every depository shall credit five per cent or such percentage as may be specified by SEBI, of its profits from depository operations every year to the Investor Protection Fund.

Utilization of the IPF :

The IPF may be utilized for the following purposes with a focus on depository related services :

– Promotion of investor education and investor awareness programmes through seminars, lectures, workshops, publications (print and electronic media), training programmes etc. aimed at enhancing securities market literacy and promoting retail participation in securities market. – To aid, assist, subsidise, support, promote and foster research activities for promotion/ development of the securities market.

– To utilize the fund for supporting initiatives of Depository Participants for promotion of investor education and investor awareness programmes.

– To utilize the fund in any other manner as may be prescribed/ permitted by SEBI in the interest of investors.

Depositories shall frame their internal guidelines on utilisation of the funds in accordance with the aforementioned objectives and post approval of their board of directors, submit the same within 30 days to SEBI. Depositories shall also keep SEBI informed of any subsequent changes in internal guidelines with regard to utilization of IPF.

Constitution and Management of the IPF :

The IPF shall be administered by way of a Trust created for the purpose :

– The IPF Trust shall consist of at least :

  a. one Public Interest Director (PID) of the depository,

  b. one person of eminence from an academic institution from the field of finance / an expert in the field of investor education / a representative from the registered investor associations, recognized by SEBI and managing director of the depository.

– The depository shall provide the secretariat for the IPF Trust.

- The depository shall ensure that the funds in the IPF are kept in a separate account designated for this purpose and that the IPF is immune from any liabilities of the depository.

Contribution to the IPF :

The following contributions shall be made by the depository to the IPF :

- 5% of their profits from depository operations every year.
- Interest or Income received out of any investments made from the IPF.
- Funds lying to the credit of IPR (Investor Protection Reserve) / BOPF (Beneficial Owners Protection Fund) of the depository or any other such fund / reserve of the depository shall be transferred to IPF.
- Any other sums as may be prescribed by SEBI from time to time.

Investments of Fund :

- Funds of the trust shall be invested in instruments such as Central Government securities, fixed deposits of scheduled banks and any such instruments which are allowed as per the investment policy approved by the board of the depository.
- The investment policy shall be devised with an objective of capital protection along with highest degree of safety and least market risk.
- The balance available in the IPF as at the end of the month and the amount utilised during the month including the manner of utilization, shall be reported in the monthly development report of the depository.

Audit Under SEBI (Depositories and Participants) Regulations, 1996 :

Regulation 55A of SEBI (Depositories and Participants) Regulations, 1996 provides that every issuer shall submit audit report on a quarterly basis to the concerned stock exchanges audited by a practicing Company Secretary or a qualified Chartered Accountant, for the purposes of reconciliation of the total issued capital, listed capital and capital held by depositories in dematerialized form, the details of changes in share capital during the quarter and the in–principle approval obtained by the issuer from all the stock exchanges where it is listed in respect of such further issued capital.

The audit report is required to give the updated status of the register of members of the issuer and confirm that securities have been dematerialized as per requests within 21 days from the date of receipt of requests by the issuer and where the dematerialization has not been effected within the said stipulated period, the report would disclose the reasons for such delay.

The issuer is under an obligation to immediately bring to the notice of the depositories and the stock exchanges, any difference observed in its issued, listed, and the capital held by depositories in dematerialized form.

4.7 Dematerialization of Shares :

It is the conversion of the physical share and debenture certificates to an electronic form. Managing investment in shares and securities becomes much easier when all physical certificates are present in the dematerialised form.

It reduces the chances of forgery and fraud that had become rampant when electronic entries were unavailable. In the case of dematerialisation, the electronic records are stored at a depository. In India, the National Securities Depository Limited (NSDL) and Central Depository Services (India) Ltd (CDSL) are the authorized depositories.

Steps for Dematerialization of Shares :

To convert any physical share or debenture certificate into an electronic form, investor need to fill Dematerialisation Request Form (DRF).

1. It is an easy and comprehensive process that begins with the Demat account. Investor need a Depository Participant (DP) that offers Demat services.
2. Fill in the DRF and submit it with the share certificates. Mention "Surrendered for Dematerialisation" on each certificate.
3. The DP should pass the request to the depository, registrars and transfer agents, along with the share certificates.
4. The registrar informs the DP of the process status.
5. Upon confirmation, the investor's account reflects the credit of shares.
6. Electronic share transfer can take between 15 to 30 days.

4.8 Re–Materialization of Shares :

Any investor who has already converted the securities and debenture certificates to electronic formats has the option of changing them to physical form once again. People opt for re–materialisation to avoid paying for the maintenance charge of a Demat account that has only 1 or 2 shares. It is the process of converting all securities in the electronic form to physical certificates. Investor need to fill out a Remat Request Form (RRF) and approach the Depository Participant (DP) with it.

Steps for Re–materialization of Shares :

To get the dematerialised securities in the traditional form once again, investor need to fill the Remat Request Form (RRF). Here is a brief account of the re–materialisation process –

1. The client needs to submit the RRF to the DP.
2. The DP approaches the depository with the form. The depository forwards the request to the registrar.
3. The DP sends the forms to the registrar.
4. The registrar prints new physical certificates and sends them over to the investor.
5. Once the registrar confirms the Remat request to the depository, the investor receives the new certificates in the account with the DP.
6. Re–materialisation can take up to 30 days.

4.9 Difference Between Dematerialization and Re–Materialization of Shares :

Sr. No.	Comparison Parameters	Dematerialisation	Re-materialisation
1.	**Meaning**	The transformation of physical certificates of shares and debentures to electronic form.	Conversion of the electronic records of the share to paper (physical) form.
2.	**Identification of Shares**	Dematerialised shares do not have a distinct number.	They possess distinct numbers issued by the RTA.
3.	**Transaction Mode**	All transactions take place in electronic formats only.	All transactions post-re-materialisation take place physically.
4.	**Account Maintenance Authority**	The Depository participant (NSDL or CDSL) is in charge of the account maintenance.	The company is in charge of account maintenance.
5.	**Maintenance Costs**	The annual charges for maintenance vary between Rs. 500 and Rs. 1000.	No maintenance charges are necessary for physical certificates.
6.	**Security**	Threats to the digital form are low.	Threat of forgery and fraud to physical paperwork is higher.
7.	**Difficulty**	Dematerialisation is an easy process. It is a ubiquitous part of share trading; almost every investor has experienced once.	Re-materialisation is a complex process that takes a long time. It is difficult and may require expert assistance.

4.10 Market Settlement of Trade :

Settlement is the process of netting of transactions and actual delivery/receipt of securities and transfer deeds against receipts/payment of agreed amount. It is necessary to make a settlement to know the net effect of a series of transactions during a given period.

Settlement date is the date specified for delivery of securities between securities firms. For administrative convenience, a stock exchange divides the year into a number of settlement periods so as to enable members to settle their trades. All transactions executed during the settlement period are settled at the end of the settlement period.

Settlement risk or principal risk is the risk that the seller of a security or funds delivers its obligation but does not receive payment or that the buyer of a security or funds makes payment but does not receive delivery. In this event, the full principal value of the securities or funds transferred is at risk.

4.11 Process/Procedure of Market Settlement :

1. Execution :

Execution is when the order to buy/sell is completed by the buyer and the seller. An execution is said to be completed only when it is filled. This is after the trader places an order and based on the instructions of the order the broker fulfils the requirements of the order in the stock market. Only then the order is said to be filled.

2. Clearance :

After the trade is executed the clearing process begins. In clearing process, it is identified how much money is owed to the seller and how many shares are owed to the buyer. Apart from identification trade recording, confirmation, determination of the obligation of different parties and risk assessment also take place. This process is managed by a third party known as a Clearing House. Clearing Activities take place on T+1 day.

3. **Settlement :**

The stage involves the actual exchange of shares and money. Here the shares are moved to the buyer's DEMAT Account and the money is transferred to the sellers trading account. These activities take place on T+2 days.

4.12 Participants Involved in The Process :

In the trading, clearing, and settlement stages

"the Stock exchanges ensure a platform for trading while Clearing Corporation ensures the funds and security–related issues of the trading members and make sure that the trade is settled through the exchange of obligations. The depositories and clearing banks provide the necessary interface between the custodians or clearing members for settlement of securities and funds obligations".

From the above short explanation of activities that take place, we will first look at what are the roles of different parties involved and link them to understand the procedure that takes place to ensure a clearer understanding.

1. **Clearing Corporation :**

The National Securities Clearing Corporation Limited (NSCCL) is responsible for clearing and settlement of trades executed and risk management at the stock exchange. It ensures short and consistent containment cycles. The NSCCL is also obligated to meet all the settlements regardless of member defaults.

2. **Clearing Members / Custodians :**

The trading members of the stock exchange place deals in the Stock Exchange which is moved to the NSCCL. The NSCCL transfers these deals to the clearing members. A clearing member is responsible for determining the position of shares and funds to suit the trade. And once it is confirmed the actual settlement process takes place.

3. **Clearing Banks :**

The settlement of funds takes place through Clearing Banks. Every clearing member is required to open a clearing account with one of the following 13 clearing banks

- HDFC Bank
- ICICI Bank Ltd
- Axis Bank Ltd
- Kotak Mahindra Bank
- JP Morgan Chase Bank
- State Bank of India
- HSBC Bank
- Stock Holding Corporation of India Ltd

- Infrastructure Leasing and Financial Services Ltd,
- Deutsche Bank, Standard Chartered Bank
- Orbis Financial Corporation Ltd
- DBS Bank
- Citibank.

The Clearing members receive funds in case of a pay–out in the clearing account or are to make funds available in the clearing account in case of a pay–in.

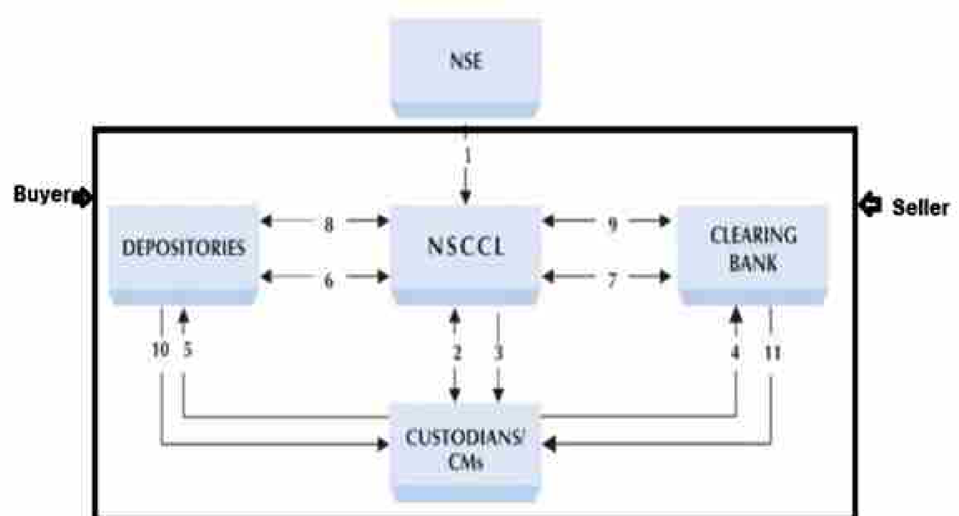
4. Depositories :

We may not be thoroughly familiar with the term depository but are familiar with a related term called DEMAT Account. There are 2 depositories in India NSDL and CDSL. These depositories hold the investor DEMAT (Dematerialised) Accounts. Clearing members are also required to maintain a clearing pool Account with the depositories. The required securities must be transferred to the clearing pool account by the clearing members on the settlement day.

5. Professional Clearing Members :

NSCCL admits a special category of members namely professional clearing members. PCM are not allowed to trade. They can only clear and settle trades similarly like the custodians for their clients.

4.13 Clearing and Stock Trade Settlement Process (Diagrammatic Presentation) :



1. Trade Details are transferred from Stock Exchange to National Securities Clearing Corporation Limited (NSCCL).
2. NSCCL notifies the details of trade to clearing members or custodians who affirm back. Based on the affirmation, it determines obligations.
3. Download of obligation and pay–in advice of funds or securities are sent by NSCCL to clearing members or custodians.

4. Instructions sent to clearing banks to make funds available by pay–in time.
5. Instructions to depositories to make securities available by pay–in–time.
6. Pay–in of securities (NSCCL directs to debit pool account of custodians or Clearing members and credit its account to depository and depository do it)
7. Pay–in of funds (NSCCL directs to the debit account of custodians or Clearing members and credit its account to Clearing Banks and clearing bank do it)
8. Pay–out of securities (NSCCL directs to credit pool account of custodians or Clearing members and debit its account to depository and depository do it)
9. Pay–out of funds (NSCCL directs to credit account of custodians or Clearing members and debit its account to Clearing Banks and clearing bank do it)
10. Depository informs custodians
11. Clearing Banks inform custodians or Clearing members.

4.14 Commonly Asked Questions :

India is one of the most advanced markets when it comes to settlement of trade. The domestic market follows a T+2 settlement cycle. India is one of the most advanced markets when it comes to settlement of trade.

What is rolling settlement ?

In a rolling settlement, each trading day is considered as a trading period and trades executed during the day are settled based on net obligations for the day. In India, trades in rolling settlement are settled on a T+2 basis i.e. on the 2nd working day after a trade.

Which days are calculated for the purpose of rolling settlement ?

For arriving at the settlement day, all intervening holidays, which include bank holidays, exchange holidays, Saturdays and Sundays, are excluded. Typically, trades taking place on Monday are settled on Wednesday, Tuesday's trades are settled on Thursday and so on.

When does the open positions result in payment/ delivery under rolling settlement ?

Under rolling settlement, all open positions at the end of the day mandatorily result in payment/ delivery 'n' days later. Currently, trades in rolling settlement are settled on T+2 basis where T is the trade day. For example, a trade executed on Monday is mandatorily settled by Wednesday (considering two working days from the trade day).

Settlement cycle for rolling settlement

	Activity	Day
Trading	Rolling Settlement	T
Clearing	Custodial confirmation and delivery generation	T+1 working days
Settlement	Securities and funds pay–in and pay–out	T+2 working days
Post settlement	Auction	T+3 working days
	Bad delivery reporting	T+4 working days
	Auction settlement	T+5 working days
	Rectified bad delivery pay–in and pay–out	T+6 working days
	Re–bad delivery reporting and pick up	T+8 working days
	Close out of re–bad delivery and funds pay–in and pay–out	T+9 working days

For intraday traders, rolling settlement changes nothing. For institutional investors, who are forbidden to square off anyway, there would be no change. It is for retail investors who take leveraged positions across one night or more that rolling settlement has an impact. The funds and securities pay–in and pay–out are carried out on T+2 days.

What is pay–in and pay–out ?

Pay–in day is the day when the securities sold are delivered to the exchange by the sellers and funds for the securities purchased are made available to the exchange by the buyers. Pay–out day is the day the securities purchased are delivered to the buyers and the funds for the securities sold are given to the sellers by the exchange. At present, the pay–in and pay–out happens on the 2nd working day after the trade is executed on the exchange, that is settlement cycle is on T+2 rolling settlement.

What is no–delivery period ?

Whenever a company announces a book closure or record date, the exchange set up a no–delivery period for that security. During this period only trading is permitted in the security. However, these trades are settled only after the no–delivery period is over. This is done to ensure that investor's entitlement for the corporate benefit is clearly determined.

What is an auction ?

On account of non–delivery of securities by the trading member on the pay–in day, securities are put up for auction by the exchange. This ensures that buying trading member receives the securities. The Exchange purchases the requisite quantity in auction market and gives them to the buying trading member

Check Your Progress :

1. A depository is place where financial securities are held in __________ form.

   a. dematerialized   b. Rematerialized

   c. Contemplated   d. None of these

2. The depository system functions similar to a ________ system.

   a. corporate   b. government   c. banking   d. market

3. Who acts as a link between the company and investor through the depository ?

   a. broker   b. depository participant

   c. Nominee   d. bank

4. The legal framework for depository system is provided under :

   a. The Depositories Act, 1992   b. The Depositories Act, 1995

   c. The Depositories Act, 1996   c. The Depositories Act, 1994

5. Which of the following are the two major depositories functioning under the depository system ?

   a. NSDL and CDSL   b. NDSL and CSDL

   c. NLDS and CLSD   d. NDLS and CSLD

6. Which of the following is not the function of depository ?

   a. FPO   b. IPO

   c. Dematerialization   d. Rematerialization

7. The conversion of physical share into an electronic form is known as _______.

   a. Dematerialization   b. Rematerialization

   c. Immaterialization   d. None of these

8. Which of the following is the correct sequence for steps involved in process of market settlement ?

   a. Clearance, Settlement, Execution

   b. Execution, Clearance, Settlement

   c. Settlement, Execution, Clearance

   d. Execution, Settlement, Clearance

9. In terms of settlement of trade, Indian domestic markets follow which trading cycle ?

   a. T + 2 b. T + 1 c. T + 3 d. T + 4

10. ___________ is a day when securities purchased are delivered to the buyers and the funds for the securities are given to the sellers by the exchange.

    a. Pay–in b. Pay–out c. Pay–it d. Pay–up

4.15 Let Us Sum Up :

The primary goal of the depository system is to eliminate the extensive and laborious paper work associated in the scrip–based system and to provide opportunities for "paperless" trading using cutting–edge technology. It is a type of institution that keeps an electronic record of stock ownership.

The depository operates like a securities bank, trading and holding custody of the physical securities that have been dematerialized. This enables a quicker, risk–free, and inexpensive settlement. Depository, Depository Participants (DPs), Companies/Registrars, and Investors are the system's constituents.

Investors' share certificates are dematerialized in the depository system (demats). Dematerialization, sometimes known as "Demat," is the process by which a Depository transforms investor securities like shares, debentures, etc. into electronic data and stores it in computers.

The process of converting securities back into physical form is known as rematerialization. Since the physical form of the security becomes irrelevant in the depository system, the securities must be "fungible." Every security held in dematerialized form is assigned a unique ISIN as a means of identification (International Securities Identification Number). In India, there are two depositories with roughly 436 DPs each. The fees they charge investors vary and are expensive for novice investors.

Both depositories have been effective in utilizing technology to the fullest extent possible for the benefit of investors and the Indian investing culture. The Depository Act of 1996 governs depositories in India, and SEBI (Depositaries & Participants) Rules of 1996 were published to make the aforementioned Act's functioning easier. Depository service, in the opinion of most, has improved India's capital market's efficiency.

4.16 Answers for Check Your Progress :

1. a	**2.** c	**3.** b	**4.** c	**5.** a
6. a	**7.** a	**8.** b	**9.** a	**10.** b

4.17 Glossary :

1. **Demat :** A depository converts investor securities like shares and debentures into electronic data and stores it in computers.

2. **Depository :** Serves as a securities bank where physical securities that have been dematerialized are exchanged and kept in custody.
3. **Depository Account :** A bank account that an investor registers with a DP and records all of their transactions in demat form.
4. **Dematerialization (Demat) :** Security certificates' physical existence is eliminated through the process and replaced with electronic holdings.
5. **Rematerialization :** The process of converting electronic shares to physical or paper shares

4.18 Assignments :

1. Depository Participant and its characteristics.
2. Dematerialization and its steps.
3. Rights and Obligations of depositories.
4. Utility of Investor Protection Fund (IPF)
5. Explain difference between Dematerialization and Rematerialization of shares.
6. What is Depository ? Explain the features and advantages of depository in India.

4.19 Activity :

1. Go through with the various guidelines under SEBI Regulations relating to depository in detail.

4.20 Case Study :

1. Explain the steps and participants involved in the market settlement of trade

4.21 Further Readings :

1. Gupta, L.C., Naveen Jain : Indian Securities Depository System, What has Gone Wrong ? Economic and Political Weekly, May 17, 2003
2. Kullu Rao, P. : Custodial services need for change, Chartered Secretary, October, 1996.
3. NSDL : A handout, National Securities Depositories Ltd., Bombay, 1997.
4. SEBI : SEBI (Custodian of Securities) Regulations, 1996.
5. SEBI (Depositories and Participants) Regulations, 1996.
6. Shah, Ravi : Emergence of Securities Depositories in India, The City, Aug–Sep 2002 Stock Lending scheme, 1997.

BLOCK SUMMARY

In this block we have learn about financial services and its different instruments as well as their parts and components. With the help of traits and characteristics, the idea and operation of various firms and related firms are explained in detailed manner. The section will go into detail regarding how financial services are marketed as well as how exchange relationships are approached. Rating and securitization plays an important role in financial services. In this block we have learnt the detail concept of credit rating, plastic money, securitization and depository services.

In first unit we learnt about credit rating. Credit rating determines how creditworthy a person, business, or even a nation is. It is a review of a borrower's overall credit history conducted by credit bureaus. Credit scores are computed using current assets and liabilities as well as financial history. In second unit, it explores the concept of plastic money. Plastic money is a term that is mostly used in reference to the hard plastic cards we use every day in place of hard cash. They can come in many different forms such as cash cards, credit cards, debit cards, pre-paid cash cards etc.

In third unit, it explains the whole concept of securitization. A strong capital market enables the securitization industry to expand smoothly. In last unit the study of depository system it explains the depository operates like a securities bank, trading and holding custody of the physical securities that have been dematerialized. This enables a quicker, risk-free, and inexpensive settlement. Depository, Depository Participants (DPs), Companies/Registrars, and Investors are the system's constituents.

BLOCK ASSIGNMENT

Short Questions :

1. What are the suggestions that you would give to various credit rating agencies operating in India for further improvement and why ?
2. Do you think that SEBI itself is unable to handle the rating issue of the credit companies and that is why it registers credit rating agencies under it ?
3. Explain the advantages and limitations of Securitization.
4. How is E–payment system better than traditional payment system ?
5. Discuss the process of dematerialization.

Long Questions :

1. Critically evaluate the contribution of credit rating system in Indian economy.
2. Explain how digital payment system has developed over years.
3. Define Securitization. Explain the process of Securitization in detail and various forms of Securitization.
4. Explain the concept and various forms of securitization.
5. Discuss the need of Depository System in a financial system

❖ **Enrolment No. :** ____________

1. How many hours did you need for studying the units ?

Unit No.	1	2	3	4
No. of Hrs.				

2. Please give your reactions to the following items based on your reading of the block :

Items	Excellent	Very Good	Good	Poor	Give specific example if any
Presentation Quality	☐	☐	☐	☐	____
Language and Style	☐	☐	☐	☐	____
Illustration used (Diagram, tables etc)	☐	☐	☐	☐	____
Conceptual Clarity	☐	☐	☐	☐	____
Check your progress Quest	☐	☐	☐	☐	____
Feed back to CYP Question	☐	☐	☐	☐	____

3. Any other Comments

....

....

....

....

....

....

....

....

DR.BABASAHEB AMBEDKAR
OPEN UNIVERSITY

'Jyotirmay' Parisar,
Sarkhej-Gandhinagar Highway, Chharodi, Ahmedabad-382 481.
Website : www.baou.edu.in