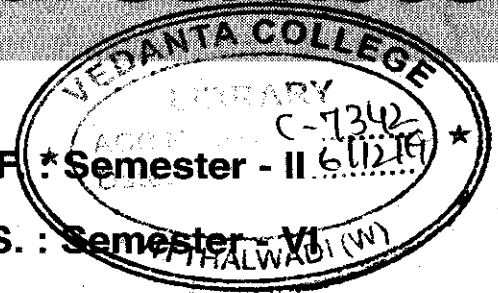


C-734

Elective Courses (EC)

Innovative Financial Services



F.Y.B.A.F * Semester - II

T.Y.B.M.S. : Semester - VI

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We express our sincere thanks to all our readers, authors and business associates for helping us in our mission of producing quality books for quality education. We wish all our young readers a brilliant success in various examinations and a bright future.

- Publisher

Preface

I am pleased to present the Revised Edition of "Innovative Financial Services" at the F.Y.B.A.F., Semester - II and T.Y.B.M.S., Semester-VI, University of Mumbai as per the Revised Syllabus w.e.f. June 2018.

The book is written as per the Choice Based Credit, Grading and Semester system.

I, the author of this book, have tried my best to capture the spirit of the 'Statement of Purpose' by working against time to lend meaning and substance to the syllabus. The theory part is replete with numerous examples to illustrate various thoughts and ideas. These examples, when expanded, should provide ideal material for case studies to be taken up during tutorials.

I express my deep gratitude to Mr. Nitin Shah for his untiring efforts to bring out this new edition of our book.

November 15, 2019

- Author

Syllabus

1. **Introduction to Traditional Financial Services (15 Lec.)**
 - (a) **Financial Services** : Concept, Objectives / Functions, Characteristics, Financial Service Market, Financial Service Market Constituents, Growth of Financial Services in India, Problems in Financial Services Sector, Banking and Non-Banking Companies, Regulatory Framework
 - (b) **Factoring and Forfaiting** : Introduction, Types of Factoring, Theoretical Framework, Factoring Cost, Advantages and Disadvantages of Factoring, Factoring in India, Factoring v/s Forfaiting, Working of Forfaiting, Benefits and Drawbacks of Forfaiting, Practical Problems
 - (c) **Bill Discounting** : Introduction, Framework, Bill Market Schemes, Factoring v/s Bill Discounting in Receivable Management
2. **Issue Management and Securitization (15 Lec.)**
 - (a) **Issue Management and Intermediaries** : Introduction, Merchant Bankers / Lead Managers, Underwriters, Bankers to an Issue, Brokers to an Issue
 - (b) **Stock Broking** : Introduction, Stock Brokers, Sub-Brokers, Foreign Brokers, Trading and Clearing / Self Clearing Members, Stock Trading (Cash and Normal) Derivative Trading
 - (c) **Securitization** : Definition, Securitization v/s Factoring, Features of Securitization, Pass through Certificates, Securitization Mechanism, Special Purpose Vehicle, Securitisable Assets, Benefits of Securitization, New Guidelines on Securitization
3. **Financial Services and Its Mechanism (15 Lec.)**
 - (a) **Lease and Hire-Purchase** : Meaning, Types of Lease - Finance Lease, Operating Lease, Advantages and Disadvantages of Leasing, Leasing in India, Legal Aspects of Leasing

Definition of Hire Purchase, Hire Purchase and Installment Sale Characteristics, Hire Purchase and Leasing, Advantages of Hire Purchase, Problems of Hire Purchase
 - (b) **Housing Finance** : Introduction, Housing Finance Industry, Housing Finance Policy Aspect, Sources of Funds, Market of Housing Finance, Housing Finance in India - Major Issues, Housing Finance in India - Growth Factors, Housing Finance Institutions in India, National Housing Bank (NHB), Guidelines for Asset Liability Management System in HFC, Fair Trade Practice Code for HFC's, Housing Finance Agencies

- (c) **Venture Capital** : Introduction, Features of Venture Capital, Types of Venture Capital Financing Stages, Disinvestment Mechanisms, Venture Capital Investment Process, Indian Scenario

4. **Consumer Finance and Credit Rating (15 Lec.)**

- (a) **Consumer Finance** : Introduction, Sources, Types of Products, Consumer Finance Practice in India, Mechanics of Consumer Finance, Terms, Pricing, Marketing and Insurance of Consumer Finance, Consumer Credit Scoring, Case For and Against Consumer Finance
- (b) **Plastic Money** : Growth of Plastic Money Services in India, Types of Plastic Cards - Credit Card - Debit Card - Smart Card - Add-on Cards, Performance of Credit Cards and Debit Cards, Benefits of Credit Cards, Dangers of Debit Cards, Prevention of Frauds and Misuse, Consumer Protection, Indian Scenario

Smart Cards - Features, Types, Security Features and Financial Applications
- (c) **Credit Rating** : Meaning, Origin, Features, Advantages of Rating, Regulatory Framework, Credit Rating Agencies, Credit Rating Process, Credit Rating Symbols, Credit Rating Agencies in India, Limitations of Rating

Question Paper Pattern

Internal Assessment :

1. **One Class Test (20 Marks)**
Match the Column/ Fill in the Blanks/
Multiple Choice Questions ($\frac{1}{2}$ Mark each) **05 Marks**
Answer in One or Two Lines
(Concept based Questions) (**01 Mark each**) **05 Marks**
Answer in Brief (Attempt Any Two of the Three)
(**05 Marks each**) **10 Marks**
2. Active participation in routine class instructional deliveries and overall conduct as a responsible learner, mannerism and articulation and exhibit of leadership qualities in organizing related academic activities **05 Marks**

Semester End Examination :

Maximum Marks : 75

Duration: 2½ Hrs.

Questions to be Set : 05

All Questions are Compulsory Carrying 15 Marks each.

Q.No.	Particulars	Marks
Q.1	Objective Questions* (A) Sub questions to be asked 10 and to be answered any 8 (B) Sub questions to be asked 10 and to be answered any 7 (* Multiple Choice / True or False / Match the Columns / Fill in the Blanks)	15
Q.2	Full Length Question OR	15
Q.2	Full Length Question	15
Q.3	Full Length Question OR	15
Q.3	Full Length Question	15
Q.4	Full Length Question OR	15
Q.4	Full Length Question	15
Q.5	(A) Theory Questions (B) Theory Questions OR	8 7
Q.5	Short Notes - To be asked 05, to be answered 03	15

Note : Full length question of 15 marks may be divided into two sub questions of 7/8 and 10/5 marks.

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1

INTRODUCTION TO TRADITIONAL FINANCIAL SERVICES

Financial Services

- *Concept*
- *Objectives/Functions*
- *Characteristics*
- *Financial Service Market*
- *Financial Service Market Constituents*
- *Growth of Financial Services in India*
- *Problems in Financial Services Sector*
- *Banking and Non-Banking Companies*
- *Regulatory Framework*

Factoring and Forfaiting

- *Introduction*
- *Meaning*
- *Types of Factoring*
- *Theoretical Framework*
- *Factoring Cost*
- *Advantages and Disadvantages of Factoring*
- *Factoring in India*

- *Factoring v/s Forfaiting*
- *Working of Forfaiting*
- *Benefits and Drawbacks of Forfaiting*
- *Practical Problems (For T.Y.B.M.S.)*

Bill Discounting

- *Introduction*
- *Framework*
- *Bill Market Schemes*
- *Factoring v/s Bill Discounting in Receivable Management*

FINANCIAL SERVICES

CONCEPT

Financial services refer to services provided by the finance industry. The financial services industry covers a broad range of organizations that deal with the management of money. Banks, insurance companies, credit card companies, consumer finance companies, financial planners and advisers, stock brokerages, merchant bankers, investment funds, venture capital, hedge funds, mutual funds are some of the organizations within the financial services industry.

Financial services are concerned with the design and delivery of advice and financial products to individuals and businesses within the above referred areas.

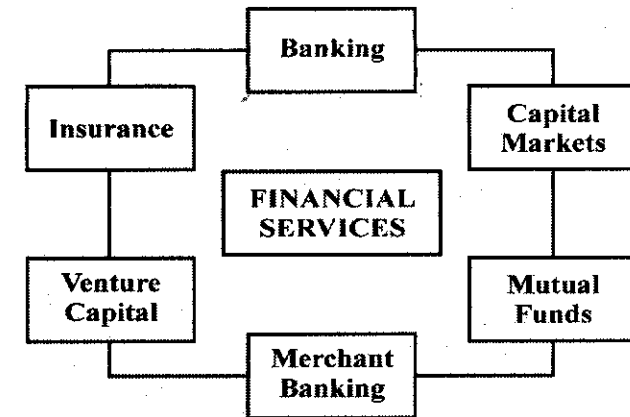


Fig. 1 : Financial Services

Definition

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, viz,

- financial leasing services including equipment leasing and hire purchase by a body corporate
- credit card services
- merchant banking services
- securities & foreign exchange broking
- asset management including portfolio management, all forms of fund management, pension fund management, custodial depository and trust services, but does not include cash management,
- advisory and other auxiliary financial services including investment and portfolio research and advice.

Types of Financial Services/Scope of Financial Services

The scope of financial services is very wide. This is because it covers a wide range of services.

The functions of financial services can be broadly classified into two:

- (a) Fund based services (or asset based services) and
- (b) Non-fund based services (or fee-based services)

(a) Fund Based Services

The fund based or asset based services include the following:

1. Underwriting
2. Dealing in secondary market activities
3. Participating in money market instruments like CPs (Commercial Papers), CDs (Certificate of Deposits) etc.
4. Equipment leasing or lease financing
5. Hire purchase
6. Venture capital
7. Bill discounting
8. Insurance services
9. Factoring
10. Forfaiting
11. Housing finance
12. Mutual fund

(b) Non-fund Based Services

The financial service companies or financial intermediaries provide services on the basis of non-fund activities also. Such services are also known as fee based services.

The non-fund based services include the following:

1. Securitisation
2. Merchant banking
3. Credit rating
4. Loan syndication
5. Project advisory services
7. Services to foreign companies and NRIs
8. Portfolio management
9. Merger and acquisition
10. Capital restructuring
11. Debenture trusteeship
12. Custodian services
13. Stock broking

The most important fund based and non-fund based services may be briefly discussed as below:

(a) Asset/Fund Based Services

1. **Equipment leasing/Lease financing:** A lease is an agreement under which a firm acquires a right to make use of a capital asset such as machinery on payment of an agreed fee called lease rentals. The person or the company which acquires the right is known as lessee. He does not get the ownership of the asset. He acquires only the right to use the asset. The person or the company who gives the right is known as lessor.
2. **Hire purchase and consumer credit:** Hire purchase is an alternative to leasing. Hire purchase is a transaction where goods are purchased and sold on the condition that payment is made in instalments which includes cash price and interest. The buyer gets only possession of goods. He does not get ownership. He gets ownership only after the payment of the

last instalment. If the buyer fails to pay any instalment, the seller can repossess the goods.

3. **Bill discounting:** Discounting of bill is fund based financial service provided by the finance companies. In the case of time bill which is payable after a specified period, the holder need not wait till maturity or due date, if he is in need of money. He can discount the bill with his banker. After deducting a certain amount as a discount, the banker credits the net amount in the customer's account. Thus, the bank purchases the bill and credits the customer's account with the amount of the bill less discount. On the due date, the drawee makes payment to the banker. If he fails to make payment, the banker will recover the amount from the customer who has discounted the bill. Thus discounting of bill means giving loan on the basis of the security of a bill of exchange.
4. **Venture capital:** Venture capital refers to capital which is available for financing the new business ventures. It involves lending finance to the growing companies as well. It is the investment in a highly risky project with the objective of earning a high rate of return. In short, venture capital means long term risk capital in the form of equity finance.
5. **Housing finance:** Housing finance simply refers to providing finance for house building. It emerged as a fund based financial service in India with the establishment of National Housing Bank (NHB) by the RBI in 1988. It is an apex housing finance institution in the country. Till now, a number of specialised financial institutions/companies have entered in the field of housing finance. Some of the institutions are HDFC, LIC Housing Finance, Citi Home etc.
6. **Insurance services:** Insurance is a contract between two parties. One party is the insured and the other party is the insurer. Insured is the person whose life or property is insured with the insurer. That is, the person whose risk is insured is called insured. Insurer is the insurance company to whom risk is transferred by the insured. Thus the person who insures the risk of insured is called insurer. It is a contract in which the insurance company undertakes to indemnify the insured on

the happening of certain event for a payment of consideration. It is a contract between the insurer and insured under which the insurer undertakes to compensate the insured for the loss arising from the risk insured. In fact insurance is a device by which a loss likely to be caused by uncertain event is spread over a large number of persons who are exposed to it and who voluntarily join together against such an event. The document which contains all the terms and conditions of insurance (i.e. the written contract) is called the 'insurance policy'. The amount for which the insurance policy is taken is called 'sum assured'. The consideration in return for which the insurer agrees to make good the loss is known as 'insurance premium'. This premium is to be paid regularly by the insured. It may be paid monthly, quarterly, half yearly or yearly.

7. **Factoring:** Factoring is an arrangement under which the factor purchases the account receivables arising out of credit sale of goods/services and makes immediate cash payment to the supplier or creditor. Thus, it is an arrangement in which the account receivables of a firm / client are purchased by a financial institution or banker. Thus, the factor provides finance to the client /supplier in respect of account receivables. The factor undertakes the responsibility of collecting the account receivables. The financial institution / factor undertakes the risk. The factor charges a fee for these services.
8. **Forfaiting:** Forfaiting is a form of financing of receivables relating to international trade. It is a non-recourse purchase by a banker or any other financial institution of receivables arising from export of goods and services. The exporter surrenders his right to the forfaiter to receive future payment from the buyer to whom goods have been supplied. Forfaiting is a funding method that helps the exporter sell his goods on credit and yet receives the cash well before the due date. In short, in forfaiting arrangement, a forfaiter discounts an export bill and pays ready cash to the exporter.
9. **Mutual fund:** Mutual funds are financial institutions which mobilise savings from the people and invest them in a mix of corporate and government securities in debt and equity market. The mutual fund managers manage this portfolio of securities

and earn income through dividend, interest and capital gains. The income is eventually passed on to the mutual fund unit holders.

(b) Non-Fund Based/Fee Based Financial Services

1. **Merchant banking:** The merchant banker acts as an intermediary. Its main job is to transfer capital from those who own it to those who need it. Today, merchant banker acts as an intermediary which understands the requirements of the promoters on the one hand and financial institutions, banks, stock exchange and money markets on the other. A merchant banker is 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".
2. **Credit rating:** Credit rating means giving an expert opinion by a rating agency on the relative willingness and ability of the issuer of a debt instrument to meet the financial obligations in time and in full. It measures the relative risk of an issuer's ability and willingness to repay both interest and principal over the period of the rated instrument. It is a judgement about a firm's financial and business prospects. In short, credit rating means assessing the creditworthiness of a company by an independent organisation.
3. **Stock broking:** Now stock broking has emerged as a professional advisory service. Stock broker is a member of a recognized stock exchange. He buys, sells, or deals in shares/securities. It is compulsory for each stock broker to get himself registered with SEBI in order to act as a broker.
4. **Custodial services:** In simple words, the services provided by a custodian are known as custodial services or custodian services. Custodian is handed over securities by the security owners for safe custody. Custodian is a caretaker of a public property or securities. Custodians are intermediaries between companies and clients. For rendering these services, he gets a remuneration called custodial charges.

5. **Loan syndication:** Loan syndication is an arrangement where a group of banks participate to provide funds for a single loan. One of the banks acts as a lead manager. This lead bank is usually decided by the corporate enterprises. Thus, loan syndication is very similar to consortium financing.
6. **Securitisation of debt:** Loans given to customers are assets for the bank. They are called loan assets. Unlike investment assets, loan assets are not tradable and transferable. Thus loan assets are not liquid. The problem is how to make the loan of a bank liquid. This problem can be solved by transforming the loans into marketable securities. This is done through the process of securitization. Securitisation is a financial innovation. It is conversion of existing or future cash flows into marketable securities that can be sold to investors. It is the process by which financial assets such as loan receivables, credit card balances, hire purchase debtors, lease receivables, trade debtors etc. are transformed into securities. Thus, any asset with predictable cash flows can be securitised.

Securitisation is defined as a process of transformation of an illiquid asset into security which may be traded later in the market. In short, securitization is the transformation of illiquid, non- marketable assets into securities which are liquid and marketable assets.

Importance of Financial Services

The successful functioning of any financial system depends upon the range of financial services offered by financial service industry. The importance of financial services may be understood from the following aspects:

1. **Economic growth:** The financial service industry mobilises the savings of the people and channels them into productive investments by providing various services to people and corporate enterprises. The economic growth of any country depends upon these savings and investments.
2. **Promotion of savings:** The financial service industry mobilises the savings of the people. It provides liability, asset and size

transformation service by providing huge loan from small deposits collected from a large number of people.

3. **Capital formation :** Financial service industry facilitates capital formation by rendering various capital market intermediary services. Capital formation is the basis for economic growth.
4. **Creation of employment opportunities :** The financial service industry creates and provides employment opportunities to millions of people all over the world.
5. **Contribution to GNP (Gross National Product) :** The contribution of financial services to GNP has been increasing year after year in almost countries.
6. **Provision of liquidity :** The financial service industry promotes liquidity in the financial system by allocating and reallocating savings and investment into various avenues of economic activity. It facilitates easy conversion of financial assets into liquid cash.
7. **Benefit to Government :** The presence of financial services enables the government to raise both short-term and long-term funds to meet both revenue and capital expenditure. Through the money market, government raises short term funds by the issue of **Treasury Bills**. These are purchased by **commercial banks** out of their depositors' money.

In addition to this, the government is able to raise long-term funds by the sale of government securities in the securities market which forms a part of financial market. Even foreign exchange requirements of the government can be met in the foreign exchange market.

OBJECTIVES / FUNCTIONS

Objectives of financial services can be listed as follows :

1. **Mobilization and allocation of savings:** Connecting the savers and investors to mobilize and allocate the savings efficiently

and effectively to ensure overall growth of the economy is one of the most important objective of financial services.

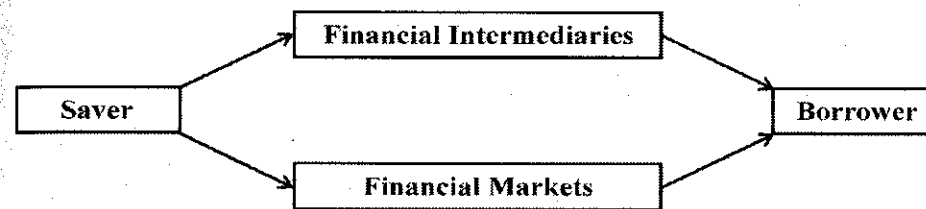


Fig. 2 : Mobilisation of Savings

2. **Selection of project and monitoring performance of industries :** The objective of financial services is to provide advisory services on project selection in terms of cost benefit study and other techniques of analysis. Undertaking subsequent performance check of the industries and/ or corporates, for the investors' decision making is also the function of financial services.
3. **Provide for an efficient and effective payment, clearing and settlement system:** Another objective of financial services is to provide for a swift and secured payment mechanism for transfer of funds across geographies or regions for the smooth functioning of trade and commerce. It is also required to ensure fair and transparent clearing and settlement mechanism in the debt market, stock market, currency market and derivative market.
4. **Offer portfolio valuation:** To offer suitable portfolios to the investors to match the risk and return of different categories of securities with that of the investor is an objective of financial services.
5. **Provide advisory services:** The financial services are required to provide timely and accurate advisory services to facilitate informed economic and financial decision making pertaining to investment, disinvestment, acquisition, merger and liquidation.
6. **Provide for fair and transparent system of financial transactions:** It is an objective of financial services to provide

fair, transparent and secured system for all financial transactions.

7. **Provide cost efficient and prompt financial services:** Providing cost efficient financial services so as to facilitate the investors and issuers both is an important function of financial services.
8. **Facilitate buying and selling of financial assets:** One of the important objective of financial services is to facilitate smooth function of buying and selling of all varieties of financial assets.
9. **Promote the process of financial deepening and broadening:** Promoting the process of financial deepening and broadening with the help of well designed financial services network is really critical to the development and growth of any economy. [It basically refers to an increase of variety of financial assets and size of the assets.]

CHARACTERISTICS

1. **Intangibility:** Financial services are intangible. Therefore, they cannot be standardized or reproduced in the same form. The institutions supplying the financial services should have a better image and confidence of the customers. Otherwise, they may not succeed. [They have to focus on quality and innovation of their services. Then only they can build credibility and gain the trust of the customers.]
2. **Inseparability:** Both origination and supply of financial services have to be performed simultaneously. Hence, there should be perfect understanding between the financial service institutions and its customers.]
3. **Variability:** In order to cater a variety of financial and related needs of different customers in different areas, financial service organisations have to offer a wide range of products and services. [This means the financial services have to be customised to meet requirements of customers.] The service institutions differentiate their services to develop their individual identity.

4. **Dominance of human element:** Financial services are dominated by human element. [It requires competent and skilled personnel to market the quality financial products.]
5. **Information based:** Financial service industry is an information based industry. [It involves creation, dissemination and use of information.] Information is an essential component in the production of financial services.

FINANCIAL SERVICE MARKET

- Banks in a financial service market provides wide range of services besides traditional banking operations. There is a huge competition amongst the different category of banks such as PSU banks, private sector bank and foreign banks in terms of services and convenience to the customers.
- Electronic revolution resulting into new distribution and service marketing have widened the reach to the customers and reduced the cost of marketing.
- Speed of service is also considerably improved in the financial service market.
- Insurance sector has witnessed the launch of innovative products in the market. Online application for policy and faster settlement of claim are some of the important features of the current insurance services market.
- Mutual funds' AUMs (Asset Under Management) have increased sharply with increasing emphasis on transparency, ease of transactions, efficiency of fund management, reduction in the transaction costs and effective regulatory control by SEBI over AMCs.
- NBFCs have been serving the unbanked customers by pioneering into retail asset backed lending and microfinance. Further NBFC are aspiring to be one stop shop for all financial services.

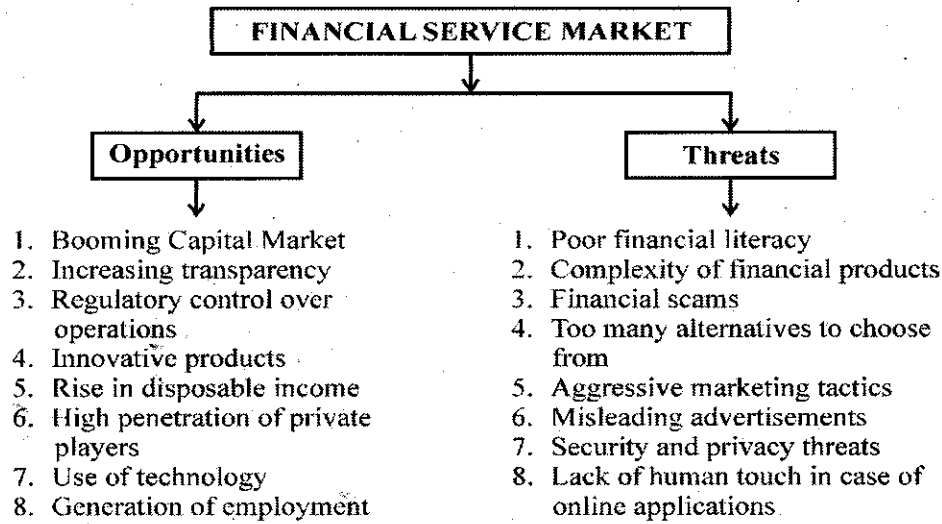


Fig. 3 : Opportunities and Threats

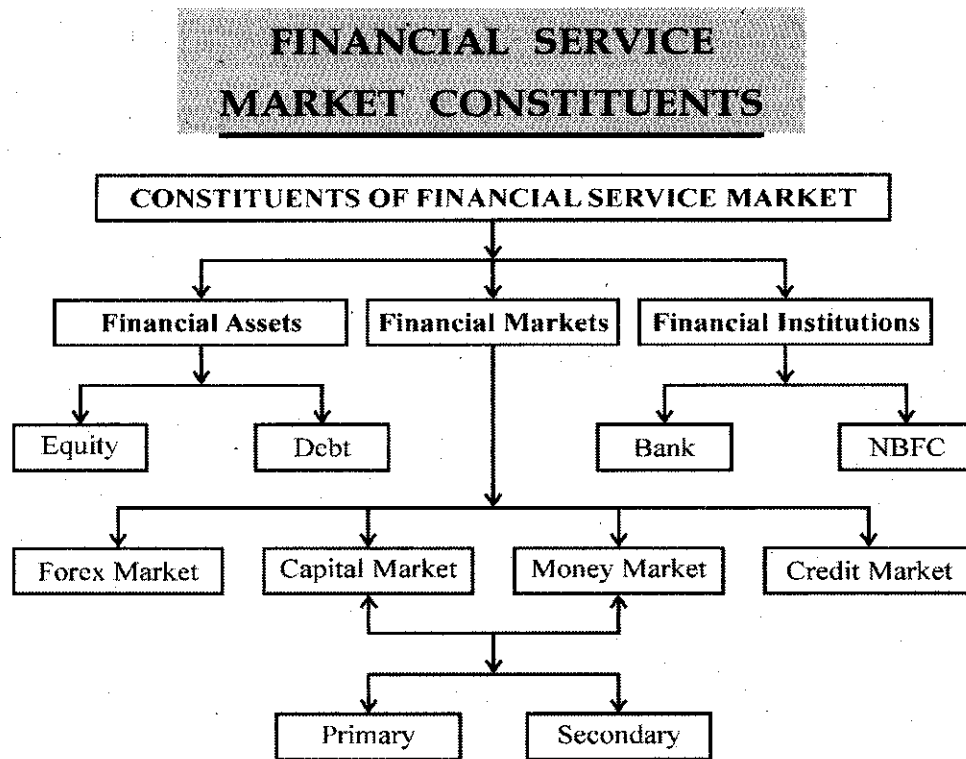


Fig. 4 : Financial Service Market Constituents

A. FINANCIAL MARKETS

Primary Market: It is a market for new issues to public. The primary market deals with those securities which are issued to the public for the first time.

Secondary Market: It is a market for secondary sale of securities. After the initial public offer of securities by the issuer to the public, the securities are quoted in the stock exchange and a continuous and regular secondary market for buying and selling of securities are available.

Forex Market: This market facilitates the trading of foreign exchange.

Capital Market: This market deals with long term securities. A capital market is a financial market in which long-term debt (over a year) or equity-backed securities are bought and sold.

Money Market: This is a market for dealing with financial assets and securities which have a short term maturity period.

Credit Market: Credit market refers to the market through which companies and governments issue debt to investors, such as investment-grade bonds and debentures.

Financial Assets: A financial asset is a tangible liquid asset that gets its value from a contractual claim. Stocks, bonds, bank deposits are examples of financial assets. Unlike land, property, commodities or other tangible physical assets, financial assets do not necessarily have inherent physical worth. The main classes of financial assets are equity and debt.

Financial Institutions: A financial institution is an establishment that conducts financial transactions such as investments, loans & deposits. Banks and Non-banking Finance Companies (NBFCs) are the main categories of financial institutions in the financial services system.

GROWTH OF FINANCIAL SERVICES IN INDIA

The financial sector in India is predominantly a banking sector with commercial banks accounting for more than 64 per cent of the total assets held by the financial system.

India has a diversified financial sector undergoing rapid expansion, both in terms of strong growth of existing financial services firms and new entities entering the market. The sector comprises commercial banks, insurance companies, non-banking financial companies, co-operatives, pension funds, mutual funds and other smaller financial entities

The Government of India has introduced several reforms to liberalise, regulate and enhance this industry. The Government and Reserve Bank of India (RBI) have taken various measures to facilitate easy access to finance for Micro, Small and Medium Enterprises (MSMEs). These measures include launching Credit Guarantee Fund Scheme for Micro and Small Enterprises, issuing guideline to banks regarding collateral requirements and setting up a Micro Units Development and Refinance Agency (MUDRA).

In 2017, a new portal named 'Udyami Mitra' has been launched by the Small Industries Development Bank of India (SIDBI) with the aim of improving credit availability to Micro, Small and Medium Enterprises' (MSMEs) in the country.

With a combined push by both government and private sector, India is undoubtedly one of the world's most vibrant capital markets. Along with the secondary market, the market for Initial Public Offers (IPOs) has also witnessed rapid expansion.

The Mutual Fund (MF) industry in India has seen rapid growth in Assets Under Management (AUM). Total AUM of the industry stood at ₹ 2.52 trillion between April - August 2018. At the same time the number of Mutual fund (MF) equity portfolios reached a high of ₹ 74.6 million as of June 2018.

Another crucial component of India's financial industry is the insurance industry. The insurance industry has been expanding at

a fast pace. Further, India's leading bourse Bombay Stock Exchange (BSE) will set up a joint venture with Ebix Inc. to build a robust insurance distribution network in the country through a new distribution exchange platform. The relaxation of foreign investment rules has received a positive response from the insurance sector, with many companies announcing plans to increase their stakes in joint ventures with Indian companies.

Over the past few years India has witnessed a huge increase in Mergers and Acquisition (M&A) activity undertaken by investment banks.

In September 2018, SEBI asked for recommendations to strengthen rules which will enhance the overall governance standards for issuers, intermediaries or infrastructure providers in the financial market.

The Government of India launched India Post Payments Bank (IPPB), to provide every district with one branch which will help increase rural penetration.

India is today one of the most vibrant global economies, on the back of robust banking and insurance sectors.

PROBLEMS IN FINANCIAL SERVICES SECTOR

Financial service sector has to face a lot of problems or challenges. Some of the important problems are listed below:

1. Lack of qualified personnel in the financial service sector

There is a gap between demand and supply of qualified personnel in the financial services sector.

2. Lack of investor awareness about the various financial services

There is a lack of investor awareness about several financial services and products such as mutual funds, venture capital and insurance services.

3. Lack of transparency in the disclosure requirements and accounting practices relating to financial services

Though there is a regulatory control over disclosure requirements and accounting practices relating to financial services, there is still lack of transparency.

4. Lack of specialisation in different financial services (specialisation only in one or two services)

Most financial services specialize in one or two services only and a very few can offer gamut of services to customers.

5. Lack of adequate data to take financial service related decisions

At times adequate data is not easily available to enable correct decision making.

6. Lack of efficient risk management system in the financial service sector

Lack of an efficient risk management system in the banks and other financial sector companies is one of the problems faced in financial service sector.

7. Many financial organizations would not recover from the loss of data that cannot be retrieved which leads to damage on reputation to their customers and suppliers.

Inadequate security of data resulting into loss of data may leads to damage to their customers.

8. The competition within the financial sector is very strong

Higher competition results into reduction in the profits for the financial services sector.

The above challenges are likely to increase in number with the growing requirements of the customers. However, the financial services system in India at present is in a process of rapid transformation.

BANKING AND NON-BANKING COMPANIES

According to Section 5 of the Banking Regulation Act, 1949, a banking company means the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise and withdrawn by cheque, draft, order, or otherwise.

Reserve Bank of India has defined NBFC as :

- a financial institution which is a company;
- a non-banking institution which is a company and which has as its principal business the receiving of deposits, under any scheme or arrangement or in any other manner, or lending in any manner;
- such other non-banking institution or class of such institutions, as the RBI may, with the previous approval of the Central Government and by notification in the Official Gazette, specify.

Difference between Non-Banking Financial Company and a Bank

It is of prime importance to understand the basic difference between a bank and a Non-Banking Financial Company (NBFC).

1. **Demand deposits cannot be accepted by NBFC:** Demand deposits are those that can be placed by anyone in the financial institution and can be withdrawn at any time as per the wish of the depositor without any prior notice to the institution e.g. current accounts in banks. NBFCs are not allowed to accept such deposits as per the RBI guidelines.
2. **Unlike banks, NBFC is not a part of payments and settlements system regulated by RBI:** Payment and settlement systems in India include cheques, credit cards, debit cards, Real Time Gross Settlement (RTGS), National Electronic Fund Transfer (NEFT) etc. NBFC cannot do these operations as per RBI regulations.
3. **NBFC cannot issue cheques on its name:** As the NBFCs are restricted to be a part of payments and settlement system by the RBI, they cannot issue cheques on its name.

4. **For the depositors in NBFC the deposit insurance facility and credit guarantee corporation is not available:** Deposit Insurance and Credit Guarantee Corporation (DICGC) is a subsidiary of RBI that insures all the deposits such as savings, fixed, recurring etc. upto a limit of ₹ 1,00,000 for each deposit and provides a guarantee for credit facilities. This facility is not extended to NBFC by the RBI.

REGULATORY FRAMEWORK

The scheme of regulation of the working and operations of the NBFCs comprises:

- (i) RBI Act
- (ii) RBI Directions
- (iii) ALM (Asset-Liability) Framework
- (iv) Guidelines of Fair Practices Code
- (iv) Credit Information Companies Act, 2005

The RBI regulates and supervises the NBFCs under the RBI Act. The regulatory and supervisory objective is to:

- (a) ensure the healthy growth of NBFCs
- (b) ensure that they function as part of the financial system within the policy framework in such a manner that their existence and functioning do not lead to any systematic aberration and
- (c) ensure that the quality of surveillance and supervision is sustained by keeping pace with the developments that take place in this sector of the financial system.

It is mandatory that every NBFC should be registered with the RBI to commence/carry on any business.

The NBFCs which can be registered with the RBI are

- (i) equipment leasing

- (ii) hire-purchase
- (iii) loan and
- (iv) investment companies.

The other types of NBFCs are regulated by other regulators.

They can be further classified into those accepting deposits and those not accepting deposits.

The registered NBFCs are required to invest in unencumbered approved securities worth at least 5 per cent of their outstanding deposits.

Every NBFC is required to create a reserve fund by transferring at least 20 per cent of its net profit before declaring any dividend.

The RBI can regulate/prohibit solicitation of deposits from public.

It can give directions to NBFCs relating to

- (i) prudential norms for income recognition, accounting standards, provisioning on capital adequacy and
- (ii) deployment of funds.

It can also issue directions for providing information relating to deposits or for conduct of business.

For contravention/defaults by an NBFC, the RBI can impose penalty. It can also cancel registration of an NBFC.

The RBI Guidelines relating to ALM focus on interest rate and liquidity risk management systems in banks, which form a part of the ALM function. The main elements of the ALM system are ALM information system, ALM organization and ALM process.

The Reserve Bank of India vide its circular dated September 28, 2006, issued guidelines on Fair Practices Code (FPC) for all NBFCs to be adopted by them while doing lending business. The guidelines covered general principles on adequate disclosures on the terms and conditions of a loan and also adopting a non-coercive recovery

method. The same was revised in view of the recent developments with sector including creation of New Category of NBFCs viz; NBFC-MFI and also the rapid growth in NBFCs lending against gold jewellery. Revised circular was issued on March 26, 2012.

Guidelines on Fair Practices Code for NBFCs pertaining to applications for loans and their processing are listed down

- (a) All communications to the borrower shall be in the vernacular language or a language as understood by the borrower.
- (b) Loan application forms should include necessary information which affects the interest of the borrower, so that a meaningful comparison with the terms and conditions offered by other NBFCs can be made and informed decision can be taken by the borrower. The loan application form may indicate the documents required to be submitted with the application form.

The NBFCs should devise a system of giving acknowledgement for receipt of all loan applications. Preferably, the time frame within which loan applications will be disposed of should also be indicated in the acknowledgement.

Note: There are several guidelines issued by RBI on fair practices Code for NBFCs which can be referred by the students on the website of RBI i.e. www.rbi.org.in

Credit Information Companies Act was enacted in 2005 to facilitate the efficient distribution of credit and to provide for regulation of CICs. Credit information includes (a) nature of loans, advances, amount under credit cards, other credit facilities; (b) nature of security; (c) guarantee/non-fund based facility; (4) credit worthiness of a borrower and so on.

The main elements of CIC's framework of regulation are: registration, management, auditors, functions, information privacy principles and offences /penalties.

FACTORING AND FORFAITING

INTRODUCTION

Factoring and forfaiting are two different types of financing of receivables. Although these fund based financial services constitute a critical segment of the financial services scenario in the advanced countries, they appeared on the Indian financial scene only in the early nineties as a result of RBI initiatives.

MEANING

Factoring is a fund based financial service which provides resources to finance receivables as well as facilitates the collection of receivables. It involves the outright sale of receivables at a discount to a factor to obtain funds.

Factoring can be defined as an agreement in which receivables arising out of sale of goods/services are sold by a firm /client to the 'factor' (a financial intermediary) as a result of which the title to the goods/services represented by the said receivables passes on to the factor. Henceforth, the factor becomes responsible for all credit control, sales accounting and debt collection from the buyer. In a full service factoring (without recourse facility), if any of the debtors fails to pay the dues as a result of his financial bankruptcy or insolvency, the factor has to absorb the losses.

Forefacting is a mechanism by which the right for export receivables of an exporter (Client) is purchased by a Financial Intermediary (Forfaiter) without recourse to him.

TYPES OF FACTORING

Factoring arrangement can be of different types depending upon the need of client or business. The collection of receivables and sales-

ledger administration is a common feature of all types of factoring arrangement. The important forms of factoring are explained below:

1. RECOURSE AND NON-RECOURSE FACTORING

A. Features of Recourse Factoring

- a. The factor has recourse to the client if the debt purchased/receivables factored turns out to be irrecoverable.
- b. The factor does not assume credit risks associated with the receivables.
- c. If the customer defaults in payment, the client has to make good the loss incurred by the factor.
- d. The factor is entitled to recover from the client the amount paid in advance in case the customer does not pay on maturity.
- e. Credit risk is with the client.
- f. Factor does not participate in the credit sanction process.
- g. In India, factoring is done with recourse.

B. Features of Non-recourse Factoring

- a. Factor purchases receivables on the condition that the factor has no recourse to the client, if the debt turns out to be non-recoverable.
- b. Credit risk is with the factor.
- c. Higher commission is charged to compensate for the loss arising out of irrecoverable receivables. The additional fee is charged by the factor as a premium for risk bearing referred to as a del credere commission.
- d. Factor participates in credit sanction process and approves credit limit given by the client to the customer.
- e. In USA/UK, factoring is commonly done without recourse.

2. ADVANCE AND MATURITY FACTORING

A. Features of Advance Factoring

- a. The factor pays a pre-specified portion, ranging between three fourth to nine-tenths, of the factored receivables in advance, the balance being paid upon collection/on the guaranteed payment date.
- b. The drawing limit as a pre-payment, is made available by the factor to the client as soon as the factored debts are approved.
- c. The client has to pay interest on the advance between the date of such payment and the date of actual collection from the customer or guaranteed payment date.
- d. The rate of interest on advance is calculated on the basis of the prevailing short-term rate, the financial standing of the client and the volume of the turnover.

B. Features of Maturity Factoring/Collection Factoring

- a. The factor does not make any advance payment to the client.
- b. The factor pays on guaranteed payment date or on the date of collection of receivables.
- c. The guaranteed payment date is usually fixed taking into account previous collection experience of the client.
- d. Nominal commission is charged by the factor.
- e. There is no risk to the factor.

3. FULL FACTORING

This is the most comprehensive form of factoring combining the features of almost all the factoring services specially those of non-recourse and advance factoring. Full factoring provides the entire spectrum of services such as collection, credit protection, sales-ledger administration and short term finance.

4. DISCLOSED AND UNDISCLOSED FACTORING

In disclosed factoring, the name of the factor is disclosed in the invoice by the supplier of the goods asking the buyer to make payment directly to the factor. Generally, the factors assume the risk of non-payment under non-recourse arrangements. The limit within which the factor works as non-recourse is specified in the agreement beyond which the dealings are done on a recourse basis.

The name of the factor is not disclosed in the undisclosed factoring although the factor maintains the sales ledger of the supplier. The entire realization of the receivables is done in the name of the client company but all control remains with the factor. He also provides short-term finance against sales invoices.

5. DOMESTIC AND EXPORT / CROSS-BORDER / INTERNATIONAL FACTORING

Domestic factoring is the factoring in which the buyer, seller-supplier and factor are domiciled in the same country.

Cross-border Factoring is similar to domestic factoring except that there are four parties, viz.,

- Exporter,
- Export Factor,
- Import Factor, and
- Importer.

As two factors are involved in the deal, it is also called Two-Factor System of Factoring.

- The exporter informs the export factor about the export of goods to a particular importer domiciled in a specified country.
- The export factor write to the import factor domiciled in the country of importer enquiring about the credit worthiness of the importer.
- On getting satisfactory information from the import factor, the exporter delivers the goods to the importer. The relevant

invoices, bills of lading and supporting documents are delivered to the export factor.

The export factor gives the works of credit checking, maintaining sales ledger and collection to the import factor.

The import factor collects the payment from the importer and remits payment to the export factor on assignment or collection as per the terms of assignment in the currency of the invoice.

Finally, the exporter factor makes payment to the exporter upon assignment or maturity or collection as per the arrangement.

International factoring provides a non-recourse factoring deal. The exporters have hundred per cent protection against bad debt loss on credit approved sales. The factors take required assistance and avail facilities provided in the exporting country for export promotion. Factor covers exchange risk also in case of international factoring.

THEORETICAL FRAMEWORK

Parties to Factoring Arrangement

There are three parties to factoring services arrangement.

1. **The Buyer:** The buyer negotiates terms of purchase. He receives delivery of goods with invoice. Buyer makes payment to factor on due date.
2. **The Seller:** The seller sells goods to the buyer as per mutual understanding. He delivers the copies of invoice, delivery challan and instruction to make payment to factor. The seller receives 80 per cent or more payment in advance from factor on selling the receivables. He receives the balance payment from factor after deduction of factor's service charges.
3. **The Factor:** The factor enter into an agreement with the seller for rendering factor services. On receipt of copies of sale documents makes payment to the seller of 80 per cent of the

price of the debt. The factor receives payment from the buyer on due date and remits the money to the seller after deducting his charges.

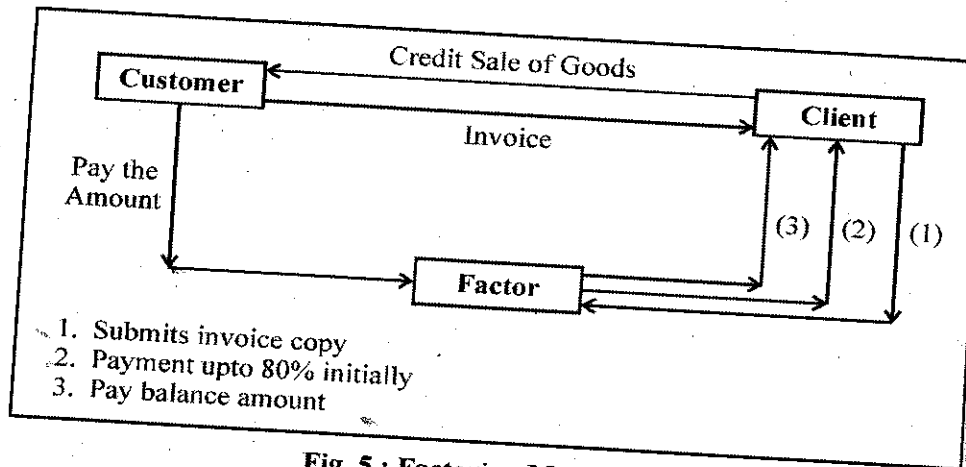


Fig. 5 : Factoring Mechanism

Functions of A Factor

- Administration of Sales Register:** The factor maintains the client's customer-wise sales ledgers. He gives periodic reports to the client on the current status of his receivables, receipts of payments from customers and other useful information.
- Provision of collection facility:** The use of trained manpower with sophisticated infrastructural back-up enables the factor to systematically follow up and make timely demands on the debtors to make payments. Collection of receivables can be considered as the most important function of a factor.
- Financing Trade bills:** The unique feature of factoring is that a factor purchases the book debts of his client at a price and the debts are assigned in favour of the factor who is usually willing to grant advances to the extent of 80-85 per cent of the assigned debts. The balance 15-20 per cent is retained as a factor reserve.
- Credit control:** Assumption of credit risk is one of the important functions of a factor. This service is provided where debts factored without recourse. The factor in consultation with the

client fixes credit limits for approved customers. Within these limits, the factor undertakes to purchase all trade debts of the customer without recourse. Thus the factor assumes the risk of default in payment by customers. The credit-worthiness of customers is assessed by factors on the basis of information from number of sources such as credit rating reports, bank reports and trade references.

5. **Advisory Services:** By virtue of their specialized knowledge and experience in finance and credit dealings and access to extensive credit information, factors can provide a variety of incidental advisory services to their clients such as :

- Customer's perception of the client's products, emerging trends etc.
- Audit of the procedures followed for invoicing, delivery and dealing with sales returns.

FACTORING COST

The factors provide various services at a charge. The charge for collection and sales ledger administration is in the form of a commission expressed as a per cent of the value of debt purchased. It is collected up-front/in advance. The charge for short term financing in the form of advance part-payment is in the form of interest charge for the period between the date of advance payment and the date of collection / guaranteed payment date. It is also known as discount charge.

ADVANTAGES AND DISADVANTAGES OF FACTORING

Advantages

- Immediate Cash inflow:** Factoring shortens the cash collection cycle. It provides swift realization of cash by selling the

- receivables to a factor. Availability of liquidity is an extremely critical factor in any business. Liquid cash provided by factoring can be used for capital expenditures or meeting contingencies.
2. **Focus on business operations and growth:** The businessman can focus on core business operations and growth as he need not worry about collections from customers by selling accounts receivables to factor. Resources employed in the receivables department can be directed towards business operations and future growth.
 3. **Evasion of bad debts:** Under without recourse factoring, the bad debts loss is borne by the factor. The seller is under no obligation to the factor after selling receivables to him. Thus factoring arrangement helps the seller in evading loss arising out of bad debts.
 4. **Quicker arrangement of finance:** Factors provide funds more rapidly than banking companies. Factoring companies require lesser documentation and provide funds faster.
 5. **No requirement of collateral:** The advances are extended on the basis of the strength of accounts receivables and their creditworthiness. Factors do not require any collateral security to be pledged/hypothecated. New businesses can easily avail the advances provided they have strong receivables.
 6. **Sale not loan:** Factoring transaction is a transaction of sale and not a loan. Unlike other types of finances, factoring does not result in an increase in liabilities of the business. Hence there are no adverse impacts on the financial ratios. It facilitates conversion of book debts into liquid cash.
 7. **Customer Analysis:** Factors provide valuable advice and insights to the seller regarding the credit worthiness of the buyer. It helps in negotiating better terms with the customers in future.
 8. **Competitive pricing:** It is a cost effective way of outsourcing sales ledger. Due to existence of many factoring companies, prices are usually competitive.

9. **Useful to small businesses:** Another important advantage is that factoring can be used by a small business. Trying to get a regular business loan or line of credit is difficult as lender require volume to ensure their profitability.

10. **Reduced current liability:** The amount received from the factoring is used to pay off the bank borrowings and other current liabilities comprising of trade creditors. As a result, current liabilities are considerably reduced. The liquidity position of the firm is strengthened further.

Disadvantages

1. **Expensive:** Factoring is a costly method of financing as the cash price of the accounts receivables is discounted by the factor company. The upfront cash price is usually 70-90% of the face value of receivables depending on the credit history of the customers.
2. **Possible harm to the customer relationship:** Selling company gives the charge of collecting receivables to the factoring company which may adversely affect company's relationship with their customers.
3. **Company's image distortion:** In the past factoring was considered as a sign of financial difficulties of the company. However, in recent times, this perception has changed and it has been considered as a normal way of doing business.
4. **Constraints on business:** In the case of non-recourse factoring, the factoring company pre-approves the selling company's customers. This may cause delay in placing new orders. Further the factoring company applies its credit limits to individual customers which may create constraints on business.
5. **Enhanced administrative burden:** Every time the seller wants an advance, he needs to submit a schedule of accounts receivables alongwith a copy of invoices and other documentations.

6. **Purchase of accounts receivables of a reputed companies only** Sometimes factors only purchase the receivables of a reputed company and therefore, a new company may not get the benefit of factoring.

7. **No funding for capital expenditure:** Another disadvantage of factoring is that it can only solve one problem i.e. cashflow problems created by slow-paying customers. It does not fund any capital expenditure.

FACTORING IN INDIA

Factoring service is of recent origin in India. It was recommended by the Kalyan Sundaram Study appointed by the RBI in 1989. Pursuant to the acceptance of these recommendations, the RBI issued guidelines for factoring services in 1990.

SBI Factors and Commercials Ltd. was the first factoring company to start its operation in India in April, 1991.

There was no legal framework to regulate factoring in India. By recognising the importance of the factoring services in the emerging financial services scenario in the country, the legal framework has been codified recently. The three elements of the framework are:

- (i) Factoring Regulations Act, 2011,
- (ii) Registration of Assignment of Receivables (Government) Rules, 2012, and
- (iii) RBI's Non-Banking Financial Company-Factor Directions, 2012.

Factoring Regulations Act

The object of the FRA is to provide for and regulate

- (i) assignment of receivables through registration and
- (ii) rights and obligations of partners to the contract for assignment of receivables. Assignment means transfer by agreement of individual interest of any assignor in any receivable due from any debtor in favour of a factor in India.

The main provisions of the FRA are:

- (i) registration of factors
- (ii) assignment of receivables
- (iii) rights and obligations of parties to the contract for assignment of receivables
- (iv) registration of assignment
- (v) offences and penalties
- (vi) miscellaneous.

Registration of Assignment of Receivables (Government) Rules, 2012

The main features of the rules framed by the Government under the FRA relate to :

- (i) registration of transactions of assignment of receivables
- (ii) time limit for registration/condonation of delay
- (iii) inspection of records of central register and
- (iv) fees

RBI's Non-Banking Financial Company-Factor Directions, 2012

The RBI had issued the NBFC - Factor Directions in 2012 under the Factoring Regulation Act. There are some specific directions applicable to the NBFC Factors.

They relate to the following :

- (i) registration
- (ii) net owned fund
- (iii) principal business
- (iv) conduct of business
- (v) asset classification

(vi) Risk Management

(vii) Import / Export factoring

- (vi) risk management and
(vii) import/export factoring.

FACTORING V/S FORFAITING

FACTORING	FORFAITING
<p>1. Meaning It is an arrangement that converts the receivables into ready cash by selling these to factor.</p>	<p>Forfaiting is an arrangement in which the forfaiter purchases claims from the exporter in return for cash payment.</p>
<p>2. Domestic/Foreign Trade Finance Factoring is both domestic and foreign trade finance.</p>	<p>Forfaiting is only financing of foreign trade.</p>
<p>3. Maturity of Receivables Factoring involves account receivables of short maturities.</p>	<p>Forfaiting involves account receivables of medium to long term maturities.</p>
<p>4. Extent of Finance Factoring provides only 80% of invoice.</p>	<p>100% finance is provided in forfaiting.</p>
<p>5. Letter of Credit There is no letter of credit involved in factoring.</p>	<p>Forfaiting requires letter of credit.</p>
<p>6. Recourse or No Recourse Factoring may have recourse to seller in case of default by buyer.</p>	<p>There is no recourse to exporter in forfaiting.</p>
<p>7. Scope for Discounting in Secondary Market Factoring does not provide scope for discounting in the market as only 80% is financed.</p>	<p>Forfaiting provides scope for discounting the bill in the secondary market due to 100% finance.</p>
<p>8. Series of Sales or Single Sale Factoring may be for financing a series of sales involving bulk trading.</p>	<p>Only a single shipment is financed under forfaiting.</p>

<p>9. Cost Cost of factoring is borne by the seller (client).</p>	<p>Cost of forfaiting is borne by the overseas buyer.</p>
<p>10. Dealing with Negotiable Instruments There is no dealing with negotiable instruments under factoring.</p>	<p>Forfaiting is evidenced by bills of exchange, promissory note or letter of credit.</p>
<p>11. Type of Goods Factoring involves trade receivable on ordinary goods.</p>	<p>Forfaiting usually takes place on trade receivable on capital goods.</p>

WORKING OF FORFAITING

Meaning

The term forfaiting is originated from a French word 'forfait', which means to surrender one's right on something to someone else.

Forfaiting is the discounting of international trade receivables such as promissory notes and bills of exchange for cash. This is the arrangement under which the exporter is provided finance against his bill by the forfaitor.

All risks and collection problems are fully the responsibility of the forfaiter who pays cash to seller after discounting the bills/notes.

Working

- The importer places an order with the exporter to import goods on a deferred payment basis.
- The exporter will refer the order to the forfaiter and check whether the forfaiter can provide forfaiting services.
- The forfaiter agrees to provide services after assessing the credit worthiness of importer.

- The exporter sells the goods and receives the bills of exchange from the importer.
- The exporter sells the availed notes/bills to the forfaiter at discount without recourse. The forfaiting agreement provides for the basic terms of the arrangement such as cost of forfaiting margin to cover risk, fees, rate of interest etc. The rate of interest/discount charged by the forfaiter depends upon the terms of the note/bill, the currency in which it is determined, the country risk of the importer etc.
- Payment by forfaiter to the exporter of the face value of the bill/note less discount.
- The forfaiter holds these notes/bills till maturity for payment by the importer's bank.
- The biggest advantage for the exporter is that he gets funds immediately. Bad debt is avoided in export transactions as guarantee is given by the bank.

BENEFITS AND DRAWBACKS OF FORFAITING

Benefits

(A) To Exporter

1. **100% financing:** Forfaiting is without recourse and does not use exporter's credit line. Once the exporter obtains the funds, he will be exempted from the responsibility to repay the debt.
2. **Improved cashflows:** Working capital is not locked as the exporter gets funds from forfaiting bank. Receivables become current cash inflow and it is beneficial to the exporters to improve financial status and liquidity so as to improve the fund raising capacity.
3. **Risk reduction:** Political risk, remittance risk and currency risks are eliminated with forfaiting. In certain countries, where protection against credit, economic and political risk is higher,

forfaiting can be a very dependable tool for exporters. It reduces default risk.

Reduction in bad debts: The possibility of bad debts caused by importer's bank inability to pay is drastically reduced.

Tool to expand sale: It is an excellent tool for the exporters who wishes to expand sales in international market. There is increased trade opportunity. The exporter is able to grant credit to his importers freely and thus be more competitive in the market.

Protective tool: Forfaiting acts as a protective tool when it comes to international finance. It is better than insurance mainly due to the fact that it provides immediate liquidity for the exporters.

Reduced administration cost: By using forfaiting, the exporter will spare himself from management of the receivables. Thus administration costs are reduced.

(B) To Banks

1. Banks can offer a new product range to clients, which enable the client to gain 100% finance against 80-85% in other discounting products.
2. Banks gain fee based income.
3. Lower credit administration and credit follow up for the banks.

Drawbacks of Forfaiting

1. Forfaiting is not available for deferred payments especially while exporting capital goods for which payment will be made on a deferred basis by the importer.
2. There is no international credit agency which can guarantee for forfaiting companies which affects long term prospects forfaiting business.
3. Only selected currencies are taken for forfaiting as they alone enjoy international liquidity.

PRACTICAL PROBLEMS (FOR T.Y.B.M.S.)**Illustration 1 :**

The turnover of F Ltd. is ₹ 60 lakh of which 80 per cent is on credit. Debtors are allowed one month to clear off the dues. A factor is willing to advance 90 per cent of the bills raised on credit for a fee of 2 per cent a month plus commission of 4 per cent on the total amount of debts. F Ltd. as a result of this arrangement is likely to save ₹ 21,600 annually in management costs and avoid bad debts at 1 per cent on the credit sales.

A bank has come forward to make an advance equal to 90 per cent of the debts at an annual interest rate of 18 per cent. However, its processing fee will be at 2 per cent on the debts. Would you accept factoring or the offer from the bank?

Solution :

To decide whether to accept factoring or bank advance, we compute the monthly costs of both the options as under :

(A) Alternative 1 : Factoring Arrangement

Cost of Factoring:		₹
Fee [(₹ 48,00,000/12) × 90% × 2%]		7,200
Commission (₹ 4,00,000 × 4%)		<u>16,000</u>
		23,200
Less: Savings in Cost:		
Management costs (₹ 21,600 /12)	1,800	
Bad debts (₹ 4,00,000 × 1%)	<u>4,000</u>	<u>5,800</u>
Net cost of factoring		<u>17,400</u>

(B) Alternative 2 : Bank Advance**Cost of Bank Advance:**

Interest (₹ 4,00,000 × 90% × 18% × 1/12)	5,400
Processing fees (₹ 4,00,000 × 2%)	8,000
Bad debts (₹ 4,00,000 × 1%)	<u>4,000</u>
	<u>17,400</u>

Note : It is assumed that F Ltd. will continue to incur management costs.

Since the costs of both the alternatives are equal, F Ltd. is likely to be indifferent between factoring and bank advance.

Illustration 2 :

The Delhi Manufacturers Ltd. sells goods on credit. Its current annual credit sales amount to ₹ 900 lakh. The variable cost ratio is 80 percent. The credit terms are 2/10, net 30. On the current level of sales, the bad debts are 0.75 per cent. The past experience has been that 50 per cent of the customers avail of the cash discount, the remaining customers pay on an average 50 days after the date of sale.

The book debts (receivables) of the firm are presently being financed in the ratio of 2 : 1 by a mix of bank borrowings and owned funds which cost per annum 25 per cent and 28 per cent respectively.

As an alternative to the in-house management of receivables, Delhi Manufacturers Ltd. is contemplating use of full advance non-recourse factoring deal with the PNB Factors Ltd. The main elements of such a deal structured by the factor are (i) factor reserve, 15 per cent; (ii) guaranteed payment date, 24 days after the date of purchase; (iii) discount charge, 22 per cent and (iv) commission for other services (payable up-front), 4 per cent of the value of receivables.

The finance manager of Delhi Manufacturers Ltd. seeks your advice, as a consultant, on the cost-benefit of the factoring arrangement. What advice would you give? You can make your own assumption, where necessary.

Solution :

To decide whether to advice to continue with In-House Management alternative or factoring arrangement, we compute the relevant annual costs of both the alternatives as under :

(A) Alternative 1 : In-House Management

Relevant Costs	Amount in lakhs	Remarks
Cash discount	9.00	₹ 900 lakh x 50 % x 2 %
Cost of funds in receivables	19.50	As per working note 1
Bad debts losses	6.75	₹ 900 x 0.75%
Total	35.25	

Working Note 1 :

Calculation of cost of funds invested in receivables:

Average collection period = (10 days x 50%) + (50 days x 0.5)
= 5 + 25 = 30 days i.e. 1 month

Average investment in debtors = ₹ 900 lakh x 1 / 12 = ₹ 75 lakh

Cost of bank funds = (₹ 75 lakh x 2/3 x 25%) = ₹ 12.5 lakh

Cost of owned funds = (₹ 75 lakh x 1/3 x 28%) = ₹ 7 lakh

Total cost = ₹ 12.5 lakh + ₹ 7 lakh = ₹ 19.5 lakh.

(B) Alternative 2 : Non-recourse Factoring

Relevant Costs	Amount in lakhs	Remarks
Factoring commission	36.00	₹ 900 lakh x 4%
Discount charge	10.77	As per working note 2
Cost of owned funds invested in receivables	3.09	(₹ 900 lakh - ₹ 734 lakh) x 28% x 24/360
Total	49.86	

Working Note 2 :

Eligible amount of advance = 0.85 x (₹ 900 lakh - ₹ 36 lakh)
= ₹ 734.4 lakh

Discount charge = (₹ 734.4 lakh x 22% x 24/360) = ₹ 10.77 lakh

Decision Analysis : Cost Benefit of Non-recourse Factoring

	Amount (₹ lakh)
Benefits (savings of cost as per In-House Management alternative)	35.25
Cost (of non-recourse factoring alternative)	49.86
Net Loss	(14.61)

Recommendation: New Delhi Manufacturers Ltd. should not go for factoring alternative.

Illustration 3 :

Compute the effective cost of factoring from the following details.

Credit sales = ₹ 12,00,000

Average collection period = 3 months

Factor's reserve = 20%

Factor's commission = 4%

Bad debts = 2%

Collection expenses = ₹ 20,000 p.a.

Interest = 18% p.a.

Solution :

Effective Cost of Factoring = $\frac{\text{Net Cost of Factoring}}{\text{Net Advance Taken}} \times 100$

(A) Computation of Net Advance Taken

Average debtors (12,00,000 x 3/12)	₹ 3,00,000
Less : Reserve (20% of ₹ 3,00,000)	60,000
Less : Commission (4% of ₹ 3,00,000)	<u>12,000</u>
	2,28,000
Less : Interest (2,28,000 x 18% x 3/12)	<u>10,260</u>
Net Advance taken	<u>2,17,740</u>

(B) Computation of Net Cost of Factoring

Commission (4% of ₹ 3,00,000)	₹ 12,000
Interest (2,28,000 x 18% x 3/12)	10,260
Less : Savings in collection expenses	(5,000)
Less : Savings in bad debts (2% of ₹ 3,00,000)	<u>(6,000)</u>
Net cost of factoring	<u>11,260</u>

$$\text{Effective cost of factoring} = \frac{11,260}{2,17,740} \times 100 = 5.17\%$$

$$\text{Annual cost of factoring} = 5.17 \times 12/3 = 20.68\%$$

Illustration 4 :

Compute the effective cost of factoring from the following details.

Average monthly receivables = ₹ 1,00,000

Average collection period = 30 days

Annual saving in collection expenses = ₹ 18,000

Days in a year = 360

Terms of the factoring company are as under:

Amount advanced	80%
Monthly factor fees charged	2%
Annual Interest rate on receivables	10%

Solution :

$$\text{Effective Cost of Factoring} = \frac{\text{Net Cost of Factoring}}{\text{Net Advance Taken}} \times 100$$

(A) Computation of Net Advance Taken

Average monthly receivables	₹ 1,00,000
Amount advanced (80% of ₹ 1,00,000)	80,000

(B) Computation of Net Cost of Factoring

Monthly factor fees charged (2% of ₹ 1,00,000)	₹ 2,000
Interest (80,000 x 10% x 30/360)	667
Less : Savings in collection expenses	<u>(1,500)</u>
Net cost of factoring	<u>1,167</u>

$$\text{Effective cost of factoring} = \frac{1,167}{80,000} \times 100 = 1.46\%$$

$$\text{Annual cost of factoring} = 1.46 \times 12/1 = 17.52\%$$

Illustration 5 :

AMRTAM Ltd. has a total sales of ₹ 3.2 crores and its average collection period is 90 days. The past experience indicates that bad debt losses are 1.5% on sales. The expenditure incurred by the firm in administering its receivable collection efforts are ₹ 5,00,000. A factor is prepared to buy the firm's receivables by charging 2%

commission. The factor will pay advance on receivables to the firm at an interest rate of 18% p.a. after withholding 10% as reserve. Calculate the effective cost of factoring to the firm.

Solution :

(ICMA Final, June 2013)

$$\text{Effective Cost of Factoring} = \frac{\text{Net Cost of Factoring}}{\text{Net Advance Taken}} \times 100$$

(A) Computation of Net Advance Taken

	₹
Average debtors (3,20,00,000 × 90/360)	80,00,000
Less : Reserve (10% of ₹ 80,00,000)	8,00,000
Less : Commission (2% of ₹ 80,00,000)	<u>1,60,000</u>
	70,40,000
Less : Interest (70,40,000 × 18% × 90/360)	<u>3,16,800</u>
Net Advance taken	<u>67,23,200</u>

(B) Computation of Net Annual Cost of Factoring

	₹
Commission (2% of ₹ 80,00,000 × 360/90)	6,40,000
Interest (70,40,000 × 18%)	12,67,200
Less : Savings in collection expenses	(5,00,000)
Less : Savings in bad debts (1.5% of ₹ 3,20,00,000)	<u>(4,80,000)</u>
Net cost of factoring	<u>9,27,200</u>

$$\text{Effective cost of factoring} = \frac{9,27,200}{67,23,200} \times 100 = 13.79\%$$

Illustration 6 :

Titan Ltd. has a total sales of ₹ 100 lakhs out of which 80% is on credit. It offers a discount as per the credit terms of 2/40 net 30. Of

the total, 50% of customers avail of discount and the balance pay in 120 days. Bad debt losses are around 1% of credit sales based on past experience. The company spends ₹ 1,20,000 p.a. to administer its credit sales. These are avoidable as a factor is prepared to buy the firm's receivables. He will charge 2% commission. He will also pay advance against receivables to the company at an interest rate of 18% after withholding 10% as reserve. You are required to answer the following questions.

- (a) What is the total credit sales?
- (b) What is the average collection period?
- (c) What is the average receivables?
- (d) What is the factoring commission payable per annum?
- (e) What is the disburseable amount to the company by the factor?
- (f) What is the total interest chargeable by the factor?
- (g) What is the cost of factoring?
- (h) Should the firm avail factoring services?

Solution :

- (a) The total credit sales = 80% of ₹ 100 lakhs = ₹ 80,00,000
- (b) The average collection period = (40 × 0.5) + (120 × 0.5)
= 20 + 60 = 80 days
- (c) The average receivables = ₹ 80 lakhs × 80/360 = ₹ 17,77,778
- (d) The factoring commission payable per annum
= 2% × 80,00,000 = ₹ 1,60,000
- (e) The disburseable amount to the company by the factor

	₹
Average Receivables	17,77,778
Less : Reserve (10% of ₹ 17,77,778)	<u>1,77,778</u>

Less : Commission (2% of ₹ 17,77,778)	<u>35,556</u>
	15,64,445
Less : Interest (15,64,445 × 18% × 80/360)	<u>62,578</u>
Net Advance taken	<u>15,01,867</u>

(f) The total interest chargeable by the factor
= ₹ 62,578 × 360/80 = ₹ 2,81,601

(g) **Computation of Net Annual Cost of Factoring**

	₹
Commission (2% of ₹ 17,77,778 × 360/80)	1,60,000
Interest (62,578 × 360/80)	2,81,601
Less : Savings in collection expenses	(1,20,000)
Less : Savings in bad debts (1% of ₹ 80,00,000)	<u>(80,000)</u>
Net cost of factoring	<u>2,41,601</u>

$$(h) \text{ Effective Cost of Factoring} = \frac{\text{Net Cost of Factoring}}{\text{Net Advance Taken}} \times 100$$

$$= \frac{2,41,601}{15,01,867} \times 100 = 16.09\%$$

If Titan Ltd. can obtain funds at the interest rate which is less than 16.09%, the company need not accept factoring services otherwise it is advised to accept factoring services.

Illustration 7 :

PQR Ltd. has total sales of ₹ 4.50 crores and its average collection period is 120 days. The past experience indicates that bad debt losses are 2% on sales. The expenditure incurred by the firm in administering its receivable collection efforts are ₹ 6,00,000. A Factor is prepared to buy the firm's receivables by charging 2% commission. The Factor will pay advance on receivables to the firm at an interest

rate of 18% p.a. after withholding 10% as reserve. You are required to calculate the effective cost of factoring to the company.

Solution :

(ICMA Final, June 2010)

$$\text{Effective Cost of Factoring} = \frac{\text{Net Cost of Factoring}}{\text{Net Advance Taken}} \times 100$$

(A) Computation of Net Advance Taken

	₹
Average debtors (4,50,00,000 × 120/360)	1,50,00,000
Less : Reserve (10% of ₹ 1,50,00,000)	15,00,000
Less : Commission (2% of ₹ 1,50,00,000)	<u>3,00,000</u>
	1,32,00,000
Less : Interest (1,32,00,000 × 18% × 120/360)	<u>7,92,000</u>
Net Advance taken	<u>1,24,08,000</u>

(B) Computation of Net Annual Cost of Factoring

	₹
Commission (2% of ₹ 1,50,00,000 × 360/120)	9,00,000
Interest (1,32,00,000 × 18%)	23,76,000
Less : Savings in collection expenses	(6,00,000)
Less : Savings in bad debts (2% of ₹ 1,50,00,000)	<u>(3,00,000)</u>
Net cost of factoring	<u>23,76,000</u>

$$\text{Effective cost of factoring} = \frac{23,76,000}{1,24,08,000} \times 100 = 19.15\%$$

Illustration 8 :

The turnover of X Ltd. is ₹ 72 lakhs of which 80% is on credit. Debtors are allowed one month to clear off the dues. A factor is willing to advance 90% of the bills raised on credit for a fee of 2% a month

plus a commission of 4% on the total amount of debts. X Ltd. as a result of this arrangement is likely to save ₹ 25,920 annually in management costs and avoid bad debts at 1% on the credit sales.

A Nationalised Bank has come forward to make an advance equal to 90% of the debts at an interest rate of 18% p.a. However, its processing fee will be at 2% on the debts.

Would you accept factoring or the offer from the bank?

Solution :

(ICMA Final, December 2014)

Alternative 1 : Factoring Arrangement

Credit sales = 80% of ₹ 72 lakhs = ₹ 57.60 lakhs

	₹	₹
Average debtors (₹ 57,60,000 × 30/360)	4,80,000	
Advance by factor 90% of ₹ 4,80,000	4,32,000	
Factor's Fees (2% of ₹ 4,80,000)	9,600	
Commission (4% of ₹ 4,80,000)	<u>19,200</u>	28,800
Less : Saving in cost		
Management cost	2,160	
Bad debts (1% of credit sales)	<u>4,800</u>	<u>(6,960)</u>
Net cost of factoring		<u>21,840</u>

Alternative 2 : Bank Finance

	₹
Cost of bank finance	
Interest (4,32,000 × 18% × 30/360)	6,480
Processing fees (2% of ₹ 4,80,000)	9,600
Bad debts (1% of credit sales)	<u>4,800</u>
Net cost of bank finance	<u>20,880</u>

Bank finance would be accepted as the cost of bank finance is lower than the factoring arrangement.

Illustration 9 :

A manufacturing company has credit sales of 360 lakhs and its average collection period is 30 days. The bad debts is estimated as 2% of credit sales. The company spends ₹ 1,40,000 annually on debtors administration. A factoring firm has offered to buy the company's receivables. The factor will charge 1% commission and will pay an advance against receivables on an interest @ 15% p.a. after withholding 10% as reserve. What should the company do? Assume 360 days in a year.

Solution :

Average receivables = ₹ 360 lakhs × 30/360 = ₹ 30 lakhs

	₹
Average receivables	30,00,000
Less : Factoring reserve (10%)	3,00,000
Less : Factor's commission (1%)	<u>30,000</u>
Net Advance provided by factor	<u>26,70,000</u>
Interest on advance (15% × 26,70,000 × 30/360)	<u>33,375</u>

Computation of Net Annual Cost of Factoring

	₹
Commission	3,60,000
Interest	4,00,500
Less : Savings in collection expenses	(1,40,000)
Less : Savings in bad debts (2% of ₹ 3,60,00,000)	<u>(7,20,000)</u>
Net cost of factoring	<u>(99,500)</u>

As the savings to the company exceeds the cost to the firm on account of factoring, the proposal is acceptable.

Illustration 10 :

Under the advance factoring arrangement, XYZ Ltd. has agreed to advance a sum of ₹ 66 lakhs against the receivables purchased from Shahi Traders Ltd. The factoring agreement provides an advance payment of 75% of the value of factored receivables for guaranteed payment after three months from the date of purchasing the receivables.

The advance carries a rate of interest of 16.5% p.a. compounded quarterly and the factoring commission is 1.75% of the value of factored receivables. Both the interest and commission are collected upfront.

- (1) Compute the amount actually made available to Shahi Traders Ltd.
- (2) Compute the effective cost of funds made available to Shahi Traders Ltd.
- (3) Assume that the interest is collected in arrears and the commission is collected in advance. Calculate the effective cost of funds made available to Shahi Traders Ltd.

Solution :*(TYBMS, April 2018)*

- (1) **Computation of the amount actually made available to Shahi Traders Ltd.**

	₹ in lakhs
Value of factored receivables (66/75%)	88.00
Less : Factor's reserve (25%)	<u>22.00</u>
Advance after keeping reserve	66.00
Less : Commission @ 1.75% of ₹ 88 lakhs	1.54
Less : Interest charge (₹ 66 lakhs × 16.5% × 90/360)	<u>2.72</u>
Funds made available to XYZ Ltd.	<u>61.74</u>

- (2) **Calculation of the effective cost of funds made available to Shahi Traders Ltd.**

Cost of funds	₹ in lakhs
Commission @ 1.75% of ₹ 88 lakhs	1.54
Interest charge (₹ 66 lakhs × 16.5% × 90/360)	<u>2.72</u>
	<u>4.26</u>

Effective cost of funds = $4.26/61.74 \times 100 = 6.90\%$ per quarter

The annualised cost of funds = $(1 + 0.069)^4 - 1 \times 100 = 30.59\%$

- (iii) **Calculation of the effective cost of funds made available to Shahi Traders Ltd. when interest is collected in arrears and commission is paid in advance.**

Cost of funds	₹ in lakhs
Advance	66.00
Less : Commission @ 1.75% of ₹ 88 lakhs	<u>1.54</u>
Funds available	<u>64.46</u>

Interest charges collected in arrears

Interest charge (₹ 66 lakhs × 16.5% × 90/360) 2.72

Effective cost of funds = $4.26/64.46 \times 100 = 6.61\%$ per quarter

The annualised cost of funds = $(1 + 0.0661)^4 - 1 \times 100 = 29.18\%$

Illustration 11 :

Ambitious Co. Ltd. has account receivables worth ₹ 120 lakhs. Optimum Factor Ltd. offers non-recourse factoring services to Ambitious Ltd. The factor would pay 80% of the value of the factored receivables @ 14% interest compounded quarterly. The remaining amount is retained as factor reserve. It also guarantees payment after 3 months from the date of purchase of the receivables. The factoring commission is 3% of the value of factored receivables. It is decided that interest and commission will be collected in advance.

- (1) Find out the advance payable to Ambitious Company.
 - (2) Calculate the effective cost of funds on an annualised basis that is made available to Ambitious Company.
 - (3) Estimate the effective cost of funds based on the assumption that commission is collected in advance and the interest is collected in arrears.
- (TYBMS, April 2017)*

Solution :

- (1) **Computation of the amount actually made available to Ambitious Co. Ltd.**

	₹ in lakhs
Value of factored receivables	120.00
Less : Factor's reserve (20%)	<u>24.00</u>
Advance after keeping reserve	96.00
Less : Commission @ 3% of ₹ 120 lakhs	3.60
Less : Interest charge (₹ 96 lakhs x 14% x 90/360)	<u>3.36</u>
Funds made available to Ambitious Co. Ltd.	<u>89.04</u>

- (ii) **Calculation of the effective cost of funds made available to Ambitious Co. Ltd.**

Cost of funds	₹ in lakhs
Commission @ 3% of ₹ 120 lakhs	3.60
Interest charge (₹ 96 lakhs x 14% x 90/360)	<u>3.36</u>
	<u>6.96</u>

Effective cost of funds = $6.96/89.04 \times 100 = 7.82\%$ per quarter

The annualised cost of funds = $(1 + 0.0782)^4 - 1 \times 100 = 35.14\%$

- (iii) **Calculation of the effective cost of funds made available to Ambitious Co. Ltd. when interest is collected in arrears and commission is paid in advance.**

Cost of funds

₹ in lakhs

Advance	96.00
Less : Commission @ 3% of ₹ 120 lakhs	<u>3.60</u>
Funds available	<u>92.40</u>
Interest charges collected in arrears	
Interest charge (₹ 96 lakhs x 14% x 90/360)	3.36

Effective cost of funds = $6.96/92.40 \times 100 = 7.53\%$ per quarter

The annualised cost of funds = $(1 + 0.0753)^4 - 1 \times 100 = 33.70\%$

Illustration 12 :

A company is considering engaging a factor. The following details are available:

- (i) The current average collection period for the company's debtors is 80 days and 1/2% of debtor's default. The factor has agreed to pay money due after 60 days and will take the responsibility of any loss on account of bad debts.
- (ii) The annual charge for the factoring is 2% of turnover payable annually in arrears. Administration cost saving is likely to be ₹ 1,00,000 per annum.
- (iii) Annual sales, all on credit, are ₹ 1,00,00,000. Variable cost is 80% of sales price. The company's cost of borrowing is 15% per annum. Assume the year is consisting of 365 days. Should the company enter into a factoring agreement?

Solution :

Evaluation of factoring option

	₹
Existing debtors (1,00,00,000 x 80/365)	21,91,781
New debtors after factoring (1,00,00,000 x 60/365)	<u>16,43,836</u>
Reduction in debtors	5,47,945
Variable cost @ 80%	4,38,356

Savings in cost

(a) Interest savings @ 15% of ₹ 4,38,356	65,753
(b) Administration cost savings	1,00,000
(c) Bad debts savings (1/2% of ₹ 1 crore)	<u>50,000</u>
Total savings	2,15,753
Less Commission @ 2% on ₹ 1 crore	<u>2,00,000</u>
Net savings due to factoring	<u>15,753</u>

As there is a net saving, company should choose factoring option.

Illustration 13 :

Under an advance factoring arrangement PNP Factors Ltd. has advanced a sum of ₹ 14 lakhs against the receivable purchased from XYZ Ltd. The factoring agreement provide for an advance payment of 80% (maintaining 'factor reserve' of 20% to provide for disputes and deductions relating to the bills assigned) of the value of factored receivables. The advance carries a rate of interest of 20% p.a. compounded quarterly. The factoring commission is 1.5% of the value of factored receivables. Both the interest and commissions are collected upfront.

- (i) Compute the amount of advance payable to XYZ Ltd.
- (ii) Calculate the effective cost of funds made available to XYZ Ltd.
- (iii) Calculate the effective cost of funds made available to XYZ Ltd. assuming the interest is collected in arrear and commission is collected in advance.

Solution :

(i) Computation of the amount of advance payable to XYZ Ltd.

	₹ in lakhs
Value of factored receivables (14/80%)	17.50
Less : Factor's reserve (20%)	<u>3.50</u>

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Advance after keeping reserve	14.00
Less : Commission @ 1.5% of ₹ 17.5 lakhs	0.26
Less : Interest charge (₹ 14 lakhs x 20% x 90/360)	<u>0.70</u>
Funds made available to XYZ Ltd.	<u>13.04</u>

(ii) Calculation of the effective cost of funds made available to XYZ Ltd.

Cost of funds	₹ in lakhs
Commission @ 1.5% of ₹ 17.5 lakhs	0.26
Interest charge (₹ 14 lakhs x 20% x 90/360)	<u>0.70</u>
	<u>0.96</u>

Effective cost of funds = $0.96 / 13.04 \times 100 = 7.36\%$ per quarter

The annualised cost of funds = $(1 + 0.0736)^4 - 1 \times 100 = 32.85\%$

(iii) Calculation of the effective cost of funds made available to XYZ Ltd. when interest is collected in arrears and commission is paid in advance.

Cost of funds	₹ in lakhs
Advance	14.00
Less : Commission upfront @ 1.5% of ₹ 17.5 lakh	<u>0.26</u>
Funds available	<u>13.74</u>

Interest charges collected in arrears	
Interest charge (₹ 14 lakhs x 20% x 90/360)	0.70

Effective cost of funds = $0.96 / 13.74 \times 100 = 6.99\%$ per quarter

The annualised cost of funds = $(1 + 0.0699)^4 - 1 \times 100 = 31.03\%$

Illustration 14 :

A company is considering engaging a factor. The following information is available :

- The current average collection period for the company's debtors is 90 days and 1/2% of debtor's default. The factor has agreed to pay money due after 60 days and will take the responsibility of any loss on account of bad debts.
- The annual charge for the factoring is 2% of turnover payable annually in arrears. Administration cost saving is likely to be ₹ 1,00,000 per annum.
- Annual credit sales are ₹ 1,20,00,000. Variable cost is 80% of sales price. The company's cost of borrowing is 15% per annum. Assume 360 days in a year.

Should the company enter into a factoring agreement?

Solution :

(IPCC, May 2018)

Evaluation of factoring option

	₹
Existing debtors (1,20,00,000 × 90/360)	30,00,000
New debtors after factoring (1,20,00,000 × 60/360)	<u>20,00,000</u>
Reduction in debtors	10,00,000
Variable cost @ 80%	8,00,000
Savings in cost	
(a) Interest savings @15% of ₹ 8,00,000	1,20,000
(b) Administration cost savings	1,00,000
(c) Bad debts savings (1/2% of ₹ 1.2 crore)	<u>60,000</u>
Total savings	2,80,000
Less : Commission @ 2% on ₹ 1.2 crore	<u>2,40,000</u>
Net savings due to factoring	<u>40,000</u>

As there is a net saving, company should choose factoring option.

Illustration 15 :

PT Factors offers recourse factoring on the following terms:

	Facility	Recourse factoring
i	Discount charge (payable upfront)	18% p.a.
ii	Reserve	21%
iii	Commission	2.50%

The finance Manager of Sagar Ltd. has approached PT Factor to factor its receivables. After analysis of the sales documents of Sagar Ltd. PT offered a guaranteed payment of 45 days.

The following information about the credit policy and trends of Sagar Ltd. is available :

Sagar Ltd. sells on terms "2/10 net 45". On an average 50% of the customers pay on the 10th day and avail the discount. Again, on an average the remaining customers pay 80 days after the invoice date. The bad debts and losses amount to 1% of the sales invoices. The sales personnel are responsible for following up collections and by and large Sagar Ltd. can increase its annual sales by ₹ 25 lakhs if the sales people are relieved from collection jobs. The gross margin on sales is 28% and the estimated sales turnover for the following year without considering the increase in sales is ₹ 300 lakhs. By off-loading sales ledger administration and credit monitoring, Sagar Ltd. can save overheads to the extent of ₹ 1.5 lakhs p.a. Currently, Sagar Ltd. is financing its investments through a mix of bank finance and long term funds in the ratio of 3 : 2. The effective rate on bank finance is 17% and the pre-tax cost of long term funds is 21%.

You are required to :

- Perform cost benefit analysis of recourse factoring and advise Sagar Ltd. whether to accept the factoring proposal or not.
- Find out the maximum rate of factoring commission Sagar Ltd. can pay if it wishes to relieve the cost of bad debts and be indifferent between recourse and non-recourse factoring.

Solution :**(a) Cost benefit analysis of recourse factoring****A. Cost of In house management of receivables** ₹ in lakhs

1. Cash discount (2% x 300 x 50%)	3
2. Cost of finance	
Average collection period = (50% x 10) + (50% x 80)	45 days
Average receivables (300 x 45/360)	37.5
Cost of bank finance (37.5 x 3/5 x 17%)	3.825
Cost of long term finance (37.5 x 2/5 x 21%)	3.15
3. Contribution lost on ₹ 25 lakhs @ 28%	7
4. Administrative overhead	1.50
Net cost of in house management	<u>18.475</u>

B. Cost of recourse factoring

Commission (2.5% on ₹ 325 lakhs)	8.13
Discount charge (payable upfront) (325 x 18% x 45/360 x 79%)	5.78
Cost of long term finance	1.76
[(325 - 5.78) x 21% x 21% x 45/360]	
	<u>15.66</u>
C. Net benefits of recourse factoring (A - B)	<u>2.81</u>

As the cost of recourse factoring is lower than in-house management, it is advised to opt for recourse factoring.

(b) The maximum amount of factoring commission increase of ₹ 3 lakhs Sagar Ltd. can pay if it wishes to relieve the cost of bad debts and be indifferent between recourse and non-recourse factoring.

Bad debts = 1% of ₹ 300 lakhs = ₹ 3 lakhs

Non-recourse factoring commission = 8.13 + 3 = ₹ 11.13 lakhs

Maximum factoring commission = 11.13/325 x 100 = 3.42%

Illustration 16 :

The turnover of Tech Ltd. is ₹ 60 lakh of which 60 per cent is on credit. Debtors are allowed one month to pay the dues. A factor is ready to advance 80 per cent of the invoices representing sale on credit for a fee of 2 per cent a month plus commission of 4 per cent on the total amount of debts. Tech Ltd. as a result of this arrangement likely to save ₹ 24,000 annually in management costs and avoid bad debts at 3 percent on the credit sales.

DFC Bank has come forward to make an advance equal to 80 per cent of the debts at an annual interest rate of 16 per cent. However, processing fee will be at 1 per cent on the debts. Would you advice the company to accept factoring or accept the offer from the bank?

Solution :

To decide whether to accept factoring or bank advance, we compute the monthly costs of both the options as under :

A) Alternative 1 : Factoring Arrangement

Cost of factoring	₹	₹
Fee [(₹ 36,00,000/12) x 80% x 2%]	4,800	
Commission (₹ 3,00,000 x 4%)	<u>12,000</u>	16,800
Less : Savings in cost		
Management costs (₹ 24,000 / 12)	2,000	
Bad debts (₹ 3,00,000 x 1%)	<u>3,000</u>	(5,000)
Net cost of factoring		<u>11,800</u>

(B) Alternative 2 : Bank advance

Cost of bank advance

Interest (₹ 3,00,000 × 80% × 16% × 1/12)	₹ 3,200
Processing fees (₹ 3,00,000 × 1 %)	3,000
Bad debts (₹ 3,00,000 × 3%)	<u>9,000</u>
	<u>15,200</u>

Since the cost of bank advance is higher than factoring cost, the company should choose factoring arrangement.

BILL DISCOUNTING

INTRODUCTION

Bill discounting is an arrangement whereby the seller recovers an amount of sales bill from the financial intermediaries before it is due. Such intermediaries charge a fee for the service. It is an advance selling of a bill to an intermediary before it is due to be paid after reducing administrative charges, fees and interest. Bills and invoices are technically known as a 'bill of exchange'.

In bill discounting, a bank earns a discount /fee from a seller to release funds before the credit period ends. The bill is presented to seller's customer on due date and full amount is collected.

Bill discounting is also known as Invoice Discounting.

Bill discounting helps the sellers get funds earlier on payment of a small fee or discount. It also helps the bank earn some revenue. The seller's customer pays money on the due date of the credit period.

Bill discounting is a source of working capital finance for the seller of goods on credit.

The difference between the bill amount and the amount paid is the fee of the invoice discounting company. The fee will depend on the period left before payment date and the perceived risk.

The bills or invoices under bill discounting are legally the 'bill of exchange'. A bill of exchange is a negotiable instrument which is negotiable by endorsing the name. Our currency is a bill of exchange. It provides value written over it to the bearer of the instrument. In the case of bill discounting, such bills can be either payable to the bearer or payable to order.

For example, a drawer has a bill for ₹ 10,000. He discounted this bill with his bank three months before its due date at 10% p.a. rate of discount. Discount will be calculated as the follow:

$$₹ 10,000 \times 10/100 \times 3/12 = ₹ 250$$

Thus the drawer will receive a cash worth ₹ 9,750 and will bear a loss of ₹ 250.

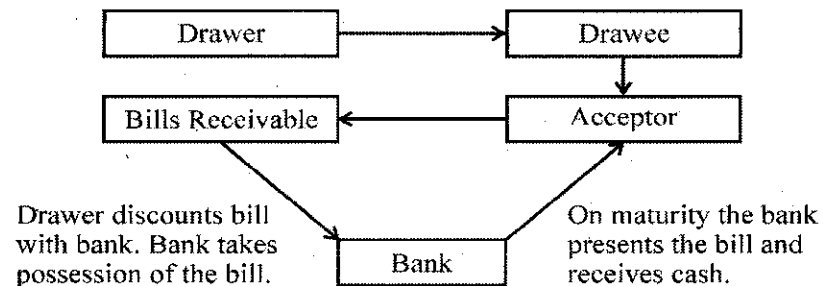


Fig. 6 : Bill Discounting Process

The bank will keep this bill in possession till the due date. On maturity i.e. due date, the bank will present the bill to the acceptor and will receive cash from him if the bill is honoured. In case, the acceptor does not make the payment to the bank, then the drawer who has discounted the bill will have to take this liability and will pay cash to the bank.

Until the bill is honoured on the due date, there is always a chance that the drawer will become liable on the bill. This is called a contingent liability for the drawer- a liability that will only arise, if a certain event occurs - the acceptor does not honour the bill.

Need for Bill Discounting

The buyers and sellers of goods have conflicting objectives. The seller wishes to get paid immediately and the buyer wants a long credit period. Bill discounting is the solution to the problem which creates a win-win situation. The seller gets his money almost instantly on payment of a small charge and is able to satisfy its customers with credit period. The bill discounting is an easy way of getting finance

Conditions of Bill Discounting

1. A bill must be usance bill.
2. It must have been accepted and bears atleast two signatures of reputed individuals or banks or companies etc.
3. The bank will normally discount trade bills only.
4. Where a usance bill is drawn at a fixed period after sight the bill must be accepted to establish the maturity.
5. The discount tenor starts from the date of discount and expires at the maturity of the bill.

'Export bill discounting' is commonly used term in international trade.

When there is an export to an overseas buyer on credit basis, the exporter needs finance immediately on shipment of his goods. He approaches his banker to finance against his exported goods by producing documentary proof of export and avail finance. Export bill discounting is common in International trade.

How does export bill discounting work?

Once the goods move out of the factory, the Customs House Agents appointed by exporter completes customs formalities on behalf of exporter and delivers the necessary customs documents. Once customs formalities completed and shipping bill received, exporter can hand over cargo to shipping carrier to carry his goods to final destination at buyer's place. After handing over cargo to shipping carrier, they issue Bill of Lading under sea

shipments or Airway bill under air shipments. The necessary export documents like Bill of Lading/airway bill, commercial invoice, packing list, certificate of origin, bill of exchange, export order copy are submitted with bank with a request of discounting export bills. Exporter can discount export documents with bank. Bank verifies all documents and arranges to discount export bills and transfer funds to the exporter's account. If the export order is in any foreign currency, he can either convert amount in his currency or he can open a foreign currency account and transfer amount accordingly.

How to repay the amount financed by bank under export bill discounting?

After the bill is discounted by bank against exports, the amount of discounted bills is collected from the buyer as per the agreed terms and conditions of buyer and seller. For example, if exporter extended a credit period of 60 days to buyer, the bank adjusts the amount of bill discounted received from buyer on maturity date on 60th day. The necessary bank interest till the date of receipt of amount from overseas buyer and other bank charges are debited to exporter's account.

TYPES OF BILL DISCOUNTING

Bills discounting is of two types :

1. Purchase bills discounting and
2. Sales bill discounting.

A purchase bill discounting means that the investor discounts the purchase bill of the company and pays the company, who in turn pay their supplier. The investor gets his money back from the company at the end of the discounting period.

A sales bills discounting means the investor discounts the sales bill of the company and pays directly to the company. The investor gets his return from the company at the end of the discounting period.

ADVANTAGES OF BILL DISCOUNTING

1. The first and foremost advantage of bill discounting is that seller get the cash immediately for day to day activities of the business and as you all know that liquidity is to business is what water is for human body, just as without water a human cannot survive for long in the same way without liquidity a business cannot survive for long. For example, if the company has sold goods and received ₹ 5,000 worth of bill of exchange from its creditors and if the company chooses to discount bill then bank will immediately give the amount to the seller and provide instant liquidity to the business after deducting fees.
2. Another benefit of bill discounting as far as banks are concerned is that banks earn commission on the bills discounted and it leads to extra income for the banks and this type of income is less risky as compared to other types of finance/loan given by banks.
3. As far as the seller is concerned there is no need for collateral and hence the assets remain with the business only and there is no additional burden of mortgaging the asset with the bank.

DISADVANTAGES OF BILL DISCOUNTING

1. In the case of bill discounting, bank discounts the bill upfront from the customers leading to extra cost for the holder of the bill is concerned.
2. As far as bank is concerned, it puts an additional burden on the bank as there are chances of creditors not honouring his bills and also incurrance of additional administrative expenses related to bill discounting. Bank receive only small amount of fees from discounting transaction.
3. Another disadvantage of bill discounting is that it is a short term source of finance and complete dependency on this type of finance is not advisable for the business.

Depending on requirements and circumstances, the company may choose to adopt bill discounting route for its financing requirements after considering both advantages as well as disadvantages.

FRAMEWORK

The process of bill discounting can be explained as under;

1. The seller sells the goods on credit and raises invoice on the buyer.
2. The buyer accepts the invoice. By accepting the invoice, the buyer acknowledges payment on due date.
3. Seller approaches the finance company or bank to discount it.
4. The bank verifies the legitimacy of the bill and creditworthiness of the buyer.
5. The bank provides funds to the seller after deducting appropriate discount/ fees as per norms.
6. The seller gets the funds and uses it for business.
7. On the due date of payment, the financial intermediary collects the money from the buyer.

Master circular of RBI addressed to all scheduled commercial banks has given below stated guidelines on Discounting/Rediscounting of Bills by Banks. (For Reference Purpose only)

Banks may adhere to the following guidelines while purchasing/ discounting/ negotiating/ rediscounting of genuine commercial/ trade bills:

- (i) Since banks have already been given freedom to decide their own guidelines for assessing/sanctioning working capital limits of borrowers, they may sanction working capital limits as also bills limit to borrowers after proper appraisal of their credit needs and in accordance with the loan policy as approved by their Board of Directors.
- (ii) Banks should clearly lay down a bills discounting policy approved by their Board of Directors, which should be consistent with their policy of sanctioning of working

capital limits. In this case, the procedure for Board approval should include banks' core operating process from the time the bills are tendered till these are realised. Banks may review their core operating processes and simplify the procedure in respect of bills financing. In order to address the often-cited problem of delay in realisation of bills, banks may take advantage of improved computer/communication networks like the Structured Financial Messaging System (SFMS) and adopt the system of 'value dating' of their clients' accounts.

- (iii) Banks should open letters of credit (LCs) and purchase/discount/negotiate bills under LCs only in respect of genuine commercial and trade transactions of their borrower constituents who have been sanctioned regular credit facilities by the banks. Banks should not, therefore, extend fund-based (including bills financing) or non-fund based facilities like opening of LCs, providing guarantees and acceptances to non-constituent borrower or/and non-constituent member of a consortium/multiple banking arrangement. However, in cases where negotiation of bills drawn under LC is restricted to a particular bank, and the beneficiary of the LC is not a constituent of that bank, the bank concerned may negotiate such an LC, subject to the condition that the proceeds will be remitted to the regular banker of the beneficiary. The prohibition regarding negotiation of unrestricted LCs of non-constituents will continue to be in force. Bank Guarantee (BG)/LC may be issued by scheduled commercial banks to clients of co-operative banks against counter guarantee of the co-operative bank. In such cases, banks may be guided by the provisions of paragraph 2.3.8.2 of the Master Circular. Further, banks must satisfy themselves that the concerned co-operative banks have sound credit appraisal and monitoring systems as well as robust Know Your Customer (KYC) regime. Before issuing BG/LCs to specific constituents of co-operative banks, they must satisfy themselves that KYC has been done properly in these cases.

- (iv) Sometimes, a beneficiary of the LC may want to discount the bills with the LC issuing bank itself. In such cases, banks may discount bills drawn by beneficiary only if the bank has sanctioned regular fund-based credit facilities to the beneficiary. With a view to ensuring that the beneficiary's bank is not deprived of cash flows into its account, the beneficiary should get the bills discounted/negotiated through the bank with whom he is enjoying sanctioned credit facilities.
- (v) Bills purchased/discounted/negotiated under LC (where the payment to the beneficiary is not made 'under reserve') will be treated as an exposure on the LC issuing bank and not on the borrower. All clean negotiations as indicated above will be assigned the risk weight as is normally applicable to inter-bank exposures, for capital adequacy purposes. In the case of negotiations 'under reserve', the exposure should be treated as on the borrower and risk weight assigned accordingly. However, in cases where the bills discounting/purchasing/negotiating bank and LC issuing bank are part of the same bank, i.e. where LC is issued by the Head Office or branch of the same bank, then the exposure should be taken on the third party/ borrower and not on the LC issuing bank.
- (vi) While purchasing/discounting/negotiating bills under LCs or otherwise, banks should establish genuineness of underlying transactions/documents.
- (vii) Banks should ensure that blank LC forms are kept in safe custody as in case of security items like blank cheques, demand drafts etc. and verified/balanced on daily basis. LC forms should be issued to customers under joint signatures of the bank's authorised officials.
- (viii) The practice of drawing bills of exchange clausured 'without recourse' and issuing letters of credit bearing the legend 'without recourse' should be discouraged because such notations deprive the negotiating bank of the right of recourse it has against the drawer under the Negotiable

Instruments Act. Banks should not, therefore, open LCs and purchase/discount/negotiate bills bearing the 'without recourse' clause. On a review it has been decided that banks may negotiate bills drawn under LCs, on 'with recourse' or 'without recourse' basis, as per their discretion and based on their perception about the credit worthiness of the LC issuing bank. However, the restriction on purchase/discount of other bills (the bills drawn otherwise than under LC) on 'without recourse' basis will continue to be in force.

- (ix) Accommodation bills should not be purchased/discounted/negotiated by banks. The underlying trade transactions should be clearly identified and a proper record thereof maintained at the branches conducting the bills business.
- (x) Banks should be circumspect while discounting bills drawn by front finance companies set up by large industrial groups on other group companies.
- (xi) Bills rediscouts should be restricted to usance bills held by other banks. Banks should not rediscount bills earlier discounted by non-bank financial companies (NBFCs) except in respect of bills arising from sale of light commercial vehicles and two/three wheelers.
- (xii) Banks may exercise their commercial judgment in discounting of bills of the services sector. However, while discounting such bills, banks should ensure that actual services are rendered and accommodation bills are not discounted. Services sector bills should not be eligible for rediscounting. Further, providing finance against discounting of services sector bills may be treated as unsecured advance and, therefore, should be within the norm prescribed by the Board of the bank for unsecured exposure limit.
- (xiii) In order to promote payment discipline which would, to a certain extent, encourage acceptance of bills, all corporates

and other constituent borrowers having turnover above threshold level as fixed by the bank's Board of Directors should be mandated to disclose 'aging schedule' of their overdue payables in their periodical returns submitted to banks.

- (xiv) Banks should not enter into Repo transactions using bills discounted/rediscounted as collateral.

BILL MARKET SCHEMES

Introduction

The RBI introduced a new bill market scheme in November 1970 with the object of developing a genuine bill market in India. It has been modified since then from time to time. As per the new bill market scheme, the bills covered under the scheme must be genuine trade bills, i.e. bills which evidence sale and/or dispatch of goods and rediscounting of these bills by the RBI which is called 'Bills Rediscounting Scheme'.

Features

The main features of the New Bill Market Scheme are as follows.

- (i) All licensed scheduled commercial banks including the public sector banks will be eligible to offer bills of exchange to the Reserve Bank for rediscounting.
- (ii) The bills covered under the scheme must be genuine trade bills relating to the sale or dispatch of goods.
- (iii) The Reserve Bank rediscouts these bills. That is why the scheme is also called 'Bills Rediscounting Scheme'. The rediscounting facility should be available at the Reserve Bank's offices at Mumbai, Kolkatta, Chennai and New Delhi. To avoid rediscounting of large number of small bills, such bills should be given in bunches.

- (iv) The bill should be drawn on and accepted by the purchaser's bank. If the purchaser's bank is not a licensed scheduled bank, the bill should, in addition, bear the signatures of a licensed scheduled bank.
- (v) The bills should have maximum of 90 days.
- (vi) The bills should bear at least two good signatures.
- (vii) According to the modification of the scheme in 1971, the bills of exchange relating to the sale of goods to government departments and quasi government bodies as well as to statutory corporations have also been covered by the scheme.

Advantages

The advantages of a genuine bill market to the banking system are stated below.

1. Normally, bills are self-liquidating and the date of repayment of a bank's advances by way of the discounting/rediscounting of bills is definite. In contrast, cash-credit is not self-liquidating.
2. Bills offer greater liquidity to their holders as they can be shifted to others in the market in case of need for cash.
3. A well-developed bill market helps greatly in evening out liquidity throughout the financial system, as those with short-term surplus funds of whatever duration can invest them in bills of desired maturities and can always hope to unload their holdings of bills to others in the market whenever they need cash. Thus, the short-term surpluses of some become available through the market to meet the short-run deficits of others.
4. The commercial bill rate is higher than the Treasury bill rate. Therefore, commercial banks and other financial institutions with short-run surpluses to invest find bills attractive not only for their liquidity but also for their return.
5. To the borrower, the cost of bill finance is lower than that of cash credit, because the bills carry the additional security in the form of acceptor's signature, are time-bound.

Extensive use of bills as an instrument of short-term commercial credit and rediscounting of bills by the RBI makes the monetary system highly elastic. Whenever the economy is in need of more cash, banks can get a part of the bills in their portfolios rediscounted with the RBI and thereby increase the supply of money. The bill discounting process helps to meet the enhanced needs of busy-season finance.

Bankers discounted bills without scrutiny

The Enforcement Directorate (ED) attached properties worth ₹ 14.5 crore of Gujarat-based textile export firm ABC Cotspin Pvt. Ltd. in May 2018 for defrauding two banks of ₹ 804.49 crore by availing bill discount facilities in 2014-15 against Letters of Credit (LCs). The firm ABC Cotspin and its directors were accused of fraud against the banks by availing bill discounting facilities from the branches of SBI and BOB against LCs. During 2014-15, the director, without making any genuine export, got prepared and signed the export documents like commercial invoice, certificate of origin, certificate of quality, certificate of quantity, phytosanitary certificate, packing list, bills of exchange, request letter to bank for discounting the bills. He also got prepared bills of lading by shipping agents like Seamax Logistics, Far Sailing Shipping Company and United Container Lines, and presented those to SBI and BOB. The bank officials of SBI and BOB discounted the export bills without proper scrutiny, without ensuring that the shipping bills were issued by the customs authorities, which is mandatory. The bank officials also discounted export bills on the basis of LCs issued by Industrial and Commercial Bank of China, which was restricted.

FACTORING V/S BILL DISCOUNTING IN RECEIVABLE MANAGEMENT

As both factoring and bill discounting are sources of short term finance which are offered by banks and financial institutions, knowing the difference between factoring and bill discounting is helpful in receivable management. Factoring and bill discounting

offer sellers, the facility to collect their receivables faster without blocking capital. Since the use of factoring and bill discounting help to improve cash flow, these sources of short-term finance are quite popular among traders and are useful in international trade as well. Despite their similarities, there are a number of subtle differences between factoring and bill discounting.

FACTORING	BILL DISCOUNTING
<p>1. Definition: Factoring receivables is a source of short term finance in which the trader sells their unpaid invoices to factoring companies such as banks and financial institutions at a discounted rate. Then these factoring companies immediately pay the value of their invoices minus a fee to the trader.</p>	<p>Bill discounting is a source of short term finance in which the seller of goods draws up a bill of exchange on the buyer of the goods and then discounts the said bill of exchange with a bank or financial company.</p>
<p>2. Funding Arrangement: The factor gives maximum part of the amount as advance when the transaction takes place and the remaining amount at the time of settlement.</p>	<p>The entire bill is discounted and paid, when the transaction takes place.</p>
<p>3. Parties: There are three parties involved in factoring viz, Factor, Debtor and Client.</p>	<p>The parties involved in bill discounting arrangement are Drawer, Drawee and Payee.</p>
<p>4. Control of Sales Ledger: In factoring, the bank giving credit takes the onus of checking on the sales ledger, control of credit and chasing the seller's clients for paying back. The work of collection and follow up is outsourced to the bank.</p>	<p>Whereas bill discounting requires seller's own accounts team to take care of the sales invoice and follow-ups.</p>

<p>5. Size of Business: Factoring is useful for larger businesses where an entire line-up of client credits have to be managed.</p>	<p>Bill discounting might be useful for small businesses. Also, bills might not be available on a continual basis for discounting.</p>
<p>6. Type: Factoring can be of two types recourse and non-recourse.</p>	<p>In bill discounting is under recourse only.</p>
<p>7. Company Involvement: Taking factor services allows the seller to focus on his business and the factor who is an expert in this field can provide a line of credit to him along with collection services.</p>	<p>Bill Discounting requires the seller's team to be involved in the entire process of recovery.</p>
<p>8. Governing Statute: Factoring is not governed by any specific Act.</p>	<p>Bill Discounting is governed by the Negotiable Instruments Act.</p>
<p>9. Compensation to Bank or Financier: In factoring bank or financier, charges commission along with interest.</p>	<p>The bank receives discounting charges for bill discounting.</p>

REVIEW QUESTIONS

1. Define financial services. What are the types of financial services.
2. What is the importance of financial services market?
3. Describe objectives of financial service market.
4. State the characteristics of financial service market in brief.
5. Explain important aspects of Financial Service Market.
6. Explain in brief the Financial Service Market Constituents.
7. What are the problems in Financial Services Sector?
8. Distinguish between Banking and Non-Banking Companies.
9. Explain in brief the regulatory framework of NBFC.
10. Describe the types of factoring in detail.
11. What are the parties involved in factoring arrangement?
12. Describe functions of a factor.
13. Explain features of Recourse and Non-Recourse Factoring.

14. Explain features of Advance and Maturity Factoring.
15. Describe advantages and disadvantage of factoring.
16. Distinguish between factoring and forfaiting.
17. Explain meaning and working of forfaiting.
18. State merits and demerits of forfaiting.
19. Explain Bill Discounting and its features.
20. List down advantages and disadvantages of Bill Discounting.
21. Explain Bill Market schemes with their advantages.
22. Explain the process of Bill Discounting.
23. What are the features of Bill Market schemes.
24. Distinguish between Factoring and Bill Discounting.
25. Write short notes on :
 - (i) Definition and types of financial services
 - (ii) Importance of financial services
 - (iii) Objectives/ Functions of financial service market
 - (iv) Characteristics of financial service market
 - (v) Financial Service Market
 - (vi) Financial Service Market Constituents
 - (vii) Growth of Financial Services in India
 - (viii) Problems in Financial Services Sector
 - (ix) Banking v/s Non-Banking Finance Companies (NBFC)
 - (x) Regulatory Framework
 - (xi) Factoring
 - (xii) Forfaiting
 - (xiii) Types of Factoring
 - (xiv) Parties to factoring arrangement
 - (xv) Functions of factor
 - (xi) Advantages of factoring
 - (xvii) Disadvantages of factoring
 - (xviii) Factoring in India
 - (xix) Factoring v/s Forfaiting
 - (xx) Working of forfaiting
 - (xxi) Advantages of forfaiting
 - (xxii) Drawbacks of forfaiting
 - (xxiii) Domestic and Export Factoring
 - (xxiv) Advance and Maturity Factoring
 - (xxv) Recourse Factoring
 - (xxvi) Non-Recourse Factoring
 - (xxvii) Bill Discounting

- (xxviii) Advantages and disadvantages of Bill Discounting
- (xxix) Features of Bill Discounting
- (xxx) Conditions of Bill Discounting
- (xxxi) Bill Market Schemes
- (xxxii) Factoring v/s Bill Discounting
- (xxxiii) Advantages of Bill Market Schemes
- (xxxiv) Features of Bill Market Schemes

OBJECTIVE QUESTIONS

- A. Select the appropriate options and rewrite the following sentences;**
1. The bills should have maximum of _____ days.

(a) 90	(b) 180
(c) 30	(d) 120
 2. Bill Discounting is governed by the _____.

(a) Negotiable Instruments Act	(b) The Contract Act
(c) Sale of Goods Act	(d) None of the above
 3. The _____ introduced a new bill market scheme in November 1970.

(a) SEBI	(b) SBI
(c) RBI	(d) None of the above
 4. In the _____ factoring, the factor does not make any advance payment to the client.

(a) Maturity	(b) Advance
(c) Both (a) & (b)	(d) None of (a) & (b)
 5. 100% finance is provided in _____.

(a) Factoring	(b) Forfaiting
(c) Both (a) & (b)	(d) None of (a) & (b)
 6. _____ may be for financing a series of sales involving bulk trading.

(a) Factoring	(b) Forfaiting
(c) Both (a) & (b)	(d) None of (a) & (b)
 7. A _____ is defined as, "any person who is engaged in the business of issue management".

(a) factor	(b) manager
(c) merchant banker	(d) insurer
 8. Financial Services are _____.

(a) intangible	(b) inseparable
(c) variable	(d) all of the above

9. _____ market facilitates the trading of foreign exchange.
- (a) Capital Market (b) Money Market
(c) Commodity Market (d) Forex Market

Ans.: (1) - (a), (2) - (a), (3) - (c), (4) - (a), (5) - (b), (6) - (a), (7) - (c), (8) - (d), (9) - (d)

B. Fill in the blanks:

- _____ refers to capital which is available for financing the new business ventures.
- _____ is an apex housing finance institution in the country.
- _____ is defined as a process of transformation of illiquid asset into security which may be traded later in the market.
- _____ are in charge of the issue process.
- _____ is a fund based financial service which provides resources to finance receivables as well as facilitates the collection of receivables.
- _____ factoring provides the entire spectrum of services such as collection, credit protection, sales-ledger administration and short term finance.
- The name of the factor is not disclosed in the _____ factoring although the factor maintains the sales ledger of the supplier.
- _____ is only financing of foreign trade.
- _____ requires letter of credit.

Ans.: (1) Venture capital (2) National Housing Bank (3) Securitisation (4) Merchant bankers (5) Factoring (6) Full (7) undisclosed (8) Forfaiting (9) Forfaiting

C. Match the following :

Column A	Column B
1. Bill Discounting	(a) Under recourse or no recourse
2. Factoring	(b) Booming capital market
3. Opportunity	(c) Non-fund based service
4. Threat	(d) Fund based service
5. Securitisation	(e) Under recourse
6. Underwriting	(f) Financial scams

Ans.: (1) - (e), (2) - (a), (3) - (b), (4) - (f), (5) - (c), (6) - (d)

D. State whether true or false :

- Under hire-purchase the buyer gets ownership only after the payment of the last instalment.
- The non-fund based services are called asset based services.

- The fund based services are also known as fee based services.
 - Discounting of bill is an attractive non-fund based financial service provided by the finance companies.
 - The person whose risk is insured is called insured in an Insurance contract.
 - Demand deposits cannot be accepted by NBFCs.
 - In case of recourse factoring, credit Risk is with the client.
 - The name of the factor is not disclosed in the undisclosed factoring although the factor maintains the sales ledger of the supplier.
 - Cross-border Factoring is similar to domestic factoring except that there are five parties.
 - Factoring is a costly method of financing as the cash price of the accounts receivables is discounted by the factor company.
 - Factoring transaction is a transaction of loan and not a sale.
 - Forfaiting is not available for deferred payments especially while exporting capital goods for which payment will be made on a deferred basis by the importer.
 - Forfaiting does not provide scope for discounting the bill in the secondary market due to 100% finance.
 - The bills covered under the scheme must be genuine trade bills relating to the sale or dispatch of goods.
 - In bill discounting, a bank earns a discount / fee from a seller to release funds before the credit period ends.
 - The bills or invoices under bill discounting are legally different from the 'bill of exchange'.
 - The bank will keep this bill in possession till the due date.
 - The buyers and sellers of goods have conflicting objectives.
 - Bill discounting is a contingent liability for the drawee.
 - A bill must not be usance bill.
 - There is no additional burden of mortgaging the asset with the bank under Bill Discounting.
 - Bill discounting improves liquidity of the business.
 - Bill Discounting is a short term source of finance.
 - Bill discounting might be useful for small businesses
 - In factoring bank or financier, charges commission along with interest.
 - Bill Discounting is not governed by the Negotiable Instruments Act.
 - Factoring can be of two types recourse and non-recourse.
 - The commercial bill rate is higher than the Treasury bill rate.
- Ans.: True : 1, 5, 6, 7, 8, 10, 12, 14, 15, 17, 18, 21, 22, 23, 24, 25, 27, 28;
False : 2, 3, 4, 9, 11, 13, 16, 19, 20, 26

2

ISSUE MANAGEMENT AND SECURITISATION

Issue Management and Intermediaries

- *Introduction*
- *Merchant Banker/Lead Managers*
- *Underwriters*
- *Bankers to an issue*
- *Brokers to an issue*

Stock Broking

- *Introduction*
- *Stock Brokers, Sub Brokers, Foreign Brokers*
- *Trading and Clearing/ Self Clearing Members*
- *Stock Trading (Cash and Normal)*
- *Derivative Trading*

Securitisation

- *Definition*
- *Securitisation v/s Factoring*
- *Features of Securitisation*
- *Pass Through Certificates*
- *Securitisation Mechanism*
- *Special Purpose Vehicle*

- *Securitisable Assets*
- *Benefits of Securitisation*
- *New Guidelines on Securitisation*

ISSUE MANAGEMENT AND INTERMEDIARIES

INTRODUCTION

The securities markets in India have a long history. The Bombay Stock Exchange is the oldest stock exchange which commenced its operations in 1875. Prior to independence, the securities market was unregulated. Thus, the new issues in the market was regulated by the Controller of Capital Issues (CCI) as per the provisions of the Capital Issues (Control) Act, 1947. However, the Act was repealed and the office of the CCI was abolished in 1992.

There was a need felt for setting up a regulatory body to ensure investor protection and for the promotion of securities market. The Securities and Exchange Board of India (SEBI) was constituted on 12th April, 1988 and established as a statutory body on 21st February, 1992. Regulation of Indian securities market required SEBI to simultaneously perform both disciplinary and developmental roles. The disciplinary dimension involves providing for disincentives and penalties for unfair practices. The development dimension is a positive aspect that involves providing incentives to market participants to engage in a constructive role.

Intermediaries are indispensable in capital market. They play a pivotal role in today's capital market. While some trade dealings may involve only a single intermediary entity, more complex transactions requires several intermediaries at different levels.

MERCHANT BANKERS / LEAD MANAGERS

Who are the Merchant Bankers?

Merchant bankers provide advice to entrepreneurs right from the stage of conception of the project till the commencement of production. Merchant bankers are in charge of the issue process. They act as intermediaries between the company and the investors. They are also responsible for preparing the prospectus and marketing the issue.

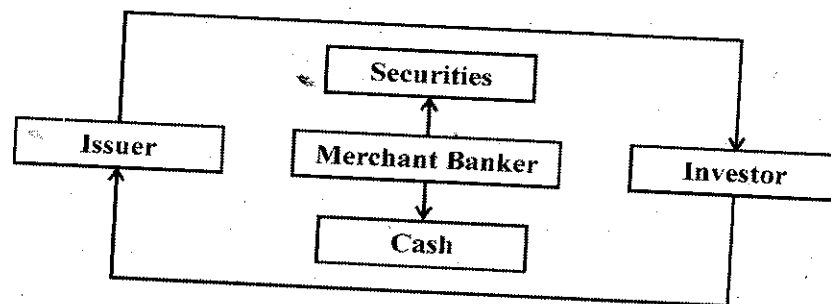


Fig. 1 : Role of Merchant Banker

Definitions of Merchant Banker

As per SEBI, a merchant banker refers to, "Any person who is engaged in the business of issue management either by making arrangement regarding buying, selling or subscribing to securities or acting as manager, consultant or rendering corporate advisory services in relation to such issue management".

Thus merchant bankers are the persons who are engaged in the business of issue management. Issue means an offer for sale of securities by any body corporate to public. It is mandatory that all public issues should be managed by merchant bankers functioning as the lead managers.

Registration

Merchant bankers require compulsory registration with the SEBI to carry out their activities.

Categories of Merchant Bankers

There are four categories of merchant bankers.

Category I : Merchant Bankers in this category, can carry on activities related to issue management i.e. preparation of prospectus, determining financial structure, tie-up of financiers, final allotment of securities, refund of subscription etc. They could also act as advisors, consultants, managers, underwriters or portfolio managers.

Category II : Merchant Bankers can act as advisors, consultants, co-managers, underwriters and portfolio managers.

Category III : Merchant Bankers can act as underwriters, advisors and consultants to an issue.

Category IV : Merchant Bankers can act only as advisor or consultant to an issue.

Only category I Merchant Bankers can act as lead managers to an issue. Category I Merchant Bankers are registered by the SEBI.

Services Provided by Merchant Bankers

The Merchant Banker plays a vital role in channelizing the financial surplus of the society into productive investment avenues. The Merchant Banker has a fiduciary role in relation to the investors. He has to ensure that only quality issues are published by the firm. He is required to exercise due diligence to ensure the adequacy and appropriateness of the disclosures made in the offer document. The Merchant Banker is the leader among all the intermediaries associated with the issue. He is required to guide and co-ordinate the activities of the Registrar to the issue, Bankers to the issue, Underwriters, Brokers, etc.

The Merchant Banker has to ensure the compliance of all the laws and regulations governing the securities market.

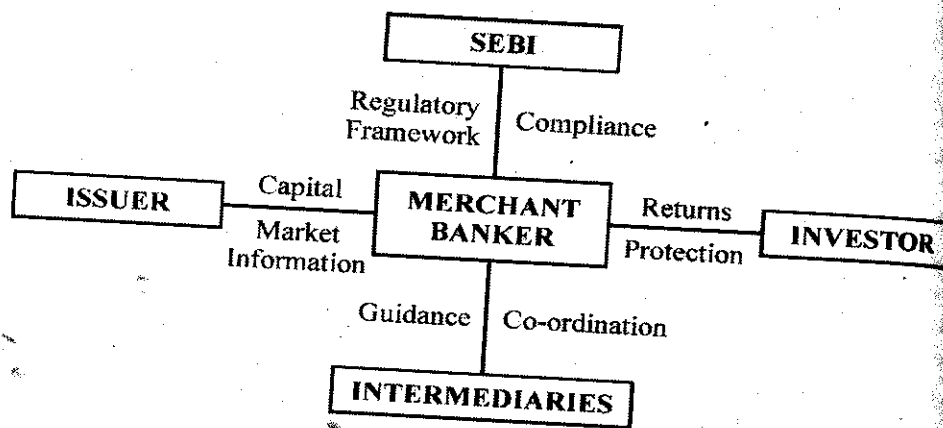


Fig. 2 : Scope of Merchant Banking

The services provided by Merchant Bankers are as follows :

- Raising finance:** Merchant Bankers help their clients in raising finance by way of issue of a debenture, shares, bank loans, etc. They tap both the domestic as well as the international markets. Finance raised by this method may be used for commencing a new project or business or it may even be used for expansion and modernization of an existing business.
- Management of public offer:** This is traditional operation for the most Merchant Bankers in India. He has to assist his corporate clients in raising funds from the market. He may also be required to advise the client on various matters that affect their finances.

The main area of his role includes:

- Designing of instrument
- Pricing the issue
- Registration of offer document
- Underwriting
- Marketing of the issue

- Allotment and refund
- Listing on stock exchanges

Placement and distribution: The distribution network of a Merchant Banker can be classified as institutional and retail. The network of institutional investors consist of Mutual Funds, Foreign Institutional Investors, banks etc. The size of this network represents the wholesale reach of the Merchant Banker. A good quality research report would help Merchant Banker to justify the investment recommendation. The retail distribution depends upon the networking with the investors.

- Corporate advisory services:** Merchant Bankers provide customized solutions to the financial problems of their clients. One of the key areas for advisory role is financial restructuring. Another area of advise is rehabilitation and turnaround management.
- Project advisory:** Merchant Bankers are sometimes associated with their clients from the early stage of their project. Merchant Bankers provide inputs to their clients in preparation of the detailed project report.
- Loan syndication:** Merchant Bankers arrange to tie up loans for their clients. The Merchant Banker also helps the client in documentation procedures.
- Advise on modernisation and expansion:** Merchant bankers advise on amalgamations, mergers, acquisitions, takeovers, foreign collaborations, diversification of business, technology up-gradation, joint-ventures, etc.
- Special assistance to entrepreneurs and small companies:** Merchant banker advises entrepreneurs and small companies on availability and existence of business opportunities, concessions, incentives and government policies and helps them to take advantage of this option available to them, to the best of their capabilities.
- Revival of sick units:** A merchant bank helps in reviving sick industrial units. They negotiate with various agencies such as

banks, long-term lending institutions, and the Board for Industrial and Financial Reconstruction (BIFR). They also plan and execute full revival packages.

10. **Servicing issues:** Merchant bankers now also act as the paying agents for service of the debt- securities and act as the registrars as well as the transfer agents. In this way, they maintain the registers of the shareholders and the debenture holders and also arrange the payment of dividend and or the interest that is due to them.
11. **Other services:** Along with all the services mentioned above, the merchant bankers also offer certain other specialized services such as advisory services on matters such as mergers, amalgamations, tax related matters, on the matter of recruitment of executives, the cost of audit as well as its management among several others. The scope of functions, activities and the services provided by the merchant bankers are ever increasing and growing with the constant development in the money market.

Obligations and Responsibilities of Merchant Bankers as per SEBI

Some of the obligations of Merchant Bankers are listed below;

1. A merchant banker shall make all efforts to protect the interests of investors.
2. A merchant banker shall maintain high standards of integrity, dignity and fairness in the conduct of its business.
3. A merchant banker shall fulfil its obligations in a prompt, ethical, and professional manner.
4. A merchant banker shall at all times exercise due diligence, ensure proper care and exercise independent professional judgment.
5. A merchant banker shall endeavour to ensure that - (a) inquiries from investors are adequately dealt with; (b) grievances of investors are redressed in a timely and appropriate manner; (c)

where a complaint is not remedied promptly, the investor is advised of any further steps which may be available to the investor under the regulatory system.

6. A merchant banker shall ensure that adequate disclosures are made to the investors in a timely manner in accordance with the applicable regulations and guidelines so as to enable them to make a balanced and informed decision.
7. A merchant banker shall attempt to ensure that the investors are provided with true and adequate information without making any misleading or exaggerated claims or any misrepresentation and are made aware of the attendant risks before taking any investment decision.
8. A merchant banker shall endeavour to ensure that copies of the prospectus, offer document, letter of offer or any other related literature is made available to the investors at the time of issue or the offer.
9. A merchant banker shall not discriminate amongst its clients, save and except on ethical and commercial considerations.
10. A merchant banker shall not make any statement, either oral or written, which would misrepresent the services that the merchant banker is capable of performing for any client or has rendered to any client.
11. A merchant banker shall avoid conflict of interest and make adequate disclosure of its interest.
12. A merchant banker shall put in place a mechanism to resolve any conflict of interest situation that may arise in the conduct of its business or where any conflict of interest arises, shall take reasonable steps to resolve the same in an equitable manner.
13. A merchant banker shall make appropriate disclosure to the client of its possible source or potential areas of conflict of duties and interest while acting as merchant banker which would impair its ability to render fair, objective and unbiased services.
14. A merchant banker shall always endeavour to render the best possible advice to the clients having regard to their needs.

15. A merchant banker shall not divulge to anybody either orally or in writing, directly or indirectly, any confidential information about its clients which has come to its knowledge, without taking prior permission of its clients, except where such disclosures are required to be made in compliance with any law for the time being in force.
16. A merchant banker shall ensure that any change in registration status/any penal action taken by the Board or any material change in the merchant banker's financial status, which may adversely affect the interests of clients/investors is promptly informed to the clients and any business remaining outstanding is transferred to another registered intermediary in accordance with any instructions of the affected clients.
17. A merchant banker shall not indulge in any unfair competition, such as weaning away the clients on assurance of higher premium or advantageous offer price or which is likely to harm the interests of other merchant bankers or investors or is likely to place such other merchant bankers in a disadvantageous position while competing for or executing any assignment.
18. A merchant banker shall maintain arms length relationship between its merchant banking activity and any other activity.
19. A merchant banker shall have internal control procedures and financial and operational capabilities which can be reasonably expected to protect its operations, its clients, investors and other registered entities from financial loss arising from theft, fraud, and other dishonest acts, professional misconduct or omissions.
20. A merchant banker shall not make untrue statement or suppress any material fact in any documents, reports or information furnished to the Board.
21. A merchant banker shall maintain an appropriate level of knowledge and competence and abide by the provisions of the Act, regulations made thereunder, circulars and guidelines, which may be applicable and relevant to the activities carried on by it. The merchant banker shall also comply with the award of the Ombudsman passed under the Securities and Exchange Board of India (Ombudsman) Regulations, 2003.

22. A merchant banker shall ensure that the Board is promptly informed about any action, legal proceedings, etc., initiated against it in respect of material breach or noncompliance by it, of any law, rules, regulations, directions of the Board or of any other regulatory body.
23. (a) A merchant banker or any of its employees shall not render, directly or indirectly, any investment advice about any security in any publicly accessible media, whether real-time or non-real-time, unless a disclosure of his interest including a long or short position, in the said security has been made, while rendering such advice.
 - (b) In the event of an employee of the merchant banker rendering such advice, the merchant banker shall ensure that such employee shall also disclose the interests, if any, of himself, his dependent family members and the employer merchant banker, including their long or short position in the said security, while rendering such advice.
24. A merchant banker shall demarcate the responsibilities of the various intermediaries appointed by it clearly so as to avoid any conflict or confusion in their job description.
25. A merchant banker shall provide adequate freedom and powers to its compliance officer for the effective discharge of the compliance officer's duties.
26. A merchant banker shall develop its own internal code of conduct for governing its internal operations and laying down its standards of appropriate conduct for its employees and officers in carrying out their duties. Such a code may extend to the maintenance of professional excellence and standards, integrity, confidentiality, objectivity, avoidance or resolution of conflict of interests, disclosure of shareholdings and interests, etc.
27. A merchant banker shall ensure that good corporate policies and corporate governance are in place.
28. A merchant banker shall ensure that any person it employs or appoints to conduct business is fit and proper and otherwise

qualified to act in the capacity so employed or appointed (including having relevant professional training or experience).

Every lead manager has to enter into an agreement with the issuing companies to determine their mutual rights, liabilities and obligations relating to such issues.

A Merchant Banker should not lead manage an issue if he is a promoter/director/associate of the issuer. However, he may be appointed if he is involved only in the marketing of the issue.

A Merchant Banker is prohibited from acquiring securities of any company on the basis of unpublished price sensitive information obtained during the course of any professional assignment.

UNDERWRITER

Definition

Underwriting can be defined as "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" In other words, the underwriter agrees to subscribe a specified number of securities in an issue, in the event of non-subscription of the same. Thus, underwriting is in the nature of contingency planning in issue management.

Meaning

An underwriter is a person who engages in the business of underwriting the public issue of securities of a particular company. They agree to take up securities which are not fully subscribed. They make a commitment to get the issue subscribed either by others or by themselves. Underwriting an issue is optional and not mandatory. Underwriters are appointed by the issuing companies in consultation with the lead managers/merchant bankers to the issues. A statement

to the effect that in the opinion of the lead manager, the underwriter's assets are adequate to meet their obligation should be incorporated in the prospectus.

The underwriters are exposed to the risk of under subscription and for assuming the risk they are remunerated by paying underwriting commission.

Certificate of registration from the SEBI is mandatory for acting as an underwriter. While granting the certificate of registration, the SEBI considers whether the necessary infrastructure like adequate office space and manpower are available, past experience in underwriting and capital adequacy requirements.

Importance Of Underwriter

Underwriting has become very important in recent years with the growth of the corporate sector. It provides several benefits to a company :

- It relieves the company of the risk and uncertainty of marketing the securities.
- Underwriters have a specialised knowledge of the capital market. They offer valuable advice to the issuing company in the preparation of the prospectus, time of floatation and the price of securities, etc. They also provide publicity service to the companies which have entered into underwriting agreements with them.
- It helps in financing of new enterprises and in the expansion of the existing projects.
- It builds up investors' confidence in the issue of securities. The association of well-known underwriters lends prestige to the company and the investors feel that the issue is sound enough for profitable investment.
- The issuing company is assured of the availability of funds. Important projects are not delayed for want of funds.

- It facilitates the geographical dispersal of securities because generally, the underwriters maintain contacts with investors **throughout the country.**

Classification of Underwriters

Underwriters in India may be classified into:

- Institutional Underwriters
- Non-institutional Underwriters

A: Institutional Underwriters

The following are the Institutional Underwriters:

- Development Banks
- Commercial Banks
- Insurance Companies
- State Finance Corporations

The Development Banks are also known as Industrial Banks. They have got long term deposits and are in a position to enter into long term investments. The Industrial banks help the companies by underwriting their shares and debentures. When an Industrial Unit approaches for underwriting the shares and for direct financial aid, the industrial banks investigate the prospects of the industry, the soundness of the financial requirements, the feasibilities and the utilities of the schemes. If the shares and debentures are not fully subscribed or the minimum subscription is not taken up by the public within a specified period, the Development Banks come to the rescue and take up the residual amount of shares and debentures.

The Commercial Banks also carry out underwriting.

The insurance companies are also involved in underwriting business.

The State Financial Corporations are also involved in underwriting business for stimulating the capital market.

B. Non-Institutional Underwriters

There are two types of non-institutional underwriters in India:

- Stock brokers
- Individuals

The Stock brokers act as intermediaries in the purchase and sale of securities in the primary and secondary markets. They rapidly supply application forms or even go to the extent of collecting money from the investors. They play a very crucial role in the area of underwriting.

The Individuals/Investment Companies obtain funds from a large number of investors by selling the shares. They do act as underwriters.

General Obligations and Responsibilities of Underwriters

1. An underwriter should make all efforts to protect the interests of its clients.
2. Maintain high standards of integrity, dignity and fairness in conduct of its business.
3. Ensure ethical act while dealing with issuer.
4. Ensure prompt and efficient dealing with issuer.
5. Render high standards of service and exercise due diligence.
6. An underwriter should not make misrepresentative statements.
7. Avoid conflict of interest and make adequate disclosure.
8. Resolve conflict of interest.
9. Maintain an appropriate level of knowledge and competency.
10. Not make any untrue statement.

11. Maintain an appropriate level of knowledge and competency and abide by the provisions of the SEBI Act.
12. Not indulge in any unfair competition which is harmful to other underwriters.
13. Develop its own internal code of conduct for governing its internal operations.

Every underwriter has to enter into an agreement with the issuing company. The agreement provides for

- the period during which the agreement is in force,
- allocation of duties and responsibilities between the underwriter and the client,
- the amount of underwriting obligations,
- the period within which the underwriter has to subscribe to the issue after being intimated,
- the amount of commission/brokerage etc.

General Responsibilities

An underwriter cannot derive any direct or indirect benefit from underwriting the issue other than by the underwriting commission. The maximum obligation under all underwriting agreements of an underwriter cannot exceed twenty times his net worth. Underwriters have to subscribe for securities under the agreement within 45 days of the receipt of intimation from the issuers.

BANKERS TO AN ISSUE

Introduction

This was one capital market activity which lacked regulatory clarity for a long time. The ambiguity arose because it was unclear as to whether RBI regulated public issue banking or SEBI. As a

consequence, investors suffered from several irregularities involving refund orders, acceptance of late applications after the closure of the issue, etc. The situation was set right, with the notification of SEBI (Bankers to an Issue) Rules, 1994, by bringing issue banking under the regulatory ambit of SEBI.

The Bankers to an Issue are engaged in activities related to an acceptance of applications along with application money from the investors in respect of issues of capital and refund of application money.

Bankers to the issue collect the application forms and the money in cash, cheque or ASBA (Applications Supported by Blocked Amount). Depending on the size of the issue there may be many collection centers and many bankers. They are appointed in consultation with lead manager. Infrastructure facilities available, manpower, past experience, location of branches, efficiency and cost effectiveness etc. are the factors considered for selection of bankers to the issue.

The Lead Merchant Banker shall ensure that Bankers to the Issue are appointed in all the mandatory collection centers. The Lead manager also ensures follow-up with bankers to the issue to get quick estimates of collection and advising the issuer about closure of the issue, based on the actual figures.

Application Supported By Blocked Amount (ASBA)

This is a new mode of payment for applying for a public issue. ASBA is an application containing an authorization to block the application money in the bank account, for subscribing to an issue. If an investor is applying through ASBA, his application money shall be debited from the bank account only if his/her application is selected for allotment after the basis of allotment is finalized. Under ASBA facility, investors can apply in any public issues by using their bank account. Investor submits the ASBA form to their banking branch by giving an instruction to block the amount in their account. Self-Certified Syndicate Bank (SCSB) is a Banker to an Issue registered under SEBI (Bankers to an Issue) Regulations, 1994 which offers the service of ASBA. The banker to the issue will transfer all the applications received

to the registrar to the issue on the closure of issue subscription. They also help the issuer in marketing the issue by distributing the application forms and publication materials.

The new circular of the SEBI is applicable for all public issues opening on or after January 1, 2016. The facility allows the bid amount to remain in the applicants account till the time the shares are finally allotted.

Definition

As per SEBI, "Banker to an issue" means a scheduled bank carrying on all or any of the following activities, namely:-

- (i) acceptance of application and application monies;
- (ii) acceptance of allotment or call monies;
- (iii) refund of application monies;
- (iv) payment of dividend or interest warrants.

Registration

To carry on activity as a banker, a person must obtain a certificate of initial as well as permanent registration from the SEBI. The SEBI grants registration on the basis of following requirements;

- (i) the applicant has the necessary infrastructure, communication and data processing facilities and manpower to effectively discharge his activities;
- (ii) the applicant or any director of the applicant is not involved in any litigation connected with securities market;
- (iii) the applicant is a scheduled bank;
- (iv) grant of a certificate is in the interest of the investors and;
- (v) the applicant is a fit and proper person.

A banker to an issue is required to maintain books of accounts for a minimum period of three years.

Every bankers to an issue enters into an agreement with the issuing company.

Code of Conduct For Bankers To An Issue

1. A banker to an issue shall make all efforts to protect the interests of investors.
2. A banker to an issue shall in the conduct of its business, observe high standards of integrity and fairness in the conduct of its business.
3. A banker to an issue shall fulfil its obligations in a prompt, ethical and professional manner.
4. A banker to an issue shall at all times exercise due diligence, ensure proper care and exercise independent professional judgment.
5. A banker to an issue shall not at any time act in collusion with other intermediaries or the issuer in a manner that is detrimental to the investor.
6. A banker to an issue shall endeavour to ensure that - (a) inquiries from investors are adequately dealt with; (b) grievances of investors are redressed in a timely and appropriate manner; (c) where a complaint is not remedied promptly, the investor is advised of any further steps which may be available to the investor under the regulatory system.
7. A banker to an issue shall not - (a) allow blank application forms bearing brokers stamp to be kept at the bank premises or peddled anywhere near the entrance of the premises; (b) accept applications after office hours or after the date of closure of the issue or on bank holidays; (c) after the closure of the public issue accept any instruments such as cheques/ demand drafts/ stock invests from any other source other than the designated Registrar to the Issue; (d) part with the issue proceeds until

BROKERS TO AN ISSUE

listing permission is granted by the stock exchange to the body corporate; (e) delay in issuing the final certificate pertaining to the collection figures to the Registrar to the Issue, the lead manager and the body corporate and such figures should be submitted within seven working days from the issue closure date.

8. A banker to an issue shall be prompt in disbursing dividends, interests, or any such accrual income received or collected by him on behalf of his clients.
9. A banker to an issue shall not make any exaggerated statement, whether oral or written to the client, either about its qualification or capability to render certain services or its achievements in regard to services rendered to other clients.
10. A banker to an issue shall always endeavour to render the best possible advice to the clients having regard to the clients' needs and the environments and his own professional skill.
11. A banker to an issue shall not divulge to anybody either orally or in writing, directly or indirectly, any confidential information about its clients which has come to its knowledge, without taking prior permission of its clients except where such disclosures are required to be made in compliance with any law for the time being in force.
12. A banker to an issue shall avoid conflict of interest and make adequate disclosure of his interest.
13. A banker to an issue shall put in place a mechanism to resolve any conflict of interest situation that may arise in the conduct of its business or where any conflict of interest arises, shall take reasonable steps to resolve the same in an equitable manner.
14. A banker to an issue shall not indulge in any unfair competition, which is likely to harm the interests of other bankers to an issue or investors or is likely to place such other bankers to an issue in a disadvantageous position while competing for or executing any assignment.
15. A banker to an issue shall not discriminate amongst its clients, save and except on ethical and commercial considerations.

As per SEBI, "stock broker" means a member of a stock exchange and "sub-broker" means any person not being a member of stock exchange who acts on behalf of a stock broker as an agent or otherwise for assisting the investors in buying, selling or dealing in securities through such stock brokers.

Brokers are persons mainly concerned with the procurement of subscription to the issue from the prospective investors. Companies can engage any number of brokers to market the new issue. The brokers may engage sub-brokers and they send their own circulars, publicity materials and applications to the clients and follow up the work for canvassing the subscription.

Appointment of Brokers to the Issue is not mandatory for public issues as per SEBI guidelines, but their expertise and contacts with investors could be used for marketing the issue. The company in consultation with the stock exchange writes to all active brokers of all exchanges and obtains their consent to act as brokers to the issue. The names and addresses of the brokers to the issue are required to be disclosed in the prospectus.

The main functions of the brokers to issue are

- Offer marketing support for the issue;
- Providing for distribution of issue forms at the retail investor level;
- Disseminate information to the investors about the issue;
- Provide advance market intelligence on the expected response to the issue.

Brokers may be paid brokerage within the limits and according to other conditions prescribed. The mailing cost and other out-of-pocket expenses for canvassing of public issues have to be borne by the stock brokers and no payment on that account is made by the companies. A clause to this effect must be included in the agreement to be entered into between the broker and the company.

The issuing company is expected to pay brokerage within two months from the date of allotment and furnish to the broker, on request, the particulars of allotments made against applications bearing their stamp, without any charge.

STOCK BROKING

INTRODUCTION

The SEBI was set up to ensure that the stock exchanges discharge their self regulatory role properly. To prevent malpractices in trading and to protect the rights of investors, the SEBI was mandated the monitoring function, requiring brokers to be registered and stock exchanges to report on their activities.

After the SEBI began to monitor brokers, stock broking has emerged as a professional advisory service in tune with the requirements of a highly matured, sophisticated, screen-based, ringless, automated exchanges in the country.

STOCK BROKERS, SUB BROKERS, FOREIGN BROKERS

Stock Broker

INTRODUCTION

A broker is a member of a recognized stock exchange, who is permitted to do trades on the screen-based trading system of different stock exchanges. He is enrolled as a member with the concerned exchange and is registered with SEBI.

DEFINITION

The SEBI has defined "stock broker means a member of a stock exchange".

- A stock broker means a person having trading rights in any recognized stock exchange including a trading member.
- A certificate of registration from the SEBI is mandatory to act as a broker.
- No separate registration is required for a SEBI - registered broker to operate in more than one stock exchange subject to the approval of the concerned stock exchange.
- A SEBI registered clearing member (i.e. a person having clearing and settlement rights in any recognized clearing corporation including a person having clearing and settlement rights on a commodity derivative exchange) would also not require a separate registration to act as a broker in the concerned stock exchange with its approval. A clearing corporation is an entity that undertakes clearing and settlement of trade in securities traded on a stock exchange.

REGISTRATION OF STOCK BROKERS

An application by a stock broker for grant of a certificate of registration shall be made in Form A through the Stock exchange or stock exchanges, as the case may be, of which he is admitted as a member. The stock exchange shall forward the application form to SEBI within 30 days from the date of its receipt. SEBI may require the applicant to furnish information or clarifications regarding the dealings in securities to consider the application for granting a certificate of registration.

SEBI shall take into account the following aspects before granting a certificate:

- (a) whether the stock broker is eligible to be admitted as a member of a stock exchange;
- (b) whether he has the necessary infrastructure like adequate office space, equipment and manpower to effectively discharge his activities;

- (c) whether he has any past experience in the business of buying, selling or dealing in securities;
- (d) whether he was subjected to disciplinary proceedings under the rules, regulations and bye-laws of a stock exchange with respect to his business as a stock broker involving either himself or any of his partners, directors or employees; and
- (e) whether he is a fit and proper person. SEBI, on being satisfied that the stock broker is eligible, shall grant a certificate of registration to him.

CONDITIONS OF REGISTRATION

The registration of a broker with the SEBI would be subject to conditions that he

- (i) holds the membership of any stock exchange,
- (ii) would abide by all the applicable rules/regulations and bye-laws of the stock exchange,
- (iii) would obtain SEBI's prior approval to act as a broker after a change in control,
- (iv) pay the requisite fee to the SEBI,
- (v) would take adequate steps for redressal of investor grievances within one month of the receipt of the complaint and keep the SEBI informed about the number, nature and other particulars of investors complaints,
- (vi) at all times, abide by code of conduct
- (vii) maintain the specified minimum net worth.

CODE OF CONDUCT

General

- A stockbroker has to maintain high standards of integrity, promptness and fairness with due skills, care and diligence in the conduct of all his business.

- He should not indulge in manipulative, fraudulent or deceptive transaction or spread rumours with a view to distort the market equilibrium or making personal gains.
- He should not create a false market either singly or in collusion with others.
- He has to abide by all the provisions of the SEBI Act and rules and regulations issued from time to time by the Government, the SEBI and the stock exchanges.

Duty to the Investors

The duties of a broker to the investors are as follows;

- In his dealings with clients and the general investing public, he should faithfully execute the orders for buying and selling of securities at the best available market price and not refuse to deal with a small investor merely on the grounds of the volume of business involved. He should promptly inform his client about the execution or non-execution of an order, make prompt payment in respect of securities sold and arrange for prompt
- He should issue contract note to the client without delay in the form specified by the stock exchange.
- He should not disclose confidential information of the client with any one else.
- He should not give false or misleading advice or information with the sole objective of earning commission and brokerage.
- He should avoid dealing with a client who has failed in his commitment with another stockbroker.
- He should disclose that there is no conflict of interest and if such conflict rises he should inform the client and seek personal advantage.
- A stockbroker should provide investment advice in the publicly accessible media after disclosing his interest.

- A stockbroker should have adequately trained staff and arrangements to render fair, prompt and competent services to his clients.

Stockbrokers vis-à-vis Other Stockbrokers

- A broker should cooperate with other brokers in comparing unmatched transactions.
- He should give full cooperation to other brokers in protecting the interests of his clients.
- While carrying out his transactions with other brokers, he should comply with his obligations in completing the settlement of transactions with them.
- A stockbroker should not advertise his business publicly unless permitted by the stock exchange.
- He should not resort to unfair means to induce clients from other stockbrokers.
- A stockbroker should not deal with any person as a sub-broker unless he has obtained a certificate of registration from the SEBI.

Sub Broker

DEFINITION

A sub broker is a person who is registered with SEBI as such and is affiliated to a member of a recognized stock exchange.

As per the SEBI, "sub-broker" means any person not being a member of stock exchange who acts on behalf of a stock broker as an agent or otherwise for assisting the investors in buying, selling or dealing in securities through such stock brokers.

All Sub-brokers are required to obtain a Certificate of Registration from SEBI without which they are not permitted to deal in securities. SEBI has directed that no broker shall deal with a person who is acting as a sub-broker unless he is registered with SEBI and it shall be the responsibility of the member-broker to ensure that his clients

are not acting in the capacity of a sub-broker unless they are registered with SEBI as a sub-broker.

It is mandatory for member-brokers to enter into an agreement with all the sub-brokers. The agreement lays down the rights and responsibilities of member-brokers as well as sub-brokers.

Where a sub-broker merely changes his affiliation from one stock broker to another stock broker being a member of the same stock exchange, there is no requirement of obtaining fresh certificate.

ELIGIBILITY FOR REGISTRATION

The stock exchange on receipt of an application shall verify the information contained therein and shall also certify that the applicant is eligible for registration as per criteria specified below:

(1) In the case of an individual:

- (a) the applicant is not less than 21 years of age;
- (b) the applicant has not been convicted of any offence involving fraud or dishonesty;
- (c) the applicant has at least passed 12th standard equivalent examination from an Institution recognised by the Government. However, SEBI may relax this criterion on merits having regard to the applicant's experience;
- (d) the applicant is a fit and proper person.

- (2) In the case of partnership firm or a body corporate, the partners or directors as the case may be shall comply with the requirements stated above. It is also to be assessed whether the applicant has necessary infrastructure like adequate office space, equipment and manpower to effectively discharge his activities. The applicant should be person recognised by the stock exchange as a sub-broker affiliated to a member broker of the stock exchange. The stock exchange shall forward the application form of such applicants, alongwith recommendation letter issued by the stock broker with whom he is affiliated alongwith a recognition letter issued by the stock exchange to SEBI within 30 days from the date of its receipt.

SEBI on being satisfied that the sub-broker is eligible, shall grant a certificate to the sub-broker and send an intimation to that effect to the stock exchange.

Conditions of Registration

Any registration granted by SEBI shall be subject to the following conditions :

- (a) he shall abide by the rules, regulations and bye-laws of the stock exchange which are applicable to him;
- (b) he shall pay fees charged by SEBI;
- (c) he shall take adequate steps for redressal of grievances, of the investors within one month of the date of receipt of the complaint and keep SEBI informed about the number, nature and other particulars of the complaints received from such investors; and
- (d) he is authorized in writing by a stock-broker being a member of a stock exchange for affiliating himself in buying, selling or dealing in securities.

The sub-broker has the following general obligations.

- (a) pay the fees ;
- (b) abide by the Code of Conduct specified ;
- (c) enter into an agreement with the stock broker for specifying the scope of his authority and responsibilities;
- (d) comply with the rules, regulations and bye laws of the stock exchange;
- (e) the sub-broker shall keep and maintain the books and documents specified in the Regulations.

Duty to the Investors

Sub-broker has duties toward the investors such as :

- faithful execution of orders of purchase and sale of securities,

- maintain confidentiality,
- not to give false or misleading advice,
- ensure no conflict of interest,
- not to give advice about securities in public media without disclosing his interest.
- He should have adequately trained staff and arrangements to render fair, prompt and competent services to his clients.
- He has to ensure continuous compliance with the regulatory system.

TRADING AND CLEARING / SELF CLEARING MEMBERS

A certificate of registration should be obtained from SEBI to act as a clearing member. However, any SEBI-registered broker who acts as clearing member with the approval of the clearing corporation would not require a separate registration. Similarly a separate registration would not be required for a SEBI-registered clearing member to operate in more than one clearing corporation.

A clearing /self clearing member would pay required fees and satisfy the minimum net worth and deposit requirement for the segment for which membership is sought.

The provisions relating to general obligations/responsibilities applicable to brokers would apply to clearing/self-clearing members.

STOCK TRADING

Meaning

The act of buying and selling of securities on a stock exchange is known as stock market trading.

Steps in Stock Trading

Following are the steps involved in the trading of securities at a stock exchange.

1. **Order Placing:** The first step in the trading of securities is placement of an order by an investor with the broker either to buy or sell certain number of shares at a certain specified price.

There are various kinds of orders. For instance, where in an order, the client places a limit on the price of the security; it is a case of 'limit order'. Where the order is to be executed by the broker at the best price, such an order takes the name of 'Best Rate Order'. An 'Immediate or Cancel Order' is one that has to be executed immediately and may have to be cancelled if the order is not executed immediately. A Limited Discretionary Order allows the broker to buy and sell within the specified price range and/or within the given time period as per the best judgement of the broker. Where the client orders the broker to sell as the price reaches a particular level, it is a case of 'Stop Loss Order'. Under the 'Open Order', the client does not fix any price limit or time limit on the execution of the order and relies on the judgement of the broker.

2. **Order Execution:** Broker executes the orders placed by the client for the purchase or sale of scripts. The execution takes place during the trading hours and during the working days of the exchange online.
3. **Contract Note Preparation:** When an agreement is reached between the parties concerned as regards price, a contract note is made out between the broker and the client. Particulars such as the price, number of scripts, date of transaction, names of party, brokerage, etc. are shown on Contract Note.
4. **Delivery and Clearing:** Delivery and clearing of share takes place through a clearance house.
5. **Demat Account Credit and Debit:** For the purpose of effecting the transfer in the name of the transferee, the parties accounts are either debited or credited.

6. **Settlement:** Settlement is the process of netting of transactions and actual delivery or receipt of securities against receipts of payment of agreed amounts. It is necessary to make a settlement to know the net effect of a series of transactions during a given period.

The rolling settlement systems is adopted in stock exchanges.

Rolling Settlement: In this system, each day constitutes the settlement period (T + 2 System). Under rolling settlements, the trades done on a particular day are settled after a given number of business days. In case of Rolling Settlements, pay-in and pay-out of both funds and securities is completed on the same day. Each trading day is considered as a trading period and trades executed during the day are settled to obtain the net obligations for the day in a rolling settlement.

Clearing and Settlement

NSE introduced for the first time in India, fully automated screen based trading.

It uses a modern, fully computerised trading system designed to offer investors across the country a safe and easy way to invest.

The NSE trading system called 'National Exchange for Automated Trading' (NEAT) is a fully automated screen based trading system, which adopts the principle of an order driven market.

The NEAT system has different types of market. They are:

Normal Market

All orders which are of regular lot size or multiples thereof are traded in the Normal Market. For shares that are traded in the compulsory dematerialised mode the market lot of these shares is one. Normal market consists of various book types wherein orders are segregated as Regular lot orders, Special Term orders, Negotiated Trade Orders and Stop Loss orders depending on their order attributes.

Odd Lot Market

All orders whose order size is less than the regular lot size are traded in the odd-lot market. These orders do not have any special terms attributes attached to them. In an odd-lot market, both the price and quantity of both the orders (buy and sell) should exactly match for the trade to take place. Currently the odd lot market facility is used for the Limited Physical Market as per the SEBI directives.

Auction Market

In the Auction Market, auctions are initiated by the Exchange on behalf of trading members for settlement related reasons. There are 3 participants in this market.

Initiator - the party who initiates the auction process is called an initiator

Competitor - the party who enters orders on the same side as of the initiator

Solicitor - the party who enters orders on the opposite side as of the initiator

The Capital Market (Equities) segment of NSE facilitates trading in the following instruments:

1. Shares
 - i. Equity Shares
 - ii. Preference Shares
2. Debentures
 - iii. Partly Convertible Debentures
 - iv. Fully Convertible Debentures
 - v. Non Convertible Debentures
 - vi. Warrants/Coupons/Secured Premium Notes/other Hybrids Bonds
3. Units of Mutual Funds.

DERIVATIVE TRADING

Definition of Derivative

A derivative is a contract between two parties which derives its value/price from an underlying asset.

These could be stocks, indices, commodities, currencies, exchange rates or the rate of interest.

These financial instruments help investors to make profits by guessing on the future value of the underlying asset. So, their value is derived from that of the underlying asset. This is why they are called '**Derivatives**'. **The trading of these derivatives on the stock exchange is called Derivative Trading.**

The value of the underlying assets changes every now and then.

For example, the value of stock may rise or fall, the exchange rate of a pair of currencies may change, indices may fluctuate, commodity prices may increase or decrease. These changes can help an investor make profits. They can also cause losses.

It could help an investor make additional profits by correctly guessing the future price, or it could act as a safety net from losses in the spot market, where the underlying assets are traded.

Use of Derivatives

In the Indian markets, futures and options are standardized contracts, which can be freely traded on exchanges.

The uses of derivatives can be listed as follows:

1. **Earn money on shares that are lying idle:** If an investor does not want to sell the shares that he bought for long term, but wants to take advantage of price fluctuations in the short term. In that case he can use derivative instruments. Derivatives

market allows him to conduct transactions without actually selling his shares – also called as physical settlement.

2. **Benefit from arbitrage:** When an investor buys low in one market and sells high in the other market, it is called arbitrage trading. He can take the advantage of differences in prices in the two markets.
3. **Protect securities against fluctuations in prices:** The derivative market offers products that allow an investor to hedge himself against a fall in the price of shares that he possesses. It also offers products that protect him from a rise in the price of shares that he plans to purchase. This is called hedging.
4. **Transfer of risk:** Another important use of these derivatives is the transfer of market risk from risk-averse investors to those with an appetite for risk. Risk-averse investors use derivatives to enhance safety, while risk-loving investors like speculators conduct risky, contrarian trades to improve profits. This way, the risk is transferred.

Types of Derivative Contracts

There are different types derivative contracts available in the stock market- forwards, futures, options.

1. **Futures and forwards:** Futures are contracts that represent an agreement to buy or sell a set of assets at a specified time in the future for a specified amount. Forwards are futures, which are not standardized. They are not traded on a stock exchange.
2. **Options:** These contracts are quite similar to futures and forwards. However, there is one key difference. There is no obligation to hold the terms of the agreement.

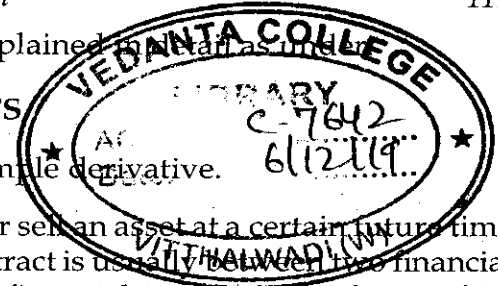
This means, even if one holds a contract to buy 100 shares by the expiry date, there is no obligation to buy. Options contracts are traded on the stock exchange.

Derivative Contracts can be explained as follows:

1. FORWARD CONTRACTS

- A forward contract is a simple derivative.
- It is an agreement to buy or sell an asset at a certain future time for a certain price. The contract is usually between two financial institutions or between a financial institution and one of its corporate clients.
- It is not normally traded on an exchange.
- One of the parties to a forward contract assumes a long position and agrees to buy the underlying asset on a certain specified future date for a certain specified price. The other party assumes a short position and agrees to sell the asset on the same date for the same price. The specified price in a forward contract will be referred to as the delivery price.
- At the time the contract is entered into, the delivery price is chosen so that the value of the forward contract to both the parties is zero. This means that it costs nothing to take either a long or a short position.
- A forward contract is settled at maturity. The holder of the short position delivers the asset to the holder of the long position in return for a cash amount equal to the delivery price.
- A key variable determining the value of a forward contract at any given time is the market price of the asset.
- As mentioned above, a forward contract is worth zero when it is first entered into. Later it can have a positive or negative value, depending on movements in the price of the asset. For example, if the price of the asset rises sharply after the initiation of contract, the value of a long position in the forward contract becomes positive and the value of a short position in the forward contract becomes negative.

Consider the following example to understand the concept of forward contract.



C-7342

Example

Forward Contract for Currency : An Indian manufacturing company imports certain materials from USA for USD 100,000 due in 90 days. The Indian importer will have to pay dollars after 90 days. Suppose present price of dollar is ₹ 69 and over the next 90 days, dollar is expected to rise against rupee. The importer can hedge this exchange risk by negotiating a 90 days forward contract with a bank at a price ₹ 70. As per the forward contract, the bank will give importer USD 100,000 on a predetermined due date on completion of 90 days and importer will give the bank ₹ 70 lakhs. Thus on the due date, importer will make a payment of ₹ 70 lakhs to bank and the bank will pay USD 100,000 to importer, irrespective of the prevailing exchange rate of dollar against rupee on that date.

Thus a forward contract is an agreement between a buyer and a seller obligating the seller to deliver a specified asset of specified quality and quantity to the buyer on a specified date at a specified place and the buyer, in turn is obligated to pay to the seller a pre-negotiated price in exchange of the delivery.

The basic features of a forward contract are stated as under :

1. Forward contracts are customized bilateral contracts between the buyer and the seller. These are usually traded between two financial institutions or between a financial institution and one of its clients.
2. Forward contracts are traded at over-the-counter and are not traded on an exchange.
3. As these contracts do not fall under the purview of rules and regulations of an exchange, they generally suffer from counter-party risk i.e. the risk of non-performance of obligation by either of the parties to the contracts.
4. Each contract is custom designed, and hence, is unique in terms of contract size, expiration date, the asset type, quality, etc.
5. In forward contract, one of the parties takes a long position by agreeing to buy the asset at a certain specified future date. The other party assumes a short position by agreeing to sell the same asset at the same date for the same specified price.

6. The specified price in a forward contract is referred to as the delivery price. It is important to differentiate between the forward price and the delivery price. Both are equal at the time the contract is entered into. However, as time passes, the forward price is likely to change whereas the delivery price remains the same. Generally the forward price at any time varies with the maturity of the contract being considered. For example, the forward price for a contract to buy or sell in three months is typically different from the one for a contract to buy or sell in six months.
7. Forward contracts are very popular in foreign exchange market and interest rates.

2. FUTURES CONTRACTS

- Like a forward contract, a futures contract is an agreement between two parties to buy or sell a specified quantity of an asset at a specified price and at a specified time and place.
- Unlike forward contracts, futures contracts are traded on an exchange. To make trading possible, the exchange specifies certain standardized features of the contract. As the two parties to the contract do not necessarily know each other, the exchange also provides a mechanism which gives the two parties a guarantee that the contract will be honoured.
- In case of a futures contract, the exact delivery date is usually not specified. The contract is referred to by its delivery month and the exchange specifies the period during the month when delivery must be made.
- The exchange specifies the amount of the asset to be delivered for one contract, how the futures price is to be quoted and limits on the amount by which the futures price can move in any one day. In the case of a commodity, the exchange also specifies the product quality and the delivery location.
- If the two investors get in touch with each other directly and agree to trade on asset in the future for a certain price, there are obvious risks. One of the investors may regret the deal and try to back out. Alternatively, the investor may not have the funds

to honour the agreement. One of the key roles of the exchange is to organize trading so that contract defaults are minimized. This is where the role of margin comes into play.

- For example, in a stock future contract on SBI stock at ₹ 330, both the buyer and seller have a margin requirement of 20% or ₹ 6,600 for 100 quantity. If the stock goes up to ₹ 340, the account of the long contract is credited with ₹ 1,000 ($₹ 340 - 330 = ₹ 10 \times 100 = ₹ 1,000$) and the account of the seller is debited by the same amount i.e. ₹ 1,000. This way at the end of each day till maturity the differences in the prices are either debited or credited to the margin account of both the parties. This arrangement is called mark to market.

The basic features of a future contract are stated as under:

1. Futures are traded only in exchanges.
2. A buyer may not know the identity of the seller and vice versa.
3. The contract terms of futures contract are standardized.
4. Every stock futures contract is guaranteed and honoured by the stock exchange, or more precisely, the clearing house or the clearing corporation of the stock exchange, which is an agency designated to settle trades of investors on the stock exchanges.
5. Futures trading requires margin payment and daily settlement.
6. Futures markets are regulated by SEBI.
7. A future contract is an agreement for a transaction in the future. Futures contracts are available in durations of 1 month, 2 months and 3 months. These are called near month, middle month and far month, respectively. Once the contracts expire, another contract is introduced for each of the three durations. The month in which it expires is called the contract month. New contracts are issued on the day after expiry.
8. Futures contracts are available on different kinds of assets - stocks, indices, commodities, currency pairs and so on.

9. Stock futures are derivative contracts that give one the power to buy or sell a set of stocks at a fixed price by a certain date. Once a person buys the contract, he is obligated to uphold the terms of the agreement.

In the derivatives market, contracts cannot be traded for a single share. Instead, every stock futures contract consists of a fixed lot of the underlying share. The size of this lot is determined by the exchange on which it is traded on. It differs from stock to stock. For instance, For example the lot size of TCS in National stock Exchange is 250 shares in futures, i.e., when you buy one futures contract of TCS, you are actually trading 250 shares of TCS.

Example : If a trader want to purchase a single July futures contract of XYZ Ltd., he would have to do so at the price at which the July futures contracts are currently available in the derivatives market. Let's say that XYZ Ltd. July futures are trading at ₹ 1,000 per share. This means, he is agreeing to buy/sell at a fixed price of ₹ 1,000 per share on the last Thursday in July. However, it is not necessary that the price of the stock in the cash market on Thursday has to be ₹ 1,000. It could be ₹ 992 or ₹ 1,005 or anything else, depending on the prevailing market conditions. This difference in prices can result in profits or losses for the buyers or sellers.

10. The theoretical price of a future contract is sum of the current spot price and cost of carry. However, the actual price of futures contract very much depends upon the demand and supply of the underlying stock. Generally, the futures prices are higher than the spot prices of the underlying stocks.

Futures Price = Spot Price + Cost of Carry

Cost of carry is the interest cost of a similar position in cash market and carried to maturity of the futures contract less any dividend expected till the expiry of the contract.

Example : Spot Price of Infosys = ₹ 1,600, Interest Rate = 7% p.a.,

Futures Price of 1 month contract

$$= 1,600 + 1,600 \times 0.07 \times 30/365 = 1600 + 11.51 = ₹ 1611.51$$

11. The investor can square up his position at any time till the expiry. The investor can first buy and then sell stock futures to square up or can first sell and then buy stock futures to square up his position. E.g. a long (buy) position in December M&M futures, can be squared up by selling December M&M futures.
12. The initial margin needs to be paid to the broker on an up-front basis before taking the position.
13. The outstanding positions in stock futures are marked-to-market daily. The closing price of the respective futures contract is considered for marking to market.

The positions in the futures contracts for each member are marked-to-market to the daily settlement price of the futures contracts at the end of each trade day.

The profits/losses are computed as the difference between the previous day's settlement price and the current day's settlement price. The members who have suffered a loss are required to pay the mark-to-market loss amount to NSE Clearing which is passed on to the members who have made a profit. This is known as daily mark-to-market settlement.

After daily settlement, all the open positions are reset to the daily settlement price.

Clearing Members are responsible to collect and settle the daily mark to market profits/losses incurred by the trading members and their clients. The pay-in and pay-out of the mark-to-market settlement is on T+1 day (T = Trade day). The mark to market losses or profits are directly debited or credited to the Clearing Members clearing bank account.

3. OPTIONS CONTRACTS

Options trade on many different exchanges throughout the world. The underlying assets include stocks, foreign currencies, stock indices and so on.

Option may be defined as a contract between two parties whereby one party obtains the right, but not the obligation, to buy or sell a particular underlying security or asset for a specified price on or

before a specified date. In a forward, futures or swap contract, the two parties have entered into a binding commitment. However, the holder of the option does not have to exercise his right under the contract.

The person who acquires the right is known as the option buyer or option holder, while the other person is known as option seller or option writer.

The seller of the option for giving such option to the buyer charges an amount which is known as the option premium. There are several factors which have an impact on option premiums which are spot price of the underlying assets, the exercise price of the option, the volatility in the underlying markets, time remaining to expiration, risk free rate of interest, dividend (in case of equity option).

Options can be divided into two types i.e. call option and put option.

- A call option gives the holder the right to buy an asset at a specified date for a specified price.
- In put option, the holder gets the right to sell an asset at the specified price and time.

The specified price in such contract is known as the exercise price or the strike price.

Thus the price at which the buyer of an option can buy the stock (in the case of a call option) or sell the stock (in the case of a put option) on or before the expiry date of option contracts is called strike price. It is the price at which the stock will be bought or sold when the option is exercised. Strike price is used in the case of options only; it is not used for futures or forwards.

The date in the contract is known as the expiration date or the exercise date or the maturity date. Futures and Options contracts expire on the last Thursday of the expiry month. If the last Thursday is a trading holiday, the contracts expire on the previous trading day.

The asset or security instrument or commodity covered under the contract is called as the underlying asset. They include shares, stocks,

stock indices, foreign currencies, bonds, commodities, futures contracts, etc.

Further the Options are classified based on type of exercise.

- **American Option** - American options are options contracts that can be exercised at any time upto the expiration date.
- **European Options** - European options are options that can be exercised only on the expiration date.

The concept of In the money, At the money and Out of the money in respect of Options.

- **In-the-money option** : An option is said to be in-the-money if on exercising the option, it would produce a cash inflow for the buyer. Thus, Call Options are in-the-money when the value of spot price of the underlying exceeds the strike price. On the other hand, Put Options are in-the-money when the spot price of the underlying is lower than the strike price.
- **Out-of-the-money option** : An out-of-the-money option is an opposite of an in-the-money option. An option-holder will not exercise the option when it is out-of-the-money. A Call option is out-of-the-money when its strike price is greater than the spot price of the underlying and a Put option is out-of-the-money when the spot price of the underlying is greater than the option's strike price.
- **At-the-money option** : An at-the-money-option is one in which the spot price of the underlying is equal to the strike price. It is at the stage where with any movement in the spot price of the underlying, the option will either become in-the-money or out-of-the-money.

There are a variety of ways in which options can be used by investors:

Bullish on the market over the short term : Buy Nifty calls

Example :

- On May 1, Spot Nifty is 11,000
- Buy May Nifty contract with Strike Price ₹ 10,900

- Premium Paid ₹ 55 × 75 = ₹ 4,125 (Lot size of 1 Nifty Contract = 75 units)
- On contract expiry on May 30, Nifty is 11,600
- Profit = 11,600 – 10,900 = ₹ 700 less premium ₹ 55 per unit
= ₹ 645 per unit

Bearish on the market over the short term : Buy Nifty puts

- On April 1, Spot Nifty is 11,200
- Buy April contract with Strike Price ₹ 11,100
- Premium Paid ₹ 45 × 75 = ₹ 3,375
- On contract expiry on April 25, Nifty is 10,600
- Profit = 11,100 – 10600 = ₹ 500 less premium ₹ 45 per unit
= ₹ 455 per unit

4. SWAP CONTRACTS

Swaps have become popular derivative instruments in recent years all over the world. A swap is an agreement between two counter parties to exchange cash flows in the future. Under the swap agreement, various terms like the dates when the cash flows are to be paid, the currency in which to be paid and the mode of payment are determined and finalized by the parties. Usually the calculation of cash flows involves the future values of one or more market variables.

There are two most popular forms of swap contracts, i.e., interest rate swaps and currency swaps.

The most common type of swap is a 'plain vanilla' interest rate swap. In this, one party, B agrees to pay to the other party, A, cash flows equal to interest at a predetermined fixed rate on a notional principal for a number of years. At the same time, party A agrees to pay party B cash flows equal to interest at a floating rate on the same notional principal for the same period of time. The life of swap can range from two years to over 15 years.

Another popular type of swap is known as a currency swap. In its simplest form, this involves exchanging principal and fixed rate interest payments on a loan in one currency for principal and fixed rate interest payments on an approximately equivalent loan in another currency. In simple words, a currency swap is used to transform a loan in one currency into a loan in another currency.

Principal amounts are not usually exchanged in an interest rate swap. In a currency swap, principal amounts are usually exchanged at both the beginning and the end of the life of the swap.

An interest rate swap can be used to transform a floating rate loan into a fixed-rate loan or vice versa.

Swaps are usually arranged by financial institutions. Ideally to eliminate interest rate or exchange rate risk, a financial institution would like to enter into offsetting swap agreements with two parties at the same time.

HOW ARE DERIVATIVE CONTRACTS LINKED TO STOCK PRICES ?

Suppose you buy a Futures contract of TCS shares at ₹ 3,000 – the stock price of the IT company currently in the spot market. A month later, the contract is supposed to expire. At this time, the stock is trading at ₹ 3,500. This means, you make a profit of ₹ 500 per share, as you are getting the stocks at a cheaper rate. Had the price remained unchanged, you would have received nothing. Similarly, if the stock price fell by ₹ 800, you would have lost ₹ 800. As we can see, the above contract depends upon the price of the underlying asset – TCS shares. Similarly, derivatives trading can be conducted on the indices also. Nifty Futures is a very commonly traded derivatives contract in the stock markets. The underlying security in the case of a Nifty Futures contract would be the 50-share Nifty index.

Trading in Derivatives Market

Following steps are required to be followed while trading in the derivative market.

1. **Research:** It is important to do research in the derivatives market. Different strategies are required to be followed in the derivative market.
2. **Arrange for the requisite margin amount:** Trader is constantly required to maintain his margin amount. This means, he cannot withdraw this amount from his trading account at any point in time until the trade is settled. The margin amount changes as the price of the underlying stock rises or falls.
3. **Conduct the transaction through trading account:** A trader will have to trade in derivatives through his trading account. He can place an order online or on phone with his broker.
4. **Stock selection:** He will select his stocks and their contracts on the basis of the amount available, the margin requirements, the price of the underlying shares, as well as the price of the contracts.
5. **Settlement:** Trader can wait until the contract is scheduled to expiry to settle the trade. In such a case, he can pay the whole amount outstanding, or he can enter into an opposing trade.

Thus, buying stock futures and option contracts is similar to buying shares of the same underlying stock, but without taking delivery of the same.

SECURITISATION

DEFINITION

Securitisation is the process of turning assets into securities. Specific assets are pooled together and repackaged as interest-bearing securities. Securities are financial or investment vehicles that are bought and sold in financial markets similar to how stocks and bonds are traded. The purchasers of the new, repackaged interest-bearing securities receive interest and principal payments.

It is the process of pooling and repackaging of homogenous illiquid financial assets into marketable securities that can be sold to investors. The process leads to the creation of financial instruments that represents ownership interest in pool of assets. The pool of securitized assets from which cash flows are generated is known as collateral. Securitized assets are usually loans and receivables, and securities are backed or collateralized by any kind of income yielding assets.

RBI in its circular on Securitisation of Standard Assets, describes Securitisation, "as a process by which assets are sold to a bankruptcy remote special purpose vehicle (SPV) in return for an immediate cash payment".

An asset that can be converted into cash quickly is called a liquid asset. An asset that takes longer to convert to cash and will likely sell for a price lower than market value is called an illiquid asset.

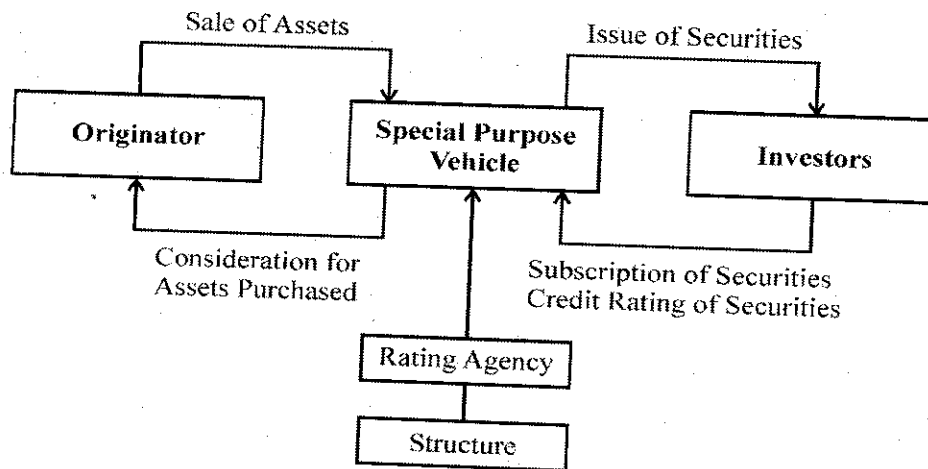


Fig. 3 : Securitisation Process

SECURITISATION V/S FACTORING

While both factoring and securitisation involves capitalizing the receivables of the company, there are some differences between factoring and securitisation as stated below :

1. While factoring is arrangement between the banks/financial institutions and a company in which financial institution purchases the book debts of a company and pays the money to the company against receivables whereas securitisation is the process of converting illiquid assets into liquid assets by converting longer duration cash flows into shorter duration cash flows.

2. Under factoring there are two parties viz., the bank and the company while under securitisation there are many investors involved who invest in the securitised asset.

3. While factoring is done for short term account receivables ranging from 1 month to 6 months whereas securitisation is done for long term receivables of the company.

4. While factoring can be with or without recourse whereas securitisation is done without recourse.

5. Since factoring involves only bank and the company there is no need for any credit rating while securitisation involves many investors and therefore, it is necessary to take credit rating before going for securitisation of receivables.

FEATURES OF SECURITISATION

A securitised instrument, as compared to a direct claim on the issuer, will generally have the following features:

1. **Process of converting illiquid assets into liquid assets:** Securitisation is the process of converting illiquid assets into liquid assets by converting longer duration cash flows into shorter duration cash flows
2. **Marketability:** The main purpose of securitisation is to ensure marketability to financial claims. Hence, the instrument is structured in such a way that it becomes marketable. This is one of the most significant features of a securitised instrument.

Marketability involves two concepts :

- (i) the legal possibility of marketing the instrument;

(ii) the existence of a market for the instrument.

Liquidity is ensured to a securitised instrument by introducing it in to a securities exchange so that it can be bought and sold at market-determined prices.

3. **Merchantable Quality:** A securitised product should be of merchantable quality. Merchantable quality, in case of physical goods, is the quality which is acceptable to merchants in normal trade. When applied to financial products, it would mean that the financial commitments embodied in the instruments are secured to the investors' satisfaction. The originator of the securitised instrument secures the instrument based on the needs of the investors.

The rating is for the benefit of the common investor, who is not in a position to appraise the degree of risk involved.

In case of securitisation of receivables, the concept of quality undergoes a drastic change, making rating a basic requirement for securitisation.

4. **Wide Distribution:** The basic purpose of securitisation is to distribute the product. The extent of distribution which the originator would like to achieve is based on a comparative analysis of the costs and the benefits that can be achieved. With wider distribution, the issuer is able to market the product with lower financial cost to him. But a wide investor base involves the high cost of distribution and servicing.

5. **Commoditization:** Securitisation is the process of commoditization, where the basic idea is to take the outcome of this process into the capital market. Thus, the result of every securitisation process is to create certain instruments which can be placed in the market.

6. **Homogeneity:** To serve as a marketable instrument, the instrument should be packaged into homogenous lots. Homogeneity is a function of retail marketing. Most securitised instruments are broken into lots affordable to the marginal investor and hence the minimum denomination becomes relative to the needs of the smallest investor.

7. **Integration and Differentiation:** Securitisation is the process of integration and differentiation where the entity that securitises its assets first pools them together into a common hotch pot. This is the process of integration. Then, the pool itself is broken into instruments of fixed denomination. This is the process of differentiation.

8. **Deconstruction:** Securitisation is the process of deconstruction of an entity wherein, one envisages an entity's assets as being composed of claims to various cash flows, the process of securitisation would split apart these cash flows into different buckets, classify them and sell these classified parts to different investors according to their needs. Thus, securitisation breaks the entity into various classes.

9. **Difficult to understand for retail investors:** In practice, securitisation issues are difficult for retail investors to understand. Hence, most securitisations are privately placed with professional investors. However, it is likely that in the future, retail investors could be attracted into buying securitised products.

PASS THROUGH CERTIFICATES

A Pass through Certificate is an instrument which signifies transfer of interest in the receivable in favour of the holder of the Pass through Certificate.

A pass through certificate (PTC) is a certificate that is given to an investor against certain mortgaged-backed securities that lie with the issuer. The certificate can be compared to securities (like bonds and debentures) that may be issued by banks and other companies to investors.

The only difference being that they are issued against underlying securities. The interest that is paid to the issuer on these securities comes to the investor in the form of a fixed income.

Investors in such instruments are usually financial institutions like banks, mutual funds and insurance companies.

Many banks and private organizations have incomes or receivables that are due to them in lieu of loans or services that they have offered in the past. Securitisation involves the conversion of these incomes or receivables into debt instruments which are then sold to investors. For this purpose, the parent organization sets up a Special Purpose Vehicle (SPV) which issues these debt instruments.

By making these debt instruments available in the markets, the organization manages to make their assets liquid and can then use the funds for some other productive business. When an investor buys these debt instruments, the investor is given a PTC. However, this does not mean that the investor owns the assets. Rather, when the original lender recovers money from the original borrower (as interest or otherwise), it is then passed on to the SPV, which then disburses it to the investor in the form of a fixed income.

All the PTCs in the market are rated by agencies like CRISIL or Fitch ratings, among others. The ratings tell the investor about the quality of the underlying securities.

In a PTC, interest earned on the receivable is directly passed to the holders, whereas, in a pay through certificate, interest received from the receivables is not passed to the holder of the unit. Instead, the SPV issues new securities to them.

SECURITISATION MECHANISM

The securitisation process or mechanism is listed below:

1. Assets are originated through receivables or any other form of debt by a company and funded on its balance sheet. The company is referred to as the 'originator'.
2. Once a large portfolio of assets has been originated, the assets are analysed as a portfolio and then sold or assigned to a third party, which is normally a special purpose vehicle company (SPV) formed for the specific purpose of funding the assets. The SPV is owned by a trust.

3. The administration of the asset is then sub-contracted back to the originator by the SPV. It is responsible for collecting interest and principal payments on the loans in the underlying pool of assets and transfer to the SPV.
4. The SPV issues tradable securities to fund the purchase of assets. The performance of these securities is directly linked to the performance of the assets.
5. The investors purchase the securities because they are satisfied that the securities would be paid in full and on time from the cash flows available in the asset pool. The proceeds from the sale of securities are used to pay the originator.
6. The SPV agrees to pay any surpluses which, may arise during its funding of the asset, back to the originator.
7. As cashflow arise on the assets, these are used by the SPV to repay funds to the investors in the securities.

- The first deal of securitisation in India between Citibank and GIC Mutual Fund was in 1990 for ₹ 160 million.
- Securitisation of cash flow of high value customers of Rajasthan State Industrial and Development Corporation in 1994-95 was done by SBI Cap.
- Securitisation of Sales Tax deferrals by Government of Maharashtra in August 2001 for ₹ 1500 million with a green shoe option of ₹ 75 million.
- India's first floating rate securitisation issuance by Citigroup of ₹ 2,810 million in 2003. The fixed rate auto loan receivables of Citibank and Citicorp Finance India included in the securitisation.
- India's largest securitisation deal by ICICI Bank of ₹ 19,299 million in 2007. The underlying asset pool was auto loan receivables.

SPECIAL PURPOSE VEHICLE (SPV)

SPV is an entity specially created for the purpose of executing securitisation deal.

- SPV is an entity which would buy the assets to be securitized from the originator.
- It makes the payment to the originator for the assets purchased.
- An SPV is typically a low-capitalised entity with narrowly defined purposes and activities.
- It has independent trustees/directors.
- The main objective of securitisation is to remove the assets from the balance sheet of the originator. The SPV holds the assets in its books and makes the upfront payment for them to the originator.
- The biggest advantage is that it helps in separating the risk and freeing up the capital.
- As a result, the SPV and the sponsoring company are protected against risks like insolvency, which may arise during the course of operation.

A good SPV should be able to stand on its feet, independent of the sponsoring company. Unfortunately, this does not happen in practice. One of the reasons for the collapse of the Enron SPV was that it became a vehicle for furthering the ends of the parent company in violation of the prudential norms of corporate financing and accounting.

SECURITISABLE ASSETS

As per Securitisation Policy, 2012, all on-balance sheet standard assets are eligible for securitisation, except:

- revolving credit facilities (e.g., credit card receivables);
- assets purchased from other entities;
- securitisation exposures (e.g., mortgage-backed/asset-backed securities); and
- loans with bullet repayment for both principal and interest.

Any type of asset with a reasonably predictable stream of future cash flows can be securitised.

The following assets are easiest to securitise.

1. The assets that occur in large pool.
2. The assets for which past experience can be used to predict default rates.
3. The assets for which documentation is standardized.
4. The assets for which ownership is transferable.

Some of the securitisable assets can be listed as follows :

- Term loans
- Commercial Loans
- Receivables from Government
- Vehicle Loans
- Lease Finance
- Mortgage Loans
- Credit Cards Receivables

The Indian securitisation transaction rose 34% in Financial Year 2017 to ₹ 90,000 crore on the back of a strong growth in priority sector qualifying assets, according to ratings firm ICRA. Securitisation of loan assets by issuing pass through certificates (PTCs) rose by 72% to ₹ 43,000 crore in Financial Year 2017.

BENEFITS OF SECURITISATION

A. Benefits to the Issuer

1. **Off the balance sheet of the originator:** For accounting purposes securitization is treated as a sale of assets and not as financing. Therefore the originator does not record the transaction as a liability on its balance sheet. Such off balance sheet raise funds without increasing the originator's or debt equity ratio.
2. **Efficient Financing:** In securitization, it is possible to achieve much higher rating for instrument as compared to the originator's credit rating. Thus the borrower can obtain fund at lower interest rates applicable to highly rated instrument and gain a pricing advantage.
3. **Lower capital requirement:** Securitisation enables banks and financial institutions to meet regulatory capital adequacy norms by transferring assets and their associated risks off the balance sheet. The capital support the assets is released and the proceeds from securitization can be used for further growth and investment.
4. **Liquidity management:** Tenor mismatch due to long term assets funded by short term liabilities can be rectified by securitisation as long term assets are converted into cash. Thus securitisation is a tool of asset liability management.
5. **Improvement in financial ratios:** Since securitisation help in undertaking larger transaction volumes with the same capital profitability and return on investment ratios increase post securitisation.
6. **Profit on sale:** Securitisation helps in up-fronting profits. This would otherwise accrue over the tenor of the loans. Profits arise from the spread is booked as profit leading to increased earnings in the year of securitisation.

B. Benefits to the Investors

1. **Safety Features:** Securitisation offers investors benefit of diversification of risks, as they have an exposure to a pool of assets. Most issuances are highly rated by independent credit rating agency and have credit support built into the transactions. Investors get the benefit of the payment structure closely monitored by an independent trustee which may not always be in the case of traditional debt instruments.
2. **Performance track record:** Securitisation instruments have demonstrated consistently good performance with low level of defaults on instruments in India due to stringent RBI guidelines.
3. **Alternate investment vehicle for investors:** Small investors are able to profit from such deals as under this scheme as they can invest small amounts through SPV and acquire beneficial interest in the securitised assets. It provides alternate investment vehicle to investors.
4. **High return:** The investor has the advantage of earning high return on risk adjusted basis.
5. **Flexibility :** An important advantage of securitization is the flexibility to customise the instrument to meet the investor's risk and tenor appetite.
 - Durations can range from few months to many years.
 - Repayment are usually made on monthly basis but can be structured on a quarterly or semi-annual basis.
 - Interest rate can be fixed or floating depending upon investor preferences.

C. Benefits to the Economy

1. **Connecting capital markets and financial markets:** Financial assets are created in the financial markets, e.g., banks or mortgage financing companies. These assets are traditionally refinanced on on-balance sheet means of funding of the respective banks.

Securitisation connects the capital markets and financial markets by converting these financial assets into capital market commodities. Securitisation benefits the economy as a whole by bringing financial markets and capital markets together.

2. **Market Efficiency:** Through securitization process the companies holding financial assets like loans have ready access to low cost sources of fund and can reduce their dependence on financial intermediaries for their capital requirement. This results into lower interest cost, the benefits of which are also passed to the consumers.
3. **Specialization:** The typical bank/financial institution model of Origination-Funding-Credit administration of loans has changed into an unbundling of roles and greater specialization as different players can now concentrate on their core function, which can be origination, funding or credit administration.
4. **Streamlined system and process:** As per RBI guidelines on securitisation, a high levels of data transparency and robust system is required. This enhances the overall monitoring and control of asset portfolios.

NEW GUIDELINES ON SECURITISATION

On May 7 2012 the Reserve Bank of India (RBI) issued to all banks its revisions to the Guidelines on the Transfer of Assets through Securitisation and Direct Assignment of Cash Flows. On August 21 2012 the RBI issued a similar set of guidelines to all non-banking finance companies (NBFCs), revising the existing guidelines on securitisation transactions, as applicable to NBFCs.

The new securitisation guidelines introduce key changes from the February 2006 guidelines, including:

- introducing a minimum holding period and minimum retention requirement that must be met in respect of loans before they can be securitised;
- specifying regulations for the direct assignment of loans;

- prohibiting any form of credit enhancement by selling banks or NBFCs in connection with the direct assignment of loans; and
- prohibiting specific categories of securitisation transaction, including:
 - any re-securitisation of assets, such as collateralised debt obligations of asset-backed securities (e.g., those backed by residential mortgage-backed securities); and
 - any form of synthetic securitisation transactions and securitisation with revolving structures (e.g., credit card receivables).

KEY FEATURES OF THE POLICY

A. Securitisation of Standard Assets

1. **Assets eligible for securitisation:** All on-balance sheet standard assets are eligible for securitisation, except:
 - revolving credit facilities (eg, credit card receivables);
 - assets purchased from other entities;
 - securitisation exposures (e.g., mortgage-backed/asset-backed securities); and
 - loans with bullet repayment for both principal and interest.
2. **Minimum holding period:** Originating banks/NBFCs can securitise loans only after fulfilling the prescribed minimum holding period requirement. The rationale for introducing a minimum holding period requirement is to:
 - ensure that the project implementation risk is not transferred to investors; and
 - require banks to demonstrate a certain minimum recovery-linked performance before securitisation.

The bank guidelines and NBFC guidelines each set out the minimum number of instalments that must have been received

in respect of loans (categorised by maturity) before they can be securitised. The minimum holding period is counted from the date of full disbursement of the loan by the bank/NBFC or the date of completion of a project, as the case may be.

3. **Minimum retention requirement:** The securitisation guidelines have introduced the concept of a minimum retention requirement in order to ensure that the originator bank/NBFC has a continued interest in the securitised assets. The minimum retention requirement is intended to improve the due diligence that is carried out on the securitised portfolio. The minimum retention requirement is in the range of 5% to 10% of the book value of the loan being securitised.

4. **Limit on total retained exposures:** The exposure of banks/NBFCs to loans securitised in the following forms should not exceed 20% of the total securitised instruments issued:

- investments in equity, subordinate or senior tranches of securities issued by the SPV, including through underwriting commitments;
- credit enhancements, including cash, and other forms of collateral, including over-collateralisation but excluding the credit enhancing interest-only strip; and
- liquidity support.

Exposures beyond this limit will be risk-weighted at 1111% for banks and 667% for NBFCs.

5. **Booking of profit upfront:** The originating banks/NBFCs are permitted to recognise higher cash profits on amortisation of principal and losses incurred as per new policy.

6. **Treatment of non-compliant securitised assets:** Originating banks/NBFCs that do not comply with the new securitisation guidelines in respect of securitised assets must maintain capital against such assets as if these were not securitised.

The RBI has also prescribed certain standards of due diligence that must be met by the purchasing bank/NBFC. Investing banks/NBFCs must also periodically stress test their

securitisation investments and continuously monitor performance information on the exposure underlying their securitisation positions.

B. Direct Assignment of Loans

The RBI has introduced regulations for the direct assignment of loans by banks/NBFCs. However, the securitisation guidelines do not apply to, among others:

- the transfer of loans by a bank/NBFC to other banks, financial institutions or NBFCs at the request of the borrower;
- trading in bonds; and
- consortium and syndication arrangements.

1. **Assets eligible for transfer:** All on-balance sheet standard assets are eligible for transfer by direct assignment, except:

- revolving credit facilities (eg, credit card receivables);
- assets purchased from other entities; and
- loans with bullet repayment for both principal and interest.

2. **Minimum holding and minimum retention requirements:** The minimum holding period requirements applicable to banks and NBFCs for securitisation transactions will also apply to any direct assignment of loans. The minimum retention requirement for both banks and NBFCs is as follows:

- For assets with original maturity of 24 months or less, the minimum retention requirement is 5% of the cash flows from the assets transferred on a pari passu basis; and
- For assets with original maturity of more than 24 months, the minimum retention requirement is 10% of the cash flows from the assets transferred on a pari passu basis.

3. **Credit enhancements:** The securitisation guidelines restrict all forms of credit enhancements by the transferring bank/NBFC in respect of a direct assignment of loans, on the ground that investors are typically institutional investors that have the

ability to conduct a sophisticated credit risk analysis of the assets being acquired. However, this restriction is likely to affect the market for direct assignments, as acquiring entities may be reluctant to absorb the entire risk linked to a loan portfolio post assignment.

The rules applicable to the direct assignment of loans in relation to the booking of profit upfront, the treatment of non-compliant securitised assets and compliance requirements for purchasing banks/NBFCs are broadly similar to those prescribed for the securitisation of assets (for banks or NBFCs, as the case may be).

4. **True sale criteria:** The securitisation guidelines lay down certain 'true sale' criteria that must be met in respect of direct assignments. (These are broadly similar to the true sale criteria prescribed by the RBI for securitisation transactions under the February 2006 guidelines.) The sale will qualify as a true sale only if:

- the assignment results in the immediate legal separation of the selling bank from the assets being sold;
- the buyer has an unfettered right to transfer, pledge, sell or otherwise dispose off the assets acquired;
- the selling bank has no economic interest in the assets following a sale;
- the purchasing bank has no recourse to the selling bank for any expenses or losses except those specifically permitted;
- other than on account of breach of a representation or warranty, the seller has no obligation to repurchase or fund the assets sold; and
- there are no 'clean-up calls' or other similar obligations of the seller in respect of the transferred assets.

The RBI has tightened the norms on securitisation transactions and the new securitisation guidelines have been drafted with a clear intention of aligning the interests of originators and

investors. The minimum holding and minimum retention requirements are central to this theme. However, the threshold requirements prescribed do not appear onerous and should not act as a disincentive to securitisation transactions.

The prohibition on any form of credit enhancement for direct assignment of loans is a stringent restriction and may affect the volumes of direct assignment transactions.

While listing the elements of a true sale for direct assignment transactions, the RBI has prohibited any form of clean-up call by the selling bank/NBFC. The need to ensure a complete legal separation of the seller from the assets being sold is an important one, but clean-up calls are sometimes required as a practical matter and such a blanket restriction may not be the most commercially sound approach.

REVIEW QUESTIONS

1. What is the meaning of Merchant Bankers? Explain various categories of Merchant Bankers.
2. Define Merchant Banker. What are the services provided by Merchant Bankers?
3. What are the obligations and responsibilities of Merchant Bankers as per the SEBI? State 15 obligations.
4. Define Underwriters. Explain importance of underwriters.
5. Explain meaning and classification of underwriters.
6. Explain general obligations and responsibilities of underwriters.
7. Define Bankers to an issue. Explain registration requirements.
8. Explain code of conduct for bankers to an issue.
9. Explain Broker to an Issue.
10. Define 'stock broker. Explain conditions of registration of a stock broker.
11. What is the meaning of stock broker? Explain code of conduct of a stock broker.
12. What are the duties of stock brokers to the investors?
13. Define sub-broker. What are the criteria for registration eligibility of an applicant?
14. What is the meaning of stock trading? Explain the steps in stock trading.

15. What do you mean 'Derivative'? What is the use of derivatives?
16. Distinguish between Securitisation and Factoring.
17. Define Securitisation. Explain its features.
18. Describe securitisation mechanism.
19. Explain benefits of securitisation.
20. Explain in brief new guidelines on securitisation.
21. Write short notes on :
 - (i) Role of Merchant Bankers
 - (ii) Underwriters
 - (iii) Bankers to an issue
 - (iv) Brokers to an issue
 - (v) Categories of merchant bankers
 - (vi) Scope of Merchant Banking
 - (vii) Any seven codes of conduct of a Merchant Banker
 - (viii) Importance of underwriters
 - (ix) Classification of underwriters
 - (x) Explain code of conduct for bankers to an issue
 - (xi) Meaning of broker and sub-broker
 - (xii) Trading and clearing member
 - (xiii) Types of derivative contracts
 - (xiv) Trading in Derivative Market
 - (xv) Features of securitisation
 - (xvi) Pass Through Certificates
 - (xvii) Special Purpose Vehicle
 - (xviii) Securitisable Assets

OBJECTIVE QUESTIONS

- A. Select the appropriate options and rewrite the following sentences:**
1. The Securities and Exchange Board of India (SEBI) was constituted in _____.

(a) 1988	(b) 1990
(c) 1992	(d) 1987
 2. The issuing company is expected to pay brokerage within _____ months from the date of allotment.

(a) two	(b) four
(c) one	(d) three
 3. The _____ also offer certain other specialized services such as advisory services on matters such as mergers and amalgamations.

- | | |
|------------------|----------------------|
| (a) Underwriters | (b) Merchant Bankers |
| (c) Brokers | (d) Bankers |
4. A banker to an issue is required to maintain books of accounts for a minimum period of _____ years.

(a) two	(b) four
(c) one	(d) three
 5. Where in an order, the client places a limit on the price of the security; it is a case of _____.
 - (a) 'Limit Order'
 - (b) 'Best Rate Order'
 - (c) 'Immediate or Cancel Order'
 - (d) 'Stop Loss Order'
 6. Securitisation is the process of pooling and repackaging of homogenous _____ financial assets into marketable securities.

(a) liquid	(b) illiquid
(c) fixed	(d) current

Ans.: (1) - (a), (2) - (a), (3) - (b), (4) - (d), (5) - (a), (6) - (b)

B. Fill in the blanks :

1. _____ are in charge of the issue process.
2. _____ are also responsible for preparing the prospectus and marketing the issue.
3. _____ make a commitment to get the issue subscribed either by others or by themselves.
4. _____ means an offer for sale of securities by any body corporate to public through a merchant banker.
5. The _____ are exposed to the risk of under subscription
6. A _____ means any person not being a member of stock exchange who acts on behalf of a stock broker as an agent or otherwise for assisting the investors in buying, selling or dealing in securities through such stock brokers.
7. A _____ is a contract between two parties which derives its value/ price from an underlying asset.
8. _____ are contracts that represent an agreement to buy or sell a set of assets at a specified time in the future for a specified amount.
9. The _____ settlement systems is adopted in stock exchanges.
10. _____ is the process of turning assets into securities.
11. _____ is an entity which would buy the assets to be securitized from the originator.

Ans.: (1) Merchant bankers (2) Merchant bankers (3) Underwriters (4) Issue (5) underwriters (6) sub-broker (7) derivative (8) Futures (9) rolling (10) Securitisation (11) Special Purpose Vehicle

C. Match the following :

Column A	Column B
1. Factoring	(a) Derivative contract
2. Securitisation	(b) Vehicle loan
3. Securitisable assets	(c) Registered with SEBI
4. Futures and forwards	(d) Purchases the book debts of a company
5. Sub-broker	(e) Converting assets into securities

Ans.: (1) - (d), (2) - (e), (3) - (b), (4) - (a), (5) - (c)

D. State whether true or false :

- The merchant bankers are exposed to the risk of under subscription.
- Underwriters agree to take up securities which are not fully subscribed.
- Underwriting an issue is optional and not mandatory
- Category IV Merchant Bankers can act as underwriter or advisor or consultant to an issue.
- Stock broker means a member of a stock exchange.
- To carry on activity as a banker, a person must obtain a certificate of initial as well as permanent registration from the SEBI.
- Every underwriter need not enter into an agreement with the issuing company.
- A Merchant Banker should not lead manage an issue if he is a promoter/director/associate of the issuer.
- An underwriter cannot derive any direct or indirect benefit from underwriting the issue other than by the underwriting commission.
- Companies can engage any number of brokers to market the new issue.
- Brokers to the Issue is mandatory for public issues as per SEBI guidelines.
- Forwards are traded on a stock exchange.
- The margin amount changes as the price of the underlying stock rises or falls.
- Risk-averse investors use derivatives to enhance safety.
- A certificate of registration should be obtained from SEBI to act as a clearing member.
- A stockbroker should not deal with any person as a sub-broker unless he has obtained a certificate of registration from the SEBI.
- In securitization, specific assets are pooled together and repackaged as interest-bearing securities.
- Securitisation is the process of integration and differentiation.

Ans.: True : 2, 3, 5, 6, 8, 9, 10, 13, 14, 15, 16, 17, 18; False: 1, 4, 7, 11, 12

3

FINANCIAL SERVICES AND ITS MECHANISM

Lease and Hire - Purchase

- Introduction
- Meaning
- Types of Lease-Finance Lease and Operating Lease
- Advantages of Leasing
- Disadvantages of Leasing
- Leasing in India
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- Definition of Hire Purchase
- Hire Purchase and Instalment Sale Characteristics
- Hire Purchase and Leasing
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Housing Finance

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- Housing Finance Industry
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- *Housing Finance in India - Major Issues*
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Venture Capital

Introduction

- *Features of Venture Capital*
- *Types of Venture Capital Financing Stages*
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- *Venture Capital Investment Process*
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LEASING

INTRODUCTION

Whenever a business needs new computers, machineries or equipments, should the businessman buy these assets or take these on lease? Read on to get an answer to this question. As you know, computers and other equipments eventually become obsolete. With a lease, you pass the financial burden of obsolescence to the equipment leasing company. For example, let's say you have a two-year lease on a copy machine. After that lease expires, you are free to lease another equipment which is newer, faster and cheaper. There are several benefits as well as drawbacks of leasing against buying.

A few simple rules of thumb may help one decide to lease or buy. If your equipment requirements are relatively small and you have the money or can get a low-interest loan then just buy it. However, if you require a substantial amount of equipments, leasing may be a better option. After all, why tie up a large amount of cash, especially when you could use that money to expand your business?

You can understand meaning of lease and how a typical lease transaction works from the following case study.

Let's assume Company XYZ needs a machine for its factory. The machine costs ₹ 10,00,000 to buy, but Company XYZ could also lease the machine for ₹ 2,000 a month instead. This certainly could preserve a considerable amount of cash for the company. If Company XYZ enters into an operating lease for the asset, it also will not assume any of the risks of ownership by leasing the machine rather than buying it. However, it will have to record all of the lease payments on its profit & loss account, thereby reducing its net profit rather than placing the asset on its balance sheet and recognizing only depreciation on the profit and loss statement.

MEANING

A lease may be defined as a contractual arrangement/ transaction in which a party owning an asset (lessor) provides the asset for use to another or transfers the right to use the asset to the user (lessee) for an agreed period of time for the consideration in the form of periodic payment (lease rentals). The asset reverts back to the lessor unless there is a provision for renewal of the contract.

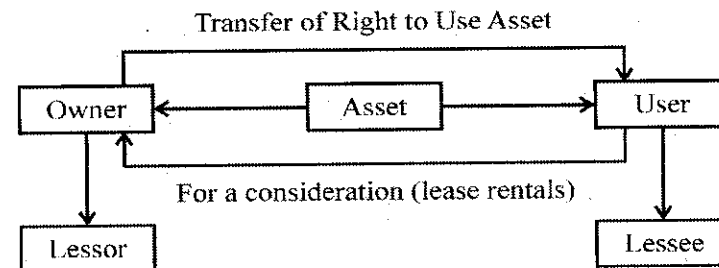


Fig. 1 : Lease Transaction

- Leasing is a mechanism of financing the cost of an asset.
- Leasing is a process by which a firm can obtain the use of a certain fixed asset for which it must make a series of contractual periodic tax deductible payments (i.e. lease rentals).
- The main function of a lessor is lending of funds rather than renting of asset.
- The lessor is owner of the asset but the possession and economic use of the asset vests in the lessee.
- The lessor does not take recourse to the asset as long as the rentals are regularly paid by the lessee.

ESSENTIAL ELEMENTS OF LEASING

- (1) **Parties to the contract:** There are essentially two parties to a contract of lease financing, viz. the owner and the user, called the lessor and the lessee respectively. Lessor and lessee can be individual, partnership firm or company.
- (2) **Asset:** The asset may be plant and machinery, car, equipment, land and building, aircraft and so on.
- (3) **Ownership v/s Use:** It is important to note that in the leasing contract, ownership of the asset is with the lessor whereas its actual use is allowed to the lessee. On expiry of the lease tenure, the asset reverts to the lessor.
- (4) **Lease term:** The lease term is the definite period for which the lease agreement remains in operation. The lease period may sometimes stretch over the entire economic life of the asset (i.e. financial lease) or a period shorter than the useful life of the asset (i.e. operating lease). The lease may be perpetual, that is, with an option at the end of lease period to renew the lease for the further period.
- (5) **Lease Rentals:** Lease rental is the consideration which the lessee pays to the lessor for the lease transaction. The lease rentals are fixed up to compensate the lessor for interest on the investment made in the asset, depreciation, repairs, maintenance, insurance and servicing charges over the lease period.

- (6) **Mode of terminating lease:** At the end of the lease period, following options are available:
 - (i) Renewal for a definite period,
 - (ii) Lessor sells the asset to the lessee,
 - (iii) Asset reverts to the lessor and he sells it to the third party.

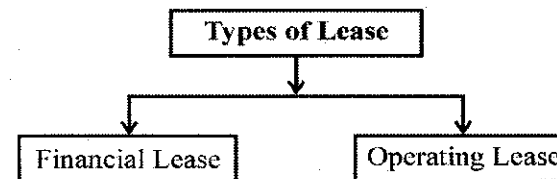
TYPES OF LEASES

According to the Accounting Standard on Leases (AS -19), the classification of lease is based on the extent to which risks and rewards incidental to ownership of a leased asset lie with the lessor or the lessee.

Risk includes the possibilities of losses due to obsolescence or changing economic conditions.

Reward includes expectations of profitable operation over the economic life of the asset.

Further whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than its form.



The different types of leases are discussed below:

1. FINANCIAL LEASE

As per Accounting Standard (AS-19), in a finance lease, the lessor transfers to the lessee, substantially all the risks and rewards incidental to the ownership of the asset whether or not the title is eventually transferred. It involves payment of rentals over the lease period which is sufficient to amortise the capital outlay of the lessor and leave some profit. In such leases, the lessor is only a financier.

Finance lease is also called 'full pay out leases'. Types of assets included under such lease, are ships, aircrafts, railway wagons, lands, building, heavy machinery etc.

This type of lease which is for a long period provides for the use of asset during the primary lease period which devotes almost the entire life of the asset. The lessor assumes the role of a financier and hence services of repairs, maintenance etc., are not provided by him. The legal title is retained by the lessor who has no option to terminate the lease agreement, if the rentals are paid regularly.

The finance lease is also called capital lease. The lessor thus is typically a financial institution and does not render specialized service in connection with the asset.

Features of Finance Lease

- (a) The lease arrangement results into transfer of ownership of the asset to the lessee by the end of the lease term by the lessor.
- (b) The lessee has the option to purchase the asset at the end of the lease term.
- (c) The lease term is for the major part of the economic life of the asset. The lease is originally for a non-cancellation period called the primary lease period during which the lessor seeks to recover his investment along with some profit. Thereafter, the lease is subject to renewal for the secondary lease period at the low rentals.
- (d) The leased asset is of the specialised nature and thus, only the lessee can use it without major modification.
- (e) The risk of obsolescence and liability for repair, maintenance and insurance of the asset rests with the lessee.

Accounting treatment of Finance Lease in the Financial Statements of a Lessor

The lessor should recognise assets given under a finance lease in its balance sheet as a receivable at an amount equal to the net investment in the lease. Under a finance lease all the risks and rewards incident to legal ownership are transferred by the lessor, and thus the lease

payment receivable is treated by the lessor as repayment of principal, i.e., net investment in the lease and finance income to reimburse and reward the lessor for its investment and services.

Accounting treatment of Finance Lease in the Financial Statements of a Lessee

At the inception of a finance lease, the lessee should recognise the lease as an asset and a liability both. Such recognition should be at an amount equal to the fair value of the leased asset at the inception of the lease.

Lease payments should be apportioned between the finance charge and the reduction of the outstanding liability.

2. OPERATING LEASE

According to the AS -19, an operating lease is one which is not a finance lease. In an operating lease, the lessor does not transfer all the risks and rewards incidental to the ownership of the asset to the lessee. The cost of the asset is not fully amortised during the primary lease period. The lessor provides services attached to the leased asset, such as maintenance, repairs and technical advice. Operating lease is also called 'service lease'. The lease rentals in an operating lease include a cost for the services provided and the lessor does not depend on a single lessee for recovery of his cost.

Features of Operating Lease

- (a) An operating lease is generally for a period shorter than the economic life of the leased asset.
- (b) As the lease periods are shorter than the expected life of the asset, the lease rentals are not sufficient to amortise the cost of the assets.
- (c) The lessor does not rely on the single lessee for the recovery of his investment.
- (d) Operating leverage normally includes maintenance clause requiring the lessor to maintain the leased asset.

Accounting treatment of Operating Lease in the Financial Statements of a Lessor

The lessor should present an asset given under operating lease in its balance sheet under fixed assets. Lease income from operating leases should be recognised in the statement of profit and loss on a straight line basis over the lease term.

Costs, including depreciation, incurred in earning the lease income are recognised as an expense.

Accounting treatment of Operating Lease in the Financial Statements of a Lessee

Lease payments under an operating lease should be recognised as an expense in the statement of profit and loss on a straight line basis over the lease term.

As per AS-19, in a finance lease, the lessor transfers to the lessee, substantially all the risks and rewards incidental to the ownership of the asset whether or not the title is eventually transferred.

According to the AS -19, an operating lease is one which is not a finance lease

Operating Lease v/s Finance Lease

OPERATING LEASE	FINANCE LEASE
<p>1. Meaning as per AS -19 : According to the AS -19, an operating lease is one which is not a finance lease.</p>	<p>As per AS-19, in a finance lease, the lessor transfers to the lessee, substantially all the risks and rewards incidental to the ownership of the asset whether or not the title is eventually transferred.</p>
<p>2. Ownership: Ownership of the leased asset lies with the lessor for the entire period.</p>	<p>Ownership transfer option at the end of the lease period is available to the lessee. The title might or might not be transferred eventually.</p>

<p>3. Purchase Option : In operating lease, the lessee does not have an option to buy asset during the lease period.</p>	<p>A finance lease allows the lessee to have a purchase option at less than the fair market value of the asset.</p>
<p>4. Lease Term : Lease term extends to less than 75% of the projected useful life of the leased asset.</p>	<p>The lease term is for the major part of the economic life of the asset.</p>
<p>5. Expenses : Lessee pays only the monthly lease payment in operating lease.</p>	<p>In finance lease, lessee bears expenses such as insurance, maintenance and taxes.</p>
<p>6. Tax Benefit : Operating lease is similar to renting. The lease rental is considered as allowable expense from taxable profits. However, depreciation cannot be claimed as an expense.</p>	<p>The lessee can claim interest and depreciation both as deductions from taxable profit and thereby reduce tax liability.</p>
<p>7. Running Costs : In operating lease, no running costs or administrative costs such as registration, repairs are borne by the lessee as it gives only right to use the asset.</p>	<p>In finance lease, running costs and administrative costs are to be borne by the lessee and these are higher.</p>
<p>8. Risk and Rewards Related to the Asset : Risk and rewards related to the asset is with the lessor.</p>	<p>Risk and rewards related to the asset is with the lessee.</p>

ADVANTAGES / SIGNIFICANCE OF LEASING

A. TO THE LESSEE

- 1. Financing of capital goods:** Lease financing enables the lessee to have finance for large investments in capital assets upto 100%, without any immediate payment.

2. **Additional source of finance:** Leasing facilitates the purchase of capital assets without finance. This improves working capital position of the lessee. Thus internal accruals are available for business operations.
3. **Balanced Cash Outflow:** The biggest advantage of leasing is that cash outflow or payments related to leasing are spread out over several years, hence saving the burden of one-time significant cash payment. This helps a business to maintain a steady cash-flow profile.
4. **Less expensive:** Leasing is less expensive mode of finance compared to other alternatives.
5. **No dilution of ownership:** There is no dilution of ownership and control in case of leasing. The other modes of long term finance such as equity, dilutes the ownership and control.
6. **Free from restrictive conditions:** Lease financing is beneficial compared to institutional finance as it is free from restrictive terms and conditions such as representation on the Board.
7. **Flexibility in structuring lease rentals:** The lease rentals can be structured to accommodate the cash flow position of the lessee, making the payment of rentals convenient to him. Further the lease period is also chosen so as to suit the lessee's capacity to pay rentals. There is no such flexibility available in debt-servicing of conventional loan. Such loans generally have to be repaid over a specified number of instalments resulting in heavy debt servicing burden in initial years of project/business whereas the project/business may actually generate substantial cashflows in later years.
8. **Simplicity:** A lease finance arrangement is simple to negotiate and requires simple documentation. Institutional finance requires compliance with terms and conditions. It also requires detailed documentation.
9. **Tax benefits:** The lessee gets certain benefits in the payment of rent, maintenance of the equipment and other expenditure incurred by him in keeping the equipment operational. For all

- these expenses, the lessee will be claiming deductions resulting in tax benefits under the Income Tax Act. The benefits will be more when initial rentals are higher. During the later part of the lease period, it will become less.
10. **Minimum delay:** Usually, leasing companies take much lesser 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.
 11. **Shifting the Risk of Obsolescence:** Due to fast 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.
 12. **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.
 13. **Convenience:** Operating or service leases are usually cancellable enabling the lessee 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.
 14. **Good Quality Assets:** While leasing an asset, the ownership of the asset still lies with the lessor whereas the lessee just pays the rental expense. Given this agreement, it becomes possible for a business to invest in good quality assets which might look unaffordable or expensive otherwise.
- B. TO THE LESSOR**
1. **Assured Regular Income:** Lessor gets lease rental by leasing an asset during the period of lease which is an assured and regular income.
 2. **Preservation of Ownership:** The lessor's interest is secured as he is the owner of the leased asset and have a right to take repossession of the asset if the lessee defaults.

3. **Tax Benefit:** As ownership lies with the lessor, tax benefit is enjoyed by the lessor by way of depreciation in respect of leased asset. If the lessor is in high tax bracket, he can lease out assets with high depreciation rates and thus, reduce his tax liability substantially.
4. **High Potentiality of Growth:** The demand for leasing is steadily increasing because it is one of the cost efficient forms of financing. Lease financing enables the lessees to acquire equipment and machinery even during depression, as they do not have to invest any capital. Thus economic growth can be maintained even during the period of depression. Therefore, the growth prospects of leasing is much higher as compared to other forms of business.
5. **Recovery of Investment:** In case of finance lease, the lessor can recover the total investment through lease rentals.
6. **Trading on Equity:** Lessors generally carry out their operations with greater financial leverage which results in higher return on equity.

DISADVANTAGES OF LEASING

A. TO THE LESSEE

1. **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.
2. **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.
3. **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. Further a lease arrangement may impose certain restrictions on use of the equipment or require compulsory insurance.
 4. **Loss of ownership incentives:** There are certain advantages of owning the assets, such as depreciation and investment allowance. In case of lease arrangement, the lessee is not entitled to such benefits.
 5. **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. Further the lessor, generally leases out assets which are purchased by him with the help of bank credit. In the event of a default by the lessor in the payment obligation to the bank, the asset would be seized by the bank which is disadvantageous to the lessee.
 6. **No ownership:** At the end of the leasing period, the lessee does not end up becoming the owner of the asset though quite a good sum of payment is being paid over the years towards the asset.
 7. **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.
 8. **Understatement of asset:** As lessee is not the owner of the asset, such an asset cannot be shown in the balance sheet which leads to understatement of lessee's asset.
- ### **B. TO THE LESSOR**
1. **Unprofitable in case of Inflation:** Lessor gets fixed amount of lease rental every year and these cannot be increased even if the cost of asset goes up.
 2. **Double taxation:** Tax may be charged twice, first at the time of purchase of asset and second at the time of leasing the asset.
 3. **Greater chance of damage of asset:** As ownership is not transferred, the lessee uses the asset carelessly and there is a

great chance that asset cannot be useable after the expiry of primary period of lease.

Section 9 of the CGST Act 2017, is the charging section, which imposes tax on any "supply".

Section 7(1) of the CGST Act defines the word "supply", which consists of all forms of supply of goods and services:

"Supply" includes "all forms of supply of goods or services or both such as sale, transfer, barter, exchange, licence, rental, lease or disposal made or agreed to be made for a consideration by a person in the course or furtherance of business."

As per Schedule II, any transfer of right in goods amounts to supply of services. In case of both, operating leases and financial leases, there is a transfer of right to use to the goods from the Lessor to the Lessee. Therefore, under the GST law, both will be treated in a similar way, unless otherwise provided in future.

LEASING IN INDIA

The numerous financial institutions and commercial banks have started leasing business. ICICI was a financial institution which entered the industry in 1980s giving a boost to the concept of leasing.

First Leasing and 20th Century were the public companies which joined the industry. International Finance Corporation opened four leasing joint ventures in India. Meanwhile, to add to the leasing boom, the Finance Ministry announced strict measures for enlistment of investment companies on stock-exchanges, which made many investment companies to turn overnight into leasing companies.

As per RBI's records by 31st March, 1986, there were 339 equipment leasing companies in India whose assets leased aggregated to ₹ 2395.5 million. One can take a note of increase in number - from merely 2 in 1980 to 339 in a short span of 6 years.

Another significant phase in the development of Indian leasing was

the Dahotre Committee's recommendations based on which the RBI formed guidelines on commercial bank funding to leasing companies. The growth of leasing in India has distinctively been assisted by funding from banks and financial institutions.

Banks themselves were allowed to offer leasing facilities much later - in 1994. However, even to date, commercial banking machinery has not been able to gear up to make any remarkable difference to the leasing scenario.

The post-liberalisation era has been witnessing the slow but sure increase in foreign investment into Indian leasing.

In order to address the ambiguities in various segments of the economy, the GST Council framed sector specific FAQs to resolve the issues. One set of such FAQs are meant for the financial services sector and it is these FAQs that has opened up whole lot of complexities.

Question 47 of the FAQs runs as follows:

47. Whether interest on a finance lease transaction is taxable under GST?

A finance lease is a method of borrowing against the asset. The interest represents the time value of the money expended by the Bank in financing the asset. Services by way of extending deposits, loans or advances in so far as the consideration is represented by way of interest or discount (other than interest involved in credit card services) is exempt. But, in a financial lease the ownership of the asset is with the bank. In essence, it is a 'purchase the asset and lend it further' transaction for bank. Therefore, neither the services are purely in the nature of extending loans nor is the consideration for a financial lease purely in the nature of interest. Thus, interest on finance lease transactions will be taxable under GST.

LEGAL ASPECTS OF LEASING

1. The Contract Act applied to leasing contracts. There are certain provisions specially applicable to leasing.

The provisions of the Law of Contract relating to bailment are specifically applicable to leasing contract. Leasing agreement is primarily a bailment agreement. Lessor is a bailor who delivers goods and lessee is a bailee to whom goods are delivered for use.

Liabilities of lessee (bailee) :

- A lessee is liable to pay lease rentals as per agreement.
- A lessee is required to take reasonable care of goods leased to him.
- The lessee must not use the goods for a purpose different from that stipulated in the lease agreement.
- The lessee is obliged to return the goods as soon as the lease agreement expires.

Liabilities of lessor (bailor) :

- The lessor is required to ensure the delivery of goods to the lessee.
- Peaceful possession by the lessee should be allowed by the lessor as per agreement.
- The lessor must disclose all defects known to him in the goods leased to the lessee.

In case of breach of obligations stated above, the lessor can forfeit the rentals paid by lessee. Where the alterations are made in the asset by lessee, the lessor can claim damages. The lessor may have a right to terminate the contract and take repossession after serving a notice.

In case of breach of obligation by lessor, the lessee can claim damages for loss resulting from termination.

2. Leasing companies are governed by RBI's directions issued to NBFCs.
3. NBFCs involved in leasing of vehicles are governed by Motor Vehicles Act. The lessor is regarded as the owner for the purpose of registration of vehicles under the Act.

4. Indian Stamp Act governs payment of stamp duty on lease documents.

DEFINITION OF HIRE PURCHASE

Hire purchase is a method of financing of the fixed asset to be purchased on future date. Under this method of financing, the purchase price is paid in instalments. Ownership of the asset is transferred after the payment of the last instalment.

Hire purchase agreements are agreements whereby an owner of goods allows a person, the hirer, to hire goods from him for a certain period of time by paying instalments. The hirer has an option to buy the goods at the end of the agreement, if all instalments are being paid. This is not a contract of sale but contract of bailment as the hirer merely has an option to buy the goods. Although the hirer has the right of using the goods, he is not the legal owner during the term of the agreement.

Terms used in Hire Purchase Agreements

1. **Hire vendor:** Hire vendor is a person who delivers the goods and gives its possession to the hire purchaser under an agreement.
2. **Hire purchaser:** Hire purchaser is a person who obtains the goods and rights to use the same from hire vendor under a hire purchase agreement.
3. **Cash price:** This is the outright purchase price of goods in cash.
4. **Down payment:** This is the initial purchase price made by the hire purchaser to the hire vendor at the time of hire purchase agreement.
5. **Hire purchase instalment:** It is the amount which the hire purchaser has to pay at regular intervals upto certain period as per hire purchase agreement. The agreement indicates the number of total instalments in which the balance amount is payable. The balance amount is equal to the Hire Purchase Price Less Down Payment. The agreement states the amount and due

date of each instalment. Each instalment amount consists of part payment towards cash price plus interest.

6. **Hire purchase price:** It is the total sum payable by the hire purchaser under the hire purchase agreement. It comprises of cash price and interest on outstanding balance.
7. **Interest:** The hire purchase agreement states the rate of interest charged by the vendor on the unpaid/outstanding amount.

Calculation of Interest (For T.Y.B.M.S)

1. Calculation of interest where cash price, interest rates and instalments are given.

Each hire purchase instalment includes the amount of interest. As Interest is a nominal account, it's amount should be separated from the cost of the asset.

Hire-Purchase Price = Cash Price of the goods plus Total Interest.

In other words, Total Interest = Hire Purchase Price Less Cash Price of the goods.

But it is not sufficient to find out total interest. The periodical interest needs to be calculated so that the Profit and Loss Account of the year to which interest belongs can be debited.

The steps to calculate the amount of interest are listed below:

1. Deduct down payment from the cash price. Calculate the interest at the given rate on the remaining balance. This is the amount of interest included in the 1st instalment.
2. Deduct the amount of interest from the 1st instalment. The resultant amount is the cash price included in the 1st instalment.
3. Deduct the cash price calculated in the above step 2 from the balance due. It represents the cash price outstanding after the 1st instalment.
4. Calculate the interest at the given rate on the balance outstanding after 1st instalment. Deduct this interest from the

amount of the 2nd instalment to get the cash price included in the 2nd instalment.

5. Deduct the cash price of the 2nd instalment obtained in step 4 from the balance due. It represents the balance due after 2nd instalment.

Repeat the above steps till the last instalment is paid. The cash price outstanding will be nil after the last instalment.

2. Calculation of interest where rate of interest is not given

The total interest should be allocated in the proportion of outstanding hire purchase price when the cash price and the amount of instalments are given, but the rate of interest is not given. The following steps are followed to calculate the interest.

1. Calculate the total interest by deducting the cash price from the hire purchase price. Hire purchase price = Down payment + (Amount of each instalment x Number of instalments)
2. Deduct down payment from the hire purchase price.
3. Calculate the amount of outstanding balances of the hire purchase price at the beginning of each year.
4. Calculate the ratio of outstanding balance of step 3.
5. Calculate the amount of interest of each instalment on the basis the ratio of step 4.

Illustration 1 : (When rate of interest and total cash price are given)

On April 1, 2015 A Ltd. purchased a Machinery on hire-purchase system from B Ltd. According to the terms of the agreement ₹ 80,000, was to be paid on the signing of the contract. The balance was to be paid in four annual installments of ₹ 50,000 each plus interest. The cash price of the plant was ₹ 2,80,000. Interest chargeable on outstanding balance was 10% per annum. Depreciation at the rate of 10% on Straight Line Method is to be provided. You are required to calculate interest.

Solution :

Calculation of Interest

Particulars	Down	1	2	3	4
Opening cash price	2,80,000	2,00,000	1,50,000	1,00,000	50,000
DP/Instalment Amount					
Amount	80,000	70,000	65,000	60,000	55,000
Interest @ 10%	0	20,000	15,000	10,000	5,000
Cash price paid	80,000	50,000	50,000	50,000	50,000
Closing cash price	2,00,000	1,50,000	1,00,000	50,000	0

Illustration 2 : (When rate of interest, total cash price and instalments are given)

M/S Shriram Transport Ltd. purchases a car on hire-purchase system on April 1, 2017 from Vista Automobile Ltd., the total cash price of the car is ₹ 3,30,000. ₹ 1,00,000 is payable at the time of delivery. Three equal annual installments of is 1,00,000 payable on 31st March for 3 years. Interest is charged at 15% per annum. You are required to calculate interest paid by the buyer to seller each year.

Solution :

Calculation of Interest

Particulars	Down Payment	1	2	3
Opening cash price	3,30,000	2,30,000	1,64,500	89,175
DP/Instalment Amount	1,00,000	1,00,000	1,00,000	1,00,000
Interest @ 15%	0	34,500	24,675	10,825
Cash price paid	1,00,000	65,500	75,325	89,175
Closing cash price	2,30,000	1,64,500	89,175	0

Illustration 3 : (When Cash Price and Instalment amount are given)

Mr. Nayak purchased a computer on hire-purchase system on April 1, 2016. Cash price of computer is ₹ 56,000. The hire purchase price of the same asset is ₹ 60,000. As per terms, he is required to pay ₹ 15,000 down, i.e., on April 1, 2016 and the balance in three equal

instalments at ₹ 15,000. You are required to calculate interest and split the instalment amount into instalment cash price and instalment interest.

Solution :

Calculation of Interest

Particulars	Down Payment	1	2	3
Opening cash price	56,000	41,000	28,000	14,333
DP/Instalment Amount	15,000	15,000	15,000	15,000
Interest	0	2,000	1,333	667
Cash price paid	15,000	13,000	13,667	14,333
Closing cash price	41,000	28,000	14,333	0

Total Interest = 60,000 - 56,000 = ₹ 4,000

Amount outstanding after down payment = ₹ 45,000

Outstanding after first instalment = 45,000 - 15,000 = ₹ 30,000

Outstanding after second instalment = 30,000 - 15,000 = ₹ 15,000

Outstanding after third instalment = 15,000 - 15,000 = Nil

Ratio in which interest can be distributed = 3 : 2 : 1

Interest included in 1st instalment = 4,000 × 3/6 = ₹ 2,000

Interest included in 2nd instalment = 4,000 × 2/6 = ₹ 1,333

Interest included in 3rd instalment = 4,000 × 1/6 = ₹ 667

Accounting Method

FULL CASH PRICE METHOD/CREDIT PURCHASE METHOD/SALE METHOD

Accounting in Hire Purchaser's Books

As per this method, the hire purchaser is treated as the owner of the asset from the beginning. The cash price of the asset is debited to

the asset account and credited to the vendor's account at the beginning. Interest payable and depreciation are required to be calculated and debited to respective accounts and credited to the Vendor's A/c and Asset A/c respectively. The balances of Interest A/c and Depreciation A/c are transferred to Profit & Loss A/c at the year end. While paying down payment and installment amount, Vendor A/c is debited and Bank A/c is credited.

Accounting in Hire Vendor's Books

As per this method, the cash price of the asset is debited to the hire purchaser's account and credited to the hire purchase sales account at the beginning. Interest amounts receivable are required to be calculated and debited to the Hire Purchaser's A/c and credited to interest due account. The balance of Interest A/c is transferred to Profit & Loss A/c at the year end. While receiving down payment and installment amount, Bank A/c is debited and Hire Purchaser's A/c is credited with the amount received. As the asset is treated as sold under hire purchase method, there is no depreciation charged.

JOURNAL ENTRIES

In The Books of Hire Purchaser

When the asset is recorded in full cash price : Full Cash Price Method

1. *For the Purchase of Asset :*

Asset A/c (Full cash price)	Dr.
To Vendor A/c	
2. *For the Payment made for 'Down Payment'*

Vendor A/c	Dr.
To Bank A/c	
3. *For Interest Due*

Interest A/c	Dr.
To Vendor A/c	

4. *For the Payment of Installment*

Vendor A/c	Dr.
To Bank A/c	

5. *For Charging Depreciation (On the Basis of Cash Value)*

Depreciation A/c	Dr.
To Asset A/c	

6. *For Transfer of Interest and Depreciation (Both Methods)*

Profit and Loss A/c	Dr.
To Depreciation A/c	
To Interest A/c	

Note: Entries 3,4,5 and 6 will be repeated year after year until the final installment is paid.

Journal Entries in The Books of Vendor

1. *For Selling Goods on Hire Purchase*

Hire Purchase A/c (Full cash price)	Dr.
To Sales/Hire Purchase Sales A/c	
2. *For Receiving Down Payment*

Bank A/c	Dr.
To Hire Purchaser A/c	
3. *For Interest Due*

Hire Purchaser A/c	Dr.
To Interest A/c	
4. *For Receiving the Installment*

Bank A/c	Dr.
To Hire Purchaser A/c	

5. For Transferring Interest

Interest A/c Dr.

To Profit and Loss A/c

Illustration 4 :

Refer Illustration 1. You are required to journalise the transactions for all the years in the books of A Ltd. under full cash price/credit purchase method. Also show the Machinery A/c and the Hire Vendor's A/c in A Ltd.'s ledger.

Solution :**JOURNAL OF A LTD.**

Date	Particulars	Debit ₹	Credit ₹
2015			
Apr. 1	Machinery A/c Dr. To B Ltd.'s A/c (Being purchase of machinery on hire purchase basis as per agreement)	2,80,000	2,80,000
Apr. 1	B Ltd.'s A/c Dr. To Bank A/c (Being the down payment paid to the hire vendor)	80,000	80,000
2016			
Mar. 31	Interest A/c Dr. To B Ltd.'s A/c (Being Interest due to the hire vendor)	20,000	20,000
Mar. 31	B Ltd.'s A/c Dr. To Bank A/c (Being Instalment amount paid to the hire vendor)	70,000	70,000
Mar. 31	Depreciation A/c Dr. To Machinery A/c (Being depreciation on the machinery for the year)	28,000	28,000

Mar. 31	Profit & Loss A/c Dr. To Interest A/c To Depreciation A/c (Being the amount charged to P & L A/c at the year end)	48,000	20,000 28,000
2017			
Mar. 31	Interest A/c Dr. To B Ltd.'s A/c (Being Interest due to the hire vendor)	15,000	15,000
Mar. 31	B Ltd.'s A/c Dr. To Bank A/c (Being Instalment amount paid to the hire vendor)	65,000	65,000
Mar. 31	Depreciation A/c Dr. To Machinery A/c (Being depreciation on the machinery for the year)	28,000	28,000
Mar. 31	Profit & Loss A/c Dr. To Interest A/c To Depreciation A/c (Being the amount charged to P & L A/c at the year end)	43,000	15,000 28,000
2018			
Mar. 31	Interest A/c Dr. To B Ltd.'s A/c (Being Interest due to the hire vendor)	10,000	10,000
Mar. 31	B Ltd.'s A/c Dr. To Bank A/c (Being Instalment amount paid to the hire vendor)	60,000	60,000
Mar. 31	Depreciation A/c Dr. To Machinery A/c (Being depreciation on the machinery for the year)	28,000	28,000
Mar. 31	Profit & Loss A/c Dr. To Interest A/c To Depreciation A/c (Being the amount charged to P & L A/c at the year end)	38,000	10,000 28,000

2019 Mar. 31	Interest A/c To B Ltd.'s A/c (Being Interest due to the hire vendor)	Dr.	5,000	5,000
Mar. 31	B Ltd.'s A/c To Bank A/c (Being Instalment amount paid to the hire vendor)	Dr.	55,000	55,000
Mar. 31	Depreciation A/c To Machinery A/c (Being depreciation on the machinery for the year)	Dr.	28,000	28,000
Mar. 31	Profit & Loss A/c To Interest A/c To Depreciation A/c (Being the amount charged to P & L A/c at the year end)	Dr.	33,000	5,000 28,000

LEDGER OF A LTD.

Dr. Machinery A/c Cr.

Date	Particulars	₹	Date	Particulars	₹
2015 Apr. 1	To B Ltd.	2,80,000	2016 Mar. 31 Mar. 31	By Depreciation By Balance c/d	28,000 2,52,000
		2,80,000			2,80,000
2016 Apr. 1	To Balance b/d	2,52,000	2017 Mar. 31 Mar. 31	By Depreciation By Balance c/d	28,000 2,24,000
		2,52,000			2,52,000
2017 Apr. 1	To Balance b/d	2,24,000	2018 Mar. 31 Mar. 31	By Depreciation By Balance c/d	28,000 1,96,000
		2,24,000			2,24,000
2018 Apr. 1	To Balance b/d	1,96,000	2019 Mar. 31 Mar. 31	By Depreciation By Balance c/d	28,000 1,68,000
		1,96,000			1,96,000

Dr. B Ltd.'s (Hire Vendor) A/c Cr.

Date	Particulars	₹	Date	Particulars	₹
2015 Apr. 1	To Bank A/c	80,000	2015 Apr. 1	By Machinery A/c	2,80,000
2016 Mar. 31 Mar. 31	To Bank A/c To Balance c/d	70,000 1,50,000	2016 Mar. 31	By Interest A/c	20,000
		3,00,000			3,00,000
2017 Mar. 31 Mar. 31	To Bank A/c To Balance c/d	65,000 100,000	2016 Apr. 1 2017 Mar. 31	By Balance b/d By Interest A/c	1,50,000 15,000
		1,65,000			1,65,000
2018 Mar. 31 Mar. 31	To Bank A/c To Balance c/d	60,000 50,000	2017 Apr. 1 2018 Mar. 31	By Balance b/d By Interest A/c	1,00,000 10,000
		1,10,000			1,10,000
2019 Mar. 31	To Bank A/c	55,000	2018 Apr. 1 2019 Mar. 31	By Balance b/d By Interest A/c	50,000 5,000
		55,000			55,000

Illustration 5 :

On April 1, 2016 a railway company buys on the hire purchase system a truck for ₹ 1,50,000 payable ₹ 30,000 cash as a down payment. The balance payment shall be made in four annual installments of ₹ 30,000 principal portion plus interest at 12% per annum. The installments are payable on 31st December each year. The first installment being payable on 31.12.2016.

Prepare the ledger accounts of the Truck A/c and Hire Purchase Vendor A/c in the books of the Railway company for 4 years assuming that the accounts are closed on 31st December each year and depreciation at 10% p.a. is charged on the original cost.

Solution :

(TYBMS, April 2017, adapted)

LEDGER OF RAILWAY COMPANY

Dr.

Truck A/c

Cr.

Date	Particulars	₹	Date	Particulars	₹
2016 Apr. 1	To Hire Purchase Vendor Ltd.	1,50,000	2016 Dec. 31	By Depreciation	11,250
		1,50,000	Dec. 31	By Balance c/d	1,38,750
					1,50,000
2017 Jan. 1	To Balance b/d	1,38,750	2017 Dec. 31	By Depreciation	15,000
		1,38,750	Dec. 31	By Balance c/d	1,23,750
					1,38,750
2018 Jan. 1	To Balance b/d	1,23,750	2018 Dec. 31	By Depreciation	15,000
		1,23,750	Dec. 31	By Balance c/d	1,08,750
					1,23,750
2019 Jan. 1	To Balance b/d	1,08,750	2019 Dec. 31	By Depreciation	15,000
		1,08,750	Dec. 31	By Balance c/d	93,750
					1,08,750

Dr.

Hire Purchase Vendor A/c

Cr.

Date	Particulars	₹	Date	Particulars	₹
2016 Apr. 1	To Bank A/c	30,000	2016 Apr. 1	By Truck A/c	1,50,000
Dec. 31	To Bank A/c	40,800	Dec. 31	By Interest A/c	10,800
Dec. 31	To Balance c/d	90,000			
		1,60,800			1,60,800
2017 Dec. 31	To Bank A/c	40,800	2017 Jan. 1	By Balance b/d	90,000
Dec. 31	To Balance c/d	60,000	Dec. 31	By Interest A/c	10,800
		1,00,800			1,00,800

2018 Dec. 31	To Bank A/c	37,200	2018 Jan. 1	By Balance b/d	60,000
Dec. 31	To Balance c/d	30,000	Dec. 31	By Interest A/c	7,200
		67,200			67,200
2019 Dec. 31	To Bank A/c	33,600	2019 Jan. 1	By Balance b/d	30,000
Dec. 31	By Interest A/c	3,600			
		33,600			33,600

Working Note :

Calculation of Interest

Particulars	Down Payment	31.12.16	31.12.17	31.12.18	31.12.19
Opening cash price	1,50,000	1,20,000	90,000	60,000	30,000
DP/Instalment Amount	30,000	40,800	40,800	37,200	33,600
Interest @ 12%	0	10,800	10,800	7,200	3,600
Cash price paid	30,000	30,000	30,000	30,000	30,000
Closing cash price	1,20,000	90,000	60,000	30,000	0

Illustration 6 :

On 1st April, 2015 Laxman Ltd. purchased a machine from SSC Ltd. on hire purchase basis. The cash price of the machine was ₹ 5,00,000. The payment was to be made ₹ 1,00,000 on the date of agreement and the balance in four annual installment of ₹ 1,00,000 plus interest at 8% per annum payable on 31st December each year. The first instalment being payable on 31st December 2015. Prepare Machine A/c and SSC Ltd. A/c in the books of Laxman Ltd. assuming that the account are closed on 31st December every year and depreciation at 10% p.a. is charged on the original cost.

LEDGER OF LAXMAN LTD.

Dr. **Machine A/c** Cr.

Date	Particulars	₹	Date	Particulars	₹
2015 Apr. 1	To SSC Ltd.	5,00,000	2015 Dec. 31	By Depreciation	37,500
			Dec. 31	By Balance c/d	4,62,500
		5,00,000			5,00,000
2016 Jan. 1	To Balance b/d	4,62,500	2016 Dec. 31	By Depreciation	50,000
			Dec. 31	By Balance c/d	4,12,500
		4,62,500			4,62,500
2017 Jan. 1	To Balance b/d	4,12,500	2017 Dec. 31	By Depreciation	50,000
			Dec. 31	By Balance c/d	3,62,500
		4,12,500			4,12,500
2018 Jan. 1	To Balance b/d	3,62,500	2018 Dec. 31	By Depreciation	50,000
			Dec. 31	By Balance c/d	3,12,500
		3,62,500			3,62,500

Dr. **SSC Ltd. (Hire Purchase Vendor) A/c** Cr.

Date	Particulars	₹	Date	Particulars	₹
2015 Apr. 1	To Bank A/c	1,00,000	2015 Apr. 1	By Machine A/c	5,00,000
Dec. 31	To Bank A/c	1,32,000	Dec. 31	By Interest A/c	32,000
Dec. 31	To Balance c/d	3,00,000			
		5,32,000			5,32,000
2016 Dec. 31	To Bank A/c	1,24,000	2016 Jan. 1	By Balance b/d	3,00,000
Dec. 31	To Balance c/d	2,00,000	Dec. 31	By Interest A/c	24,000
		3,24,000			3,24,000

2017 Dec. 31	To Bank A/c	1,16,000	2017 Jan. 1	By Balance b/d	2,00,000
Dec. 31	To Balance c/d	1,00,000	Dec. 31	By Interest A/c	16,000
		2,16,000			2,16,000
2018 Dec. 31	To Bank A/c	1,08,000	2018 Jan. 1	By Balance b/d	1,00,000
			Dec. 31	By Interest A/c	8,000
		1,08,000			1,08,000

Working Note :

Calculation of Interest

Particulars	Down Payment	31.12.15	31.12.16	31.12.17	31.12.18
Opening cash price	5,00,000	4,00,000	3,00,000	2,00,000	1,00,000
DP/Instalment Amount	1,00,000	1,32,000	1,24,000	1,16,000	1,08,000
Interest @ 8%	0	32,000	24,000	16,000	8,000
Cash price paid	1,00,000	1,00,000	1,00,000	1,00,000	1,00,000
Closing cash price	4,00,000	3,00,000	2,00,000	1,00,000	0

Illustration 7 :

On 1st January, 2014 Sudha purchased a LED T.V. from Vijay Sales on hire purchase system.

The terms of the Contract were as under :

1. The cash price of the T.V. was ₹ 1,30,000.
2. ₹ 40,000 was to be paid on signing of the contract.
3. The balance was to be paid in annual installments of ₹ 30,000 each plus interest at the rate of 10%.

Depreciation is charged @ 10% p.a. on written down value.

You are required to prepare T.V. A/c and Vijay Sales A/c for the year ended 31.12.14, 31.12.15 & 31.12.16 by using full cash price method.

Solution :

LEDGER OF SUDHA

Dr.			T.V. A/c			Cr.		
Date	Particulars	₹	Date	Particulars	₹			
2014			2014					
Jan. 1	To Vijay Sales A/c	1,30,000	Dec. 31	By Depreciation	13,000			
			Dec. 31	By Balance c/d	1,17,000			
		2,80,000			2,80,000			
2015			2015					
Jan. 1	To Balance b/d	1,17,000	Dec. 31	By Depreciation	11,700			
			Dec. 31	By Balance c/d	1,05,300			
		1,17,000			1,17,000			
2016			2016					
Jan. 1	To Balance b/d	1,05,300	Dec. 31	By Depreciation	10,530			
			Dec. 31	By Balance c/d	94,770			
		1,05,300			1,05,300			

Dr.			Vijay Sales (Hire Purchase Vendor) A/c			Cr.		
Date	Particulars	₹	Date	Particulars	₹			
2014			2014					
Jan. 1	To Bank A/c	40,000	Jan. 1	By Machine A/c	1,30,000			
Dec. 31	To Bank A/c	39,000	Dec. 31	By Interest A/c	9,000			
Dec. 31	To Balance c/d	60,000						
		1,39,000			1,39,000			
2015			2015					
Dec. 31	To Bank A/c	36,000	Jan. 1	By Balance b/d	60,000			
Dec. 31	To Balance c/d	30,000	Dec. 31	By Interest A/c	6,000			
		66,000			66,000			
2015			2016					
Dec. 31	To Bank A/c	33,000	Jan. 1	By Balance b/d	30,000			
			Dec. 31	By Interest A/c	3,000			
		33,000			33,000			

Working Note :

Calculation of Interest

Particulars	Down Payment	31.12.14	31.12.15	31.12.16
Opening cash price	1,30,000	90,000	60,000	30,000
DP/Instalment Amount	40,000	39,000	36,000	33,000
Interest @ 10%	0	9,000	6,000	3,000
Cash price paid	40,000	30,000	30,000	30,000
Closing cash price	90,000	60,000	30,000	0

Illustration 8 :

M/s Cool Cabs purchased a Car from Toyota Motors Ltd. on Hire Purchase basis. The cash price of the car was ₹ 5,00,000. M/s Cool Cabs paid ₹ 2,00,000 on the date of purchase i.e. 1st January, 2014. The balance was paid in three annual instalments including interest @ 10% p.a. on unpaid Cash Price on 31st December each year. The instalments are as follows :

31.12.2014	₹ 1,30,000
31.12.2015	₹ 1,20,000
31.12.2016	₹ 1,10,000

M/s Cool Cabs decided to write off depreciation @ 15% p.a. on the Diminishing Balance Method. You are required to prepare Car Account and M/s Toyota Motors Ltd. Account in books of the M/s Cool Cabs, by using Credit Purchase Method for the year ended 31.12.2014, 31.12.2015 & 31.12.2016. (F.Y.B.Com., November 2017)

Solution :

LEDGER OF M/S COOL CABS

Dr.			Car A/c			Cr.		
Date	Particulars	₹	Date	Particulars	₹			
2014			2014					
Jan. 1	To Toyota Motors A/c	5,00,000	Dec. 31	By Depreciation	75,000			
			Dec. 31	By Balance c/d	4,25,000			
		5,00,000			5,00,000			

2015			2015		
Jan. 1	To Balance b/d	4,25,000	Dec. 31	By Depreciation	63,750
			Dec. 31	By Balance c/d	3,61,250
		4,25,000			4,25,000
2016			2016		
Jan. 1	To Balance b/d	3,61,250	Dec. 31	By Depreciation	54,188
			Dec. 31	By Balance c/d	3,07,062
		3,61,250			3,61,250

Dr. **Toyota Motors Ltd. (Hire Purchase Vendor) A/c** Cr.

Date	Particulars	₹	Date	Particulars	₹
2014			2014		
Jan. 1	To Bank A/c	2,00,000	Jan. 1	By Machine A/c	5,00,000
Dec. 31	To Bank A/c	1,30,000	Dec. 31	By Interest A/c	30,000
Dec. 31	To Balance c/d	2,00,000			
		5,30,000			5,30,000
2015			2015		
Dec. 31	To Bank A/c	1,20,000	Jan. 1	By Balance b/d	2,00,000
Dec. 31	To Balance c/d	1,00,000	Dec. 31	By Interest A/c	20,000
		2,20,000			2,20,000
2016			2016		
Dec. 31	To Bank A/c	1,10,000	Jan. 1	By Balance b/d	1,00,000
			Dec. 31	By Interest A/c	10,000
		1,10,000			1,10,000

Working Note :

Calculation of Interest

Particulars	Down Payment	31.12.14	31.12.15	31.12.16
Opening cash price	5,00,000	3,00,000	2,00,000	1,00,000
DP/Instalment Amount	2,00,000	1,30,000	1,20,000	1,10,000
Interest @ 10%	0	30,000	20,000	10,000
Cash price paid	2,00,000	1,00,000	1,00,000	1,00,000
Closing cash price	3,00,000	2,00,000	1,00,000	0

Illustration 9 :

Mr. Murugan purchased a Machinery from Rallys Ltd. on hire purchase system on 1st April 2014. The cash price of the machine was ₹ 9,00,000. An initial payment of ₹ 3,00,000 was made on the date of purchase. The balance was paid in three annual instalments of ₹ 2,00,000 plus interest @ 15% p.a. on outstanding principal amount. Depreciation is charged @ 10% p.a. on written down value.

Mr. Murugan closes his books on 31st March every year. You are requested to draw Machinery Account, Rallys Ltd. Account and Interest Account in the books of Mr. Murugan for the year 2014-15, 2015-16 and 2016-17 using Full Cash Price Method.

Solution :

(F.Y.B.Com, November 2017)

LEDGER OF MR. MURUGAN

Dr. **Machinery A/c** Cr.

Date	Particulars	₹	Date	Particulars	₹
2014			2015		
Apr. 1	To Rallys A/c	9,00,000	Mar. 31	By Depreciation	90,000
			Mar. 31	By Balance c/d	8,10,000
		9,00,000			9,00,000
2015			2016		
Apr. 1	To Balance b/d	8,10,000	Mar. 31	By Depreciation	81,000
			Mar. 31	By Balance c/d	7,29,000
		8,10,000			8,10,000
2016			2017		
Apr. 1	To Balance b/d	7,29,000	Mar. 31	By Depreciation	72,900
			Mar. 31	By Balance c/d	6,56,100
		7,29,000			7,29,000

Dr. **Rallys Ltd. (Hire Purchase Vendor) A/c** Cr.

Date	Particulars	₹	Date	Particulars	₹
2014			2014		
Apr. 1	To Bank A/c	3,00,000	Apr. 1	By Machine A/c	9,00,000

2015			2015		
Mar. 31	To Bank A/c	2,90,000	Mar. 31	By Interest A/c	90,000
Mar. 31	To Balance c/d	4,00,000			
		9,90,000			9,90,000
2016			2015		
Mar. 31	To Bank A/c	2,60,000	Apr. 1	By Balance b/d	4,00,000
Mar. 31	To Balance c/d	2,00,000	2016		
		4,60,000	Mar. 31	By Interest A/c	60,000
					4,60,000
2017			2016		
Mar. 31	To Bank A/c	2,30,000	Apr. 1	By Balance b/d	2,00,000
			2017		
		2,30,000	Mar. 31	By Interest A/c	30,000
					2,30,000

Dr. Interest A/c Cr.

Date	Particulars	₹	Date	Particulars	₹
2015			2015		
Mar. 31	To Rallys A/c	90,000	Mar. 31	By Profit & Loss A/c	90,000
		90,000			90,000
2016			2016		
Mar. 31	To Rallys A/c	60,000	Mar. 31	By Profit & Loss A/c	60,000
		60,000			60,000
2017			2016		
Mar. 31	To Rallys A/c	30,000	Mar. 31	By Profit & Loss A/c	30,000
		30,000			30,000

Working Note :

Calculation of Interest

Particulars	Down Payment	31.3.15	31.3.16	31.3.17
Opening cash price	9,00,000	6,00,000	4,00,000	2,00,000
DP/Instalment Amount	3,00,000	2,90,000	2,60,000	2,30,000

Interest @ 15%	0	90,000	60,000	30,000
Cash price paid	3,00,000	2,00,000	2,00,000	2,00,000
Closing cash price	6,00,000	4,00,000	2,00,000	0

Illustration 10 :

M/s Presto Plast Company purchased machinery from M/s Kabra Ltd. on Hire Purchase System on 1st April 2013. The cash price of the machine was ₹ 10,00,000. An initial payment of ₹ 2,50,000 was made on the date of purchase. The balance was paid in 3 annual installments including interest @ 8% p.a. as follows :

31.3.2014	₹ 3,10,000
31.3.2015	₹ 2,90,000
31.3.2016	₹ 2,70,000

M/s Presto Plast Company charged depreciation @ 10% p.a. on written down value method. You are required to prepare Machinery Account and M/S Kabra Ltd. A/c in the books of M/s Presto Plast Company for 3 years ending 31.3.2014, 31.3.2015 and 31.3.2016.

Solution :

LEDGER OF M/s PRESTO PLAST COMPANY

Dr. Machinery A/c Cr.

Date	Particulars	₹	Date	Particulars	₹
2013			2014		
Apr. 1	To Toyota Motors A/c	10,00,000	Mar. 31	By Depreciation	1,00,000
			Mar. 31	By Balance c/d	9,00,000
		10,00,000			10,00,000
2014			2015		
Apr. 1	To Balance b/d	9,00,000	Mar. 31	By Depreciation	90,000
			Mar. 31	By Balance c/d	8,10,000
		9,00,000			9,00,000

2015 Apr. 1	To Balance b/d	8,10,000	2016 Mar. 31	By Depreciation	81,000
			Mar. 31	By Balance c/d	7,29,000
		8,10,000			8,10,000

Dr. M/S Kabra Ltd. (Hire Purchase Vendor) A/c Cr.

Date	Particulars	₹	Date	Particulars	₹
2013 Apr. 1	To Bank A/c	2,50,000	2013 Apr. 1	By Machine A/c	10,00,000
2014 Mar. 31	To Bank A/c	3,10,000	2014 Mar. 31	By Interest A/c	60,000
Mar. 31	To Balance c/d	5,00,000			
		10,60,000			10,60,000
2015 Mar. 31	To Bank A/c	2,90,000	2014 Apr. 1	By Balance b/d	5,00,000
Mar. 31	To Balance c/d	2,50,000	2015 Mar. 31	By Interest A/c	40,000
		5,40,000			5,40,000
2016 Mar. 31	To Bank A/c	2,70,000	2015 Apr. 1	By Balance b/d	2,50,000
			2016 Mar. 31	By Interest A/c	20,000
		2,70,000			2,70,000

Working Note :

Calculation of Interest

Particulars	Down Payment	31.3.15	31.3.16	31.3.17
Opening cash price	10,00,000	7,50,000	5,00,000	2,50,000
DP/Instalment Amount	2,50,000	3,10,000	2,90,000	2,70,000
Interest @ 8%	0	60,000	40,000	20,000
Cash price paid	2,50,000	2,50,000	2,50,000	2,50,000
Closing cash price	7,50,000	5,00,000	2,50,000	0

HIRE PURCHASE AND INSTALMENT SALE CHARACTERISTICS

Features of Hire Purchase

1. Hire purchase is an agreement to hire goods.
2. The hire purchaser pays the amount in instalments over a specific predetermined period.
3. The asset will be delivered to the hirer at the time of entering into the contract for use.
4. Every instalment is treated as hire charge for using the asset.
5. The lender has the right to repossess the asset in case of default in the payment of instalment.

Thus the finance company purchases the equipment from the supplier and gives it on hire to the hirer to use. The hirer is required to make a down payment and pay balance with interest in EMIs (Equated Monthly Instalments) over predetermined period. The interest component of each hire-purchase instalment is computed on the basis of a flat rate of interest on the declining balance of the cash price. During the hire period, the hirer can opt for an early repayment and repurchase of the asset. The hirer has the right to terminate the contract after giving due notice.

Instalment Sale Characteristics

Like hire purchase, in instalment system an agreement is made between buyer and seller for purchase and sell of goods. The buyer makes certain down payment at the time of signing agreement and the balance is paid in instalments over a period of time.

An instalment system is a credit sale in which payments are made in instalments over a period of time. In this system, the buyer gets the possession as well as ownership of the goods right at the time of signing the agreement. The vendor can sue the buyer for recovery of dues in case of default instead of taking back possession of goods. The paid instalments can not be forfeited in case of default.

Features of Instalment Sale

1. Instalment sale is just like an outright credit sale of goods.
2. The buyer makes the payment in different instalments over a period of time as agrees upon in the agreement.
3. Under instalment sale, the buyer gets the immediate possession as well as the ownership of goods.
4. The seller cannot repossess the good if the buyer made default in the payment of instalment but he can sue against the buyer for the recovery of amount due.
5. In case of default in the payment of instalment, the total amount of instalments already paid by the buyer cannot be forfeited.
6. Under instalment system, the buyer can sell or mortgage the goods even before paying all the instalments.
7. Risk of goods/assets are to be borne by the buyer just after signing the agreement.
8. The buyer of the goods under instalment purchase system has no right to return the goods to the seller.

There are differences between hire purchase and instalment sale.

HIRE PURCHASE	INSTALMENT SALE
1. Nature of Contract : Hire purchase is an agreement to hire goods.	It is an agreement to sell goods.
2. Number of Parties : There are three parties in hire purchase viz., the seller, the financier and the buyer.	There are only two parties involved in instalment sale viz., the seller and the buyer.
3. Ownership : The ownership of the good is transferred after the payment of final instalment.	The ownership of the good passes on to the purchaser simultaneously with signing the agreement and payment of the initial instalment.

4. Right to Sell or Transfer : The buyer under hire purchase agreement cannot sell, transfer or destroy the goods.	The buyer under instalment sale can sell, transfer or destroy goods.
5. Risk : All the risks are born by the vendor/financing company till the last payment.	All risks are to be borne by the buyer from the date of agreement.
6. Right to Return : The buyer can return the goods before making the final payment.	The buyer cannot return the goods to the seller.
7. Repairs and Maintenance : The liability of repairs and maintenance lies with the seller provided the buyer takes good care of the goods.	The buyer is responsible for repairs and maintenance.
8. Damage Claim : In hire purchase, any damage to the goods will only lead to claiming of insurance by the financier from the insurance company since the ownership has not been transferred.	In instalment sale, any damage to the goods will be claimed by the buyer from the insurance company.
9. Right to Terminate Contract : The hire vendor has a right to terminate contract.	The seller has no right to terminate the contract.
10. Forfeiture of Instalment Paid : When a hirer defaults in the payment of hire charges, the financier has the right to forfeit the money paid till that date and take back the possession of the goods.	The instalments paid are not forfeited and the financier is liable to receive the remaining dues.

In short, the hire purchase system is suitable for the buyers who need the asset for short period or are not sure of long term needs. The option of returning the asset gives them flexibility. Instalment system is useful for those who are sure of utilizing the asset till its lifetime and those who are capable of taking responsibility of the asset in terms of its repairs and maintenance.

HIRE PURCHASE AND LEASING

Without purchasing assets one can use it just by paying a price under Hire Purchase and Leasing arrangements.

The points of distinction between the two are explained as under :

HIRE PURCHASE	LEASING
<p>1. Meaning: Hire Purchase is a contract of purchase where the hirer agrees to pay the cost of the asset in different instalments over a period of time. Each instalment covers the principal amount and the interest cost towards the purchase of an asset for the period the asset is utilized.</p>	<p>Lease is a financial contract between the user and the equipment supplier (normally owner) for using a particular asset/equipment over a period of time against the periodic payments called "Lease rentals".</p>
<p>2. Agreement Type: Hire purchase is a tripartite agreement involving the seller, finance company and the purchaser/hirer.</p>	<p>Leasing is only a bipartite agreement, involving lessor and lessee.</p>
<p>3. Ownership: Ownership of the asset is transferred to the hire purchaser on the payment of the last instalment.</p>	<p>Lessor is the owner until the end of the agreement.</p>
<p>4. Governing Accounting Standard: There is no specific accounting standard governing Hire Purchase.</p>	<p>Accounting Standard 19 governs accounting of Lease.</p>
<p>5. Down Payment: Down payment is required.</p>	<p>Down payment is not required.</p>
<p>6. Payment: Payment is in the form of instalment consisting of principal plus interest.</p>	<p>Rental payments are the cost of using the asset.</p>

<p>7. Duration: Duration is short term.</p>	<p>Duration is comparatively long term.</p>
<p>8. Depreciation: Hirer claims depreciation.</p>	<p>Lessor claims the depreciation.</p>
<p>9. Repairs and Maintenance: It is the responsibility of hire purchaser.</p>	<p>Repairs and maintenance is the responsibility of the lessee in the financial lease, and of the lessor in operating lease.</p>
<p>10. Tax Impact: Only interest component is allowed as expenditure by the hire purchaser.</p>	<p>Lease rentals are allowed as expenditure by lessee.</p>
<p>11. Asset Type: Examples of assets dealt in hire purchase are cars, trucks, lorries etc.</p>	<p>Land, Building etc. are dealt in leasing arrangement.</p>
<p>12. Payment Defaults: Any default in payment of instalment enables the seller/finance company to seize the goods from the purchaser/hire purchaser.</p>	<p>Any default in payment of lease rental enables the lessor to take back the goods from the lessee.</p>

ADVANTAGES OF HIRE PURCHASE

Hire purchase as a source of finance has the following advantages:

- 1. Convenience in payment:** The buyer is greatly benefited as he has to make the payment in instalments. This system is advantageous to the people having limited income.
- 2. Increased volume of sales:** This system attracts more customers as the payment is to be made in easy instalments. This leads to increased volume of sales.
- 3. Increased Profits:** Large volume of sales ensures increased profits to the seller.

4. **Encourages savings:** It encourages thrift among the buyers who are forced to save some portion of their income for the payment of the instalments. This inculcates the habit to save among the people.
5. **Helpful for small traders:** This system is a blessing for the small manufacturers and traders. They can purchase machinery and other equipment on instalment basis. As the fixed amount of instalments are payable under the hire purchase arrangement, it helps the management in cash flow forecasting.
6. **Earning of Interest:** The seller gets the instalment which includes cash price and interest. The interest is calculated in advance and added in total instalments to be paid by the buyer.
7. **Lesser Risk:** From the point of view of seller this system is greatly beneficial as he knows that if the buyer fails to pay one instalment, he can get the goods back. Hire purchaser can return the goods if the performance is not satisfactory. Thus, he can also terminate the contract before making the final payment.
8. **Easy:** Financing of an asset through hire purchase is easy.
9. **Depreciation and tax payment:** Hire purchaser gets the benefit of depreciation on asset hired by him.

Hire purchasers also enjoy the tax benefit on the interest payable by them.
10. **No drain on working capital:** Hire Purchase allows companies to control and deploy assets without significant drain on working capital. It is a form of off-balance sheet financing and therefore, a hire purchase can improve a company's return on capital employed.

PROBLEMS OF HIRE PURCHASE

1. **Higher price:** A buyer has to pay higher price for the good purchased which includes cost plus interest. The rate of interest is high.

2. **Artificial demand:** Hire purchase system creates artificial demand for the product. The buyer is tempted to purchase the products, even if he does not need or afford to buy the product.
3. **Heavy risk:** The seller runs a heavy risk under such system, though he has the right to take back the goods from the defaulting customers. The second hand goods fetch less price.
4. **Difficulties in recovery of instalments:** It has been observed that the sellers do not get the instalments from the purchasers on time. They may choose wrong buyers which may put them in trouble. They have to waste time and incur extra expenditure for the recovery of the instalments.
5. **Transfer of ownership:** Ownership of asset is transferred only after the payment of the last instalment. Even though the purchaser has made some payment for the asset and have been given the chance to use it, it does not belong to him. He does not have ownership of the good he is buying on hire purchase system until he makes full payment.

HOUSING FINANCE

INTRODUCTION

Housing is the basic need of people. It is linked with the socio-economic development of a country. In India, there is a great need for the development of housing sector due to large population.

The growth in housing finance is considered an important barometer measuring growth in an economy. Increased activity in housing sector leads to enhanced demand for iron, steel and cement which have a positive effect on various sectors. It generates employment opportunities in the economy.

The demand for housing finance arises from following category of persons from salaried employees and self-employed professionals with their basic need of shelter and non-residents investing in the house for capital appreciation.

The responsibility to provide housing finance was largely the responsibility of Government of India till the mid-eighties. The setting up of the National Housing Bank (NHB), a fully owned subsidiary of the Reserve Bank of India in 1988, as the apex institution marked the beginning of emergence of housing finance as a fund based financial service in India. A number of financial institutions and companies entered the housing finance business in the private and public sector later.

According to the World Bank, housing plays a key socio-economic role and represents the main wealth of the poor in most developing countries. The UN estimates that the global population will reach 8.5 billion by 2030, with almost 60% of the population living in urban centers. An estimated 3 billion people will need new housing and basic urban infrastructure by 2030. Against the backdrop of rapid urbanization putting pressure on housing delivery systems, many urban poor will not be able to afford formal housing without proper housing finance solutions. This puts the issue of housing finance at the forefront of global development agenda.

HOUSING FINANCE INDUSTRY

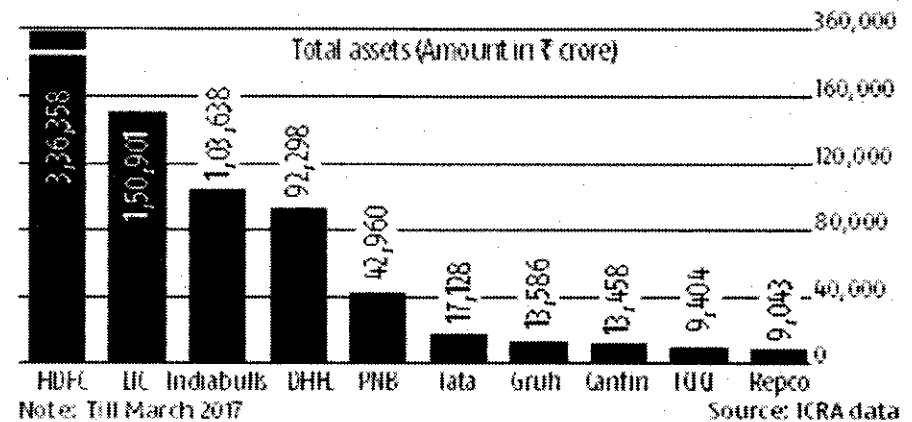
The supply of housing finance comes from following financial institutions.

1. National Housing Bank, LIC, PSU banks in the government sector.
2. Private sector housing companies and banks such as HDFC, private commercial banks.
3. Non-Banking Finance Companies, Co-operative and Credit Societies.

There are several housing finance companies in the housing finance market in India. However, two large companies, HDFC and LIC, each has assets over ₹ 1.5 lakh crore, consisting of more than 50 per cent of the total market, according to rating agency ICRA. The other

three Housing Finance Companies (HFCs) are DHFL, Indiabulls and PNB HFL which have a combined market share of almost 20 percent. These five housing finance companies have a dominant market share. The emphasis on affordable housing finance is expected to gradually change the scenario. There are almost 25 HFCs set up since 2015 in India.

TOP 10 HOUSING FINANCE COMPANIES



Further down the ladder, eight players with an asset base of ₹ 5,000 - 15,000 crore have a combined 12 per cent share in the market. The prominent ones here include Gruh, HDFC's subsidiary, Tata Capital Housing, Canfin Homes, India Infoline and ICICI Home. The reported capital adequacy of HFCs remains comfortable, given the relatively lower risk weight for home loans.

HOUSING FINANCE POLICY ASPECTS

Some of the important housing finance policies as stated below :

1. The Housing and Habitat Policy 2018

This policy is to be released soon. The new policy aims to address the demand and supply gap in the housing industry.

The following four issues are to be considered important for the success of the above policy.

- (i) Direct provisioning of the houses to those who cannot afford to buy.
- (ii) Remove glitches in law and policy at the Central and State levels. Create an enabling environment for the private sector to build houses.
- (iii) Create an incentive and subsidy structure that can stimulate demand and overcome supply bottlenecks.
- (iv) Promote mortgage finance.

2. Pradhan Mantri Awaas Yojana

Pradhan Mantri Awaas Yojana was launched in June 2015 with an aim to provide affordable housing to urban poor.

Under the above programme, it is proposed to build 2 crore houses for urban poor including Economically Weaker Section and Low Income Groups in urban areas by the year 2022 through a financial assistance of ₹ 2 trillion from central government. This Mission has four components viz., Slum Redevelopment with private sector participation using land as resource, Affordable Housing through Credit Linked Subsidy, Affordable Housing in Partnership with private and public sector and Beneficiary led house construction/enhancement. Under these components, central assistance will be in the range of ₹ 1 lakh to ₹ 2.30 lakh.

The features of Pradhan Mantri Awas Yojana (PMAY) are that the government will provide an interest subsidy of 6.5% on housing loans availed by the beneficiaries for a period of 20 years under Credit Link Subsidy Scheme (CLSS) from the start of a loan. The houses under Pradhan Mantri Awas Yojana would be constructed through a technology that is eco-friendly, while allotting ground floors in any housing scheme under PMAY, preference will be given to differently abled and older persons.

Phases of PMAY envisage starting and completing the house construction work as follows:

- PMAY Phase-1 from April 2015 to March 2017 to cover 100 cities.
- PMAY Phase-2 from April 2017 to March 2019 to cover additional 200 cities.
- PMAY Phase-3 from April 2019 to March 2022 to cover the remaining cities.

The World Bank Group held its 7th Global Housing Finance Conference on May 25-26, 2016. Jointly hosted biannually by the World Bank and the International Finance Corporation (IFC), the underlying theme of the conference was based around the new Sustainable Development Goals (SDGs), particularly Goal 11 which focuses on sustainable cities and communities. The conference explored innovative ideas on how to ensure access for all to adequate, safe and affordable housing and basic services.

SOURCES OF FUNDS

1. **Housing Finance Companies:** Primary Lending Institutions (PLIs) include housing finance companies which have been lending housing finance. In the evolution of housing finance over the last three decades, the HFCs have engaged actively in the market and thereby, contributed immensely to the growth of housing finance.
2. **NHB:** NHB was set up in 1988 to be the apex institution for regulating and controlling housing finance companies in the country. The preamble of NHB reads as "to operate as a principal agency to promote housing finance institutions both at local and regional levels and to provide financial and other support to such institutions and for matters connected therewith or incidental thereto." Over the years, through its innovative measures, active guidance and appropriate regulatory interventions, NHB has significantly facilitated broadening and deepening of the housing finance market in the country. NHB

has facilitated registration of 82 specialised housing finance institutions.

3. **The Scheduled Commercial Banks:** The scheduled commercial banks have always been offering housing loans to their customers. A large number of scheduled commercial banks have focused on housing finance by creating separate housing finance verticals and leveraging their extensive branch network.
4. **HUDCO:** It was established on 25th April 1970, as a fully owned Government of India enterprise. Its main objectives are to provide long term finance for construction of houses for residential purposes or finance or undertake housing and urban development programmes in the country or undertake the setting up of the new building materials industries.

A TYPICAL OFFER OF HOUSING LOAN FROM HFL	
LIC HFL	
TERMS OF HOUSING LOAN	
RESIDENT INDIANS	
1. Purchase	
Loan Amount	: Min. ₹ 1,00,000/-
Loan to Property cost	: 85% of total cost of the property for loans up to ₹ 20 Lakh; 80% of total cost of the property for loans above ₹ 20 Lakh and up to ₹ 75 Lakh; 75% of total cost of the property for loans above ₹ 75 lakh
Loan Term	: Maximum term - For Salaried - 30 years, for self employed -20 Years
Repayment Mode	: Equated Monthly Instalments (EMI)- Monthly Rest Basis
Rate of Interest	: Contact nearest Office for details on the Prevailing Interest Rates
Upfront Fees	: As applicable from time to time

2. Construction	
Loan Amount	: Min. ₹ 1,00,000/-
Loan to Property Cost	: 85% of total cost of the property for loans up to ₹ 20 Lakh; 80% of total cost of the property for loans above ₹ 20 Lakh and up to ₹ 75 Lakh; 75% of total cost of the property for loans above ₹ 75 lakh
Loan Term	: Maximum term - For Salaried - 30 years, for self employed -20 Years
Repayment Mode	: Equated Monthly Instalments (EMI) - Monthly Rest Basis
Rate of Interest	: Contact nearest Office for details on the Prevailing Interest Rates
Upfront fees	: As applicable from time to time
3. Extension	
Loan Amount	: Min. ₹ 1,00,000/-
Loan to Property Cost	: 85% of total cost of the property for loans up to ₹ 20 Lakh; 80% of total cost of the property for loans above ₹ 20 Lakh and up to ₹ 75 Lakh; 75% of total cost of the property for loans above ₹ 75 lakh
Loan Term	: Maximum term - For Salaried - 30 years, for self employed -20 Years
Repayment Mode	: Equated Monthly Instalments (EMI) - Monthly Rest Basis
Rate of Interest	: Contact nearest Office for details on the Prevailing Interest Rates
Upfront Fees	: As applicable from time to time

MARKET OF HOUSING FINANCE

At present there are a number of entities offering housing finance. This has helped in deepening and expansion of the existing markets. In that period of late 1990s and early 2000s, the country also

witnessed good economic growth that fuelled the growth of the housing industry. This growth of economy and within that the National Housing Bank, under its promotional and regulatory roles, has developed the market oriented housing finance system over the years.

Primary Lending Institutions (Housing Finance Companies, Scheduled Commercial Banks, co-operative institutions) have engaged actively in the market and have thereby contributed immensely to the growth of housing credit. As of March, 2016, the housing loan book created in the country by all PLIs put together was ₹ 10,63,000 crore.

The RBI's monetary policy measures in terms of reserve requirements, credit growth limits, liquidity requirements, and policy rates, among others have had a direct impact on housing finance credit. RBI has prescribed prudential norms for housing finance and so has NHB along similar lines. These norms cover asset classification, provisioning, risk weights, capital adequacy requirements and loan to value ratios. These have helped in ensuring that the housing finance portfolio that is being built is healthy and resilient to systemic risks which may arise in the economy due to any global and/or local disruptions.

Today, borrowing over 80 per cent of the value of a property is quite common, and more and more homebuyers prefer home loans. It also gives the homebuyers an assurance about the property they are planning to invest in as banks perform due diligence of the property before lending.

There is lack of focus on informal housing.

There is an affordable housing crisis in India for which the Centre has launched the ambitious Housing For All by 2022 Mission. However, the experts point out that there can be no respite unless housing finance for those employed in informal sectors is announced. This sector makes up for 96 per cent of the housing shortage and there is every need to go beyond the traditional way of disbursing housing finance where documentation and technology are supreme. However, documents and technology does not come easy for the economically weaker sections.



What are the Tax Benefits on Home Loan?

Home loans are eligible for tax benefits under the Income Tax Act.

Home loan consists of two components: **Principal and Interest.**

You may be eligible to claim tax benefits for these components based on certain criteria. Firstly, you must be the owner, or a co-owner and co-borrower in the case of joint home loans.

(a) **Principal amount under Section 80 C:** An Individual or a HUF (Hindu Undivided Family) can claim tax benefits on the principal repayment of a loan.

Stamp duty and registration charges are also eligible for deductions.

Life Insurance Premium, NSCs, EPF, ELSS can be claimed along with the home loan, subject to an overall deduction of ₹ 1.5 lakh in a year.

The loan should be taken from banks, HFCs, Central & State governments, LIC, NHB, Public Company or a Public Sector Undertaking.

(b) **Interest payment under Section 24(b):** It allows for tax deduction on interest payable on a loan taken to buy or construct a house.

You can also claim this benefit for repair or reconstruction of an existing property.

This benefit is available for residential and commercial property as well.

Owners of let-out properties can claim full interest payment, but exemption for self-occupied properties is restricted to ₹ 2 lakhs per annum.

HOUSING FINANCE IN INDIA-MAJOR ISSUES

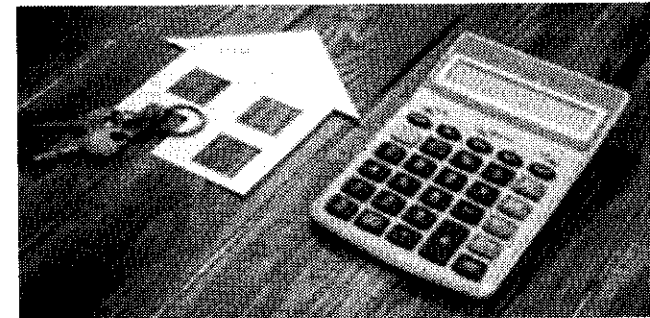
- Rapid population growth coupled with rapidly increasing urbanization and widespread poverty has created a serious shelter problem in India. This has contributed to the rapid increase of slums, increased demand for urban infrastructure and services, and declining quality of life for low-income households.
- Other important factors that have aggravated India's critical housing situation include institutional deficiencies, especially among state and local housing agencies, and regulatory constraints to new housing development and investment such as the Urban Land (Ceiling and Regulation) Act of 1976 and the State Rent Control Acts.
- In terms of the magnitude of the housing shortage, the Working Group on Housing has estimated the urban housing shortage at the beginning of Tenth Plan at 8.89 million units. While this is indeed an alarming number, it includes the obsolescence and replacement of old houses, and upgrading of all the kutchha houses.
- One critical indication of the housing shortage in urban areas is the unprecedented growth of slums. It is estimated that nearly 25 percent of slum residents are home-based workers, mostly women. For these families, access to decent living conditions and basic urban infrastructure and services is extremely important.
- With the exception of government-sponsored housing programmes, formal housing finance institutions (HFIs) are reluctant to lend to low-income households. This is due to the

reasons such as the relatively high transaction and servicing costs, irregular and unsubstantiated income sources, and the absence of collateral in the form of title to property. Therefore, increasing funding through both the formal and informal sector is an important way to meet the housing needs of low-income households in India.

Housing prices have inflated due to lack of access to formal housing finance and monopolistic housing supply market. Therefore, increasing funding through both the formal and informal sector is essential.

HOUSING FINANCE IN INDIA-GROWTH FACTORS

Based on past trends, the housing finance market in the country is expected to grow annually at an average of over 15 per cent, in the next five years. The growth of the housing finance industry over the coming years is a function of growth in both the supply side and the demand side. Banks and HFCs have been playing a key role in not just the demand side, but also the supply side. The demand side is addressed by offering retail loans to individuals in the low, middle and high-income households. The supply side is addressed by offering construction finance to developers. Developers who build residential projects are often in need of funds to complete their projects. Several banks and HFCs offer construction finance to developers to complete their projects, which helps developers complete their projects and make the units available for sale.



The real estate sector has begun to attract the renewed interest of homebuyers with the government's focus on affordable housing.

According to the housing finance company HDFC Ltd. the government's focus on affordable housing through various initiatives is quite enthusiastic. It was awarded by Prime Minister Narendra Modi at a function as the best performing primary lending institution in the credit linked subsidy scheme for EWS (Economically Weaker Section) and LIG (Lower Income Group) homebuyers.

HOUSING FINANCE INSTITUTIONS IN INDIA

There are more than 80 housing finance institutions in India. However, there are two large companies, HDFC and LIC, each having substantial market share. There are several other small housing companies in the market.

Top Banks That Offer Home Loan in India:

India has a long list of both private and public sector banks that offer home loans. The main confusion which arises most first-time home loan applicants is which bank to apply with. There are pros and cons applicable to every bank. Public sector banks are more stable and less likely to go bankrupt in the long run than private sector banks. Alternatively, private sector banks offer smoother customer service and processing time as compared to public sector banks.

One of the most popular strategies that customers employ is to avail home loan from the bank where their salary account or savings account is hosted. This eases out the approval process a bit since all the KYC details and financial data is already available with the lending bank.

Various surveys have come up with a list of most popular banks for home loans in India. However, the five names which are always present in these lists are:

State Bank of India

ICICI Bank

LIC Housing Finance

HDFC Bank

Axis Bank

While SBI is the most trusted brand because of its public holding, HDFC despite being a private lender is popular since it is basically aimed at offering housing finance to customers in India. Most customers look for an established brand name before selecting a particular bank name. The main reason for this is home loan as a product is a long-term offering and it is wise to choose a bank that has been around for some time and one that has a substantial customer base.

Apart from banks, there are several NBFCs which offer home loans to customers. The biggest differentiating factor is that the eligibility guidelines for NBFCs are slightly flexible as compared to those of banks. Also, the loan amount sanctioned by an NBFC is generally greater than that sanctioned by any bank. The main NBFCs that offer housing finance to customers in India are India bulls Housing Finance, Dewan Housing Finance, Reliance Capital company, Shriram Housing Finance, Muthoot Homefin India Ltd., LIC Housing Finance Ltd.

NATIONAL HOUSING BANK (NHB)

Role of National Housing Bank :

1. The National Housing Bank was established under the National Housing Bank Act, 1987, with the objective to promote housing finance institutions, provide regulatory guidance to these institutions, financial support, knowledge and research support to these institutions for the development of the housing finance system in India.

2. The NHB, which is a wholly-owned subsidiary of the Reserve Bank of India, is a multi-functional Development Finance Institution for the housing sector. Its functions include regulation & supervision of housing finance companies, financing, and promotion & development of housing finance in India. The NHB aims to promote a sound, healthy, viable and cost effective housing finance system to cater to all segments of the population and to integrate the housing finance system with the overall financial system.
3. During the year 2015-16, the NHB granted Certificate of Registration to 11 HFCs. As of 31st December 2016, there were 82 HFCs registered with the NHB.
4. To ensure that HFCs are conducting their business affairs in a manner that is not detrimental to the interest of depositors, customers and the public at large, NHB intervenes in the executional and governance frameworks of HFCs.
5. NHB as the regulator of HFCs, guides, monitors and inspects the activities of HFCs so that their efforts are channelized in the right direction.
6. To provide value to the stakeholders, an online Grievance Registration and Information Database System (GRIDS) has been set up by NHB to look into the grievances of customers against HFCs.
7. Another key area where NHB actively intervenes is fraud containment in the housing finance industry. NHB collects information about frauds in the housing finance industry and regularly disseminates consolidated information on frauds to all the HFCs through caution advices. This helps the HFCs become more aware of the market events and safeguard their exposures.
8. NHB regularly interacts with other regulators in the country for information sharing and co-ordination. Financing for Sustainable housing finance system through Refinance which includes General Refinance Scheme available at normal interest rate, as well as Special Refinance Schemes available at concessional interest rate through funds established at NHB.

9. Project Finance directly to Public Agencies such as Housing Boards, and Development Authorities or through the Public Private Partnership Mode for land development and housing projects available at normal interest rate, as well as at concessional interest rate through fund established at NHB for slum redevelopment and low income housing.
10. **Promotion & Development:**
 - Creating new players through equity participation;
 - Strengthening the existing network of lending institutions;
 - Capacity building for the sector;
 - Spreading consumer awareness through training, seminars and so on;
 - Becoming knowledge partners to various stakeholders;
 - Being a nodal agency for various Government schemes; and
 - Assisting in product development and hand-holding for the sector.
11. **Equity Participation:** In terms of the mandate given to the NHB towards the promotion and development of the housing finance system in the country, the NHB participates in the equity share capital of HFCs and other related companies.
12. **Implementation of Government Schemes:** The NHB works for the implementation of the Government of India's schemes. The schemes where NHB performs this role include Interest Subsidy Scheme for Housing the Urban Poor and Pradhan Mantri Awas Yojana (Urban) under the Mission for Housing for All by 2022 of the Ministry of Housing and Urban Poverty Alleviation, 1 per cent Interest Subvention Scheme under the Ministry of Finance, and Capital Subsidy Scheme for the Installation of Solar Water Heating and Solar Lighting Systems in Homes under the Ministry of New and Renewable Energy.
13. **Capacity Building:** The NHB regularly undertakes measures towards the training and capacity building of various

stakeholders in the sector. This includes regular interaction with various PLIs in forums such as the CEO meetings and round tables, as well as imparting and conducting training programmes.

(The students can visit the website of NHB www.nhb.org.in for further information.)

GUIDELINES FOR ASSET LIABILITY MANAGEMENT SYSTEM IN HFC

In the normal course, HFCs are exposed to credit and market risks in view of the asset-liability transformation.

- With liberalisation in Indian financial markets over the last few years and growing integration of the domestic markets with external markets, the risks associated with the operations of an HFC have become complex and large. It requires strategic management.
- HFCs are operating in a fairly deregulated environment and are required to determine on their own, interest rates on advances and deposits, subject to the ceiling on maximum rate of interest they can offer on deposits.
- The interest rates on investments of HFCs in government and other securities are also now market related.
- Intense competition for business involving both the assets and liabilities has brought pressure on the managements of HFCs to maintain a good balance amongst spreads, profitability and long-term viability.
- These pressures call for structured and comprehensive measures and not just ad hoc action. The managements of HFCs have to base their business decisions on a dynamic and integrated risk management system and process driven by corporate strategy.

- HFCs are exposed to several major risks in the course of their business - credit risk, interest rate risk, equity/commodity price risk, liquidity risk and operational risk. It is, therefore, important that HFCs introduce effective risk management systems that address the issues relating to interest rate and liquidity risks.

HFCs need to address the risks in a structured manner by upgrading their risk management and adopting more comprehensive Asset-Liability Management (ALM) practices. ALM, among other functions, is also concerned with management of risks and provides a comprehensive and dynamic framework for measuring, monitoring and managing liquidity and interest rate risks of an HFC.

The ALM process rests on three pillars:

- **ALM Information System :** (a) Management Information Systems (b) Information availability, accuracy, adequacy and expediency
 - **ALM Organisation :** (a) Structure and responsibilities (b) Level of top management involvement
 - **ALM Process :** (a) Risk parameters (b) Risk identification (c) Risk measurement (d) Risk management (e) Risk policies and tolerance levels
1. **ALM Information Systems:** ALM has to be supported by a management philosophy that clearly specifies the risk policies and tolerance limits. This framework needs to be built on sound methodology with necessary supporting information system. The central element of the entire ALM exercise is the availability of adequate and accurate information with expedience. Thus, information is the key to the ALM process. Collecting accurate data in a timely manner will be the biggest challenge before the HFCs.
 2. **ALM Organisation:**
 - (a) Successful implementation of the risk management process would require strong commitment on the part of the senior management in the HFC. It has to integrate basic operations and strategic decision making with risk management. The

Board should have overall responsibility for management of risks and should decide the risk management policy of the HFC. The limits for liquidity, interest rate, exchange rate and equity price risks should be kept.

- (b) The Asset-Liability Committee (ALCO) consisting of the HFC's senior management including the Chief Executive Officer (CEO) should be responsible for ensuring adherence to the limits set by the Board. It should decide the business strategy of the HFC (on the assets and liabilities sides) in line with the HFC's budget and risk management objectives.
- (c) The ALM Support Groups consisting of operating staff should analyse, monitor and report the risk profiles to the ALCO.
3. **ALM Process:** The scope of ALM function can be described as under:
- Liquidity risk management
 - Management of market risks
 - Funding and capital planning
 - Profit planning and growth projection
 - Forecasting and analysing 'what if scenario' and preparation of contingency plans

The Liquidity and Interest Rate risks can be explained as under.

Liquidity Risk Management

Measuring and managing liquidity needs are vital for effective operation of HFCs. By assuring an HFC's ability to meet its liabilities as they become due, liquidity management can reduce the probability of an adverse situation developing. Liquidity shortfall in one institution can have effects on the entire system. HFCs' management should measure not only the liquidity positions of HFCs on an ongoing basis but also examine how liquidity requirements are likely to evolve under different assumptions.

Interest Rate Risk

The operational flexibility given to HFCs in pricing most of the assets and liabilities imply the need for the financial system to hedge the interest rate risk. Interest rate risk is the risk where changes in market interest rates might adversely affect an HFC's financial condition. The immediate impact of changes in interest rates is on HFC's earnings by changing its Net Interest Income (NII). A long-term impact of changing interest rates is on HFC's Market Value of Equity (MVE) or Net Worth as the economic value of the assets, liabilities and off-balance sheet positions get affected due to variation in market interest rates. The interest rate risk when viewed from these two perspectives is known as 'earnings perspective' and 'economic value perspective', respectively.

The Gap or Mismatch risk can be measured by calculating gaps over different time intervals as at a given date. Gap analysis measures mismatches between rate sensitive liabilities and rate sensitive assets.

General

The classification of various components of assets and liabilities into different time buckets is required for preparation of Gap reports (Liquidity and Interest Rate Sensitivity). HFCs which are better equipped to reasonably estimate the behavioural pattern of various components of assets and liabilities on the basis of past data/empirical studies could classify them in the appropriate time buckets.

FAIR TRADE PRACTICE CODE FOR HFC'S

The National Housing Bank has framed guidelines on a Fair Practices Code for Housing Finance Companies (HFCs). The Code seeks to promote good and fair practices by setting minimum standards in dealing with customers, increase transparency so that the customer can have a better understanding of what he / she can reasonably expect of the services, encourage market forces through competition to achieve higher operating standards, promote fair and cordial relationship between customer and HFC and foster confidence in the housing finance system.

Some of the important codes are summarized as follows :

A. Commitment To Customers

1. **To act fairly and reasonably in all dealings with customers by ensuring that**
 - they meet the commitments and standards in this Code for the products and services they offer and in the procedures and practices their staff follows.
 - their products and services meet relevant laws and regulations in letter and spirit.
 - their dealings with customers rest on ethical principles of integrity and transparency.
2. **To help customers understand how their financial products and services work, by:**
 - giving customers information about their products and services in any one or more of the following languages: Hindi, English or the appropriate local language.
 - ensuring that their advertising and promotional literature is clear and not misleading.
 - ensuring that customers are given clear information about their products and services, the terms and conditions and the interest rates/service charges, which apply to them.
3. **To help customers to use the products and services by:**
 - providing them regular, appropriate updates.
 - keeping them informed about changes in the interest rates, charges or terms and conditions.
4. **To deal quickly and sympathetically with things that go wrong, by:**
 - correcting mistakes promptly and cancelling any charges applied due to the HFCs' mistake.

- handling customers' complaints promptly.

5. **To treat all personal information of customers as private and confidential:** HFCs shall treat all personal information as private and confidential.

6. **To publicise the code HFCs shall:**

- provide existing and new customers with a copy of the Code;
- make this Code available on request either over the counter or by electronic communication or mail;
- make available this Code at every branch and on their website; and
- ensure that their staff are trained to provide relevant information about the Code and to put the code into practice.

7. **To adopt and practice a non - discrimination policy**

HFCs shall not discriminate on the basis of age, race, caste, gender, marital status, religion or disability.

B. Disclosure and Transparency

1. **HFCs should provide information on interest rates, common fees and charges through any one of the following:**

- Putting up notices in their branches;
- Through telephone or help-lines;
- On the company's website;
- Through designated staff/help desk ;or
- Providing service guide/ tariff schedule.

2. **Changes in interest rates and fees:** HFCs shall inform their customers when they change interest rates on their products.

3. Terms and conditions

- Customer availing a product/service for the first time, should be advised the relevant terms and conditions for the service he / she has asked HFC to provide.
- All terms and conditions shall be fair and will set out respective rights especially with regard to nomination facility and liabilities & obligations clearly and as far as possible in simple language.

4. Changes to Terms and Conditions: Customers should be told of changes to terms and conditions through any of the following channels:

- Personal intimation,
- Notice Board at each branch,
- Internet, including email and website,
- Newspaper,
- Normally, changes should be made with prospective effect giving due notice.

If any change is made without notice, the change shall be notified within 30 days. If such change is to the disadvantage of the customer, he/she may within 60 days and without notice close his / her account or switch it without having to pay any extra charges or interest.

C. Advertising, Marketing and Sales

HFCs shall:

- ensure that all advertising and promotional material is clear, and not misleading.
- in any advertising in any media and promotional literature that draws attention to a service or product and includes a reference to an interest rate, HFCs shall also indicate whether other fees

and charges will apply and that full details of the relevant terms and conditions are available on request.

- If HFCs avail of the services of third parties for providing support services, HFCs shall require that such third parties handle customer's personal information (if any available to such third parties) with the same degree of confidentiality and security as the HFCs would.
- In the event of receipt of any complaint from the customer that HFC's representative has engaged in any improper conduct or acted in violation of this Code, appropriate steps shall be initiated to investigate and to handle the complaint and to make good the loss.

D. Privacy and Confidentiality

All personal information of customers shall be treated as private and confidential [even when the customers are no longer customers], and shall be guided by the following principles and policies. HFCs shall not reveal information or data relating to customer accounts, whether provided by the customers or otherwise, to anyone, including other companies entities in their group, other than in the following exceptional cases:

- If the information is to be given by law.
- If there is a duty towards the public to reveal the information.
- If the HFCs' interests require them to give the information (for example, to prevent fraud) but it should not be used as a reason for giving information about customer or customer accounts [including customer name and address] to anyone else, including other companies in the group, for marketing purposes.
- If the customer asks the HFC to reveal the information, or with the customer's permission.
- If HFCs are asked to give a reference about customers, they shall obtain his / her written permission before giving it.

- The customer shall be informed the extent of his / her right under the existing legal framework for accessing the personal records that an HFC holds about him / her.
- HFCs shall not use customer's personal information for marketing purposes by anyone including HFCs unless the customer specifically authorizes them to do so.

E. Collection of Dues

1. Whenever loans are given, HFCs should explain to the customer the repayment process by way of amount, tenure and periodicity of repayment. However, if the customer does not adhere to repayment schedule, a defined process in accordance with the laws of the land shall be followed for recovery of dues. The process will involve reminding the customer by sending him/her notice or by making personal visits and/or repossession of security if any.
2. The HFCs' collection policy should be built on courtesy, fair treatment and persuasion.
3. All the members of the staff or any person authorised to represent the HFC in collection or/and security repossession should follow the guidelines set out

F. Complaints and Grievances

Internal Procedures: If the customer wants to make a complaint, he/she should be told:

- how to do this,
- where a complaint can be made,
- how a complaint should be made,
- when to expect a reply,
- whom to approach for redressal,
- what to do if the customer is not happy about the outcome,

HFCs' staff shall help the customer with any questions the customer has,

Customer should be told where to find details of HFC's procedure for handling complaints fairly and quickly.

G. Know Your Customer (KYC) Guidelines

HFCs shall carry out due diligence as required under "Know Your Customer" (KYC) guidelines of the company before account opening and operation.

H. Deposit Accounts

Information:

- (a) When a customer opens a Deposit Account, he/she shall be informed of the rate at which interest is paid on his/her fixed/recurring deposit, how it is calculated and its periodicity.
 - (b) Customer should be informed of different type of accounts that can be opened with the HFC such as term deposits, recurring deposits, etc.
2. **Premature-withdrawal of deposits:** The procedure pertaining to premature withdrawal of term deposits should be informed to the depositor disclosing the interest rates policy for premature withdrawal of term deposit.

HOUSING FINANCE AGENCIES

1. Central and State Governments

The Central and State Governments indirectly support the housing finance efforts in the country. The central government has introduced, from time to time, various housing schemes. The role of central government in these schemes is limited to laying down of broad principles, providing necessary advice and rendering financial

assistance in the form of loan and subsidies to the state governments. The central government has set up the Housing and Urban Development Corporation (HUDCO) to finance and undertake housing and urban development programmes and setting up of building materials industry.

The central government provides equity support to the HUDCO and guarantees the bonds issued by it. Apart from this, Central and State governments provide house building advances to their employees.

2. HUDCO

HUDCO was established on 25th April 1970, as a fully owned Government of India enterprise.

Objectives of HUDCO are as follows :

1. To provide long term finance for construction of houses for residential purposes or finance or undertake housing and urban development programmes in the country.
2. To finance or undertake the setting up of new satellite towns.
3. To finance or undertake the setting up of the new building materials industries.
4. To administer the funds received from the Government of India and other such grants, for the purposes of financing or undertaking housing and urban development programmes.
5. To subscribe to the debentures and bonds to be issued by the state housing boards, improvement trusts etc. specifically for the purpose of financing housing and urban development programmes.

The HUDCO has a resource base of equity and has also been mobilizing resources from institutional agencies like LIC, GIC, UTI, banks, international assistance and public deposits.

It provides assistance in the form of following programmes;

1. **Housing:** It includes rural housing, co-operative housing and urban employment through housing.

2. **Infrastructure:** Land acquisition, basic sanitation and environmental improvement of slums.

3. **Consultancy services:** Building centres for technology transfer, building materials industries and building technology.

4. **Training:** Training in human settlements and technical assistance to all borrowing agencies.

5. **Urban Infrastructure:** The HUDCO has also been entrusted with the responsibility of financing urban infrastructure projects.

3. The LIC and GIC

The LIC and GIC support housing activity both directly and indirectly. These institutions subscribe to the HUDCO bonds. The LIC grants loans to the states for rural housing programmes and to public sector companies for construction of staff quarters. The LIC promoted a subsidiary called the LIC Home Finance Ltd. to grant direct loans to individuals.

The GIC supports housing indirectly by subscribing to bonds/debentures floated by the HUDCO and state housing boards. It has also set up a housing finance subsidiary called GIC Housing Finance Ltd. in 1990 to enable it to lend directly to individuals.

4. Commercial Banks

Commercial banks have been lending to the housing sector based on annual credit allocations made by the RBI. As per RBI guidelines, scheduled commercial banks are required to allocate 1.5 per cent of their incremental deposits for disbursing as housing finance every year. A portion of lending as direct loan and some as indirect loan by lending to housing finance institutions, housing finance companies and for subscription to the HUDCO and the NHB bonds.

5. Co-operative Banks

Co-operative banks provide finance to individuals, co-operative group housing societies and housing boards.

6. Specialised Housing Finance Institutions

They cater to the needs of housing sector. A lead player in the HFC category is the HDFC Ltd. It lends mainly for new residential housing to individuals.

Besides the HDFC, a number of HFCs have been sponsored by banks such as the SBI Home Finance Ltd., Canfin Homes Ltd., etc.

VENTURE CAPITAL

INTRODUCTION

Venture capital, also called VC, refers to the financing of a startup company by typically high-wealth investors who believe that the business has potential to grow substantially in the long run.

It is also defined as an equity/equity related investment in a growth-oriented small/medium business to enable investees to accomplish corporate objectives, in return for minority shareholding in the business.

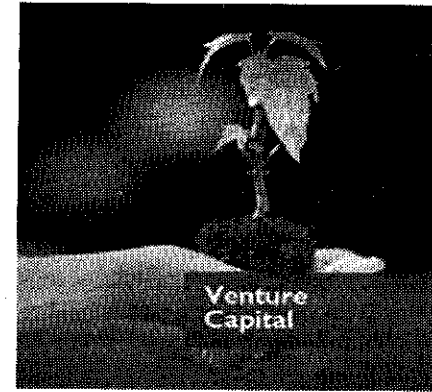
Venture capital is defined as "The support by investors of entrepreneurial talent with finance and business skills to exploit market opportunities and thus obtain capital gains."

It is the provision of risk-bearing capital, usually in the form of participation in equity, to companies with high growth potential.

Such investments are risky as they are illiquid, but are capable of giving impressive returns if invested in the right venture.

A venture capitalist is an institutional investor who has an access to liquid funds and is willing to provide it to talented start ups and innovative enterprises that require extra bit of hand holding.

The returns to the venture capitalists depend upon the growth of the company. Venture capitalists have the power to influence major decisions of the companies as it is their money at stake.



Different venture groups prefer different types of investments. Some specialize in seed capital and early expansion while others focus on exit financing. Biotechnology, medical services, communications, electronic components and software companies seem to be receiving the most financing. Venture capital firms finance both early and later stage investments to maintain a balance between risk and profitability.

In India, software sector has been attracting a lot of venture finance. Besides media, health and pharmaceuticals, agri-business and retailing are the other areas that are favoured by a lot of venture companies.

Some of the most successful, innovative ideas of today's time which have got momentum due to venture funds are - whats up & facebook. These businesses had venture capitalists helping them to get the most required capital and also assisting them in mergers and takeovers by larger entities.

FEATURES OF VENTURE CAPITAL

1. **High Risk:** The Venture capital financing is highly risky. The chances of failure are high as it provides long term start up capital to high risk-high reward ventures. Venture capital assumes four types of risks as follows:
 - Management risk - Inability of management teams to work together.

- Market risk – Product may fail in the market.
 - Product risk – Product may not be commercially viable.
 - Operation risk – Operations may not be cost effective resulting in increased cost and decreased gross margins.
2. **High Technology:** Though venture capital is not technology finance, there is a lot of financing of hi-tech projects which generally offer higher returns than projects in more traditional areas. Venture capital investments are made in high technology oriented areas using new technologies or producing innovative goods by using new technology. Venture capital is available for expansion of existing business or diversification to a high risk area. Thus technology financing had never been the primary objective but incidental to venture capital.
 3. **Equity Participation & Capital Gains:** Investments are generally in equity and quasi equity participation through direct purchase of shares, convertible debentures where the debt holder has the option to convert the loan instruments into stock of the borrower or a debt with warrants to equity investment. The funds in the form of equity help to raise term loans that are cheaper source of funds. In the early stage of business, as dividends can be delayed, equity investment implies that investors bear the risk of venture. The investor would earn a return commensurate with success in the form of capital gains at the time of exit. Debt financing is only supplementary mode of finance.
 4. **Participation In Management:** Venture capital provides value addition by managerial support, monitoring and follow up assistance. It monitors physical and financial progress as well as market development initiative. It helps by identifying key resource person. Venture capitalist requires one seat on the company's board of directors and involvement in the major decision affecting the direction of company. This is a unique philosophy of "hands on management" where venture capitalist acts as complementary to the entrepreneurs. Based upon the experience with other companies, a venture capitalist advises the promoters on project planning, monitoring, financial

management, including working capital and public issue. Venture capital investor cannot interfere in a day to day management of the enterprise but keeps a close contact with the promoters or entrepreneurs to protect his investment.

5. **Long term Investment:** Venture capitalist help companies grow, but they eventually seek to exit the investment in three to seven years. An early stage investment may take seven to ten years to mature, while most of the later stage investment takes only a few years. The process of having significant returns takes several years and it depends on the capacity and talent of venture capitalist and entrepreneurs.
6. **Illiquid Investment:** Venture capital investments are illiquid, that is, not subject to repayment on demand or following a repayment schedule. Investors seek return ultimately by means of capital gains when the investment is sold at market place. The investment is realized only on enlistment of security or it is lost if enterprise is liquidated for unsuccessful working. It may take several years before the first investment starts generating returns. Venture capitalist understands this illiquidity and factors this in his investment decisions.

TYPES OF VENTURE CAPITAL FINANCING STAGES

The selection of investment by a venture capital firm is closely related to the stages and type of investment. Venture capital firms finance both early and later stage investments to maintain a balance between risk and profitability. Venture capital firms usually recognise the following two main stages when the investment could be made in a venture namely:

A. Early Stage Financing

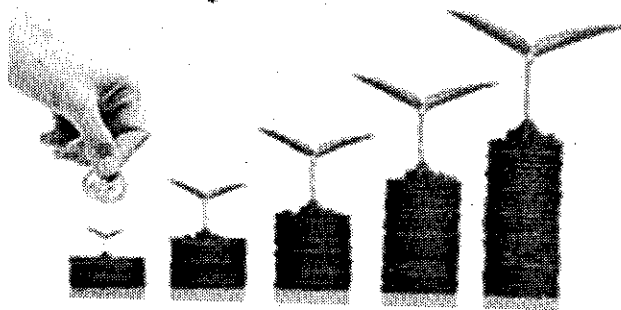
This stage includes :

- (i) Seed Capital & Research and Development Projects/Pre-start ups

- (ii) Start ups
- (iii) Second Round Finance

B. Later Stage Financing

- (i) Development Capital
- (ii) Expansion Finance
- (iii) Buy outs
- (iv) Replacement capital
- (v) Turn-arounds



A. EARLY STAGE FINANCING

(i) Seed Capital and R & D Projects/Pre- start ups

This stage is an 'applied research' phase where the concepts and ideas of the promoters constitute the basis of a pre-commercialisation research project. It is usually expected to end in a prototype which may or may not lead to a business launch.

Venture capitalists are more often interested in providing seed finance i.e. making provision of very small amounts for finance needed to turn into a business. Research and Development activities are required to be undertaken before a product is to be launched. External finance is often required by an entrepreneur during the development of the product. The financial risk increases progressively as the research phase moves into the development

phase, where a sample of the product is tested before it is finally commercialized.

The main risk at this stage is marketing related. The evaluation of the project by the Venture Capital Firm has to ensure that the technological skill of the entrepreneur matches with market opportunities.

The risk perception of investment at this stage is extremely high. However, a very few Venture Capital Firms invest in this pre-commercialisation / seed stage of product development.

(ii) Start Ups

This is the stage when commercial manufacturing has to commence. Venture capital financing is provided for product development and initial marketing. The essence of this stage is that the product / service is being commercialized for the first time in association with the Venture Capital Firms.

A new business is launched after the Research and Development activities are over. At this stage, the entrepreneur and his products or services are still not tried and tested in the market. Start-ups may include new industries/businesses set up by the experienced persons in the area in which they have knowledge, specialization and proficiency. Others may result from the research bodies or large corporations, where a venture capitalist joins with an industrially experienced or corporate partner. Along with this, other start-ups occur when a new company is floated to commercialise a new technology by an existing company and is lacking adequate finances to establish.

At this stage, some indication of the potential market for the new product / service is available.

The involvement of VC firms in start-up projects is generally low. The risk perception is very high.

(iii) Second Round Financing

It refers to the stage when product has already been launched in the market but has not earned enough profits to attract new investors.

Additional funds are needed at this stage to meet the growing needs of business. Venture Capital Institutions (VCIs) provide larger funds at this stage than at other early stage financing in the form of debt. The time scale of investment is usually shorter than in case of start ups. The VC firms provide larger funds at this stage than at other early stage financing. This financing is partly in the form of debt to also provide some income to them.

B. LATER STAGE FINANCING

Those established businesses which require additional financial support but cannot raise capital through public issue approach venture capital funds for financing expansion, buyouts and turnarounds or for development capital. It includes the development capital, bridge/expansion finance, buyouts, replacement capital and turnarounds.

I. Development Capital

It refers to the financing of an enterprise which has overcome the highly risky stage and have recorded profits but cannot go public, thus needs financial support. Funds are needed for the purchase of new equipment/ plant, expansion of marketing and distributing facilities, launching of product into new regions, induction of new management and so on. The time scale of investment is usually one to three years and falls in medium risk category. It constitutes significant part of the activities of many Venture Capital Institutions.

II. Expansion Finance

Venture capitalists perceive low risk in ventures requiring finance for expansion purposes either by growth implying bigger factory, large warehouse, new factories, new products or new markets or through purchase of existing businesses. The time frame of investment is usually from one to three years. It represents the last round of financing before a planned exit.

III. Buy-Outs

It refers to the transfer of management control by creating a separate business by separating it from their existing owners. There are two categories of buyouts.

- (i) **Management Buy-outs (MBOs):** In Management Buy-outs (MBOs), VCIs provide funds to enable the current operating management/investors to acquire an existing product line/business. They represent an important part of the activity of VCIs.
- (ii) **Management Buy-ins (MBIs):** Management Buy-ins are funds provided to enable an outside group of manager(s) to buy an existing company. It involves three parties, a management team, a target company and an investor (i.e. Venture Capital Institution). MBIs are more risky than MBOs and hence are less popular. It is difficult for new management to assess the actual potential of the target company. Usually, MBIs are able to target the weaker or under-performing companies.

Buy-outs involve a time-frame from investment to public offering of one to three years with low risk perception.

IV. Replacement Capital

VCIs another aspect of financing is to provide funds for the purchase of existing shares of owners. This may be due to a variety of reasons including personal need of finance, conflict in the family, or need for association with a well known name. The time scale of investment is one to three years and involve low risk.

V. Turnarounds

Such form of venture capital financing involves medium to high risk on a time scale of three to five years. It involves buying the control of a sick company which requires specialised skills in finance and management. It may require rescheduling of company's all the borrowings, change in management or even a change in ownership. It is gaining widespread acceptance and increasingly becoming the focus of attention of VCI.

DISINVESTMENT MECHANISMS

The last stage in venture capital financing is the exit to realize the investment so as to make a profit/minimize losses. Expected exit

time needs to be planned at the time of the initial investment. The precise timing of exit depends on several factors such as nature of the venture, the extent and type of financial stake, market conditions, state of competition and so on. The early stage financing typically takes a long term view of eventual realization/exit from five to seven years. In case of later stage financing, the realization horizon could be shorter around three to five years.

Living together happily ever after might be the fairytale ideal. If Robert Noyce and Gordon Moore had not walked out of Fairchild Semiconductor in 1968 (not disinvested from venture capital), there would be no Intel today. Some parting of ways is better for society.

There are different disinvestment alternatives available related to equity/quasi-equity and debt instruments.

1. Disinvestment of Equity/Quasi-Equity Investments

There are five disinvestment channels for realization of such investments:

- (a) going public
- (b) sale of shares to entrepreneurs/employees
- (c) trade sales/sale to another company
- (d) selling to a new investor
- (e) liquidation

The first four alternatives are voluntary while the last one is involuntary.

(a) **Going public/Initial Public Offering:** This is the most common channel of disinvestment by a VCI. There are several advantages of public issues such as higher liquidity of investments through stock exchange listing higher price of securities compared to private placement, better image and credibility with public, customers, financial institutions etc. However, companies going public are subject to stringent reporting requirements, stock

exchange regulation and disclosure requirements. Further the floatation cost of issue is high and there is high accountability to shareholders. On the whole, public issue method is the most popular exit route for VCIs.

(b) **Sale of shares to entrepreneurs/Employees:** The stake of VCIs can be sold to the entrepreneurs/companies allowed to buy their own equity. Alternatively, the entrepreneurs can acquire the shares from VCIs through employees by forming an employees' stock ownership trust. The sources of the trust to acquire the shares of VCIs are contribution by employees/company and borrowing from banks.

VCI may also enter into formal exit agreement with a put and call option at a price based on pre-determined formula with entrepreneurs. The put option is the right to sell while the call option is the right of the entrepreneurs to buy.

The important put-and-call formula are as follows.

- (i) **Book Value Method:** This is used in companies that have achieved a reasonable degree of stability in operations.
- (ii) **P/E Ratio:** This is most common method for exercising the put and call option.
- (iii) **Percentage of Sales Method:** This is modified P/E ratio. On the basis of the profit before tax as a percentage of sales for the industry, notional profit before tax is determined. Based on notional profit, earning per share is determined. The value of the shares is obtained by multiplying the notional earning per share with the industry P/E ratio. This method is suitable in the early stages.
- (iv) **Agreed Price:** This is the price agreed between the VCI and the entrepreneur at the time of investment.
- (v) **Multiple of Cash Flow Method:** The cash flow is multiplied by the industry multiplier to arrive at the value of the shares.
- (vi) **Independent Valuation:** Valuation by outside experts on the basis of price-earning ratio or the liquidation method.

- (c) **Trade Sales/sale to another company:** Trade Sale implies the sale of the entire investee company to another company. The most appropriate method for such sale would differ from case to case, considering taxation and other aspects. This is a highly popular method.
- (d) **Selling to a new investor:** The equity stake of VCIs can be sold to a new investor who may be a corporate body or even another venture capital organization. The corporate investor may acquire the stake to take advantage of synergy of operations. The corporate investor may have financed an early stage venture and may like to exit after its operations have stabilized. For second round financing, he may sell his equity to another VCI which is willing to provide financing to the venture.
- (e) **Liquidation:** This is an involuntary exit forced on the VCI as a result of a totally failed investment. The VCIs can use this exit method when the venture is not performing well and has reached a stage beyond recovery due to stiff competition, technology failure/obsolescence of technology or poor management.

2. Exit of Debt Instruments

In case of debt component of venture capital financing such as loan, the exit is possible at the end of the period of loan. As per loan agreement, whole or part can be converted into equity prior to maturity. In case of conditional loans, exit prior to the projected time is possible on the basis of lumpsum repayment.

VENTURE CAPITAL INVESTMENT PROCESS

Venture Capital Investment process describes the manner in which venture capital assistance is provided to the entrepreneurs. The entrepreneur who has an idea which qualifies for venture capital assistance should contact appropriate venture capitalists.

Selection of investment decision is very important both for the entrepreneur and the capitalists. The proposal for assistance to the

entrepreneur by the venture capitalist is the first step in the investment process.

The venture capital investment process has two aspects,

- (i) the assessment by the entrepreneur as to whom he should contact for assistance and a comparison of the terms and conditions of various venture capitalists and
- (ii) assessment of the entrepreneur and his proposal by the investor. Considering the type of industry, nature investment and risk involved in it, the investors generally apply some criteria for investment. Investors consider only those proposals which qualify these stipulations.

The investment process involves the knowledge of the:

- (A) Eligibility criteria for evaluating proposals,
- (B) Screening of venture capitalist by the entrepreneur,
- (C) Screening of entrepreneur and the proposal by the venture capitalists,
- (D) Stages of venture capital financing and
- (E) Types of finance provided by venture capitalists.

A brief description of these processes is given below:

A. Eligibility Criteria for Proposals

The minimum eligibility conditions to process an application for venture capital assistance are:

- (a) **The Venture must be technically feasible.**
The technology/ idea should have integrity and must be technically feasible.
- (b) **It should be commercially viable.**
There must be public acceptance for the idea/ technology. If commercial production takes place there should be adequate reason to believe that there will be demand for the item in the market.

(c) The technical & managerial competence and integrity of the entrepreneur.

The entrepreneur should have technical competence to apply his idea to production. The entrepreneur must be reliable and should have integrity.

(d) The long run competitive advantage of the units

The idea should have long run competitive advantage over other existing products/service in the market.

(e) Future prospects

The idea should have an excellent future prospect.

(f) Availability of inputs

Availability of inputs i.e. factors of production is another important aspect to be considered before financing. If inputs for production are not available in right quantity, it is not possible to convert idea into commercial applications.

(g) Legality of the proposal

The financier makes sure that the proposal is legally viable. The proposal should satisfy pollution standards, emission standards, government policies, etc.

B. Screening of Venture Capitalist by the Entrepreneur

There are several venture capital institutions in India both in government sector and in private sector. The lending policies and other terms and conditions of these organizations vary widely. The proposer must be vigilant in selecting the right capitalist.

The following points should be considered while choosing venture capitalists:

(a) Approach of the Capitalists: The entrepreneur should assess the approach and attitude of the venture capitalist. Some capitalists show very keen interest and offer all possible value added service (hands on approach) in fields of activity. Hands on approach of capitalist are also called 'investment nurturing'.

Investment nurturing is the process by which venture capitalists continue to involve themselves in the operations of the concerns

assisted by them. It is through personal discussions, plant visits, feedbacks, periodic reports studies etc. that they make it possible. Some capitalists may be very passive in dealing with entrepreneurs (hands off approach). The entrepreneur should approach those who offer hands on approach.

(b) Terms and Conditions: The entrepreneurs should assess the implications of each of the terms and conditions laid down in the agreement.

(c) Exit Policy: The entrepreneur should assess the exit policy of the capitalists. There are several modes of exit available for the venture capitalist.

(d) Availability of funds: Financial base and liquidity of the capitalist are other important area to be looked into. It will be easy for one with adequate financial base to provide adequate finance in times of emergency.

(e) Past history of the Capitalists: Capitalists who have a steady profile based on past history should be chosen.

(f) Miscellaneous: Procedural delay, processing charges, rate of interest, duration of advance etc. are other matters of concern.

C. Screening of Entrepreneur and the Proposal by the Venture Capitalists

As investing in ventures is highly risky the capitalist has to be vigilant in assessing and granting advances to such ventures. The capitalist assesses the proposal of entrepreneurs at various stages and apply number of assessment tools to assess the credibility of the proposer, his past history, feasibility of the proposal, amount involved and amount requested by the proposer, future growth prospects of the idea/technology etc.

To assess the potential of the idea and the proposer, the venture capitalists apply the following tests and analysis:

1. **Fundamental Analysis:** Here the venture capitalists analyses and assesses the fundamental aspects of the proposed business.

It includes analysis and assessment of the following:

- (a) **Past history:** It assess the past history of the proposer, date of incorporation, summary of annual reports, profile of the company for years, etc.,
 - (b) **Management:** The company assesses the quality of its management. It assesses the quality of board of directors and shareholders.
 - (c) **Products:** The capitalist checks the quality and features of the company's products.
 - (d) **Markets:** The markets which the company serves, nature of industry, degree of competition etc.
 - (e) **Manufacturing:** Manufacturing and operational aspects of the business is to be checked. That is to say the type of technology used, access to sources of supply, manufacturing capacity and the holdings of premises etc.
 - (f) **Risks:** The capitalist need to assess the potential risk involved in the venture.
2. **Financial Analysis:** The financial analysis is undertaken to assess the performance of the strategies of the organization. The capitalists assesses the earnings growth of the organization, margin of profit, time lag between investment and return, impact on cash flow, expected value of the company at the time divestment. In the assessment for venture capital, financial performance is very vital.
 3. **Portfolio Analysis:** In portfolio analysis, the capitalists assess the present portfolio balance of the proposer at the time of proposal. The capitalist also assesses the feasibility of the future portfolio, if the proposal is accepted and loans granted. The proposal will be considered only if the future portfolio is acceptable. Portfolio analysis involves analysis of the size, stage, location and industry of the investment proposal.
 4. **Divestment Analysis:** Here the capitalists analyses the opportunity for divestment. It assesses the method, timing and valuation of the company upon divestment. There are four

common ways in which venture capitalists divest their interests in the venture projects. These are called exit mechanisms. (Exit mechanism is discussed above.)

INDIAN SCENARIO

The venture capital industry in India is of recent origin. Prior to emergence of venture capital industry, the development finance institutions (DFIs) were providing assistance for direct equity participation to ventures before public issue of new ventures. In 1985 many investors lost funds in stock market by investing in unproven projects. Therefore, the amendment in the Securities Contract Regulation Act barring companies having an equity capital of less than ₹ 3 crore from being listed on stock exchanges was carried out.

Although the DFIs started coming with venture capital schemes from 1986 to provide finance to technology based entrepreneurs for their research and development efforts in innovative products or processes. During 1988, comprehensive guidelines were issued by the Controller of Capital Issues for setting up of VCFs for investing in unlisted companies. These guidelines construed venture capital rather narrowly as a vehicle for equity-oriented finance for technological upgradation and commercialisation of technology promoted by relatively new entrepreneurs. In recognition of the growing importance of venture capital as one of the sources of finance for the Indian industry, the Government of India announced a policy governing the establishment of domestic VCF/VC. In 1995-96 budget speech, the Finance Minister announced exemption from tax on income by way of dividends and long term capital gains from equity investment made by approved VCFs. The VCFs were brought on par with mutual funds from the viewpoint of tax.

The venture capital funds were regulated by the SEBI Venture Capital Funds Regulation, 2000 and SEBI Foreign Venture Capital Investors Regulation Act, 2000. The SEBI Alternative Investment Fund Regulations, 2012 has replaced the SEBI VCF Regulations.

(The students can read the complete regulation on SEBI's website : <https://www.sebi.gov.in>)

In a notification dated June 1, 2018, SEBI said it has made amendments to Alternative Investment Funds (AIF) regulations with respect to 'Angel Funds'.

With an aim to provide impetus to early-stage startups, market regulator SEBI has increased the maximum investment limit by Angel funds in venture capital undertakings to ₹ 10 crore from the current ₹ 5 crore.

In this fast changing ecosystem, wherein angels are investing much higher amounts, such increase is needed to provide more opportunities to angel funds according to the industry experts.

REVIEW QUESTIONS

1. Define leasing. Explain types of lease.
2. Explain features of finance lease and operating lease.
3. Distinguish between operating lease and financial lease.
4. Describe advantages of leasing.
5. Explain disadvantages of leasing.
6. Explain legal aspects of leasing.
7. Define Hire Purchase and state its characteristics.
8. Distinguish between Hire Purchase and Instalment Sale.
9. Distinguish between Hire Purchase and Leasing.
10. State advantages of Hire Purchase.
11. State problems of Hire Purchase.
12. State various sources of Housing Finance.
13. What are the major issues in Housing Finance in India?
14. Explain role of NHB.
15. Explain in brief guidelines for Asset Liability Management System in HFC.
16. Explain fair trade practice code of HFC with respect to commitment to customers.
17. Explain fair trade practice code of HFC with respect to disclosure and transparency.
18. Explain fair trade practice code of HFC with advertising, marketing and sales.
19. Explain fair trade practice code of HFC with privacy and confidentiality.

20. Explain meaning of Venture Capital. State its features.
21. Explain types of Venture Capital Financing Stages.
22. Explain disinvestment mechanisms of Venture Capital.
23. Explain Venture Capital Investment process in brief.
24. Write short notes on :
 - (i) Meaning of lease and its features.
 - (ii) Essential elements of leasing
 - (iii) Types of lease
 - (vi) Features of Finance Lease
 - (v) Features of Operating Lease
 - (iv) Advantages of Leasing to lessee
 - (vii) Advantages of Leasing to lessor
 - (viii) Disadvantages of Leasing to lessee
 - (ix) Disadvantages of Leasing to lessor
 - (x) Features of Hire Purchase
 - (xi) Terms used in Hire Purchase Agreement
 - (xii) Characteristics of Instalment sale
 - (xiii) Advantages of Hire Purchase
 - (xiv) Problems of Hire Purchase
 - (xv) Sources of Housing Funds
 - (xvi) Housing Finance in India-Growth Factors
 - (xvii) NHB
 - (xviii) Housing Finance Agencies
 - (xix) Features of Venture Capital
 - (xx) Early Stage Financing of Venture Capital
 - (xxi) Later Stage Financing of Venture Capital
 - (xxii) Seed Capital
 - (xxiii) Disinvestment mechanisms of Venture Capital
 - (xxiv) Indian Scenario of Venture Capital

OBJECTIVE QUESTIONS

- A. Select the appropriate options and rewrite the following sentences:
1. According to the Accounting Standard on Leases _____, the classification of lease is based on the extent to which risks and rewards incidental to ownership of a leased asset lie with the lessor or the lessee.

(a) 9	(b) 10
(c) 19	(d) 1

2. It is important to note that in the leasing contract, ownership of the asset is with the _____.
- (a) lessor (b) lessee
(c) no one (d) both (a) & (b)
3. In a _____ lease, the lessor does not transfer all the risks and rewards incidental to the ownership of the asset.
- (a) finance (b) operating
(c) both (a) & (b)
4. The setting up of the National Housing Bank (NHB), a fully owned subsidiary of the Reserve Bank of India in _____, as the apex institution marked the beginning of emergence of housing finance as a fund based financial services in India.
- (a) 1987 (b) 1988
(c) 1989 (d) 1990
5. The NHB, which is a wholly-owned subsidiary of the _____.
- (a) State Bank of India (b) Bank of India
(c) HDFC (d) Reserve Bank of India
6. Pradhan Mantri Awaas Yojana was launched in _____ with an aim to provide affordable housing to urban poor.
- (a) July 2016 (b) June 2017
(c) June 2015 (d) June 2018
7. The Early Stage Financing of a venture capital includes _____.
- (a) Seed Capital & Research and Development Projects/Pre-start ups
(b) Start ups
(c) Second Round Finance (d) All the above
8. Features of venture capital includes _____.
- (a) High risk (b) Illiquid investment
(c) High Technology (d) All the above

Ans.: (1) - (c), (2) - (a), (3) - (b), (4) - (b), (5) - (d), (6) - (c), (7) - (d), (8) - (d)

B. Fill in the blanks :

1. In a _____, the lessor transfers to the lessee, substantially all the risks and rewards incidental to the ownership of the asset.
2. The _____ is suitable for the buyers who need the asset for short period or are not sure of long term needs.
3. The growth in _____ finance is considered an important barometer measuring growth in an economy.
4. _____ as the regulator of HFCs, guides, monitors and inspects the activities of HFCs so that their efforts are channelized in the right direction.

5. _____ refers to the financing of a startup company by typically high-wealth investors who think the business has potential to grow substantially in the long run.
6. A _____ is an institutional investor who has an access to liquid funds and is willing to provide it to talented start ups and innovative enterprises.
7. _____ stage is an 'applied research' phase.
8. _____ is the stage when commercial manufacturing has to commence.
9. _____ refers to the financing of an enterprise which has overcome the highly risky stage and have recorded profits but cannot go public, thus needs financial support.
10. _____ refers to the transfer of management control by creating a separate business by separating it from their existing owners.
11. _____ is an involuntary exit forced on the VCI as a result of a totally failed investment.

Ans.: (1) finance lease (2) hire purchase system (3) housing (4) NHB (5) Venture capitalist (6) venture capitalist (7) Seed Capital (8) Start Ups (9) Development Capital (10) Buy Outs (11) Liquidation

C. Match the following :

(1)	Column A	Column B
1.	Party owning an asset	(a) Full pay out leases
2.	Party using the asset	(b) Lessor
3.	Finance lease	(c) Lessee
4.	Operating lease	(d) Service lease
5.	Instalment sale	(e) Agreement to hire goods
6.	Hire purchase	(f) Outright credit sale

Ans.: (1) - (b), (2) - (c), (3) - (a), (4) - (d), (5) - (f), (6) - (e)

(2)	Column A	Column B
1.	Early Stage Financing	(a) Going public
2.	Later Stage Financing	(b) Seed Capital
3.	Disinvestment of Equity	(c) P/E Ratio
4.	Put-and-call formula	(d) Development Capital

Ans.: (1) - (b), (2) - (d), (3) - (a), (4) - (c)

D. State whether true or false :

1. Leasing is a mechanism of financing the cost of an asset.
2. Leasing is a process by which a firm can obtain the use of a certain fixed asset for which it must make a series of contractual periodic tax deductible payments (i.e. lease rentals).

4

CONSUMER FINANCE AND CREDIT RATING

- 252 *Innovative Financial Services (FYBAF : SEM-II, TYBMS : SEM-V)*
3. The main function of a lessor is lending of funds rather than renting of asset.
 4. The lessor is owner of the asset but the possession and economic use of the asset vests in the lessee.
 5. In a finance lease, the lessor does not transfer all the risks and rewards incidental to the ownership of the asset.
 6. Lease financing is beneficial compared to institutional finance as it is free from restrictive terms.
 7. The buyer under instalment sale can not sell, destroy or transfer goods.
 8. Hire purchaser does not gets the benefit of depreciation on asset hired by him.
 9. The ALM process rests on three pillars: ALM Information System, ALM Organisation and ALM Process.
 10. Rapid population growth coupled with rapidly increasing urbanization and widespread poverty has created a serious shelter problem in India.
 11. RBI as the regulator of HFCs, guides, monitors and inspects the activities of HFCs so that their efforts are channelized in the right direction.
 12. ALM of HFC has to be supported by a management philosophy that clearly specifies the risk policies and tolerance limits.
 13. In India, software sector has been attracting a lot of venture finance.
 14. The Venture capital financing is highly risky.
 15. The venture capital is technology finance.
 16. The last stage in venture capital financing is the exit to realize the investment so as to make a profit/minimize losses.
- Ans.: True : 1, 2, 3, 4, 6, 9, 10, 12, 13, 14, 16*
False : 5, 7, 8, 11, 15

Consumer Finance

- *Introduction*
- *Sources*
- *Types of Products*
- *Consumer Finance Practice in India*
- *Mechanics of Consumer Finance*
- *Terms*
- *Pricing*
- *Marketing and Insurance of Consumer Finance*
- *Consumer credit Scoring*
- *Case for and against Consumer Finance*

Plastic Money

- *Growth of Plastic Money Services in India*
- *Types of Plastic Cards - Credit Card, Debit Card, Smart Card, Add-on Cards*
- *Performance of Credit Cards and Debit Cards*
- *Benefits of Credit Cards*
- *Dangers of Debit Cards*
- *Prevention of Frauds and Misuse*
- *Consumer Protection*

- *Indian Scenario*
- *Smart Cards - Features, Types, Security Features and Financial Applications*

Credit Rating

- *Meaning*
- *Origin*
- *Features*
- *Advantages of Rating*
- *Regulatory Framework*
- *Credit Rating Agencies*
- *Credit Rating Process*
- *Credit Rating Symbols*
- *Credit Rating Agencies in India*
- *Limitations of Rating*

CONSUMER FINANCE

INTRODUCTION

Consumer finance has grown rapidly due to the change in culture, life style, spending pattern and priority of needs in the last few years. Today people give a lot of emphasis to amenities and convenience.

Consumer durables such as a car, scooter, bike, computer, laptop, LCD television, music system, a cooking range, washing machine, mobile phone etc. have become part of life (or aspiration) of an average consumer. As finance is needed to satisfy these needs, facilities to finance to consumers also emerged. This emerging set

wants and consequent need for funds multiplies the scope and of consumer finance.

Consumer finance refers to the raising of finance by individuals for the acquisition of durable consumer goods. Consumer finance includes credit merchandising, deferred payments, instalment buying, hire purchase, pay-as-you earn scheme and credit cards.

Under consumer finance scheme, the consumer or buyer pays a part of the purchase price in cash at the time of the delivery of the asset and the balance with interest over a pre-determined period of time.

Definition

According to Reavis Cox, consumer credit is "a business procedure through which the consumers purchase semi-durables and durables other than real estate, in order to obtain from them a series of payments extending over a period of three months to five years, and obtain possession of them when only a fraction of the total price has been paid".

Features of Consumer Credit

1. Consumer credit is a method of financing semi-durables and durables.
2. It assists consumers to acquire assets.
3. Consumers get possession of the assets immediately when a fraction of the price is paid.
4. The balance payment is payable in instalments over an agreed span of time.
5. The duration of the finance normally ranges between three months to five years.
6. It is an agreement between parties to the contract.
7. When there are only two parties to the contract, it is called a Bipartite Agreement (the customer and the dealer cum

financier) and where there are three parties, such agreements are called Tripartite Agreements (the customer, the dealer and the financier.)

8. The structure of financing may be by way of hire-purchase or credit sale. In the case of hire purchase, ownership of the asset is transferred only on completion of all the terms of agreement. But in the case of credit sale, ownership is transferred immediately on payment of first instalment.
9. Generally advances are made on the security of the asset itself.
10. It involves down payment normally ranging from 20 to 25% of the asset price.

SOURCES

The main sources of consumer finance can be listed as follows:

1. **Traders:** Traders are the important sources of consumer finance. Traders include sales finance companies and non-banking finance companies.
2. **Commercial banks:** Commercial banks generally offer a greater variety of credit. Banks can offer credit cards, lines of credit, term loans and installment loans, both on a secured or an unsecured basis. Commercial banks provide consumer finance either directly or indirectly. In other words, it finances consumers directly by granting personal loans for purchase of consumer durables without any security. Commercial banks also lend large sum of money at wholesale rates to sales finance companies and thereby, indirectly providing consumer finance.
3. **Credit card companies:** Credit card companies facilitate credit purchases of consumer goods through respective banks which issue the credit cards. The credit card system enables a person to buy goods on credit. On presentation of the credit card by the buyer, the seller prepares three copies of the sales voucher, one for the seller, second for the bank or credit card company and third for the buyer. The seller forwards a copy to the bank

for collection. The seller's bank forwards all such bills to the card issuing bank or company. The bank debits the amount to the customer's account. The buyer receives monthly statement from the card issuing bank and the amount is to be paid within a period of 45 days without any additional charges. If the repayment is delayed, bank charges interest on the outstanding amount.

4. **NBFC: Non-banking finance companies** constitute another important source of consumer finance. These finance companies charge a very high rate of interest. Consumers approach these companies as a last option.
5. **Co-operative Credit Societies:** Co-operative Credit societies accept savings from and make loans to member individuals. People qualify for membership by way of a job or organizational affiliation. Due to their membership status, they can participate in the financial services which are offered by the society. They provide most types of consumer credits like banks. Their rates may be lower due to lower overhead costs.
6. **Consumer finance companies:** These companies concentrate on making installment loans. Finance companies are generally more willing to make relatively small loans that commercial banks avoid. These lenders are more likely to approve loans for applicants with bad or no credit histories. However, the interest rates that they charge are considerably higher. If an individual's credit score is poor, the greater amount of collateral is required by a finance company before it approves a loan. This source of consumer finance is expensive due to high interest rates and fees.
7. **Sales finance companies:** These companies are formed to lend money to customers of an affiliated company. For example, Tata Motor Credit Company acts as a credit source to car buyers at Tata dealerships. Sales finance companies periodically offer borrowers particularly attractive interest rates or financing offers in order to stimulate business at the affiliated company. Though the loans from this credit source are convenient, they are expensive as compared to loans from commercial banks.

8. **Life insurance companies:** These companies are a source of credit for certain policyholders who own policies that include a savings component. Life insurance loans carry relatively low interest rates. Borrowers should be aware that utilizing this source of financing actually involves borrowing one's own money, and any loan amount that is outstanding at the time of the insured's death is deducted from the policy's death benefit.

FORMS/TYPES OF CONSUMER CREDIT

Following are the different forms for financing consumers:

1. **Revolving Credit:** It is an ongoing credit arrangement. It is similar to overdraft facility. Here a credit limit will be sanctioned to the customer and the customer can avail credit to the extent of credit limit sanctioned by the financier. Credit Card facility is an excellent example of revolving credit.
2. **Cash Loan:** In this form of credit, the buyer or consumer gets loan amount from bank or non-banking financial institutions for purchasing the required goods from seller. Banker acts as lender of finance. Lender of finance and seller of goods are different.
3. **Secured Credit:** In this form of credit, the financier advances money on the security of appropriate collateral. The collateral may be in the form of personal or real assets. If the customer makes default in payments, the financier has the right to appropriate the collateral. This kind of consumer credit is called secured consumer credit.
4. **Unsecured Credit:** When financier lends fund without any security, such advances are called unsecured consumer credit. This type of credit is granted only to customers with good credibility.
5. **Fixed Credit:** In this form of financing, funds are made available to the customer as a term loan for a fixed period of time i.e., for a period of one to five years. Monthly installment loan, hire purchase etc. are the examples.

CONSUMER FINANCE PRACTICE IN INDIA

- (a) **Rapid Growth:** Consumer finance market is growing rapidly in India. Growing consumer appetite for consumer durable goods due to convenience needs resulted into development of competitive market for such consumer goods and their financing. The tendency of people to borrow early in life to satisfy needs is increasingly evident in emerging Indian consumer credit market.
- (b) **Reduced Rate of Interest:** The overall reduction in the interest rate and flexibility in the purchase schemes fuelled the rapid growth of consumer credit industry. There are number of schemes with alternative payment schedules and rates of interest placed before the customer for selection. The customer is thus offered several options to choose from based on his convenience and suitability.
- (c) **Increased Income Level:** Another change in the Indian economy is the increase in the startup salary scales and pay structure. The pay structure has been increased considerably in the last few years leading to increased purchasing power in the hands of people. This has changed the purchasing preferences of middle class families. Increased pay structure together with the double income families, made a certain class of people more and more extravagant. People have started tasting the fruits of modern life which eventually turns them into wanting-beings demanding more and more consumer goods.
- (d) **Changes in Life Concepts:** Changes in the life style, living standard and life perspective of Indian middle class families were another important recent change in the consumer durables industry. People have started dreaming and trying to convert their dreams to reality. People have started visualizing a luxurious life and wish to live with as many facilities possible. All these factors have lead consumer durables industry and its financing industry to further heights within a short while.
- (e) **Competition among Financiers:** Modern life has made people

more and more mechanical and busy. People hardly have any time to spend on negotiation and settlement. Today everything has become customer oriented. Therefore, unless financing schemes are framed keeping in view customer requirements and suitability, it will be difficult even for lenders to survive. The financiers compete with competitive schemes to attract potential customers.

- (f) **Tie-Ups and Collaborations:** The manufacturers in India have to tie up with financiers to market/finance their product and services. Similarly financiers also need to tie up with dealers and manufacturers to market their financing services. It is difficult to survive for both in the long run without appropriate business collaboration.
- (g) **Credit Cards:** The introduction and subsequent popularity of credit cards is another land mark in the consumer finance industry in India. Credit cards provide short term credit at no cost. Large numbers of credit cards with varied features to suit the individual requirements of customers are available in the market. The convenience and the economy of large scale purchases added to the popularity and use of credit cards by Indian customers.
- (h) **Various Schemes and Offers:** Luring schemes and tempting advertisements are other peculiar features emerged these days. Zero interest schemes, walk in and drive out, free test drive, exchange schemes, exchange bonus offers, festival offers, special schemes, off season schemes, free packages, lucky draws, etc. offers brighter future for consumer credit market in India and thereby, the market for consumer finance also.
- (i) **Development of Used Cars Market:** Another trend currently gained momentum in India is the market for used cars. Across the country large dealer network for used cars has been established. Most of them have financial backing. It is interesting to note that financiers have come forward to finance used cars purchase also.

This shows the paradigm shift that took place in the consumer finance market.

The high-growth emerging market in India represents a significant opportunity for consumer finance lenders to seize market share as the growing middle-class seeks financing for durable goods. These emerging markets, also present significant challenges as credit history and data on the credit worthiness of most of the customers are not available easily.

Moreover mass availability of credit is new to the Indian financial culture with limited history on the consequences of non-payment of consumer credit. However, use of controlled testing of different market segments and products to learn about consumer propensity, systematic approach over judgmental decisions, systems to track lending and pricing decisions, establish customers' credit profile etc. will make the role of consumer credit market in India imperative.

Is it time to worry about a consumer loans bubble?

Indian banks have been on a consumer lending spree. Should policymakers begin to worry?

It is important to understand consumer lending has been growing far quicker than the underlying nominal gross domestic product (GDP). This means that consumer credit i.e. household financial debt has is outpacing income growth. Debt is rising faster than income.

There are two important points that need to be noted.

1. Bank credit to industry does not capture the entire story because companies with strong credit ratings are now going to the financial markets to directly raise either equity or debt.
2. Higher household borrowing is not always a danger sign. Modern economic theory tells us that people make their decisions on how much to spend, save and borrow based on their assumptions of income over their entire working lives, rather than in one particular year. Individuals who are expecting robust income growth in the years ahead have the confidence to borrow today. Households also borrow to maintain consumption levels when income is volatile. A

lot depends on their optimism about the future. The recent borrowing binge, however, does not seem to be supported by a rise in consumer confidence.

The growing burden of consumer debt should be seen against the larger trends on national savings. Indian households traditionally provided an overwhelming share of the total savings needed for investment activity. Their share has been coming down through this decade.

It may be premature to worry about a severe economic shock in case consumer loan defaults rise, as was the case with the mortgage defaults in the US in 2008. But that does not mean that there are no worries at all.

MECHANICS OF CONSUMER FINANCE

Typically, in a consumer finance transaction, an individual-consumer-buyer pays a fraction of the cash purchase price at the time of the delivery of the durable asset and pays the balance with interest over a specified period of time.

Mechanics of consumer finance can be explained with respect to following:

- (1) **Parties to the transaction:** The parties to a consumer finance transaction depend upon the nature of the transaction i.e. a bipartite arrangement between consumer and dealer cum financier or a tripartite arrangement amongst consumer, dealer and financier.
- (2) **Structure of credit depends on the form of credit:** Revolving credit, cash loan, secured credit, unsecured credit and fixed credit are some of the forms of credit based on which the structure of credit would be determined.
- (3) **Mode of payment:** In case of down payment schemes, a part of the cost is paid by the consumer and the remaining repayment is paid in monthly instalments.

- (4) **Payment period and rate of interest:** Typically, the repayment period ranges between 12-60 monthly instalments. The rate of interest is normally at a flat rate and the effective rate of interest is not disclosed. In some schemes, the rate of interest is not disclosed, instead the EMI associated with the different repayment periods is mentioned. Most of the schemes provide for easy repayment. They also provide for either a rebate for prompt payment and charge for delayed payment.
- (5) **Security:** In case of secured credit, security which is in the form of first charge on the asset is provided by the consumer to the financier.

The evaluation of consumer credit can be made with reference to effective rate of interest, rebate for early repayment and effective rate of interest on completed transaction.

The mechanism of consumer finance can be explained as below.

Illustration 1 :

The Consumer Finance Ltd. has structured a consumer credit deal for ₹ 5,00,000 on the following basis:

Alternative	Monthly Repayment Period	Equated Monthly Installment
1	12	₹ 47,000
2	24	₹ 26,200

You are required to compute the flat and effective rates of interest for each alternative.

Solution :

Flat and Effective Rates of Interest

	Repayment Period (Months)	
	12	24
	Alternative 1	Alternative 2
Total charge for credit	₹ 64,000	₹ 64,400
Flat rate of interest (%)	12.80%	12.88%
Effective rate of interest (%)	23.63%	24.73%

Working Notes :**Alternative 1 :**

$$1. \text{ Total Annual charge for credit} = (\text{₹ } 47,000 \times 12) - 5,00,000$$

$$= \text{₹ } 64,000$$

$$2. \text{ Flat rate of interest (F)} = \frac{\text{₹ } 64,000}{\text{₹ } 5,00,000} \times 100 = 12.80\%$$

$$3. \text{ Effective rate of interest} = \frac{n}{n+1} \times 2F = \frac{12}{13} \times 25.6 = 23.63\%$$

Alternative 2 :

$$1. \text{ Total Annual charge for credit} = [(\text{₹ } 26,200 \times 24) - 5,00,000]/2$$

$$= \text{₹ } 1,28,800/2$$

$$= \text{₹ } 64,400$$

$$2. \text{ Flat rate of interest (F)} = \frac{\text{₹ } 64,400}{\text{₹ } 5,00,000} \times 100 = 12.88\%$$

$$3. \text{ Effective rate of interest} = \frac{n}{n+1} \times 2F = \frac{24}{25} \times 25.76 = 24.73\%$$

TERMS

- Eligibility:** The basic eligibility for consumer finance is the level of income of the individual customer and the nature of employment (permanent or temporary). The EMIs (Equivalent Monthly Instalments) are worked out on the basis of number of instalments and tenure of employment of the customer.
- Tenure:** Consumer finance is granted for short period ranging from 6 months to 5 years. The tenure also depends on the value of the asset purchased. Assets of smaller values are given short term credit and assets of higher value are given comparatively longer term credit.

- Guarantee:** Finance companies will insist on guarantee from a guarantor for credit availed by the customer. Guarantee is obtained in order to ensure prompt payment of instalment and security against default risk.
- Rate of interest:** The effective rate of interest on consumer finance is generally higher than the rate applicable to business finance. This is because loans are granted based on personal integrity of the customer and carries higher risk for the lender.
- Other charges:** Finance companies also charge brokerage, documentation fees, processing fees, management fees, service charges, collection costs etc. A deposit is also taken as a precautionary measure to protect against default in repayment of principal and interest.
- Mode of payment:** Individual loan payments are collected in advance by means of post dated cheques or debit mandates in case of electronic payment.

In case of institutional financing, there is an arrangement for deduction of instalments from the salary of the employees which is remitted to the finance company.

- Credit evaluation:** A verification of details furnished by the customer is carried out in order to ascertain the validity of the statement and the credit standing of customer. The evaluation may be carried out by the financier or an independent agency to collect and verify the details of age, address, monthly income, status of employment, previous credit record, assets owned, type of collateral offered etc.

PRICING

The pricing of consumer credit depends upon the type and extent of credit provided. The components of the price are risk-free rate of interest assuming no probability of default, default risk premium and administrative expenses.

MARKETING AND INSURANCE OF CONSUMER FINANCE

Consumer Finance Marketing

Retail outlets often provide loyalty cards to the loyal customers. When the facility to avail credit is provided by a retail store, the customer tends to buy from such stores. This results in loyalty to the stores which is beneficial for the store as such schemes attract consumers. Retailers send personal letters to the customers informing about credit schemes and other financing offers to attract them to the shop. Finance companies too need to promote their financing schemes. These schemes attract the existing customers as well as potential customers with credit needs.

Cost Benefit Analysis is carried out before providing consumer finance to ensure efficient collection of dues. Salaried class customers are considered as most reliable class as they generate regular income enabling them to repay their obligations on time. Several times finance companies have tie ups with the employers to satisfy credit needs of employees.

Consumer Finance Insurance

Consumer finance insurance means to grant credit insurance in respect of finance to consumers. The insurance provides for coverage in the case of consumer default in instalment payments. The premium is to be paid by consumer availing such credit. This type of insurance covers is provided in the USA.

CONSUMER CREDIT SCORING

It is imperative for the financier to assess the repayment capacity of the customer before advancing money. To assess the credibility and repayment capacity of a customer several methods are used. Those methods which are used to assess the credit worthiness and

repayment capacity of a customer are called consumer credit scoring methods or credit rating methods.

These methods provide standards for accepting or rejecting a customer based on assessment of the credit worthiness. Some of the commonly used methods are Dunham Greenberg Formula, Specific Fixed Formula and Machinery Risk Formula. In India, the largest credit rating agency for individual consumer finance is Credit Bureau of Information India Ltd. (CBIL)

A. Dunham Greenberg Formula

This method is based the customer's (i) employment record, (ii) income level, (iii) financial position, (iv) type of security offered and (v) past payment record. It gives more importance to the customer's income level and past records. Under this method, points are allotted to the various parameters of the customer's loan proposal, the total points being 100. An applicant scoring more than 70 points is considered as one with good credit standing.

The points are composed of the following:

Parameter	Score (Points)
Applicant employment record	20
Applicant's income	25
Applicant's finance	10
Type of security offered	20
Past payment record	25
Total	100

An applicant scoring more than 70 points is considered as one with good credit standing.

B. Specific Fixed Formula

This method is based on another credit rating formula. It give emphasis to (i) Age, (ii) Gender, (iii) Stability of Residence, (iv) Occupation, (v) Type of Industry, (vi) Stability of Employment and (vii) Assets of the Customer in assessing the credit worthiness of a customer. Specific scores are allotted to each of these parameters.

The borrowers getting a score more than 3.5, is ranked as 'excellent borrower' and those getting more than 2.5 but less than 3.5 is ranked as 'marginal borrower'.

The method of scoring is as follows:

Parameter	Credit Score
Age	0.1-0.5
Gender	0.4
Stability of residence	0.042-0.42
Occupation	0.16-0.55
Industry	0.21
Stability of employment	0.059-0.59
Assets	0.20-0.45

C. Machinery Risk Formula

This method is based upon the amount of down payment, monthly income and length of service. Basically this method is based upon the present financial position and future income earning capacity of the customer. Generally this method is used in government departments to advance loans to its employees. The loan amount to be sanctioned is calculated using the following formula.

$$\text{Loan amount} = \text{Down payment} + (0.124 \times \text{monthly income}) \\ + (6.45 \times \text{length of service in months})$$

CASE FOR AND AGAINST CONSUMER FINANCE

Case For Consumer Finance

1. **Compulsory savings:** Consumer credit promotes compulsory savings habit among the people. People cut short their other expenditures and save to pay periodical instalments. These

savings ultimately enable them to own the desired asset in the due course of time. Thus consumer credit adds to the savings habit of people.

Convenience: Considering the nature and type of customers, consumer credit facility is offered as per their convenience and suitability. Pay as you earn, everything at the door step, one time processing etc. are such examples.

Assists to meet sales and profit targets: In all business activities, there will be sales and profit targets to be achieved by the executives. Most people postpone purchasing of goods due to scarcity of sufficient fund. When the dealer themselves arrange for fund, people get attracted and purchase goods in large quantity. Thus it assists to meet sales targets and profit targets.

Assists to covert dreams into reality: A car, a TV, a washing machine, a laptop, a mobile phone, etc. is undoubtedly a dream of an average person. But people may not purchase because of fund problem. In such cases, consumer credit facilitates an opportunity to possess and realise dreams on convenient terms.

Enhances living standard: Consumer credit enhances living standard of the people by providing latest durable goods and amenities at reasonable and affordable terms.

Accelerates industrial investments: Demand for consumer durables enhances further investment in the consumer durables industry. This provides more and more employment opportunities in the country. Higher employment opportunities lead to higher income in the hands of people.

Promotes economic development: Increasing demand for consumer durables leads to increase in investments in consumer durables industry, increased living standard of people, improved employment opportunities and income etc. This results into overall economic development of the country.

Economies of large scale production: Increased demand leads to large scale production. Large scale operations lead to the

economies of large scale operation. This helps in lowering costs and prices.

9. **National importance:** Consumer credit is of national importance in India. A convenient mode of financing will facilitate higher demand for consumer durables leading to higher employment, income and production level in the economy.

Case Against Consumer Finance

Following are the disadvantages of consumer finance:

1. **Promotes unthoughtful buying:** Facility to purchase at somebody else's money tempts people to buy goods without thinking about it's real necessity. They may fall into a debt trap.
2. **Leads to insolvency:** Thoughtless buying of goods make people insolvent within a shorter span of time. This ultimately spoils their life in the long run.
3. **Consumer credit is costlier:** Consumer credit is costlier when compared to other forms of finance.
4. **Artificial boom:** The economic development posed by the impact of consumer credit is not real but artificial. Economy will take years to stabilize the artificial boom claimed by the proponents of consumer credit.
5. **Bad Debts Risk:** Credit is always risky so is the case with consumer credit as well. Defaults are a major threat to consumer credit. Once there is a default, repossession and other legal formalities are difficult.
6. **Causes Economic Instability:** Artificial boom and depression leads to economic instability and causes chaos in the economic progress.

PLASTIC MONEY

GROWTH OF PLASTIC MONEY SERVICES IN INDIA

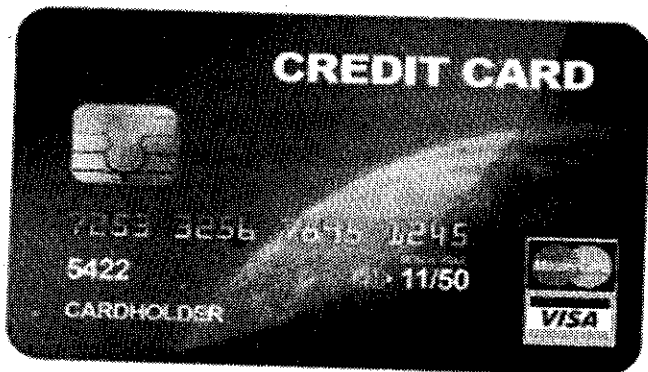
The plastic money in the form of cards was introduced by banks in India in 1990's. But it was not very popular among Indian consumer at the time of its introduction. The change in demographic features of consumers in terms of their income, marital status, education level etc. and upgradation of technology and its awareness has brought the relevant changes in consumers' preferences. These changing preferences have also modified their outlook and decision regarding the acceptance and non- acceptance of products and services in the market.

Today the plastic cards are gaining popularity among bankers as well as customers. These cards are getting accepted in the market place. The plastic cards market is growing at a fast pace in India. It has become important that the payment system in India has to be modernized enough to be at par with the systems prevalent in other countries, since our domestic financial markets are increasingly getting integrated with markets abroad. RBI is also taking important steps in order to enhance its usage and popularity through initiatives like regulating card market to maintain the security levels and to build up confidence of bankers and customers.

In nutshell, we can say that the Indian banking sector is accepting the challenge of information technology as the bankers have recognized plastic cards and security aspects pertaining to card usage as essential requirement for their survival and growth in future.

TYPES OF PLASTIC CARDS-CREDIT CARD, DEBIT CARD, SMART CARD, ADD-ON CARDS

1. Credit Cards



Introduction

A credit card is a system of payment in which you can buy now and pay later.

A credit card is a plastic card which is issued by banks and other entities approved by the RBI which enables the users of the card to pay merchants for goods and services. Thus it is a system of the payment. It allows its holder to buy goods and services based on the holder's promise to pay for these goods and services. The issuer of the card grants a line of credit to the user from which the user can borrow money for payment to merchant or a cash advance.

The cards are used for :

- Purchase of goods and services and electronic-commerce transactions.
- These cards can be used domestically and internationally, provided it is enabled for international use.
- The cards can be used to withdraw cash from an ATM and for transferring funds from bank accounts.

Meaning

A credit card is a plastic card issued by a bank or financial institution that allows its user to borrow pre-approved funds at the point of sale in order to complete a purchase.

Definition

A credit card can be defined as a standard-size plastic token, with a magnetic stripe that holds a machine readable code. Credit cards are convenient substitute for cash or cheque. Credit card holders who may be required pay annual services charges. They can draw on a credit limit approved by the card-issuer i.e. a bank. Cardholders normally must pay for credit card purchases within 45 days of purchase to avoid interest and/or penalties.

Credit card relieves the consumers from the botheration of carrying cash and ensures safety, convenience and credit.

2. Debit Cards



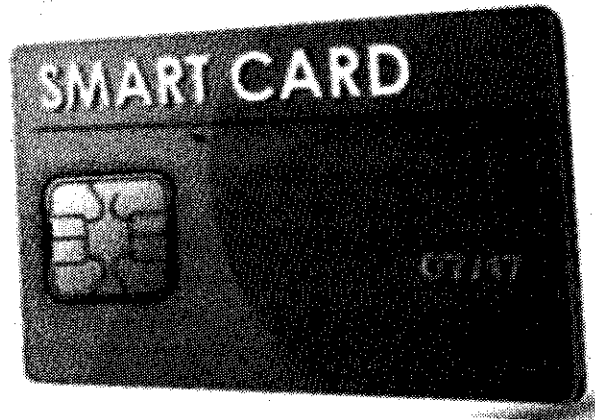
Debit Cards are the payment cards which provide the electronic access to the cardholder to his bank account. These cards are issued by the banks and linked to bank account.

Features of debit cards are as below:

1. Card is directly linked to the cardholder's bank account.
2. When the card is swiped or used electronically in case of E-commerce, transaction amount is debited immediately from the bank account.

3. There is no credit facility provided by the bank unlike credit card.
4. The holder of the card can withdraw cash from an ATM.
5. Purchase of goods and services at point of sale both domestically and internationally provided it is enabled for international use.

3. Smart Card



A plastic card contains a microprocessor that enables the holder to perform operations requiring data that is stored in the microprocessor. It is typically used to perform financial transactions.

It looks like a credit card or debit card.

Smart cards are used for a variety of purposes, including:

- Storing digital cash
- Storing a patient's medical records

It is considered to be a secured and time saving device that can access information without use of a computer or the internet.

However, smart cards have both advantages and disadvantages.

Smart cards are individually encrypted and can only be accessed by PIN number and hence considered secured.

Information on a smart card cannot be erased or removed accidentally by any electrical or magnetic means. This feature of smart card enables data integrity.

Smart card readers are expensive to produce.

4. Add-on Cards

Add-on card is a privilege of credit card offered to the family members i.e. spouse, parents or children above 18 years of age of the primary credit card holder, depending on the terms and conditions attached with the card. All expenses incurred on an add-on card are billed to the primary cardholder.

As most credit cards allow usage in India and abroad for shopping, supplementary credit card offers the users the same benefits. If a person is a holder of an add-on card he can shop online as well as offline. The add-on cards granted to children who are dependent on parents, helps parents to easily monitor the spending habits of children whenever the credit card is swiped. The add-on credit cards given to parents give them financial freedom and are useful in times of emergency.

PERFORMANCE OF CREDIT CARDS AND DEBIT CARDS

Performance of Credit Cards

Credit cards have a maximum amount called a credit limit which the user can borrow during a given period of time. The credit limit is pre-determined by the card issuer based on the cardholder's credit rating and credit history.

When an individual uses a credit card to make a purchase, he is authorizing the credit card issuer to pay the merchant on his behalf. Merchants are required by law to verify that the individual using the card is its rightful owner by obtaining proper identification via a Personal Identification Number (PIN).

Merchants generally prefer payment by credit card because they are immediately paid by the card issuer despite the fee the merchant must pay to the card processing company for each transaction.

Credit card issuers require the cardholder to pay his or her balance in full, usually on a monthly basis. If the user does not pay the balance in full, the issuer adds interest to the balance, and this interest compounds for as long as the balance is outstanding.

Issuers of card use several methods to calculate interest and it is important for the card holder to read and understand the issuer's disclosure statement. Many credit cards also charge an annual fee, late payment fees, cash advance fees.

How Does a Credit Card Work?

The credit card functions differently for a cardholder and for the other parties.

(a) **For a credit cardholder:** When you apply for a credit card, the card provider will check if you are financially eligible to own it or not. If you are eligible, then based on the amount you earn, the bank or Credit Card Company will set a credit limit for you.

Once you receive your credit card, you can use it to make payments on credit. By using this card, you are borrowing money from your card provider (Credit Card Company or bank). Every billing cycle you can use either the full credit limit or a portion of it. If you exceed your credit limit, you will have to pay a interest or penalty.

At the end of every billing cycle, the lender expects you to repay the amount you have borrowed. There is a fixed interest free credit period, within which the cardholder is supposed to pay either the full amount due or a part of it. Credit card providers generally specify the minimum amount that cardholders have to pay every billing cycle, to avoid being considered a defaulter.

If the cardholders pay the full amount due, they do not have to pay any interest on their card. In case they pay only the minimum amount due or do not repay any money, then they

will have to pay an interest on the outstanding balance as well as on the new purchases. The card provider will keep charging the interest until they pay the full outstanding balance.

(b) **For the other parties:** The other parties involved in the credit card system are:

- **Merchants or sellers:** They use the POS (Point of Sale) Terminals to swipe the credit cards of the customers to get their money.
- **Payment Gateway:** It is the online version of the POS machines used at retail outlets. The payment gateway authorises the purchases that are made using a credit card online.
- **Credit Card Issuers:** These are the banks or Credit Card Companies that offer credit cards, collect the monthly bills and deal with the customers.
- **The Acquirer:** It is the bank or financial institution that process the credit card payments on behalf of the merchants. The acquirers provide the POS machines to the merchants.
- **Association or Network:** It refers to the payment processing network, which collects information from the processors, authorizes and collects the payments for the purchases. For example - Visa, MasterCard, American Express, etc.
- **Payment Processors:** The payment processors take care of collecting the data and sending it to the Network. The right network is identified by the first and last digits of the credit card numbers.

(c) **Process:** When a cardholder swipes his/her credit card to make payment at a merchant outlet, a request is submitted by the merchant to the acquirer via a phone or network connection. The acquirer forwards this request to the card issuer to authorize the transaction. The card issuer has to check if the cardholder has enough credit available in his/her account to make the

purchase. If yes, then an authorization code is sent by the issuer to the acquirer, who then approves the transaction and the purchase is made.

A merchant does not swipe just one card on the POS machine in a day. Depending on the number of customers, there can be many requests sent by the merchant to the acquirer. So, in order to track the sales, merchants send the requests to the acquirer in batches through the card association or network to the issuers to get the payment. The association distributes the transactions according to the issuers. The issuers deduct the fee and transfer the amount to the acquirer, who after deducting their share, sends the balance to the merchants. The transaction rates vary from merchant to merchant and are dependent on the transaction numbers, type, category, etc. The payment process is same in case of online purchases as well except that the payments are processed by payment gateways such as PayUMoney, VeriSign, etc.

Performance of Debit Cards

A debit card is basically a Debit cum ATM card used for financial transactions issued by bank. A person can enjoy electronic access to his savings account in any bank via ATMs. He can deposit and withdraw as per his convenience without the hassle of standing in long queues. It can be utilized for mobile banking and internet banking.

Features of Debit cards :

- Debit cards come with almost every feature of a credit card except the fact that it does not allow credits.
- Card holder will require a four digit Personal Identification Number to complete his purchases.
- In addition to ATM machines, the debit card can be used at stores or restaurants and can also be used for online payments
- There are usually two types of debit cards – Visa debit cards and MasterCard debit cards.

- The debit card allows its holder to use the money from his savings account.
- It is different from a credit card as the customer does not have to pay interests or make a repayment schedule

Transactions that can be done at ATMs with Debit cum ATM card

Most individuals with Debit cum ATM cards usually use ATM machines for the sole purpose of withdrawing cash. However, ATM machines perform other functions as well when debit cards are swiped or inserted in ATM. They include:

- (i) **Payment of Utility Bills:** ATMs can be used to make payments for utilities such as electricity, insurance premiums, and telephone companies. However, these payments can be done only if the bills have not crossed their due dates.
- (ii) **Requesting a cheque book:** Card holders can make requests for a new cheque book through the ATM owned by his bank.
- (iii) **Making credit card payments:** Most ATMs have an option for paying credit card bills. However, it is essential that the payment is made at the ATM that is owned by the bank where the credit card was issued.
- (iv) **Paying taxes:** Card holders will have to register for the service of making their tax payments at an ATM. However, this service is only available for payment of direct taxes. After a card holder has registered for the service, the amount payable will be debited from the card holder's account.
- (v) **Recharging mobile phones:** Cardholders can use their debit card to recharge their pre-paid mobile numbers. This can be done by visiting the ATM owned by the card holder's bank. The process would require the card holder to enter their mobile number and their ATM PIN to confirm and authenticate the transaction.

Transaction charges on debit card payments

In a survey conducted in 2015, it was revealed that there were around 61.5 crore debit card users and 2.3 crore credit card users in India.

Generally, customers pay a transaction cost on debit card payments which is also known as merchant discount rate (MDR). In a move to increase cashless transactions post demonetization, the government had notified banks to not charge customers for debit card transactions for a limited period of time.

BENEFITS OF CREDIT CARDS

Benefits of credit cards are listed as below.

1. **A credit card is safer than carrying cash.**
While there is only a small chance of having lost or stolen cash returned, a credit card can quickly be cancelled, if its holder loses his wallet. Most financial institutions have security processes in place to protect the card holder, if the card has been lost or stolen or if he suspects that his account has been used for a fraudulent transaction. The card holder should contact his bank to report the issue as soon as possible in case of loss of card.
2. **A credit card can build holder's credit rating.**
A holder's credit card account details and payment history plays a key role in determining his credibility. If a card holder keeps his account in good standing, this information will help him build up a good credit score, which could increase his chances of approval for other products such as car loans or a mortgage.
3. **A card holder can get interest-free credit.**
While a card holder pays by credit card he gets an interest free credit, if repayment is made before the due date.
4. **Earn reward points when a card holder spend.**
Credit card purchases allow a card holder to earn reward points on every rupee he spends on eligible purchases, such as the groceries and petrol costs. He can earn reward points to redeem with the bank's rewards programs for perks including products from the rewards store or cash back.

5. **Credit cards can be used for payments in foreign currency.**
Although currency conversion fees usually apply, the card holder can use his credit card overseas to make payments in a foreign currency.
6. **Credit cards give its holder an emergency line of credit.**
Credit cards can be a financial safety net for the holder if he does not have enough cash or savings to cover any unexpected costs. However he needs to remember that he will have to repay everything he borrows.
7. **Credit cards often have complimentary extras.**
Credit card provides other value-adding features including complimentary flight offers, airline lounge passes, discount in certain restaurants and cash backs at certain shopping malls.
8. **A person can consolidate debts and save money on existing balances.**
Balance transfer credit cards allows a holder to move existing high-interest debts to a new account with a low or 0% promotional interest rate. This can save his money on interest charges and help him pay down debt faster.

DISADVANTAGES OF USING A CREDIT CARD

The downsides of spending with a credit card include:

- **Paying high rates of interest:** If card holder carries a balance from month-to-month, he will pay interest charges. Purchase and cash advance interest rates can be as high as 22% p.a., so he can end up paying a very high amount of interest if he is unable to make repayments each month.
- **Credit damage:** Missed credit card repayments and ongoing debts are recorded on card holder's credit file and can impact his chances of getting a loan down the track.
- **Credit card fraud:** There are a range of fraud schemes that target credit cards. Dealing with credit card fraud can be a time-consuming and stressful experience.

- **Cash advance fees and rates:** Financial institutions make it very expensive to use credit card to get cash withdrawals or make other cash equivalent transactions such as buying foreign currency. Using a credit card for a cash withdrawal will attract a cash advance fee. It also typically attracts a very high rate of interest.
- **Annual fees:** While a holder can often get debit cards without annual fees, most credit cards have them. Generally, the more perks the credit card holder wants, the higher the cost of the annual fee. If he wants to avoid this charge, he can consider a no annual fee credit card.
- **Credit card surcharges:** Businesses often apply a surcharge when a card holder pays with a credit card. There is an extra cost for the convenience of paying with plastic.
- **Other fees can quickly add up:** Depending on the card, it's holder could be charged fees when he misses a payment, if he spends more than his credit limit, fees for overseas transactions, balance transfer fees and even some rewards programs fees.

DANGERS OF DEBIT CARDS

Credit cards, when used wisely, can be safer than debit cards. In fact, debit cards have a few serious drawbacks. Here are a few debit card dangers one should know about.

Although convenient in use, debit cards are not perfect. Here are a number of dangers you need to watch out for.

1. **Fraud protection:** If a debit card holder's wallet falls into the wrong hands, his debit card's fraud protection is not as strong as a credit card's. Plus, some banks will hold him fully liable if his debit card is used fraudulently for pin-based transactions.

Finally, if a thief uses holder's credit card, he can withhold payment for the charges until his credit card investigates the suspected fraud. If a thief uses his debit card, he can drain holder's bank account in a matter of minutes, and he may not

get that money back until his bank investigates. So, it's important to keep track of debit card and if holder lose it, he should report it to bank on a priority basis.

Building credit: If a card holder doesn't have a credit history yet or he is trying to rebuild his credit score, a debit card payment will not help.

Merchant disputes: If a card holder goes to a restaurant and pays for a lunch with his debit card and the cashier swipes his card for a higher amount. Further if he declines a receipt, he will never notice the mistake until he uses his debit card again and it is declined. He gets home to check with his bank and see the problem. Obviously, the merchant will probably return his money, but returning the money to his account will take several days. In the meantime, he needs to get his bank to reverse any overdraft fees.

If this same thing happened with a credit card, he would not owe the card company any amount until the problem was solved.

If there is a dispute regarding a purchase he makes, he is in a weaker position when he uses a debit card. The merchant already has his money when he pays with a debit card.

4. **Fees:** If a card holder uses a debit card for most of his purchases, he needs to be extremely diligent about keeping track of his account balance. If he overcharges by a few rupees, his card may be declined.

There are also spending limits on debit cards per day. There are spending limits on credit cards, but that is the credit limit set.

5. **Rewards and services:** Many credit cards offer cash back or other rewards programs. Most debit cards do not have the same perks.

The smart way to use a debit card

Follow these simple rules to use your debit card securely.

HOW TO STAY SAFE?

- Do not share your card number, CVV, and expiry date .
- Notify the bank immediately about suspicious transactions.
- Do not share PIN with anyone.

Case 1 : Debit Card Fraud

3.2 million debit cards compromised and the banks such as SBI, HDFC Bank, ICICI, YES Bank, Axis Bank were worst hit on during October, 2016.

A malware attack has resulted in what could be one of the biggest ATM card frauds. The security of more than 32 lakh debit cards was compromised in India. Several banks have admitted to being hit by cyber attacks.

Banks in India were required to either replace or ask users to change the security codes of as many as 3.2 million debit cards in what's emerging as one of the biggest ever breaches of financial data in India. Several victims have reported unauthorised usage from locations in China.

Of the cards, 2.6 million are said to be on the Visa and MasterCard platform and 600,000 on the RuPay platform. The worst-hit of the card-issuing banks are State Bank of India.

The breach is said to have originated in malware introduced in systems of Hitachi Payment Services, enabling fraudsters to steal information allowing them to steal funds.

A forensic audit was then ordered by Payments Council of India on Indian bank servers and systems to detect the origin of frauds that might have hit customer accounts.

Some of the banks took action in the matter by advising customers who had used other Bank's ATM in the recent past to change (their) ATM PIN. It was also reiterated that it is always prudent to change ATM PINs from time to time to prevent misuse.

Visa and MasterCard were alerted. A forensic audit was conducted by Bengaluru-based payment security specialist SISA.

Case 2 : Debit card fraud

A Man involved in a racket of debit card frauds on 14th August 2018. He used to travel to other city to withdraw cash from ATMs using cloned debit cards. The accused told the police that he used to withdraw ₹ 5,000 to ₹ 10,000 in each transaction from different cloned cards. He had installed a specially developed software in his laptop for cloning of the cards.

When the accused worked at a petrol pump in Mumbai, he used to copy data of the debit cards presented for payment by the customers. He first swiped the debit card on a hand held device with him without the customers knowledge before swiping it on the device actually belonging to the petrol pump. He used to notice the PIN that the customer entered and immediately wrote it on a paper slip. Later he produced a cloned debit card using the customer's data and withdraw money from ATM using the later's PIN. He was caught by police and he admitted to the fraud committed by him.

PREVENTION OF FRAUDS AND MISUSE

In India, according to a provision in credit card contracts, the card-issuing company is not liable for any fraudulent transaction unless the customer files a report immediately.

Usually, banks have dedicated transaction monitoring units and fraud detection systems to analyse suspicious patterns. So, if two transactions are made from different countries with the same card within a short period, the system will highlight this. However, it is important that the customer is also cautious. For instance, opting for cards with signature lamination and a photograph, registering for transaction alerts and transacting only through secured websites are common precautions.

Once a loss of card is reported, the card holder is no longer liable. Card frauds range from purchases made on lost or stolen cards to phishing, identity theft and traps set up through unsecured Internet transactions.

Frauds can be prevented in the following ways.

1. **Skimming or cloning:** While travelling abroad, data in the card's magnetic stripe is recorded when swiped at a machine. This information is then used to make duplicates. It can happen anywhere, at a petrol pump or a restaurant. So one needs to make sure the card is swiped in his presence.

Banks advice customers to replace cards after foreign trips to minimize skimming risk.

2. **Beware of cyber swindles:** Cyber swindles involve unauthorised use of card details, such as the card number, the Card Verification Value (three-digit code printed on the back side of the card), to make purchases online.

The card holder should register for online transaction passwords such as Verified by Visa or MasterCard Secure Code and avoid using public computers. The transaction should happen through a secure website.

3. **Takeover of accounts and identity theft:** This can happen in two ways.

(i) A cardholder's information is stolen and used for transactions where the card's physical presence is not required, for example online purchases.

(ii) By placing a request for a new card using the stolen information.

Monitoring credit card report is a best defence in the above stated situations.

User should check for unusual transactions, especially small ones, as fraudsters make these small transactions to check the card's validity.

4. **Phishing mails:** The card holder should not fall prey to phishing mails (that appear to be sent by an institution he deals with but are not), SMSs or calls.

5. **ATM safeguards:** Stay away from ATMs that appear dirty or in disrepair. They may not work or may be fake machines set

to capture confidential card information. Here are some other things a card holder should keep in mind:

Check machine: Do not use ATMs with unusual signage, such as a command to enter a PIN twice to complete the transaction. Also watch out for machines that appear to have been altered, if the front looks crooked, loose or damaged. It could be a sign that someone has attached a skimming device

Cover keypad: Make sure to cover the keypad with hand while entering the PIN to escape any cameras attached nearby.

Do not take help: It is advisable to use only own bank ATMs, particularly those attached to a bank branch and those that have security guards. Also, avoid taking the help of any person loitering outside the ATM or volunteering to assist in case stuck.

6. **Online precautions:**

Use safe sites: Go only to well-known and established sites for e-shopping. Remember to confirm the site's legitimacy before using it and shop only on those sites that are Secure Sockets Layer (SSL)-certified. These can be identified through the lock symbol next to the browser's URL box.

Also make sure that the website uses the 'https' protocol instead of 'http', where 's' stands for 'secure'. Additionally, make sure not to click on the option that asks for saving card details on any site.

Anti-virus software: While banks deploy ATM network security measures, on an individual level a person can safeguard transactions by installing anti-virus software on his computer and smart phone to keep out malware.

Debit card: Make sure that card holder does not use his debit card for e-commerce transactions. This is because if card is compromised, the entire cash in his bank account can be wiped out instantly. The credit card, on the other hand, offers a month's grace period before the cash leaves his account, during which the investigation can possibly be carried out to.

Register for alerts: This is a very important step since the bank will alert the cardholder to any online card transaction or ATM withdrawals the moment these take place. The cardholder should remember to update his mobile contact number in case of a change.

Log out: Always log out from social media sites and other online accounts to ensure data security and avoid storing confidential passwords on mobile phones as these can be used by fraudsters.

Change passwords: Card holder should keep changing passwords from time to time to reduce the probability of identity theft.

9. **Other offline preventive measures:** There are some additional precautions that one can take to ensure the card is safe.

Do not disclose details: Never reveal PIN, CVV or password to anyone. Make sure not to respond to e-mails or SMSs that ask for crucial personal or card-related details. No bank or credit card firm is authorised to seek card details from customers on mail or through phone.

Check statements: Regularly go through bank or credit card statements so that any unauthorised transaction can be detected through identity theft and alert the bank immediately.

Merchants & POS: At shops or petrol pumps, make sure that the card is not taken by the salesperson to a remote location where the card information can be easily copied and stolen. Also, try shopping with retailers that use chip-enabled card readers. Though not every merchant has such readers, this provision can help bring down the risk of fraudulent card activity significantly.

Lost/stolen card : A card holder can genuinely lose his card when he forgets to collect it from the ATM machine or the cashier after signing for the goods or loses his wallet with his card in it and in many other ways.

10. **Grievances:** The RBI has appointed an ombudsman for redressal of complaints which a bank has failed to respond to

satisfactorily. A bank must respond within 30 days from the date a card holder lodges the complaint. In case of wrongful billing, the card company should provide documentary evidence within 60 days. If unsatisfied, the cardholder can go to the ombudsman.

Mumbai Police to fight against card frauds

Mumbai city has seen a whopping 43 per cent rise in cases of debit/credit card fraud as compared to last year. While as many as 546 cases of credit/debit card fraud were registered in Mumbai from January till November this year, 382 cases were registered last year during the same period. An increased number of citizens have gone for cashless transactions following demonetisation in 2016 and hence the instances of debit and credit card frauds have increased. There are various modus operandis that cyber-fraudsters use to dupe citizens. The most common of them is where debit cards of users are being cloned using skimming devices, according to a senior Mumbai police officer. In a bid to increase the detection and conviction rate of cyber crimes in the city, Mumbai police have set up specialised cyber crime investigation units at each police station in Mumbai. The policemen working in these cyber-units are well trained and the main aim for setting up these units is to take the burden off the Cyber-Crime police station.

CONSUMER PROTECTION

The consumer protection Act, 1986 provides an apex platform for the redressal of grievances of credit card holders. The credit card holder is a consumer according to the definition of "consumer" under the Act, since he hires or avails of services for a consideration. Accordingly, the credit card issuers are legally responsible for any deficiency in services or unfair trade practices.

Under the Act, a complaint means any allegation in writing made by a complaint which includes unfair and restrictive trade practices and deficiency in services. A complaint should contain information about the name, description and the address of the complainant,

name, description and address of the opposite party or parties, the facts relating to complaint and when and where it arose, documents if any, in support of the allegations contained in the complaint, the relief, which the complainant is seeking, the complainant or his authorized agent should sign the complaint.

The complaint is to be filed within two years.

Section 11, 17 and 21 provides for segmented redressal machinery for filing of complaints based on the value of the claim lodged:

- Upto ₹ 5,00,000- District Forum
- More than ₹ 5,00,000 and less than ₹ 20,00,000 - State Commission.
- Exceeds ₹ 20,00,000 - National Commission.

Generally, the credit cardholder falls in the first category. The procedure for filling complaints and seeking redressal are simple enough. There is no fee for filing a complaint before the District Forum, the State Commission, or the National Commission. The complainant or his authorized agent can present the complaint in person or it can be sent by post to the appropriate forum/ commission. Aggrieved cardholder can see the relief under section 14 of the Act depending on the nature of relief sought by the consumer and the facts of case. The aggrieved cardholder can appeal against the order of district forum/state commission/national commission within a period of 30 days respectively.

Procedure for filing the appeal is same as that of complaint, except the application should be accompanied by the order of the District Forum/State Commission as the case may be specified for filing the appeal should be specified for filing the appeal should be specified. Following issues are important to be considered in this regard.

- In their card application forms, the issuers specifically indicate the jurisdiction in case of dispute, which is major problem to the redressal process.
- The consumer courts are presently flooded with a pile of pending cases, which renders logically impossible for a credit card holder to file a complaint.

The credit card regulations are not shown to the cardholders at the time of issue.

Credit card fraud : RBI steps in to protect customers

In a bid to limit customer liability in fraudulent credit card and online transactions, the Reserve Bank of India (RBI) has come out with revised guidelines and has also sought to make rules stricter for banks in cases of frauds.

With a view to limit customer liability in fraudulent credit card, online transactions, the RBI has come out with revised guidelines and has also sought to make rules stricter for banks in cases of frauds. "With the increased thrust on financial inclusion and customer protection and considering the recent surge in customer grievances relating to unauthorised transactions resulting in debits to their accounts/cards, the criteria for determining the customer liability in these circumstances have been reviewed," the RBI said in a circular.

According to the revised guidelines, a customer will have zero liability in respect of a fraudulent transaction, if there is contributory fraud or negligence on the part of the bank, irrespective of whether or not the transaction is reported by the customer. In case of a third party breach also, where the deficiency lies neither with the bank nor with the customer and the customer informs the bank within 3 working days of receiving communication from the bank regarding the unauthorised transaction, the customer will not be liable. Similarly, customer liability has been capped at ₹ 25,000 if a person reports unauthorised transactions within seven working days. However, a bank is free to determine customer liability if such a transaction is reported after seven working days.

It is clear, thus, that although customer liability has become limited as per revised guidelines, however, a customer is also liable to some extent in case of negligence on his part. Therefore, if you do not want to suffer at all, then it is also your responsibility to be careful while doing any financial transaction.

Here is what you need to do:

1. The RBI has advised banks to ask their customers to mandatorily register for SMS alerts and wherever available register for e-mail alerts for electronic banking transactions. The SMS alerts shall mandatorily be sent to the customers, while email alerts may be sent, wherever registered. Thus, if you have not still got registered for SMS alert, then it is in your own interest to do so as soon as possible even if your bank takes some time in sending you a request for SMS alert registration. After all, the money is yours and it is also your duty to keep it as safe as possible.
2. A customer will now have zero liability in respect of a fraudulent transaction, if there is contributory fraud or negligence on the part of the bank, irrespective of whether or not the transaction is reported by the customer. In case of a third party breach also, where the deficiency lies neither with the bank nor with the customer and the customer notifies the bank within three working days of receiving communication from the bank regarding the unauthorised transaction, the customer will not be liable. Thus, if you don't want to have any liability in respect of a fraudulent transaction, then inform the bank about this as soon as possible. If the bank is closed for some reason, then talk to any customer care officer and lodge your complaint. Don't forget to get the complaint number. Also write an email to the bank, which will remain as a proof that you acted on time.
3. A customer, however, will now be liable for the loss occurring due to unauthorised transactions in cases where the loss is due to negligence by a customer. For instance, in case he has shared the payment credentials, the customer will bear the entire loss until he reports the unauthorised transaction to the bank. Any loss occurring after the reporting of the unauthorised transaction shall be borne by the bank. Here also it is in your own interest to report the matter to the bank as soon as possible. Until that is done, you will have to bear the loss all by yourself.
4. In cases where the responsibility for the unauthorised electronic banking transaction lies neither with the bank nor with the customer, but lies elsewhere in the system and when there is a delay (of four to seven working days after receiving the communication from the bank) on the part of the customer in notifying the bank of such a transaction, the per transaction liability of the customer shall be limited to the transaction value or the amount notified by the RBI. For instance, in case of credit cards with limit up to ₹ 5 lakh, the maximum liability has been fixed at ₹ 10,000, and in case of credit cards with limit above ₹ 5 lakh, the maximum liability has been fixed at ₹ 25,000. Thus, here also reporting the matter to the bank as soon as possible is in your own interest.
5. You need to remember that if the delay in reporting is beyond seven working days, the customer liability shall be determined as per the bank's Board-approved policy. Banks, however, have been asked to provide the details of their policy in regard to customers' liability formulated in pursuance of the RBI directions at the time of opening the accounts. Banks will also have to display their approved policy in public domain for wider dissemination. The existing customers will also have to be individually informed about the bank's policy.
6. The RBI has said that the burden of proving customer liability in case of unauthorised electronic banking transactions shall lie on the bank. However, you also need to be careful while doing any financial transaction so that you are not held liable for the loss occurring due to unauthorised transactions.

INDIAN SCENARIO

Today it is impossible to imagine modern bank operations, commercial transactions and other payments without using the plastic cards in India. Plastic currency is now gradually becoming

the norm across India as more people are opting for plastic compared to paper money as there are several inherent advantages. The Government has also moved forward for a "Digital India" and its focus on growing electronic payments is a significant driver of growth of plastic money.

Use of plastic Money is growing at an unprecedented rate in India.

E-wallets such as PAYTM, Airtel money, m-paisa, Jio money are thriving in the market. An e-wallet is an application that can be downloaded via the Internet and installed on your hand-held device such as a smart phone. To a first-time user, the application allows the creation of a unique ID based on the user's phone number and email address. The registration process is completed by OTP (One Time Password) to prevent misuse of identity. Once account is created, it needs to be loaded with cash, digitally. This is done by linking the e-wallet account with your net-banking, credit card or debit-card accounts. After linking the account, you can transact with any merchant who accepts payments from the same e-wallet company. During demonetizations move, such wallet has gained popularity.

The Unified Payment Interface is also a revolutionary development in Indian banking. It was created by the RBI-backed National Payments Corporation of India. It allows account holder to send and receive money in real time, using your bank account connected to its net-banking application or any third party UPI application. This potentially works better than e-wallets. With UPI, transactions happen directly between bank accounts, whereas e-wallets are intermediaries between bank accounts. UPI can be used to pay as well as to collect money.

If you live in a connected, urban area, most of your transacting requirements can be met with plastic money or Internet money.

The unbanked population is coming into banking stream through E wallets. It will be difficult task for plastic money to sustain their presence in coming years. Mobile will become complete banking wallet for anyone and everyone in India.

Usage of cards in India

In April 2018, the number of debit cards increased to 906 million, with 45.3 million new cardholders, while a total of 37.78 million credit cards were in operation, with the addition of 0.30 million cards, according to the Reserve Bank of India. Between April 2017 and April 2018, India added some 7.41 million credit cards and 39.36 million debit cards.

Card usage spiked during the months of November 2016, December 2016 and January 2017, following the demonetization of ₹ 500 and ₹ 1000 notes. The unavailability of cash forced cardholders to use them. But since February 2017, both debit card and credit card usage have been range-bound. In June 2017, debit cards were down by 86.2 million to 793.83 million, shaving off most of the increase that demonetization brought in.

SMART CARDS-FEATURES, TYPES, SECURITY FEATURES AND FINANCIAL APPLICATIONS

Meaning & Features

A smart card, chip card, or integrated circuit card (ICC), is any pocket-sized card that has embedded integrated circuits. Smart cards typically look like a credit card. Smart cards are typically made of plastic.

What makes the card "smart" is the embedded chip. The chip is a powerful minicomputer that can be programmed for different applications. The chip enables a smart card to store and access data and applications securely and exchange data securely with readers and other systems. Smart card technology can provide high levels of security and privacy protection, making smart cards ideal for handling sensitive information.

ADVANTAGES

1. The first main advantage of smart cards is their **flexibility**. Smart cards have multiple functions such as an identity card, a credit card, a stored-value cash card, and a repository of personal information such as telephone numbers or medical history. The card can be easily replaced if lost, and, the requirement for a PIN (or other form of security) provides additional security from unauthorised access to information by others. At the first attempt to use it illegally, the card would be deactivated by the card reader itself.
2. The second main advantage of smart card is its **security**. There are encryption devices to enable the user to encrypt and decrypt information.
3. Other general benefits of smart cards are:
 - Portability
 - Increasing data storage capacity
 - Reliability that is virtually unaffected by electrical and magnetic fields.

How do smart cards work?

A smart card connects to a card reader either through direct physical contact or through a remote, contactless radio frequency (RF) interface. A typical contact smart card has a plastic card body, a chip embedded in the body and a contact plate. The contact plate (usually gold-plated) is visible on the surface of the card. A contact smart card is inserted into a smart card reader, which touches the contact plate. Commands, data and card status are transmitted over the physical contact points. Contactless smart cards look like contact smart cards but without the contact plate. They communicate with the reader through a contactless RF interface. Contactless smart cards are held in close proximity to a reader and commands, data etc. are transmitted without any physical contact.

Types

Types of Smart Cards based on connection to the Smart Card Reader

- (a) **Contact Smart Card:** Contact smart card consists of electrical contacts which connect to the card reader where the card is inserted. The electrical contacts are arranged on a gold plated coating on the surface.
- (b) **Contactless Smart Card:** This contactless smart card communicates with the reader without any physical contact. It consists of an antenna which is used to communicate with the RF (Radio Frequency) band with the antenna on the smart card reader. The antenna receives power from the card reader through the electro-magnetic signal.

Types of Smart Cards based on their functionalities and configuration

- (a) **Memory Cards:** Memory cards consist of memory circuits. It can store, read and write data to a particular location. The data cannot be manipulated or processed.
- (b) **Microprocessor based Cards:** These smart cards comprise of micro processor embedded on the chip along with the memory blocks. It has specific sections of files which are associated with a particular function. The data in the files are managed either by dynamic operating system or fixed operating system. It also performs the multiple functions and also used for data processing and manipulations.

Security Features

1. **Authentication:** Smart cards provide authentication to others who want to gain access to the card. It helps to validate users, devices, or applications to enable use of the data on the card's chip. These features can protect privacy by ensuring that a banking application has been authenticated as having the

appropriate access rights before accessing financial data or functions on the card,

2. **Secure data storage:** Smart cards provide a way to securely store data on the card. This data can only be accessed through the smart-card operating system by those with proper access rights. The user has better knowledge and control over his personal data.
3. **Encryption:** Smart cards provide a robust set of encryption capabilities. These capabilities can be used to protect privacy in many ways. For example, a smart-card system can produce a digital signature for an e-mail message, providing a way to validate the e-mail's authenticity. This protects the message from being tampered with, and also provides the recipient with assurance about origination. The fact that the signing key originated from a smart card adds credibility to the origin and the intent of the signer.
4. **Strong device security:** Smart-card technology is extremely difficult to duplicate or forge. Smart-card chips include a variety of hardware and software capabilities that detect and react to tampering attempts, and help counter possible attacks.
5. **Secured communications:** Smart cards provide secured communication between the card and reader. Similar to security protocols used in many networks. This feature allows smart cards to send and receive data in a secure manner.
6. **Biometrics:** Smart cards provide ways to securely store biometric templates and perform biometric matching functions. These features can be used to improve privacy in systems that use biometrics. For example, storing fingerprint templates on smart cards can be an effective way to increase privacy in a single sign-on system that uses fingerprint biometrics.
7. **Personal device:** A smart card is a personal and portable device associated with a particular cardholder. The smart-card plastic is often personalized which provides a stronger binding to the cardholder.

Financial Applications

Smart cards can be used as credit card, ATM cards, fuel cards, mobile phone SIMs, authorization cards, utility pre-payment cards, high-security identification and access badges, and public transport card.

Smart cards may also be used as electronic wallets. The smart card chip can be loaded with funds to pay for parking, vending machines or merchants.

Usage of Smart Card

There are people who disapprove usage of smart cards as they say that technological innovation can never be 100% protected and no matter how hard one may try, there will still be a loophole through which smart cards can be misused. But then, one can't succumb to not using a technological innovation because some people out there are using or rather misusing it for personal gains. Like every other thing, smart credit cards too have their benefits and drawbacks, but for a technological innovation to survive the advantages should always outweigh the drawbacks and that luckily is the case with smart cards. A lot of innovation has taken place in smart card technological innovation over the years and in near future smart credit cards are expected to play a larger and more important role in our daily life.

CREDIT RATING

MEANING

Credit rating means an assessment made of an entity's ability and willingness to meet the financial obligations of interest and principal repayment of the concerned debt instrument on time.

- It is a process of evaluating risk associated with the credit instrument.

- Rating is an isolated function of a credit risk evaluation.
- Rating is useful in differentiating credit quality.
- It is an expression of opinion by a rating agency.
- Rating will facilitate comparison of relative value between competing securities.
- It helps in recognizing the risk involved in the investment.

Credit rating is not linked with :

- (1) A general purpose evaluation of the issuer.
- (2) A recommendation to buy/sell/hold a security.
- (3) An extensive audit of the issuing company.
- (4) One time assessment of creditworthiness valid over the future life of the security.
- (5) Opinion of the holding company, subsidiaries of the issuer entity.

DEFINITION

According to Moody's Investor Service, "Ratings are designed exclusively for the purpose of grading according to their investment qualities."

Standard & Poor's defined the Credit Rating, "A S&P's Corporate or Municipal debt rating is a current assessment of the credit worthiness of an obligator with respect to specific obligation".

The CRISIL has defined the Credit Rating as "The CRISIL rating symbols indicate in a summarized manner CRISIL's current opinion as to the relative safety of timely payment of interest and principal on a debenture, preference share, fixed deposit or short-term instruments".

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 100 years ago. These ratings did not have a profound effect on the market until 1936, when a new rule was passed that prohibited banks from investing in speculative bonds, or bonds with low credit ratings, to avoid the risk of default which could lead to financial losses. This practice was quickly adopted by other companies and financial institutions and, soon enough, relying on credit ratings became the norm.

High level of defaults in U.S. capital markets in 1970 and regulators stipulation for mandatory ratings contributed to the growth of credit rating.

The need for starting credit rating agencies was felt during the 1980s in India as a number of non banking financial companies were accepting deposits by offering competitive interest rates. RBI felt the need for protecting the interests of depositors in these NBFCs and so it made credit rating mandatory for the instruments of NBFCs.

The first credit rating agency in India was set up in the year 1988. The Credit Rating Information Services of India Ltd. (CRISIL) was started as a subsidiary of ICICI and later it was followed by ICRA (Investment information and Credit Rating Agency of India - 1990) and CARE (Credit Analysis and Research Ltd. - 1993). These rating agencies have established their creditability through their independence, professionalism, continuous research, consistent efforts and confidentiality of information.

FEATURES

1. Credit rating is used to estimate the worthiness of the credit for the company's debt instruments.
2. Credit rating is been done after considering various factors such as financial, non-financial parameters, and past credit history.
3. Credit rating is simple to understand and it facilitates universal applicability. Credit rating also makes it widely accepted as the symbols which are used are generalized.
4. The process of credit rating is very detailed and it involves lots of information such as financial information, client's office and works information and other management information. It involves in-depth study.
5. A rating is an opinion given on the basis of information available at particular point of time. Many factors affect the debt servicing capability of the issuer. It is, therefore, essential that rating agencies monitor all outstanding debt issues rated by them. The rating agencies should put issues under close credit watch and upgrade or downgrade the ratings as per the circumstances after intensive interaction with the issuers.
6. In India, ratings are undertaken only at the request of the issuers and only those ratings which are accepted by the issuer are published.
7. The quality of the services offered, consistency and integrity would determine a rating agency's success.
8. The rating is done for a particular issue and not for a company or the issuer. Thus, it is quite possible that the two instruments issued by the same company carry different rating.
9. As per the definition, credit rating is an opinion on the issuers capacity to service debt. In case of equity there is no pre-determined servicing obligation and so credit rating does not apply to equity shares.

10. Credit rating is much broader concept than financial analysis. The rating is normally done at the request of and with the active co-operation of the issuer.

ADVANTAGES OF RATING

The advantages of rating to various parties are listed below:

- (a) Investors
- (b) Borrowers/issuers
- (c) Brokers and financial intermediaries
- (d) Government
- (e) Credit rating companies

(A) INVESTORS

- (i) **Helps in investment decision:** Credit rating will guide the investors in selection of debt instrument. Thus it helps in decision making pertaining to investment. Usually, higher the rating, the more will be the willingness to invest in these instruments considering the safety and vice-versa.
- (ii) **Quality information at low cost:** The investors will get the good quality of information at low cost.
- (iii) **Benefits of rating reviews:** The rating review helps investors in investing their money according to risk. If company is highly rated, it means low risk and vice-versa. Thus, the investors can take the calculated risk on investment activities.
- (iv) **Assurance of safety:** High credit rating gives assurance to the investors about the safety of the instrument and minimum risk of bankruptcy. This will protect them from bankruptcy. So the investors will be safe. Credit rating will provide safeguard against malpractices by the borrowers.
- (v) **Easy understandability of investment proposal:** The rating agencies gives different symbols of rating which is easy to

understand by investors or public. 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 expected to default on maturity.

- (vi) **Choice of instruments:** Credit rating gives choice of debt instruments to the public. This choice depends upon the safety or risk of the instrument.
- (vii) **Saves investor's time and effort:** Credit ratings save the time of investors by providing them different symbols of rating. A higher symbol means less risk or vice-versa and it also saves the efforts of investors.

(B) BORROWERS/ISSUERS

1. **Lower Cost of Borrowing:** High credit 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. High rating means low risk and vice-versa.
2. **Wider investor base for Borrowing:** If the company gets high credit rating for its debt issue from rating agency, most of the investors are interested in investing in it. A company with high rating for its instruments can get a wider investor base for borrowing. It can approach financial institutions, banks, investing companies. The good rating can attract international investors also.
3. **Good for unknown Companies:** Credit rating is beneficial to the relatively unknown companies, such as closely-held companies. If the credit rating is good, the public will invest in these companies. Thus investors rely on rating grade rather than on 'name recognition'.
4. **Acts as a Marketing Tool:** It acts as a marketing tool which helps in developing confidence of customers. The customers feel confident about the products manufactured by the companies carrying higher rating for their credit instruments. Credit rating not only helps to develop a good image of the

company among the investors, but also among the customers, dealers, suppliers, etc.

5. **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. The good rating can attract the foreign collaborators.
6. **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. Companies with good rating can enter the capital market confidently.
7. **Reduction of cost in public issues:** A company with higher rated instrument is able to attract the investors with least efforts to raise funds. Thus the rated company can minimize cost of public issues by controlling expenses on publicity.
8. **Motivation for growth:** Rating provides motivation to the company for growth as the promoters feel confident in their own efforts and are encouraged to undertake expansion of their operations or take up new projects.

(C) BROKERS AND FINANCIAL INTERMEDIARIES

1. **Less efforts:** Stock brokers have to make less efforts in persuading their clients to select an investment proposal of making investment in highly rated instruments.
2. **Saving of time, energy, costs and manpower:** Brokers save time, energy, cost and manpower in convincing clients about investment in any particular rated instrument.

(D) GOVERNMENT

1. **Channelisation of idle funds:** Fair and good ratings motivate the investors towards investment. Therefore, the idle funds will be channelized for the productive uses.

2. **Employment opportunities:** Mega issues rated by the credit rating agencies enhance employment opportunities in the economy.
3. **Investors protection:** It provides investors protection without any burden on the part of the government.
4. **Facilitates formulation of public policy:** It facilitates the formulation of public policy guidelines on institutional investments.

(E) CREDIT RATING COMPANIES

1. Honest and sincere credit rating agencies would survive in the market.
2. There is a scope for other allied financial services for a credit rating company.

REGULATORY FRAMEWORK

Credit rating is intended for investors' guidance and protection. Securities Exchange Board of India (SEBI) has made credit rating compulsory for the Indian companies. The Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999 empower SEBI to regulate credit rating agencies operating in India. Thus, SEBI regulates the credit rating agencies under the SEBI (Credit Rating Agencies) Regulations, 1999 of the Securities and Exchange Board of India Act, 1992 (15 of 1992). In fact, SEBI was one of the first few regulators, globally, to put in place an effective and comprehensive regulation for Credit Rating Agencies. SEBI regulates the functioning of credit rating agencies in order to protect the interest of investors and to make the system more helpful to them. Credit rating agencies are amongst the very few market intermediaries for which such detailed operating guidelines have been prescribed under the regulations.

In terms of the SEBI Regulations, a credit rating agency has been defined as a body corporate which is engaged in or proposes to be

engaged in, the business of rating of securities offered by way of public or rights issue. The term 'securities' has been defined under the Securities Contract (Regulation) Act, 1956.

The following regulations regarding functioning and affairs of Credit Rating Agencies in India have been prescribed by SEBI :

- (i) Process of getting certificate of registration.
- (ii) Obligations of credit rating agency towards SEBI.
- (iii) Restrictions on the ratings of the securities.
- (iv) Procedure for inspection and investigation by SEBI.
- (v) Action in case of default.

Process of Getting Certificate of Registration

Registration with the SEBI is mandatory for carrying on rating business. The application for the grant of certificate of initial registration should be made to the SEBI in form A and accompanied by a non-refundable fee of ₹ 50,000. Rating is defined by the SEBI Regulations as an opinion regarding securities, expressed in the form of standard symbols / in any other standardized form, assigned by a credit rating agency and used by the issuer of such securities to comply with a requirement specified by SEBI regulations.

Promoter of Credit Rating Agency

A credit rating agency can be promoted by a

- public financial institution, as defined in section 4 A of the Companies Act,
- a scheduled commercial bank,
- a foreign bank operating in India with the approval of the RBI
- a foreign credit rating agency recognised by or under any law for the time being in force in the country of its incorporation, having at least five years experience in rating securities,

- any company or a body corporate, having continuous net worth of minimum rupees one hundred crores as per its audited annual accounts for the previous five years prior to filing of the application with the SEBI for the grant of certificate.

Eligibility Criteria

The eligibility criteria for a rating agency are specified below.

- the applicant is set up and registered as a company;
- the applicant has specified rating activity in its Memorandum of Association as one of its main objects;
- the applicant has a minimum net worth of ₹ 5 crores;
- the applicant has adequate infrastructure, to enable it to provide rating services;
- the applicant and the promoters of the applicant, referred to in regulation 4 have professional competence, financial soundness and general reputation of fairness and integrity in business transactions, to the satisfaction of the SEBI;
- neither the applicant, nor its promoter, nor any director of the applicant or its promoter, is involved in any legal proceeding connected with the securities market, which may have an adverse impact on the interests of the investors;
- neither the applicant, nor its promoters, nor any director, of its promoter has at any time in the past been convicted of any offence involving moral turpitude or any economic offence;
- the applicant has, in its employment, persons having adequate professional and other relevant experience to the satisfaction of the Board;
- the applicant and any person directly or indirectly connected with the applicant has in the past been - (i) refused by the SEBI a certificate under these regulations or (ii) subjected to any proceedings for a contravention of the Act or of any rules or regulations made under the Act. Explanation: For the purpose of this clause, the expression "directly or indirectly connected

person" means any person who is an associate, subsidiary, inter-connected or group company of the applicant or a company under the same management as the applicant.

- the applicant is a fit and proper person in all respects for the grant of a certificate;
- grant of certificate to the applicant is in the interest of investors and the securities market.

Grant of Certificate of Initial / Permanent Registration

- SEBI will grant of initial or permanent registration on payment of fees.
- On payment of a registration fee, the SEBI will grant a certificate of initial registration to eligible applicants.
- Three months before the expiry of the 5 year validity of the initial registration, the Credit Rating Agency should apply for permanent registration together with a fee. It should also be accompanied by details of the changes in the information submitted to the SEBI while seeking initial registration and a declaration that no changes other than those mentioned in such details have taken place.
- The Credit Rating Agency would pay a fixed amount of fees every three years.

Conditions of certificate and validity period

The certificate granted under regulation shall be, subject to the following conditions, namely:

- the credit rating agency shall comply with the provisions of the Act, the regulations and the guidelines, directives, circulars and instructions issued by the SEBI, from time to time, on the subject of credit rating.
- where any information or particulars furnished to the Board by a credit rating agency:
 - is found to be false or misleading in any material particular;
 - or

- (ii) has undergone change subsequently to its furnishing at the time of the application for a certificate; the credit rating agency shall forthwith inform the Board in writing. It should obtain prior approval of the SEBI for continuing to act as a Credit Rating Agency after the change in control.

General Obligations of Credit Rating Agencies

The general obligations of credit rating agencies are as stated below.

Code of Conduct

A credit rating agency should:

- Make all efforts to protect the interests of investors.
- Observe high standards of integrity, dignity and fairness in the conduct of its business.
- Fulfil its obligations in a prompt, ethical and professional manner.
- At all times exercise the due diligence, ensure proper care and exercise independent professional judgement in order to achieve and maintain objectivity and independence in the rating process.
- Follow a reasonable and adequate basis for performing rating evaluation, with the support of appropriate and in depth rating researches. It should also maintain records to support its decisions.
- Follow a rating process which reflects consistent and international rating standards.
- Not to indulge in any unfair competition nor should it wean away the clients of any other agency on assurance of higher rating.
- Keep track of all important changes relating to the client and develop efficient systems to generate timely and accurate rating. Monitor all relevant factors that might affect the credit worthiness of the issuers.

- Disclose its rating methodology to clients, users and the public.
- Ensure that no conflict of interest exists between any member of its rating committee participating in the rating analysis and that of its client.
- Not making any exaggerated statement its qualification or its capability.
- Not to make any untrue statement, suppress any material fact or make any misrepresentation in any documents, reports or information furnished to the SEBI or public.
- Not generally and particularly in respect of issue of securities rated by, it be a party -
 - (a) to creation of false market
 - (b) passing of price sensitive information to brokers, members of the stock exchanges, other players in the capital market or to any other person or take any other action which is unethical or unfair to the investors.
- Maintain an appropriate level of knowledge and competence and abide by the provisions of the SEBI Act, regulations and circulars, which may be applicable and relevant to the activities carried on by it.
- Ensure that there is no misuse of any privileged information including prior knowledge of rating decisions or changes.
- Not to render, directly or indirectly any investment advice about any security in the public accessible media.
- Ensure that any changes in registration status/ any penal action taken by SEBI or any material changes in financials which may adversely affect the interests of clients/investors is promptly informed to the clients.
- Maintain an arm's length relationship between its credit rating activity and any other activity.
- Develop its own internal code of conduct for governing its internal operations and laying down its standards of

appropriate conduct for its employees and officers in the carrying out of their duties within the credit rating agency and as a party of the industries.

- Provide adequate freedom and powers to its compliance officer for the effective discharge of his duties.
- Ensure that good corporate policies and corporate governance are in place.

Agreement with The Client

Every credit rating agency is required to enter into a written agreement with each client whose securities it proposes to rate, and every such agreement should include the following provisions, namely:

- (a) the rights and liabilities of each party in respect of the rating of securities
- (b) the fee to be charged
- (c) a periodic review of the rating by the credit rating agency during the tenure of the rated instrument and to co-operate with the credit rating agency in order to enable it to arrive at, and maintain, a true and accurate rating of the clients' securities and shall in particular provide to it true, adequate and timely information for the purpose;
- (d) disclose to the client the rating assigned to the securities through regular methods of dissemination, irrespective of whether the rating is or is not accepted by the client;
- (e) the client shall agree to disclose the rating assigned to the client's listed securities by any credit rating agency during the last three years and any rating given in respect of the client's securities by any other credit rating agency, which has not been accepted by the client in the offer document;
- (f) the client shall agree to obtain a rating for any issue of debt securities in accordance with the relevant regulations.

Monitoring of Rating

Credit rating agency should during the lifetime of securities rated by it continuously monitor the rating of such securities. It should also disseminate information regarding newly assigned ratings, and changes in earlier rating promptly through press releases and websites. In the case of securities issued by listed companies, such information should also be provided simultaneously to the concerned stock exchanges where the securities are listed.

Procedure for Review of Rating

Every credit rating agency should carry out a periodic review of all published ratings during the lifetime of the securities. If the client does not co-operate with the credit rating agency so as to enable the credit rating agency to comply with its obligations, the credit rating agency should carry out the review on the basis of the best available information. However, it has been provided that if owing to such lack of co-operation, a rating has been based on the best available information, the credit rating agency should disclose to the investors the fact that the rating is so based. A credit rating agency should not withdraw a rating so long as the obligations under the security rated by it are outstanding, except where the company whose security is rated is wound up or merged or amalgamated with another company.

Internal Procedures

Credit rating agency should frame appropriate procedures and systems for monitoring the trading of securities by its employees in the securities of its clients, in order to prevent contravention of SEBI (Insider Trading) Regulations, 1992; SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to the Securities Market) Regulations, 2003; and other laws relevant to trading of securities.

Disclosure of Rating Definitions

Credit rating agency should make public the definitions of the concerned rating, along with the symbol and state that the ratings do not constitute recommendations to buy, hold or sell any securities. It should also make available to the general public information

relating to the rationale of the ratings, which shall cover an analysis of the various factors justifying a favourable assessment, as well as factors constituting a risk.

Submission of Information

In case any information is called for by SEBI from a credit rating agency including any report relating to its activities, the credit rating agency is required to furnish such information to SEBI within a period specified or if no such period is specified, then within a reasonable time. It should also furnish to SEBI, copies of its balance sheet and profit and loss account at the close of each accounting period.

Every credit rating agency is required to comply with such guidelines, directives, circulars and instructions as issued by SEBI from time to time.

Appointment of Compliance Officer

It is under an obligation to appoint a compliance officer who will be responsible for monitoring the compliance of the Act, Rules and Regulations, notifications, guidelines, instructions *etc.* issued by SEBI or the Central Government. The compliance officer should immediately and independently report to SEBI any non-compliance observed by him.

Maintenance of Books of Accounts and Records

Credit rating agency should keep and maintain, for a minimum period of five years, the following books of accounts, records and documents:

- (i) copy of its balance sheet, as on the end of each accounting period;
- (ii) a copy of its profit and loss account for each accounting period;
- (iii) a copy of the auditor's report on its accounts for each accounting period.
- (iv) a copy of the agreement entered into, with each client;

- (v) information supplied by each of the clients;
- (vi) correspondence with each client;
- (vii) ratings assigned to various securities including upgradation and down gradation (if any) of the ratings so assigned;
- (viii) rating notes considered by the rating committee;
- (ix) record of decisions of the rating committee;
- (x) letter assigning rating;
- (xi) particulars of fees charged for rating and such other records as SEBI may specify from time to time.

Steps on Auditor's Report

Credit rating agency should within two months from the date of the auditor's report, take steps to rectify the deficiencies if any, made out in the auditor's report, insofar as they relate to the activity of rating of securities.

Confidentiality

Every credit rating agency shall treat, as confidential, information supplied to it by the client and no credit rating agency shall disclose the same to any other person, except where such disclosure is required under any law.

Rating Process

- Credit rating agency should specify the rating process and file a copy of the same with SEBI for its record and also file with SEBI any modifications or additions made therein from time to time.
- It should in all cases follow a proper rating process.
- Credit rating agency is required to have professional rating committees, comprising of members who are adequately qualified and equipped with the knowledge to assign a rating. All rating decisions, including the decisions regarding changes in rating, should be taken by the rating committee.

- Credit rating agency should be staffed by analysts qualified to carry out a rating assignment.
- Credit rating agency should inform SEBI about new rating instruments or symbols introduced by it.
- Credit rating agency, while rating a security should exercise due diligence in order to ensure that the rating given by the credit rating agency is fair and appropriate.
- A credit rating agency should not rate securities issued by it.
- Rating definition, as well as the structure for a particular rating product, should not be changed by a credit rating agency, without prior information to SEBI.
- A credit rating agency should disclose to the concerned stock exchange through press release and websites for general investors, the rating assigned to the securities of a client, after periodic review, including changes in rating, if any.

Restrictions on Rating of Securities

Credit rating agency shall not rate a security issued by its promoter:

- (1) No credit rating agency should rate a security issued by an entity,
 - (a) which is a borrower of its promoter or
 - (b) a subsidiary of its promoter or
 - (i) an associate of its promoter, if there are common Chairman, Directors between credit rating agency and these entities,
 - (ii) there are common employees,
 - (iii) there are common Chairman, Directors, Employees on the rating committee.
- (2) No credit rating agency should rate a security issued by its associate or subsidiary, if the credit rating agency or its rating

committee has a Chairman, director or employee who is also a Chairman, director or employee of any such entity.

However, these conditions do not apply to securities whose rating has been already done by a credit rating agency before the commencement of these regulations, and such securities may, subject to the provisions of the other Chapters of these regulations, continue to be rated, without the need to comply with the restrictions imposed by the regulations.

Procedure for Inspection and Investigation

SEBI can appoint one or more persons as inspecting officers, to undertake inspection or investigation of the books of account, records and documents of the credit rating agencies, for any of the purposes specified in the regulations. The purposes referred to in the regulations should be

- to ascertain whether the books of account, records and documents are being maintained properly,
- to ascertain whether the provisions of the Act and these regulations are being complied with,
- to investigate into complaints received from investors, clients or any other person on any matter having a bearing on activities of the credit rating agency and in the interest of the securities market or in the interest of investors.

The inspections ordered by SEBI should not ordinarily get into an examination of the appropriateness of the assigned ratings on the merits. Inspections to judge the appropriateness of the ratings may be ordered by SEBI, only in cases of complaints which are serious in nature to be carried out either by the officers of SEBI or independent experts with relevant experience or combination of both.

Notice of Inspection or Investigation

SEBI shall give ten days written notice to the credit rating agency before ordering an inspection or investigation. SEBI in the interest of the investors may by an order in writing, direct that the inspection

or investigation of the affairs of the credit rating agency to be taken up without such notice. During the course of an inspection or investigation, the credit rating agency against whom the inspection or investigation is being carried out shall be bound to discharge all its obligations as provided in the regulations.

Action in Case of Default

A credit rating agency which -

- (a) fails to comply with any condition subject to which a certificate has been granted;
- (b) contravenes any of the provisions of the Act or these regulations or any other regulations made under the Act; shall be dealt with in the manner provided under Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations.

CREDIT RATING AGENCIES

Credit rating agencies in India are CRISIL Ltd., ICRA Ltd., CARE Ltd., FITCH Ltd. and SMERA. (Each of these agencies working has been explained in detail below.)

CREDIT RATING PROCESS

All the four rating agencies in the country adopt a similar rating process. The steps followed by them in rating process are explained with reference to :

- (1) New issues/instruments
- (2) Review of rating

1. Rating Process of New Issues

The following steps are involved in rating the issuers of instruments for the first time, before going public.

(a) **Rating Agreement and assignment of Analytical Team:** The process of rating starts with the issue of the rating request letter by the issuer of the instrument and execution of rating agreement. On receipt of the request, a team of analysts who have expertise in the relevant business area would be given rating analysis.

(b) **Meeting with management:** Prior to meeting with the issuer, the analytical team obtains and analyses information relating to its financial statements and other relevant information as below:

- Annual reports for past five years
- Two copies of the latest prospectus
- Consolidated financial statements for the past three years
- Two copies of the statements of projected sources and application of funds, balance sheets and operating statements for at least the next three years
- Copies of existing loan agreements along with recent compliance letters
- List of banks, showing lines of credit and contact officers
- Information on the company's principal officers and the names of the board members.

A complete brief followed by a discussion on management philosophy and plans should also be obtained. The topics discussed during the management meeting cover competitive position, strategies, financial policies, historical performance, near and long term financial and business outlook. The rating process ensures complete confidentiality of the information provided by the company.

(c) **Rating Committee:** After meeting with the management, the analysts present their report to a rating committee, which then decides on the rating. The rating is arrived at after a composite assessment of all the factors concerning the issuer with special emphasis on the key issues.

- (d) **Communication to the issuer:** After the rating is assigned by the committee, the rating decision is communicated to the issuer, with the rationale supporting the rating. The thoroughness and transparency of its rating methodology and the integrity and fairness of its approach are important factors in establishing and maintaining credibility.

If the issuer disagrees with the rating outcome, he may appeal the decision for which additional information need to be provided to the analysts. Based on the additional information, rating may or may not be changed. The client has the right to reject the rating and the whole exercise is kept confidential.

The entire process starting from the initial management meeting to the assignment of the rating normally takes three to four weeks.

- (e) **Dissemination to the public:** Once the issuer accepts the rating, the credit rating agency disseminate it, alongwith the rationale, through the print media.

2. Review of Rating

In the case of rated instruments, the rated company is on the surveillance system of the credit rating agency and the earlier ratings are reviewed regularly for potential rating changes. The following steps are necessary in the rating process for review cases.

- (i) Analysts review the new information or data available on the company, which might be sent by the company or obtained from routine channels. If the new information is crucial for rating, then the analysts study the same to determine its relevance and authenticity.
- (ii) If the analysts feel that there is a possibility for change in the rating, they meet the management before proceeding with a comprehensive rating analysis. The remaining process of presenting rating opinion before committee remains the same as is followed in case of new issues.
- (iii) During the review monitoring exercise, rating analysts come to know of important events like mergers, etc. which affect

rating and require rating change. In such situation, the issuer's rating is put on 'credit watch' indicating the possibility of change and supporting reasons for a review.

CREDIT RATING SYMBOLS

SEBI observed that the Credit Rating Agencies registered with it use different rating symbols and definitions. So there was a need to be common rating symbols and definitions :

- (i) for easy understanding of the rating symbols and their meanings by the investors, and
- (ii) to achieve high standards of integrity and fairness in ratings.

SEBI, in consultation with the credit rating agencies and on the recommendation of its Corporate Bonds and Securitisation Advisory Committee, standardised rating symbols and their definitions have been devised for the following :

- (a) Long term debt instruments
- (b) Short term debt instruments
- (c) Long term structured finance instruments
- (d) Short term structured finance instruments
- (e) Long term mutual fund schemes and
- (f) Short term mutual fund schemes.

Rating symbols should have CRA's first name as prefix. For Example : CARE AAA, CARE AA etc.

(a) Long Term Debt Instruments

These instruments are with original maturity exceeding one year.

- **AAA** - Instruments with this rating are considered to have the highest degree of safety regarding timely servicing of financial obligations. Such instruments carry lowest credit risk.

- **AA** - Instruments with this rating are considered to have high degree of safety regarding timely servicing of financial obligations. Such instruments carry very low credit risk.
- **A** - Instruments with this rating are considered to have adequate degree of safety regarding timely servicing of financial obligations. Such instruments carry low credit risk.
- **BBB** - Instruments with this rating are considered to have moderate degree of safety regarding timely servicing of financial obligations. Such instruments carry moderate credit risk.
- **BB** - Instruments with this rating are considered to have moderate risk of default regarding timely servicing of financial obligations.
- **B** - Instruments with this rating are considered to have high risk of default regarding timely servicing of financial obligations.
- **C** - Instruments with this rating are considered to have very high risk of default regarding timely servicing of financial obligations.
- **D** - Instruments with this rating are in default or are expected to be in default soon.

Modifier {"+" (plus)} can be used with the rating symbols for the categories A1 to A4. The modifier reflects the comparative standing within the category.

(c) Long Term Structured Finance Instruments

These instruments are with original maturity exceeding one year.

- **AAA (SO)** - Instruments with this rating are considered to have the highest degree of safety regarding timely servicing of financial obligations. Such instruments carry lowest credit risk.
- **AA (SO)** - Instruments with this rating are considered to have high degree of safety regarding timely servicing of financial obligations. Such instruments carry very low credit risk.
- **A (SO)** - Instruments with this rating are considered to have adequate degree of safety regarding timely servicing of financial obligations. Such instruments carry low credit risk.
- **BBB (SO)** - Instruments with this rating are considered to have moderate degree of safety regarding timely servicing of financial obligations. Such instruments carry moderate credit risk.

Modifiers {"+" (plus)"/"-" (minus)} can be used with the rating symbols for the categories AA to C.

The modifiers reflect the comparative standing within the category.

(b) Short Term Debt Instruments

These instruments are with original maturity of upto one year. Rating symbols should have CRA's first name as prefix.

- **A1** - Instruments with this rating are considered to have very strong degree of safety regarding timely payment of financial obligations. Such instruments carry lowest credit risk.

- **AA** - Instruments with this rating are considered to have high degree of safety regarding timely servicing of financial obligations. Such instruments carry very low credit risk.
- **A** - Instruments with this rating are considered to have adequate degree of safety regarding timely servicing of financial obligations. Such instruments carry low credit risk.
- **BBB** - Instruments with this rating are considered to have moderate degree of safety regarding timely servicing of financial obligations. Such instruments carry moderate credit risk.
- **BB** - Instruments with this rating are considered to have moderate risk of default regarding timely servicing of financial obligations.
- **B** - Instruments with this rating are considered to have high risk of default regarding timely servicing of financial obligations.
- **C** - Instruments with this rating are considered to have very high risk of default regarding timely servicing of financial obligations.
- **D** - Instruments with this rating are in default or are expected to be in default soon.

Modifiers {"+" (plus)/"-"(minus)} can be used with the rating symbols for the categories AA to C.

The modifiers reflect the comparative standing within the category.

(b) Short Term Debt Instruments

These instruments are with original maturity of upto one year. Rating symbols should have CRA's first name as prefix.

- **A1** - Instruments with this rating are considered to have very strong degree of safety regarding timely payment of financial obligations. Such instruments carry lowest credit risk.

- **A2** - Instruments with this rating are considered to have strong degree of safety regarding timely payment of financial obligations. Such instruments carry low credit risk.
- **A3** - Instruments with this rating are considered to have moderate degree of safety regarding timely payment of financial obligations. Such instruments carry higher credit risk as compared to instruments rated in the two higher categories.
- **A4** - Instruments with this rating are considered to have minimal degree of safety regarding timely payment of financial obligations. Such instruments carry very high credit risk and are susceptible to default.
- **D** - Instruments with this rating are in default or expected to be in default on maturity.

Modifier {"+" (plus)} can be used with the rating symbols for the categories A1 to A4. The modifier reflects the comparative standing within the category.

(c) Long Term Structured Finance Instruments

These instruments are with original maturity exceeding one year.

- **AAA (SO)** - Instruments with this rating are considered to have the highest degree of safety regarding timely servicing of financial obligations. Such instruments carry lowest credit risk.
- **AA (SO)** - Instruments with this rating are considered to have high degree of safety regarding timely servicing of financial obligations. Such instruments carry very low credit risk.
- **A (SO)** - Instruments with this rating are considered to have adequate degree of safety regarding timely servicing of financial obligations. Such instruments carry low credit risk.
- **BBB (SO)** - Instruments with this rating are considered to have moderate degree of safety regarding timely servicing of financial obligations. Such instruments carry moderate credit risk.

- **BB (SO)** - Instruments with this rating are considered to have moderate risk of default regarding timely servicing of financial obligations.
- **B (SO)** - Instruments with this rating are considered to have high risk of default regarding timely servicing of financial obligations.
- **C (SO)** - Instruments with this rating are considered to have very high likelihood of default regarding timely payment of financial obligations.
- **D (SO)** - Instruments with this rating are in default or are expected to be in default soon.

Modifiers {"+" (plus)/"-"(minus)} can be used with the rating symbols for the categories AA (SO) to C (SO). The modifiers reflect the comparative standing within the category.

(d) Short Term Structured Finance Instruments

The instruments with original maturity of upto one year.

- **A1 (SO)** - Instruments with this rating are considered to have very strong degree of safety regarding timely payment of financial obligation. Such instruments carry lowest credit risk.
- **A2 (SO)** - Instruments with this rating are considered to have strong degree of safety regarding timely payment of financial obligation. Such instruments carry low credit risk.
- **A3 (SO)** - Instruments with this rating are considered to have moderate degree of safety regarding timely payment of financial obligation. Such instruments carry higher credit risk a compared to instruments rated in the two higher categories.
- **A4 (SO)** - Instruments with this rating are considered to have minimal degree of safety regarding timely payment of financial obligation. Such instruments carry very high credit risk and are susceptible to default.
- **D (SO)** - Instruments with this rating are in default or expected to be in default on maturity.

Modifier {"+" (plus)} can be used with the rating symbols for the categories A1 (SO) to A4 (SO). The modifier reflects the comparative standing within the category.

(e) Long Term Debt Mutual Fund Schemes

These debt mutual fund schemes have an original maturity exceeding one year. Rating symbols should have CRA's first name as prefix.

- **AAAmfs** - Schemes with this rating are considered to have the highest degree of safety regarding timely receipt of payments from the investments that they have made.
- **AAmfs** - Schemes with this rating are considered to have the high degree of safety regarding timely receipt of payments from the investments that they have made.
- **Amfs** - Schemes with this rating are considered to have the adequate degree of safety regarding timely receipt of payments from the investments that they have made.
- **BBBmfs** - Schemes with this rating are considered to have the moderate degree of safety regarding timely receipt of payments from the investments that they have made.
- **BBmfs** - Schemes with this rating are considered to have moderate risk of default regarding timely receipt of payments from the investments that they have made.
- **Bmfs** - Schemes with this rating are considered to have high risk of default regarding timely receipt of payments from the investments that they have made.
- **Cmfs** - Schemes with this rating are considered to have very high risk of default regarding timely receipt of payments from the investments that they have made.

Modifiers {"+" (plus)/"-"(minus)} can be used with the rating symbols for the categories AAmfs to Cmfs. The modifiers reflect the comparative standing within the category.

(f) Short Term Debt Mutual Fund Schemes

These debt mutual fund schemes that have an original maturity of upto one year. Rating symbols should have CRA's first name as prefix.

- **A1mfs** - Schemes with this rating are considered to have very strong degree of safety regarding timely receipt of payments from the investments that they have made.
- **A2mfs** - Schemes with this rating are considered to have strong degree of safety regarding timely receipt of payments from the investments that they have made.
- **A3mfs** - Schemes with this rating are considered to have moderate degree of safety regarding timely receipt of payments from the investments that they have made.
- **A4mfs** - Schemes with this rating are considered to have minimal degree of safety regarding timely receipt of payments from the investments that they have made.

Modifier {"+" (plus)} can be used with the rating symbols for the categories A1mfs to A4mfs. The modifier reflects the comparative standing within the category.

CREDIT RATING AGENCIES IN INDIA

Credit rating agencies in India are CRISIL Ltd., ICRA Ltd., CARE Ltd., FITCH Ltd. and SMERA.

A. CRISIL LTD.

CRISIL is the first credit rating agency in India promoted in 1987 jointly by the ICICI Ltd. and the Unit Trust of India. It commenced operation on 1st January, 1988. It pioneered the concept of credit rating in the country. It has diversified into related areas of information and advisory services. It offered its share capital to public in 1993. CRISIL forged a strategic business alliance with Standard & Poor's (S&P) Ratings Group. The tie-up was a part of

CRISIL's strategy to develop its skills and processes. S &P acquires a 9.68 % stake in CRISIL on May 8, 1997. The alliance with the world's leading rating agency added a new dimension to CRISIL's methodologies. It provides CRISIL with exposure to the international rating markets and to S&P's rating processes.

CRISIL was set up to rate debt obligations that would guide investors as to the risk of timely payment of interest and principal. Its main objectives are listed as below:

- To assist individual and institutional investors in making investment decisions in fixed interest securities;
- To enable companies to mobilize funds in large amounts from a wide investor base, at a fair cost;
- To enable intermediaries to place debt instruments with investors by providing them with an effective marketing tool;
- To provide regulators with a market -driven system for bringing about discipline and a healthy growth of capital markets.

To achieve these objectives, the functions performed by the CRISIL currently fall under four broad categories of services;

1. Corporate sector rating,
2. Financial sector rating,
3. Structured finance rating,
4. New rating products.

1. Corporate Sector Rating

CRISIL follows a three pronged approach to arrive at the standalone credit rating of a given firm, comprising evaluation of:

- Business risk - factors in industry risk, market position, and operating efficiency of the entity.
- Management risk - considers competence, integrity and risk appetite of the firm's management.

- Financial risk – assesses accounting quality, present and future financial position, cash flows, and financial flexibility of the firm. Project based risks are also factored in at this stage.

CRISIL offers a wide palette of corporate sector instrument ratings including:

- Bank loan ratings
- Long term debt instruments such as bonds, non-convertible debentures (NCDs), and preference shares
- Short term debt instruments such as commercial papers (CPs) and short term NCDs
- Fixed deposits (FDs)

2. Financial Sector Rating

CRISIL rates a large number of financial sector entities, including banks and non-banking financial institutions, housing finance companies, securities firms, etc.

CRISIL has also rated the highest number of NBFCs in India (over 80% of the sector).

CRISIL uses the 'CRAMEL' framework to rate finance companies. This entails assessment of six major parameters: capital, resource raising ability, asset quality, management, earnings, and liquidity.

In addition, CRISIL also assesses instrument-specific risk factors, and has developed ratings framework and methodologies to evaluate the same.

3. Structured Finance Rating

CRISIL assigns ratings to

- Securitization transactions through the pass through certificate (PTC) route
- Structured obligation transactions

Securitisation transactions through PTC route

CRISIL's ratings on PTCs indicates the relative degree of risk associated with timely servicing of financial obligations on the PTCs, as per the terms of the securitisation transaction.

CRISIL rates PTCs issued by a wide range of entities such as:

- Banks
- NBFCs
- Infrastructure entities
- Microfinance institutions
- Urban local bodies

Structured obligation transactions

CRISIL may use an (SO) suffix to ratings to indicate 'structured obligation', where the credit rating on an instrument is enhanced over and above the issuer rating by means of a structure or mechanism. This credit enhancement, that supports the payment of interest and principal on the instrument, may be internal or external. SO ratings apply only to instruments, and not to the companies issuing them.

4. New Rating Products

The CRISIL offers the following services ;

- Opinions for investments in real estate or infrastructure assets
- Independent assessment of issuances in infrastructure projects
- Rating of subordinated debt & preference shares of insurance companies
- The resolution plans of stressed assets

B. ICRA LTD.

The ICRA Ltd. has been promoted by the IFCI Ltd. as the main promoter holding 26% of the share capital. Apart from the main

promoter, the other shareholders are the Unit Trust of India, banks, LIC, GIC, EXIM Bank, HDFC Ltd. and ILFS Ltd. It started operations in 1991.

The international Credit Rating Agency Moody's Investors Service is ICRA's largest shareholder. The participation of Moody's is supported by a Technical Services Agreement, which entails Moody's providing certain high-value technical services to ICRA. Specifically, the agreement is aimed at benefiting ICRA's in-house research capabilities, and providing it with access to Moody's global research base. The agreement also envisages Moody's conducting regular training and business seminars for ICRA analysts on various subjects to help them better understand and manage concepts and issues relating to the development of the capital markets in India.

Objectives :

The main objectives of the 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, in large amounts and at a lower cost for highly rated entities;
- To enable banks, investment bankers, brokers in placing debt with investors by providing them with a marketing tool ;
- To provide regulator with market driven systems to encourage the healthy growth of the capital markets in a disciplined manner, without additional burden on the Government.

ICRA Ltd. currently provides three types of services:

1. rating services,
2. information services
3. advisory services.

C. CARE LTD.

The CARE Ltd. is a credit rating and information services company promoted by the Industrial Development Bank of India jointly with

financial institutions, public/private sector banks and private finance companies. It started 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.

Unlike the CRISIL and ICRA, the CARE is very cautious in entering new areas of business.

The CARE Ltd. currently provides following services:

1. rating of all types of debt instruments,
2. advisory services in the area of securitization transactions, structuring financial instruments, financing of infrastructure projects,
3. information services.

D. FITCH RATING INDIA LTD.

It is a joint venture between the international credit rating Duff and Phelps and JM Financial and Alliance Group. In addition to debt instruments, it also rates companies and countries, on request.

E. SMERA (SMALL AND MEDIUM ENTERPRISES RATING AGENCY)

It is the latest entrant in the credit rating business. It has been launched by the SIDBI in association with several banks to focus on rating of small and medium enterprises. It has commenced operation recently. SMERA has pioneered SME ratings in the country.

LIMITATIONS OF RATING

1. **Biased rating and misrepresentation:** If the credit rating industry has a linkage with the company or the persons interested in the company, the reports may be biased and partial. Further companies having lower grade rating do not advertise or use rating while raising funds from the public. In

such case the investor cannot get information about the riskiness of the instrument and therefore, is at loss.

2. **Static study:** Rating is done on the present and the past historic data of the company and this is only a static study. Prediction of the company's health through rating is momentary and anything can happen after assignment of rating symbols to the company.
3. **Concealment of material information:** Rating company might conceal material information from the investigating team of the credit rating company. In such case, quality of rating suffers and renders the rating unreliable.
4. **Rating is no guarantee for soundness of company:** Rating is done for a particular instrument to assess the credit risk but it should not be construed as a certificate of quality of the company or its management.
5. **Human bias:** The investigation team may suffer with human bias due to unavoidable personal weakness of the staff which might affect the rating.
6. **Reflection of temporary adverse conditions:** Time factor affects rating. Sometimes, misleading conclusions are derived. For example, company in a particular industry might be temporarily in adverse condition and given low rating that time. This adversely affects the company's interest.
7. **Downgrade:** Once a company has been rated and if it is not able to maintain its performance, credit rating agencies would review the grade and down grade the rating. This results into impairing the image of the company.
8. **Difference in rating of two agencies:** Rating done by the two different credit rating agencies for the same instrument of the issuer company may not be identified. Such differences arise due to value judgement differences in the analysis in two different agencies.

IL&FS default : Did rating agencies' failure to connect dots lead to crisis ?

This is the question asked when the Indian economy saw a sudden sale of a large holding of instruments of IL&FS in the market affecting the returns of the investors unfavourably in September, 2018 .

In this case, the rating agency had also not asked why the promoters' line of credit had not been invoked despite the dues being already so delayed. An AAA-rated company was delaying making good the line of credit, but no agency had taken that into cognisance. No warning bells were rung.

It is the first time the SEBI is taking up the matter against a credit rating agency.

REVIEW QUESTIONS

1. Define Consumer Finance. Explain features of consumer finance.
2. Describe various sources of consumer finance.
3. Describe different types of consumer finance.
4. Explain mechanics of consumer finance.
5. Describe typical terms of consumer finance.
6. Explain Consumer Credit Scoring Methods.
7. State advantages of consumer finance.
8. State disadvantages of consumer finance.
9. Explain various types of cards.
10. How does a credit card work?
11. State the transactions that can be done at ATMs with Debit cum ATM card.
12. Describe benefits of credit cards.
13. State disadvantages of using a credit card.
14. What are the dangers of debit cards?
15. How can frauds and misuse of credit cards be prevented?
16. Explain meaning and features of smart card.

17. Explain security features of smart card.
18. Define credit rating. Explain its features.
19. State advantages of rating to the investors and borrowers.
20. Explain the process of getting certificate of registration for a rating business.
21. Explain general obligations of credit rating agencies.
22. Explain credit rating process followed by rating agencies in India.
23. Explain limitations of rating.
24. Write short notes on :
 - (i) Meaning and definition of consumer finance and its features
 - (ii) Sources of consumer finance
 - (iii) Types of consumer finance
 - (iv) Consumer finance practices in India
 - (v) Marketing and insurance of consumer finance
 - (vi) Dunham Greenberg Formula
 - (vii) Consumer credit scoring methods
 - (viii) Case for consumer finance
 - (ix) Case against consumer finance
 - (x) Credit Card
 - (xi) Debit Card
 - (xii) Smart Card
 - (xiii) Add-on cards
 - (xiv) Consumer protection mechanism
 - (xv) Types of smart cards
 - (xvi) Security features of smart cards
 - (xvii) Features of credit rating
 - (xviii) Advantages of credit rating to the investors
 - (xix) Advantages of credit rating to the issuers and financial intermediaries
 - (xx) Advantages of credit rating to the Government and credit rating companies.
 - (xxi) CRISIL Ltd-its objectives and functions
 - (xxii) ICRA Ltd- its objectives and functions
 - (xxiii) CARE Ltd- its objectives and functions
 - (xxiv) Limitations of Rating
 - (xxv) Credit Rating Agencies in India

OBJECTIVE QUESTIONS

- A. Select the appropriate options and rewrite the following sentences:**
1. Methods of consumer credit scoring are _____.
 - (a) Dunham Greenberg Formula
 - (b) Specific Fixed Formula
 - (c) Machinery Risk Formula
 - (d) All of the above
 2. An applicant scoring more than _____ points is considered as one with good credit standing.

(a) 30	(b) 50
(c) 70	(d) 100
 3. The effective rate of interest on consumer finance is generally _____ than the rate applicable to business finance.

(a) lower	(b) higher
(c) same	
 4. Dunham Greenberg Formula is not based the customer's

(a) employment record	(b) income level
(c) financial position	(d) marital status
 5. Credit Card facility is an excellent example of revolving credit.

(a) Cash credit	(b) revolving credit
(c) secured credit	(d) term loan
 6. _____ credit is granted only to customers with good credibility.

(a) Unsecured	(b) Secured
(c) Fixed	(d) Short term
 7. The borrowers getting a score more than 3.5, is ranked as _____ under Specific Fixed Formula of Credit Score method.

(a) excellent borrower	(b) marginal borrower
(c) ordinary borrower	(d) extra-ordinary borrower

Ans.: (1) - (d), (2) - (c), (3) - (b), (4) - (d), (5) - (b), (6) - (a), (7) - (a)

B. Fill in the blanks :

1. _____ refers to the raising of finance by individuals for the acquisition of durable consumer goods.
2. _____ accept savings from and make loans to member individuals.
3. _____ facilitate credit purchases of consumer goods through respective banks which issue the credit cards.
4. Tata Motor Credit Company acts as a credit source to car buyers at Tata dealerships is an example of _____.

5. _____ companies are the source of credit for certain policyholders who own policies which include a savings component.
6. _____ facility is an excellent example of revolving credit.
7. _____ means an assessment made of an entity's ability and willingness to meet the financial obligations of interest and principal repayment of the concerned debt instrument on time.
8. _____ is a process of evaluating risk associated with the credit instrument.
9. _____ is an isolated function of a credit risk evaluation.
10. _____ is useful in differentiating credit quality.
11. _____ is a privilege of credit card offered to the family members i.e. spouse, parents or children above 18 years of age of the primary credit card holder.
12. _____ is used to estimate the worthiness of the credit for the company, country or any individual company.

Ans.: (1) Consumer finance (2) Co-operative Credit societies (3) Credit card companies (4) Sales Finance companies (5) Life insurance (6) Credit Card (7) Credit rating (8) Credit rating (9) Credit rating (10) Credit rating (11) Add-on card (12) Credit rating

C. Match the following :

Column A	Column B
1. CIBIL	(a) Ongoing credit
2. Effective rate of interest	(b) Credit Bureau of Information India Ltd.
3. Revolving Credit	(c) $\frac{n}{n+1} \times 2F$
4. Source of consumer finance	(d) Insolvency
5. Type of consumer finance	(e) Traders
6. Machinery Risk Formula	(f) Secured credit
7. Thoughtless buying	(g) Consumer Credit Scoring Method

Ans.: (1) - (b), (2) - (c), (3) - (a), (4) - (e), (5) - (f), (6) - (g), (7) - (d)

D. State whether true or false :

The effective rate of interest on consumer finance is generally lower than the rate applicable to business finance.

Consumers get possession of the assets immediately when a fraction of the price is paid under consumer finance arrangement.

Consumer credit is a method of financing semi-durables and durables.

4. Consumer finance refers to the raising of finance by businesses for the acquisition of durable goods.
5. The tendency of people to borrow early in life to satisfy needs is increasingly evident in emerging Indian consumer credit market.
6. Credit Cards are the payment cards which provide the electronic access to the cardholder to his bank account.
7. In case of debit card, no credit facility is provided by the bank unlike credit card.
8. Rating is useful in differentiating credit quality.
9. Rating will facilitate comparison of relative value between competing securities.
10. Rating helps in recognizing the risk involved in the investment.
11. Credit rating is linked with a general purpose evaluation of the issuer.
12. Contact less smart card consists of electrical contacts which connect to the card reader where the card is inserted.
13. Always log out from social media sites and other online accounts to ensure data security.
14. Smart-card technology is easy to duplicate or forge.
15. If you use a debit card for most of your purchases, you need to be extremely diligent about keeping track of your account balance.
16. Credit cards can be used for payments in foreign currency.
17. Credit cards give you an emergency line of credit.
18. The credit card holder is not a consumer according to the definition of "consumer" under the Consumer Protection Act.
19. Card holder should keep changing passwords from time to time to reduce the probability of identity theft.
20. Credit rating is an extensive audit of the issuing company
21. One time assessment of creditworthiness is valid over the future life of the security.
22. A credit rating is a recommendation to buy/sell/hold a security
23. Credit rating will guide the investors in selection of debt instrument
24. High credit rating gives assurance to the investors about the safety of the instrument and minimum risk of bankruptcy.
25. AAA (Triple A), given by CRISIL for debentures ensures highest safety.
26. Credit rating helps to improve the corporate image of a company.
27. Mega issues rated by the credit rating agencies enhance employment opportunities in the economy.

Ans. True : 2, 3, 5, 7, 8, 9, 10, 13, 15, 16, 17, 19, 23, 24, 25, 26, 27;

False : 1, 4, 6, 11, 12, 14, 18, 20, 21, 22

No. _____

Employee ID (in case of sta only)



सेंट्रल बँक ऑफ इंडिया
Central Bank of India



Branch No.

CREDIT CARD APPLICATION FORM
(All variants)

Date

CREDIT CARD CHOICE

Please indicate your Central Bank of India Credit Card choice:

DOMESTIC CARD

INTERNATIONAL CARD

Aspire



World

Titanium

IDA Card

Reliance Big Cinema

FD No. _____

FD No. _____

FD No. _____

FD No. _____

International Use:

USD 500

USD 1000

USD 1500

Specify any other _____

PERSONAL DETAILS

Name (First Name) _____ (Middle Name) _____ (Last Name) _____

Name as desired on the Card (Maximum of 20 characters) _____

Age _____ Gender Male Female

Mothers Maiden Name _____ Date of Birth _____ PAN No. _____

Nationality _____ (This information may be used to verify your identity when you want your card account details over the phone)

Vehicle Owned Car Two wheeler Organization Provided None Educational Qualification PG Graduate SSC/HSC Others _____

Number of Dependents (Excluding Spouse) 0 1 2 3 4 >4 Married Yes No Others _____

RESIDENTIAL ADDRESS

Landmark _____ City _____ Pin _____

State _____ Preferred Mailing Address: Residence Office

Std Code _____ Tel. No. _____ Mobile No. _____ Email _____

Permanent Address same as above (if no then Please fill in the details below) Yes No

Landmark _____ City _____ Pin _____

State _____ Std Code _____ Tel. No. _____

EMPLOYMENT DETAILS

Salaried Self Employed Retired

Name of the company _____

Designation _____

Office Address _____

Landmark _____

City _____ Pin _____

State _____ Tel. No. 1 _____ Extn. _____

Fax No. _____ Classification Managerial or Self Employed Executive Junior/Clerical Others _____

Total Years of Experience <1 _____ >1 _____ <3 _____ >3 _____ <5 _____ >5 _____ <10 _____ >10 _____ <15 _____ >15 _____

Numbers of yrs. in current job <1 _____ >1 _____ <3 _____ >3 _____ <5 _____ >5 _____ <7 _____ >7 _____ <10 _____ >10 _____

Left over Service <1 _____ >1 _____ <3 _____ >3 _____ <5 _____ >5 _____ <10 _____ >10 _____

Gross Annual Income <1.5 Lac _____ 1.5-3.5 Lac _____ 3-5 Lac _____ 5-10 Lac _____ >10 Lac _____

Income from other sources <75,000 _____ upto 1,50,000 _____ upto 2,50,000 _____ above 2,50,000 _____

% Loan servicing of Gross Income None _____ 5% _____ 10% _____ 15% _____ 20% _____ >20% _____

Nature/type of Business of Organization Software/IT Eng./Infrastructure Finance/Insurance Textile/Leather FMCG/Retail Others _____

IT Return Provided Not-Provided

Credit Cards held with other Banks/Institutions

S.No. Card No. Issued by Bank Credit Limit

1. _____

2. _____

3. _____

ID PROOF

1) Passport No. _____

2) Voter ID: _____

3) UID: _____

4) Driving Licence: _____

5) Any Other: _____

BUSINESS

Business Type Corporate Proprietorship Partnership Not Applicable Length of Business Not applicable upto 5 years upto 10 years > 10 years Sales Tax Return Provided Not-Provided

ALERTS

Please consider these valuable services SMS Alerts Statement by E-mail (If you opt for statement by E-mail, no physical statement will be sent. However a physical statement will be provided on request through customer care. This is our Banks Green Initiative to "Save Paper and Save Trees". Please join us in this initiative.)

I understand that unless the opt facility, Central Bank of India will enable me to receive Customer Alert Messages with respect to events/transactions relating to my Credit Card or information that will be useful to me over my Mobile Phone or through e-mail subject to the information provided in the Application Form. I signed in-accord by the terms and conditions.

MANDATE FORM FOR DEBIT FACILITY

I/We hereby authorize the Bank to debit my/our bank account no. _____ with Branch _____ through Auto Debit Clearing for making payment towards credit card dues.

Account Type: Savings Current Cash Credit/OD Total Amount Due Minimum Amount Due

(I/We declare that the particulars given above are correct and complete. If the transaction is delayed or not executed at all for reasons of incomplete or incorrect information, I would not hold the bank institution responsible. We also authorize the bank to debit my account for charges towards mandate verification and transactions bonused due to "Insured Funds" as applicable. I have read the option/information letter and agree to discharge the responsibility espoused of me as a participant under the scheme.)

Confirmed that the particulars furnished above are correct as per our records. Signature of the Authorized official from the Bank _____ Date _____ Signature of Account Holder _____

RELATIONSHIP WITH BANK

Are you existing customer of Central Bank of India Yes No

Banking with Central Bank of India Since _____
 (Please provide your existing Central Bank of India account number)

SB/CA Ac. No.

Do you have any other relationship with Central Bank of India:
 Home Loans Bonds Consumer Loans Car Loans Personal Loans Credit Card Debit Card Other: _____

Preferred: Non-PhotoCard PhotoCard OF No.

ADD ON CARD

(Liability of Add-on Card will be on Primary/Principal Cardholder)
 (Please fill up this section for applying for Add on Card. Add-on Card can be issued to family members (over 18 years of age) of the Primary Card member).

I would like an Add-On Card of my:
 Spouse Father Mother Son Daughter

Date of Birth: Gender: Male Female

Mob. No.:

PAN No.:

Name of the Add-on Card Holder:

Place: _____ Signature of Add-on member: _____

Please note that it is mandatory for the Add-On card holder to comply with the KYC norms. The Add-On card will be processed only after the norms are satisfied.

ENCLOSURE CHECKLIST

- 1) ID Proof (Passport / Voter ID / Driving Licence / PAN / UID, etc.)
- 2) Address Proof (Ration Card / Passport/Driving Licence / Copy of electricity bill or telephone bill showing residential address / Any documents or communication issued by any authority of the Central Government, State Government or local bodies showing residential address / Any other documentary evidence in support of his address given in the declaration)
- 3) Pan Card 4) Income Proof / ITR Return/Form No.16/Pay slip etc. (Optional in case of Aspire Credit Card)
- 5) Statement of Bank A/c. for 3 months. 6) Copy of term deposit(s) with lien mark in case of Aspire Credit Card.

MOST IMPORTANT TERMS AND CONDITIONS

In these terms and conditions "The Bank" means Central Bank of India and its subsidiaries and assignees. "The Card" means the Central card currently issued to card holder. Card holder means the member of the Central card scheme to whom or to who use a card issued by the bank/Account issues the current or savings/demand account to which all the dues payable by the Card holder to be debited and "Contracted Branch" means branch office of the bank at which the account is maintained either in the name of cardholder or in the name of the Company/Firm.

- 1) Applicants and Add-on member (if any) must be Indian resident preferably over eighteen (18) years of age.
- 2) The bank may at its sole discretion refuse the application without assigning any reason whatsoever.
- 3) The Card holder shall sign the Central card as per the specimen signature given on the application form.
- 4) The Card shall remain the property of the bank at all times and the bank shall be entitled at its absolute discretion at any time to withdraw or cancel or suspend the card any any services thereby named without giving any prior notice or reason therefor. The card holder shall immediately and immediately upon demand surrender Card to the bank. The card holder shall not change the name/signature during the currency of the card.
- 5) The bank shall be entitled from time to time to impose any limit whether as amount or otherwise on the use of the card.
- 6) The bank's record of all transactions effected by the use of card shall be conclusive and binding on the card holder for all purposes.
- 7) The bank reserves the right to combine or consolidate the outstanding balance on the card holder's card account with any other account of the card holder maintain or which may be opened afterwards with the bank and the card holder agrees to transfer any credit balance in these accounts to set off the outstanding debit balance on the card holder's card account.
- 8) All payments made by the card holder shall be applied by the bank of towards satisfaction of all the fees - interest and usage charge payable and security of the outstanding purchase money, cash advances and all other debt outstanding on the use of the card.
- 9) The card holder will collect from the Member Establishments, the card holder's copy of every charge slip that he signs, and will present the same carefully for his record. The card holder agrees to pay handing charge, for the supply of photocopy of any particular charge slip, he signed that is specially requested by the card holder from the bank or such rate as the bank shall determine from time to time. The bank will not supply photocopy of charge slip older than one year from the date thereof.
- 10) The Central card shall be used by the card holder only by himself and he shall not allow any other person to use it on his behalf or shall he lend or transfer the card to anyone else.
- 11) The bank may issue add-on cards in the name of those person nominated by the card holder. Both the card holder and the add-on card holder shall be jointly and severally liable for the use of the add-on card.
- 12) These terms and conditions shall apply to the use of all add-on cards, and be binding on the add-on cardholder.
- 13) The cardholder must promptly notify the bank in writing of any change in address (or of home) or any other material information already supplied by him.
- 14) The fee charged for Central card is not refundable under any circumstances. Bank has right to change the fees with intimation to card holder.
- 15) In case of non-renewal of card, the cardholder has to give 3 months notice before the card falling due for renewal, failing which the cardholder will be liable for the charges. The renewal of card is automatic subject to satisfactory card utilization, however bank shall have sole discretion and liberty to renew/refuse to renew any card without assigning any reason whatsoever.
- 16) The bank reserves the right to change banking charges to the Account for the supply of replacement card.
- 17) The bank has the right to withdraw the privileges attached to the Central card and to call upon the cardholder to surrender the card and to pick it up through the member establishments, or their representatives or any other representative of the bank without assigning any reason whatsoever.
- 18) The use of the Central card after the expiry date or after the notice of withdrawal of the privileges is fraudulent and subject the cardholder to legal proceedings.
- 19) Use of the card shall be terminated without notice upon the death, bankruptcy or insolvency of the cardholder shall notify the bank immediately of its loss or theft by telephone, telegram or letter and also inform the same by registered AD letter. Any transaction taken place before reporting, the same to be paid by the cardholder. Necessary fee will be charged.
- 20) If the cardholder loses or allows, stolen, to be as the subject of a copy of the FIR lodged with the police. The cardholder shall notify the bank immediately of its loss or theft by telephone, telegram or letter and also inform the same by Registered AD letter. Any transaction taken place before reporting, the same to be paid by the cardholder. Necessary fee will be charged.
- 21) Whenever the card is used at one of the Member Establishments of the bank, the cardholder must sign his signature on the charge slips presented by the Member Establishments showing the amount payable by him. Even if it is not done for some reason, the cardholder shall remain liable to pay the bank such amounts which become due on the use of this Central card.

- 22) The Member Establishment may not honour the Central card when conducting an advance reduction sale.
- 23) All liability charges will be subject to local and state laws.
- 24) The bank is not responsible for the refusal by any Member Establishment to accept or honour the card no shall be responsible in any way for the goods or services supplied to the cardholder. The cardholder shall handle or resolve all claim or dispute directly with such Member Establishment and the claim by the cardholder against the member Establishment may be the subject to set-off or counter claim against the bank. The bank will credit the cardholder's account with the amount of any refundatory overpayment of a properly issued credit slip or cheque or demand draft.
- 25) The original bills of the Member Establishment will be collected by the cardholder at the time of signing the charge slip. The bank will not be responsible to furnish such original bills of the Member Establishment to the cardholder.
- 26) The cardholder shall pay all costs of collection of dues, legal expenses and decretal amounts with interest should it become necessary to refer the matter to a collection agency or to a legal recourse to enforce payment.
- 27) The bank reserves the right to claim from the cardholder any amount due to the bank which may not have appeared in the last statement within six (6) months after the termination or cancellation of the card.
- 28) Non-payment of card usage within the due date shall attract service charge as applicable per month (compounded). Any outstanding amount payable by the Cardholder is liable to be levied further service charges until the outstanding amount is fully paid.
- 29) Credit Card payment can be made at any of our branches. If you wish to avail auto-debit facility, please exercise the option by providing your account number of Central Bank of India to Centralized Department. Sufficient balance shall be maintained in the Account to debit auto-debit of the dues payable in respect of the Central card. Bill will be sent to you for your examination. Cheque/IDs should be drawn favouring CBI A/c. Centralized No. 1800222268 or 022-66387737/66387743 payable to Member Credit to card account will be used only on realization of Cheque/ID of other Bank. Outstanding cheques will not be accepted.
- 30) Service tax is levied on air-fares as per rates specified by the Govt. from time to time.
- 31) Non-receipt of Bills will not be accepted as a valid reason for non-payment or delayed payment of bills. As per the billing cycle, cardholder can make payment on due date by contacting our customer care on toll free No. 1800 222 268 or 022-66387737/66387743 to know the outstanding due. Payment can also be made on the basis of copies of charge slips held by you.
- 32) If you have opted for Minimum Amount Due of 5% every month, then the service charges/service tax will be applied on the balance amount under revolving credit.
- 33) You have to bring any dispute in writing to our notice within 21 days from the date of the statement. We will advise you the procedure to be followed for a Dispute Resolution Form (DRF) or a signed letter from you and any documents we may require, to make us to process your dispute. The procedure for resolution does not apply to cash bills.
- 34) In case of disputes and legal proceedings that may be initiated, only the Courts in India shall have jurisdiction.
- 35) The bank would be at its sole discretion to approve/reject any card transactions.
- 36) The bank is entitled to add, alter or amend these terms and conditions at its absolute discretion and without assigning any reason whatsoever. Any such change will become effective and binding on the cardholder irrespective of whether the cardholder has or facts, actual notice or knowledge thereof. The terms and conditions as printed at any time will be binding on the cardholder.
- 37) Fee Structure

CREDIT CARDS	CHARGES
Issuing Charges	Silver, Gold, Platinum, Titanium: NIL World: ₹300 Cobrand IDA: NIL Aspire: NIL Big Cinema: NIL Other Cards: Please refer to the Most Important Terms and Conditions Brochure.
Annual Fees	Silver, Gold, Platinum, Titanium: NIL Aspire: ₹500 Big Cinemas: ₹96
Annual fee will be waived if spend is more than 3 lakhs p.a.	World: ₹500 Cobrand IDA: NIL
Other Cards: Please refer to the Most Important Terms and Conditions Brochure.	
Add-on card	NIL
Renewal	₹100/-
Card Reinstated/Replacement of lost card	₹100/- per card
Emergency card replacement (when abroad)	₹150/- per card
Exceeding credit limit	2% over and above the sanctioned credit limit or minimum Rs.100/-
De-blocking charges	₹100/- per De-blocking
Charge slip Retrieval Charges	₹100/- per charge slip
Late Payment Fee	World Card/IDA/ Other Super Premium Card: Less than ₹ 100 (NIL) ₹ 100 to Rs. 500 (₹ 100) ₹ 500 to Rs. 10,000 (₹ 100) ₹ 10,000 to Rs. 20,000 (₹ 100) Above ₹ 20,000 (₹ 100)
Cheque Return Charges	As per CBI's Minimum ₹100/- upto ₹10,000/- and thereafter 1% of outstanding amount.
Dishonour of ECS/Auto Debit	₹ 150/- per Instrument
Duplicate statement request (beyond 3 months)	₹100/- per request
Cash withdrawal	₹100/- plus service charges from date of transaction
Service charge on the amount remaining unpaid, beyond due date	Silver : @ 2.50% per month or part thereof Gold : @ 2.75% per month or part thereof Platinum/IDA : @ 2.99% per month or part thereof Titanium : @ 2.99% per month or part thereof World : @ 3.5% per month or part thereof Big Cinema : @ 2.99% per month or part thereof Aspire : @ 1.2% per month or part thereof (rollover amount, after payment of minimum balance dues)
Petrol transaction charge	Big Cinema/World Card/IDA: Waived for all transaction between ₹ 400 to ₹4000/- Other Cards : 2.5%
Railway Ticket Purchase or cancellation fee	2.5% (plus ₹ 35/-)
Foreign currency transactions	Association conversion Mark up fee - 3.5%

Branch Recommendation: _____

Recommended Limit: _____

Branch Manager (Print and Sign) _____ Date: _____

Sanction by R/o _____ R/o Name: _____ R/o Code: _____

Sanctioning Authority (Seal and Sign) _____ Date: _____

CentralCard

For Central Card Department: _____

Place: _____ Date: _____ Signature: _____

15/16, Bajaj Bhavan, Barrister Rajani Patel Road, Nariman Point, Mumbai - 400 021.
 Tel: +91 22 - 66387737 / 66387743 - Fax No.: +91 22 22024004 - Toll Free 1800 222 368

(ONLY FOR T.Y.B.M.S. - SEM.-VI STUDENTS)

CASE STUDIES

CASE - 1

A new manufacturing company called Dynamic Pvt Ltd. which has started business last year has a requirement of machineries worth ₹ one crore. The business is new and not started generating enough profits due to heavy competition in the market. The liquidity position of the company is tight. The company applied for term loan to ABC Bank. The credit manager of the bank after extensive discussion on the risk parameters with the lending committee rejected the loan proposal of the company.

Meanwhile the company's finance manager has received a proposal to acquire the machineries on lease from a finance company. He considered the benefits of taking the machineries on lease and accepted the lease proposal. Do you agree with the finance manager. Give reasons.

Solution :

The finance manager is justified in accepting the lease proposal. As the Dynamic Pvt Ltd. has neither enough cash nor could it obtain any loan to buy the machineries required for business, leasing is one of the convenient way it can possess and use machineries to meet business requirement. The company will save on huge amount of immediate cash outflow. It can use the machine for the lease term and pay lease rentals. On completion of the lease term it can also take another latest machines on lease. By taking machines on lease, the company is saved from liquidity risk and obsolescence risk. The advantages of leasing are stated below.

- **Financing of capital goods :**
Lease financing enables the lessee to have finance for large investments in capital assets upto 100%, without any immediate payment.
- **Additional source of finance :**
Leasing facilitates the purchase of capital assets without finance. This improves working capital position of the lessee. Thus internal accruals are available for business operations.
- **Balanced Cash Outflow :**
The biggest advantage of leasing is that cash outflow or payments related to leasing are spread out over several years, hence saving the burden of one-time significant cash payment. This helps a business to maintain a steady cash-flow profile.
- **Less expensive :**
Leasing is less expensive mode of finance compared to other alternatives.
- **No dilution of ownership :**
There is no dilution of ownership and control in case of leasing. The other modes of long term finance such as equity, dilutes the ownership and control.
- **Free from restrictive conditions :**
Lease financing is beneficial compared to institutional finance as it is free from restrictive terms and conditions such as representation on the Board.
- **Flexibility in structuring lease rentals :**
The lease rentals can be structured to accommodate the cash flow position of the lessee, making the payment of rentals convenient to him. Further the lease period is also chosen so as to suit the lessee's capacity to pay rentals. There is no such flexibility available in debt-servicing of conventional loan. Such loans generally have to be repaid over a specified number of instalments resulting in heavy debt servicing burden in initial years of project/business whereas the project/business may actually generate substantial cashflows in later years.

- **Simplicity :**

A lease finance arrangement is simple to negotiate and requires simple documentation. Institutional finance requires compliance with terms and conditions. It also requires detailed documentation.

- **Tax benefits :**

The lessee gets certain benefits in the payment of rent, maintenance of the equipment and other expenditure incurred by him in keeping the equipment operational. For all these expenses, the lessee will be claiming deductions resulting in tax benefits under the Income Tax Act. The benefits will be more when initial rentals are higher. During the later part of the lease period, it will become less.

- **Minimum delay :**

Usually, leasing companies take much lesser 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.

- **Shifting the Risk of Obsolescence :**

Due to fast 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.

- **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.

- **Convenience :**

Operating or service leases are usually cancellable enabling the lessee 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.

- **Good Quality Assets :**

While leasing an asset, the ownership of the asset still lies with the lessor whereas the lessee just pays the rental expense. Given this agreement, it becomes possible for a business to invest in good quality assets which might look unaffordable or expensive otherwise.

CASE - 2

Ramesh told Mahesh that credit cards, when used wisely, can be safer than debit cards. According to Ramesh there are dangers in using debit cards. Mahesh laughs at him and says that the debit cards are safe and he is grossly mistaken. Both of them approach you for your advice. What would be your advice in this case ?

Solution :

It is to be explained to Mahesh that although convenient in use, debit cards have a few serious drawbacks.

A few debit card dangers which needs to be explained to Mahesh are listed below;

If a debit card holder's wallet falls into the wrong hands, his debit card's fraud protection is not as strong as a credit card's fraud protection. Further, some banks will hold him fully liable if his debit card is used fraudulently for pin-based transactions.

Finally, if a thief uses holder's credit card, he can withhold payment for the charges until his credit card company or bank investigates the suspected fraud. If a thief uses his debit card, he can empty holder's bank account in a matter of few minutes, and he may not get that money back until his bank investigates.

If a card holder goes to a restaurant and pays for a lunch with his debit card and the cashier swipes his card for a higher amount. Further if he declines a receipt, he will never notice the mistake until he uses his debit card again and it is declined. He gets home to check with his bank and see the problem. Obviously, the merchant

will probably return his money, but returning the money to his account will take several days. In the meantime, he needs to get his bank to reverse any overdraft fees. If this same thing happened with a credit card, he would not owe the card company any amount until the problem was solved.

If there is a dispute regarding a purchase he makes, he is in a weaker position when he uses a debit card. The merchant already has his money when he pays with a debit card.

CASE - 3

Mr. Dilip is a businessman. He has to travel all over India to meet clients. He incurs various expense related to hotel, tickets, entertainment, etc. Several times he finds it difficult to use his debit card due to shortage of funds and last minute travel plans. He approaches his banker for a better alternative.

1. Assume yourself as a banker and offer him a type of card. Justify your answer.
2. List down the merits of the offered card.
3. List the precautions to be taken for usage of the card.

Solution :

(TYBMS, April 2017)

1. As Mr. Dilip is a business man who travels frequently to meet clients and incurs expenses, use of plastic card as against cash is an advisable alternative for him. There are different types of plastic cards such as debit card, credit card or prepaid cards. For use of debit card he need to have balance in the savings bank account with which his card is linked for payment. In other words, he need to have sufficient balance to honour his payments through debit card. However as stated above he has shortage of funds and his travel plans are not abrupt.

As a banker I would advise him to accept credit card from our bank as this will meet his requirements better compared to debit card. He need not keep balance in the bank account on daily basis while using it. He can make payment at the end of the

credit period or billing cycle for all the expenses incurred during the credit period. When the billing cycle is over, a consolidated bill for all the payments made during the period to different vendors while travelling can be paid before the due date of payment.

A credit card is a system of payment in which you can buy now and pay later.

A credit card is a plastic card which is issued by banks and other entities approved by the RBI which enables the users of the card to pay merchants for goods and services. Thus it is a system of the payment. It allows its holder to buy goods and services based on the holder's promise to pay for these goods and services. The issuer of the card grants a line of credit to the user from which the user can borrow money for payment to merchant or a cash advance.

2. Merits of credit cards are as under :

- (a) **A credit card is safer than carrying cash.**

While there is only a small chance of having lost or stolen cash returned, a credit card can quickly be cancelled, if its holder loses his wallet. Most financial institutions have security processes in place to protect the card holder, if the card has been lost or stolen or if he suspects that his account has been used for a fraudulent transaction. The card holder should contact his bank to report the issue as soon as possible in case of loss of card.

- (b) **A card holder can get interest-free credit**

While a card holder pays by credit card he gets an interest free credit, if repayment is made before the due date.

- (c) **Earn reward points when a card holder spend.**

Credit card purchases allow a card holder to earn reward points on every rupee he spends on eligible purchases, such as the groceries and petrol costs. He can earn reward points to redeem with the bank's rewards programs for perks including products from the rewards store or cash back.

(d) Credit cards give its holder an emergency line of credit.

Credit cards can be a financial safety net for the holder if he does not have enough cash or savings to cover any unexpected costs. However he needs to remember that he will have to repay everything he borrows.

(e) Credit cards often have complimentary extras.

Credit card provides other value-adding features including complimentary flight offers, airline lounge passes, discount in certain restaurants and cash backs at certain shopping malls.

3. List the precautions to be taken for usage of the card.

In India, according to a provision in credit card contracts, the card-issuing company is not liable for any fraudulent transaction unless the customer files a report immediately.

(a) Skimming or cloning

While travelling, data in the card's magnetic stripe is recorded when swiped at a machine. This information is then used to make duplicates. It can happen anywhere, at a petrol pump or a restaurant. So one needs to make sure the card is swiped in his presence.

Banks advice customers to replace cards after foreign trips to minimize skimming risk.

(b) Beware of cyber swindles.

Cyber swindles involve unauthorised use of card details, such as the card number, the Card Verification Value (three-digit code printed on the back side of the card), to make purchases online.

The card holder should register for online transaction passwords such as Verified by Visa or MasterCard Secure Code and avoid using public computers. The transaction should happen through a secure website.

(c) Takeover of accounts and identity theft

This can happen in two ways.

- (i) a cardholder's information is stolen and used for transactions where the card's physical presence is not required, for example online purchases.
- (ii) by placing a request for a new card using the stolen information.

Monitoring credit card report is a best defence in the above stated situations.

User should check for unusual transactions, especially small ones, as fraudsters make these small transactions to check the card's validity.

(d) Phishing mails

The card holder should not fall prey to phishing mails (that appear to be sent by an institution he deals with but are not), SMSs or calls.

(e) Other offline preventive measures

There are some additional precautions that one can take to ensure the card is safe.

Do not disclose details: Never reveal PIN, CVV or password to anyone. Make sure not to respond to e-mails or SMSs that ask for crucial personal or card-related details. No bank or credit card firm is authorised to seek card details from customers on mail or through phone.

Check statements: Regularly go through bank or credit card statements so that any unauthorised transaction can be detected through identity theft and alert the bank immediately.

CASE - 4 (FOR SELF-PRACTICE)

Mr. Prakash has a habit of taking his salary in cash from his employer. He has saved an amount of ₹ 2.5 lakhs over the past 8 months. He makes all his payments by cash. However the new demonetization move by the government, has affected Mr. Prakash as all his savings is of denominations of ₹ 500 and ₹ 1,000. He is running out of cash to meet his daily expenses like medicines, grocery etc. He approaches his bank to seek advisory service as to which type of plastic money should he opt for. While talking to the banker, he informs that he receives a monthly salary of ₹ 40,000 and is eager to avail a plastic money application.

1. Assume yourself as a banker and offer him a type of card. Justify your answer.
2. List down the merits of the offered card.
3. List the precautions to be taken for usage of the card.

(TYBMS, April 2018)

UNIVERSITY QUESTION PAPER

(F.Y.B.A.F.)

APRIL - 2019

Time : 2½ Hours

Total Marks : 75

N.B. (1) Q.1 is compulsory.

(2) Q.2 to Q.5 are compulsory with internal choice.

(3) All questions carry equal marks.

Q.1 (A) Select the appropriate options and rewrite the following sentences. (Any eight) (8)

1. 100% finance is provided in _____.

(a) Factoring	(b) Forfaiting
(c) Both (a) and (b)	(d) None of (a) and (b)
2. A _____ is defined as any person who is engaged in the business of issue management.

(a) factor	(b) manager
(c) merchant banker	(d) insurer
3. Financial services are _____.

(a) inseparable	(b) intangible
(c) variable	(d) all of the above
4. _____ is an apex housing finance institution in the country.

(a) RBI	(b) National Housing Bank
(c) HDFC	(d) LIC Housing Finance

5. Equipment leasing is an example of _____ services.
- (a) fund based (b) non-fund based
(c) both the above (d) none of the two
6. Securitisation is the process of pooling and repackaging of homogeneous _____ financial assets into marketable securities.
- (a) liquid (b) illiquid
(c) fixed (d) current
7. In a _____ lease, the lessor does not transfer all the risks and rewards incidental to the ownership of the asset.
- (a) finance (b) operating
(c) both (a) and (b) (d) none of (a) and (b)
8. Features of Venture Capital includes _____.
- (a) high risk (b) illiquid investment
(c) high Technology (d) all of these
9. Credit Card facility is an excellent example of _____ credit.
- (a) long term (b) secured
(c) revolving (d) non-revolving
10. Where in an order, the client places a limit on the price of the security; it is a case of _____.
- (a) limit order (b) best rate order
(c) stop loss order (d) immediate or cancel order
- Q.1 (B)** Rewrite the following statements and state whether they are True or False. (Any seven) (7)
- The non-fund based services are called asset based services.
 - The bills covered under the scheme must be genuine trade bills relating to the sale or dispatch of goods.

- Underwriters agree to take up securities which are not fully subscribed.
- A stock broker is a member of a recognized stock exchange.
- A derivative is a contract between two parties which derives its value or price from an underlying asset.
- In a finance lease, the lessor does not transfer all the risks and rewards incidental to the ownership of the asset.
- The last stage in venture capital financing is the exit to realize the investment so as to make a profit or minimize losses.
- Consumer finance refers to the raising of finance by businesses for the acquisition of durable goods.
- NBFCs are not allowed to accept demand deposits.
- One time assessment of creditworthiness is valid over the future life of the security.

Q.2 (a) Define financial services. What are the types of financial services? Explain with any three examples of each type. (8)

(b) Distinguish between factoring and forfeiting. (7)

OR

(c) Define Merchant Banker. State any seven services provided by Merchant Bankers. (8)

(d) What is the meaning of 'Securitisation'? Explain its features. (7)

Q.3 (a) Distinguish between Operating Lease and Financial Lease. (8)

(b) Explain the meaning of Venture Capital. State its features. (7)

OR

(c) State any eight advantages of Hire Purchase. (8)

(d) Describe various sources of Consumer Finance. (7)

Q.4 (a) Explain limitations of Credit Rating. (8)

(b) How can frauds and misuse of Credit Cards be prevented? (7)

OR

(c) What are the benefits of using Credit Cards? (8)

(d) Explain features of recourse and non-recourse factoring. (7)

Q.5 (a) State any eight advantages of leasing to the lessee. (8)

(b) Explain meaning & importance of underwriters in issue management. (7)

OR

Q.5 Write a short note on: (Any three) (15)

(a) Role of NHB

(b) Advantages of credit rating to the investors

(c) Importance of financial services

(d) Code of conduct for Bankers to an issue

(e) Bill Discounting process

UNIVERSITY PAPER SOLUTIONS

(T.Y.B.M.S.)

APRIL - 2019

Time : 2½ Hours

Total Marks : 75

N.B. (1) Q.1 is compulsory.

(2) Q.2 to Q.5 are compulsory with internal choice.

(3) All questions carry equal marks.

Q.1 (A) True and False : (Any 7) (7)

1. Financial services do not have physical existence.
2. Cost of Factoring = Finance cost - Operating cost.
3. There are 5 types of underwriters.
4. In Venture Capital, Mezzanine Financing is the part of Expansion capital stage.
5. Revolving credit is very much like the overdraft facility provided by banks.
6. Bills of exchange cannot be rediscounted.
7. Sub broker can operate only on behalf of registered FIIIs. He cannot deal in securities on his own account as principal.
8. Debit card is also called Electronic Cheque.
9. Home loan is available for purchase of land as well as improvement/extension of house.
10. CRISIL is the leading credit rating agency in the world.

Q.1 (B) Match the columns : (Any 8) (8)

Column A	Column B
1. DRT	(a) Hundis
2. Underwriters	(b) Usance
3. Corporate counselling	(c) T-bills
4. Time bills	(d) Act of guarantee for sale of shares and debentures
5. Securitisation instrument	(e) Fund based
6. Whole sale Debt Market	(f) Debt Recovery Tribunal
7. Financial Services	(g) Moody's
8. Indigenous bills	(h) Fee Based
9. Housing Finance	(i) Mobilization of savings
10. Credit Rating Agency	(j) Pass through securities
	(k) Data response tribunal

Q.2 (A) Explain any 7 drawbacks of Forfeiting. (7)

(B) What are financial services? Explain any 6 Fund based financial services. (8)

OR

Q.2 (A) Ruby factors advances ₹ 27 lakhs to Pearl Enterprise against agreement of providing advance payment of 90% of receivables and for guaranteed payment after 3 months. The rate of Interest is 10% compounded quarterly and factoring commission is 2% of receivables. Both collected upfront. (7)

(a) Compute amount actually made available to Pearl Enterprise.

(b) Calculate effective cost of funds made available to Pearl Enterprise.

(c) Assume interest is collected in arrear and commission in advance, what will be the effective rate of interest.

(B) What are the qualities of Merchant bankers ? (8)

Q.3 (A) What is a Clearing member? Explain its functions and types of Clearing members. (7)

(B) Explain the process of securitization with the help of the diagram. (8)

OR

Q.3 (A) Define Lease. Explain any 6 types of Lease. (7)

(B) Explain the issues in Housing Finance Sector. (8)

Q.4 (A) Explain the features of Venture Capital. (7)

(B) Explain the reasons for growth of Consumer Finance. (8)

OR

Q.4 (A) What is Smart card? Explain 5 features of Smart Cards. (7)

(B) Describe the process of credit rating. (8)

Q.5 (A) Discuss the Stages of venture capital Finance. (7)

(B) The Vibhu Transport Ltd., purchased Truck from, the Hindustan Motors Ltd. on Hire Purchase basis. (8)

The Cash price of the truck was ₹ 16,00,000. The amounts were payable as under :

- ₹ 5,00,000 on the date of purchase i.e. 1st April, 2012
- ₹ 4,00,000 on 31st March, 2013
- ₹ 4,00,000 on 31st March, 2014
- ₹ 4,12,390 on 31st March, 2015

The Hindustan Motors Ltd., charged interest at 5% p.a. on the unpaid amount on the Diminishing balance each year. It closes its account on 31st March every year.

You are required to prepare Hindustan Motor Ltd. A/c and Interest A/c in books of Vibhu Ltd. according to credit purchase method.

OR

Q.5 Write a Short notes on : (Any 3) (15)

1. Recourse & Non-Recourse Factoring
2. Banker to an Issue
3. National Housing Bank
4. Option Contract
5. Bill Market Scheme, 1970

ANSWERS (HINTS)

1. (A) True : 1, 4, 5, 8, 9; False : 2, 3, 6, 7, 10
1. (B) (1) - (f), (2) - (d), (3) - (h), (4) - (b), (5) - (j), (6) - (c), (7) - (i), (8) - (a), (9) - (e), (10) - (g)
2. (A)
 1. No Recourse to forfeitor,
 2. No legal framework to protect forfeitor,
 3. High fees,
 4. Non -availability for short and long periods,
 5. Non availability if financially weak countries,
 6. Dominance of western currencies,
 7. Difficulty in procuring international bank's guarantee,
 8. No Secondary market,
 9. Lack of international credit agency to guarantee.
 10. Not available for deferred payment.
2. (B) Meaning of Financial Services
Any Funds Based Services

Equipment Leasing, Hire Purchase, Bill Discounting, Venture Capital, Housing Finance, Factoring, Consumer Credit.

OR

2. (A)

Steps	Solution	Calculation	Amount
a. 1.	Value of Factored Receivable	$27,00,000/0.9$	30,00,000
2.	Max Advance		27,00,000
3.	Less : Commission	$30,00,000 \times 2\%$	(60,000)
4.	Total (2 - 3)		26,40,000
5.	Less : Interest	$(27,00,000 \times 0.1 \times 90/360)$	(67,500)
6.	Total funds made available to Pearl Enterprises (4 - 5)		25,72,500
b. 7.	Effective Interest as % of Funds	$(67,500/25,72,500 \times 100)$	2.62%
8.	Annualised Rate of Interest	$\frac{[(1 + i)^n - 1]}{[1 + 0.0262]^4 - 1} \times 100$	10.89%
c. 9.	Effective Interest as % of Funds	$(67,500/26,40,000 \times 100)$	2.55%
10.	Annualised Rate of Interest	$\frac{[(1 + i)^n - 1]}{[1 + 0.0255]^4 - 1} \times 100$	10.59%

2. (B) Any 8 qualities

1. Analytical Nature,
2. Abundant knowledge,
3. Relationship building ability,
4. Innovative approach,
5. Integrity, Maintenance of High Standard,
6. Capital Market familiarity, Skilled based,
7. In depth of business issues, Advisor,
8. Consultant for corporate services.

3. (A) **Meaning, Functions** - Clearing, Settlement, Risk Management.

Types of Clearing Member - Trading Member Clearing Member, Professional Clearing Member Self Clearing Member

3. (B) **Diagram**

Process

1. Originator lends finance to Borrower
2. Borrower gives loan/lease agreement
3. Originator transfer Assets to SPV
4. SPV issue agents appoints various parties to execute pre-issue role
5. SPV to Obligor, Originator becomes Obligor
6. SPV issues Debt securities to Investor
7. Investors issue/sales proceeds, transfer cash to SPV
8. SPV transfer cash to Originator or sales proceeds
9. Borrowers pays on maturity of Obligor
10. Obligor Transfer payment to Investor

OR

3. (A) **Definition**

Types of lease - Any 5 points

Finance, Operating, Sale and Lease, Leverage, Close and Open-end, Up-front and Back-end, Cross border, Direct, Domestic, Dry, Wet, Percentage Lease, etc.

3. (B) **Any 8 Issues**

1. Non availability of funds,
2. Higher cost of acquisition of land,

3. Slow progress of housing co-operative movement in India,
4. Cut-throat competition among housing finance companies,
5. High stamp duty,
6. Traditional marketing network,
7. Unclear property rights,
8. Fluctuation in home loan interest rates,
9. Tiresome and technical paper formalities,
10. Shortage of professional builders and developers, etc.

4. (A) **Any 7 Features**

1. Catering to small/medium business,
2. A mean of supporting entrepreneurial talent,
3. Provision of risk bearing capital,
4. Involvement of investment capitalists,
5. Mode of investment,
6. Mode of Investment,
7. Objective of investment,
8. Hands on approach,
9. High risk-high returns,
10. Small and medium firms,
11. Liquidity.

4. (B) **Any 8 Reasons**

1. Promotion of saving habits,
2. Possession of goods,
3. A relief in case of an emergency,

4. High level of revenue for the seller,
5. Realising of dreams,
6. Accelerating industrial investment,
7. Standard of living,
8. Promoting economic development,
9. Effective stock management,
10. Large scale production,
11. Protection against inflation.

OR

4. (A) Meaning

Features

1. Authentication,
2. Biometrics, Encryption,
3. Personal device,
4. Secure communication,
5. Secure data storage,
6. Strong device security.

4. (B) Steps

1. Rating Request,
2. Submit the Application form,
3. Relevant document and fees,
4. Site visit,
5. Management interview, Rating,
6. Assessment process,

7. Rating committee,
8. Rating Decision.

5. (A) Stages - Minimum 7 points

1. Early stage capital - Seed financing, Start-up Financing, First Stage Financing.
2. Expansion Capital - Second stage financing, third stage financing, Mazzanine Financing.
3. Later stage Financing buyers - Management Buy-in, Management Buy-out.

5. (B) Analysis of Payment

Date	Interest @ 5%	Total Instalment	Cash Price	Balance Amount
1.4.2012			Down Payment	16,00,000 (5,00,000)
31.3.2013	(11,00,000 x 5%) = 55,000	4,00,000	Balance c/d (4,00,000 - 55,000) = 3,45,000	11,00,000 (3,45,000)
31.3.2014	(7,55,000 x 5%) = 37,750	4,00,000	Balance c/d (4,00,000 - 37,750) = 3,62,250	7,55,000 (3,62,250)
31.3.2015	(4,12,390 - 3,92,750) = 19,640	4,12,390	3,92,750	3,92,750 (3,92,750)
				NIL

Dr. In the Books of Hindustan Motors Ltd. Account Cr.

Date	Particular	₹	Date	Particular	₹
1.4.12	To Cash/ Bank A/c	5,00,000	1.4.2012	By Vibhu Transport Ltd.	16,00,000
31.3.13	To Cash/ Bank A/c	4,00,000	31.3.13	By Interest A/c	55,000

31.3.13	To balance b/d	7,55,000			
		16,55,000			16,55,000
31.3.14	To Cash/ Bank A/c	4,00,000	1.4.13	By Balance c/d	7,55,000
31.3.14	To balance b/d	3,92,750	31.3.14	By Interest A/c	37,750
		7,92,750			7,92,750
31.3.15	To Cash/ Bank A/c	4,12,390	1.4-14	By Balance c/d	3,92,750
		4,12,390	31.3.15	By Interest A/c	19,640
					4,12,390

Dr. **Interest Account** Cr.

Date	Particular	₹	Date	Particular	₹
31.3.13	To Hindustan Motors A/c	55,000	31.3.13	By Profit & Loss A/c	55,000
		55,000			55,000
31.3.14	To Hindustan Motors A/c	37,750	31.3.14	By Profit & Loss A/c	37,750
		37,750			37,750
31.3.15	To Hindustan Motors A/c	19,640	31.3.15	By Profit & Loss A/c	19,640
		19,640			19,640

OR

5. Minimum 5 points for each short notes.

