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SKILL ENHANCEMENT

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ACCESSIBILITY

**JAGAT GURU NANAK DEV
PUNJAB STATE OPEN UNIVERSITY, PATIALA**

(Established by Act No. 19 of 2019 of the Legislature of State of Punjab)

MASTER OF COMMERCE

Semester-III

**MCMM22301T
MANAGEMENT OF FINANCIAL
SERVICES**

Head Quarter: C/28, The Lower Mall, Patiala-147001

Website: www.psou.ac.in

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COURSE COORDINATOR AND EDITOR:

Dr. Balpreet Singh

Assistant Professor

JGND PSOU, Patiala.





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PREFACE

Jagat Guru Nanak Dev Punjab State Open University, Patiala was established in December 2019 by Act 19 of the Legislature of State of Punjab. It is the first and only Open University of the State, entrusted with the responsibility of making higher education accessible to all, especially to those sections of society who do not have the means, time or opportunity to pursue regular education.

In keeping with the nature of an Open University, this University provides a flexible education system to suit every need. The time given to complete a programme is double the duration of a regular mode programme. Well-designed study material has been prepared in consultation with experts in their respective fields.

The University offers programmes which have been designed to provide relevant, skill-based and employability-enhancing education. The study material provided in this booklet is self-instructional, with self-assessment exercises, and recommendations for further readings. The syllabus has been divided in sections, and provided as units for simplification.

The Learner Support Centres/Study Centres are located in the Government and Government aided colleges of Punjab, to enable students to make use of reading facilities, and for curriculumbased counselling and practicals. We, at the University, welcome you to be a part of this institution of knowledge.

Prof. G. S. Batra
Dean Academic Affairs



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M.COM
SEMESTER-III

(MCMM22301T): MANAGEMENT OF FINANCIAL SERVICE

MAX. MARKS: 100
EXTERNAL: 70
INTERNAL: 30
PASS: 40%
Credits:6

Objective:

This course aims at acquainting the participants with the operations, functions and management of banking and insurance sector. It will enable the students to know more about emerging trends in banking and insurance sector.

INSTRUCTIONS FOR THE PAPER SETTER/EXAMINER:

1. The syllabus prescribed should be strictly adhered to.
2. The question paper will consist of three sections: A, B, and C. Sections A and B will have four questions from the respective sections of the syllabus and will carry 10 marks each. The candidates will attempt two questions from each section.
3. Section C will have fifteen short answer questions covering the entire syllabus. Each question will carry 3 marks. Candidates will attempt any ten questions from this section.
4. The examiner shall give a clear instruction to the candidates to attempt questions only at one place and only once. Second or subsequent attempts, unless the earlier ones have been crossed out, shall not be evaluated.
5. The duration of each paper will be three hours.

INSTRUCTIONS FOR THE CANDIDATES:

Candidates are required to attempt any two questions each from the sections A and B of the question paper and any ten short questions from Section C. They have to attempt questions only at one place and only once. Second or subsequent attempts, unless the earlier ones have been crossed out, shall not be evaluated

SECTION A

Financial System, Markets and Services

Financial System
Financial Markets and Institutions
Financial services: An introduction
Management of Risk in Financial Services
Regulatory Framework

Financial Market Operations & Services

Stock Exchanges: Functions and Organisation

Broking and Trading in Equity
Broking and Trading in Debt Instruments
Depositories

Fee Based Services I

Issue Management
Corporate Advisory Services

SECTION B

Fee Based Services II

Credit Rating
Mutual Funds
Asset Securitization

Fund Based Services

Leasing and Hire Purchase
Housing Finance
Credit Cards
Venture Capital
Factoring, Forfaiting and Bill Discounting

Insurance Services

Life Insurance
Non-Life Insurance
Insurance Broking Services

Suggested Readings:

1. Indian Financial System by H.R. Machiraju, Vikas Publishing House Pvt. Ltd.
2. Indian Financial System by Varshney & Mittal, Sultan Chand & Sons.
3. Management of Indian Financial Institutions by R.M.Srivastava – Himalya Publishing House.
4. Managing Indian Banks by Vasant C. Joshi, Sage Publications.
5. Indian Financial System by Vasant Desai, Himalya Publising House.
6. Financial Institutions & Markets by L.M.Bhole.
7. M.Y. Khan, Financial Services, Tata McGraw Hills, New Delhi,



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SEMESTER-III

(MCMM22301T):

MANAGEMENT OF FINANCIAL SERVICES

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SECTION A

UNIT NO.	UNIT NAME
Unit 1	Financial System, Markets and Services
Unit 2	Financial Market Operations & Services Stock
Unit 3	Fee Based Services I

SECTION B

UNIT NO.	UNIT NAME
Unit 4	Fee Based Services II
Unit 5	Fund Based Services
Unit 6	Insurance Services

Structure

- 1.1 Introduction to Financial System
- 1.3 Financial Markets
- 1.4 Capital Market
- 1.5 Money Market
- 1.6 Financial Institutions
- 1.7 Financial Services
- 1.8 Management of Risk in Financial Services
- 1.9 Regulatory Framework of Financial Markets in India
- 1.10 Exercise

OBJECTIVES

- Explain the functions of financial system
- Describe the components of financial system
- Define financial markets
- Understand the role of financial institutions and services
- Risk management in financial services

1.1 Introduction

A financial system is a framework designed to create and maintain a consistent, seamless, cost-efficient connection between those who deposit their money and those who invest it. The primary role of the financial system is to direct funds from those with excess capital to those in need of it. An effective financial system not only promotes savings and investments but also skillfully distributes resources across various investment opportunities, thereby boosting economic growth. The financial system in a nation holds a vital responsibility in directing limited resources towards productive endeavors, and its effective operation is of paramount significance to the overall economy.

1.2 FINANCIAL SYSTEM

The financial system represents one of the key sectors within an economy. It holds particular significance due to its substantial impact on both society and the overall economy. However, when we demystify its complex façade, it essentially resembles any other industry, comprising a collection of firms that combine the factors of production (such as land, labor, and capital) under the guidance of a management team. These firms produce a product or a range of products intended for sale in the financial market. Unlike tangible goods, the product of the financial industry is intangible in nature.

The financial industry, as a whole, generates a diverse array of services, all of which are directly or indirectly tied to assets and liabilities, essentially representing claims on individuals, organizations, institutions, companies, and governments. These claims are the primary means through which people accumulate a significant portion of their wealth. In simpler terms, we are referring to financial assets such as shares, debentures, deposits, mortgages, and various other securities.

Therefore, the financial system plays several crucial roles in the economy, including the maintenance of a payment system that facilitates the transfer of purchasing power between participants (from buyers to sellers), the collection and allocation of society's savings, and the creation of various forms of wealth storage options to cater to the preferences of savers. This overview of the financial system's functions provides us with its essence.

To understand the financial system and assess its performance, one must recognize its functions within an economy. In reality, the financial system serves the following functions:

a) Capital formation function:

This refers to the process of redirecting the economy's ability to produce goods towards the creation of capital goods that enhance future production capabilities. Capital formation involves three separate yet interconnected activities: saving, financing, and investing.

b) Allocation function:

In the process of capital formation, the financial system plays a crucial role in determining the allocation of capital. Making poor choices regarding which economic projects to pursue can result in the inefficient use of resources. The higher the quality of decision-making in allocating capital, the faster economic advancement will occur.

c) Service function:

A well-functioning financial system provides various services to different economic sectors by offering secure and convenient wealth-holding opportunities that yield a positive rate of return. The presence of these financial system services significantly, albeit indirectly, enhances consumer satisfaction.

Finance serves as the lifeblood within the framework of the financial system. It acts as the critical link between savings and investments by establishing a mechanism that aggregates the savings (representing claims to resources) of savers and places these resources into the hands of those who are capable and willing to invest, facilitated by financial intermediaries. These intermediaries generate assets that possess the important characteristic of liquidity, or the ability to be readily converted into a fixed amount of money when needed. Liquidity encompasses cash, money, and assets easily convertible to cash. Liquidity is a fundamental aspect of financial intermediation, allowing intermediaries to create liquid assets that can be held by ultimate savers in the economy, even though the intermediaries themselves may primarily hold relatively illiquid assets. Illiquid assets refer to the process of credit creation.

In the Indian economy, the Central Bank (RBI in India) is responsible for cash creation, while financial institutions are instrumental in creating credit. The flow of finance in the system operates between two primary segments: Surplus Units and Deficit Units (Figure 1). Surplus Units, whether they are public or private, have excess income beyond their current consumption needs. Public surplus units save through regular budgetary channels and the retained earnings of public sector enterprises. Private surplus units encompass household savings and savings from the non-corporate sector, with corporate sector savings dominating in terms of volume. Corporate sector savings are heavily influenced by profitability and enterprise distribution policies, while household savings depend on the capacity, ability, and willingness of individuals to save, influenced by various factors like psychological, social, and economic conditions.

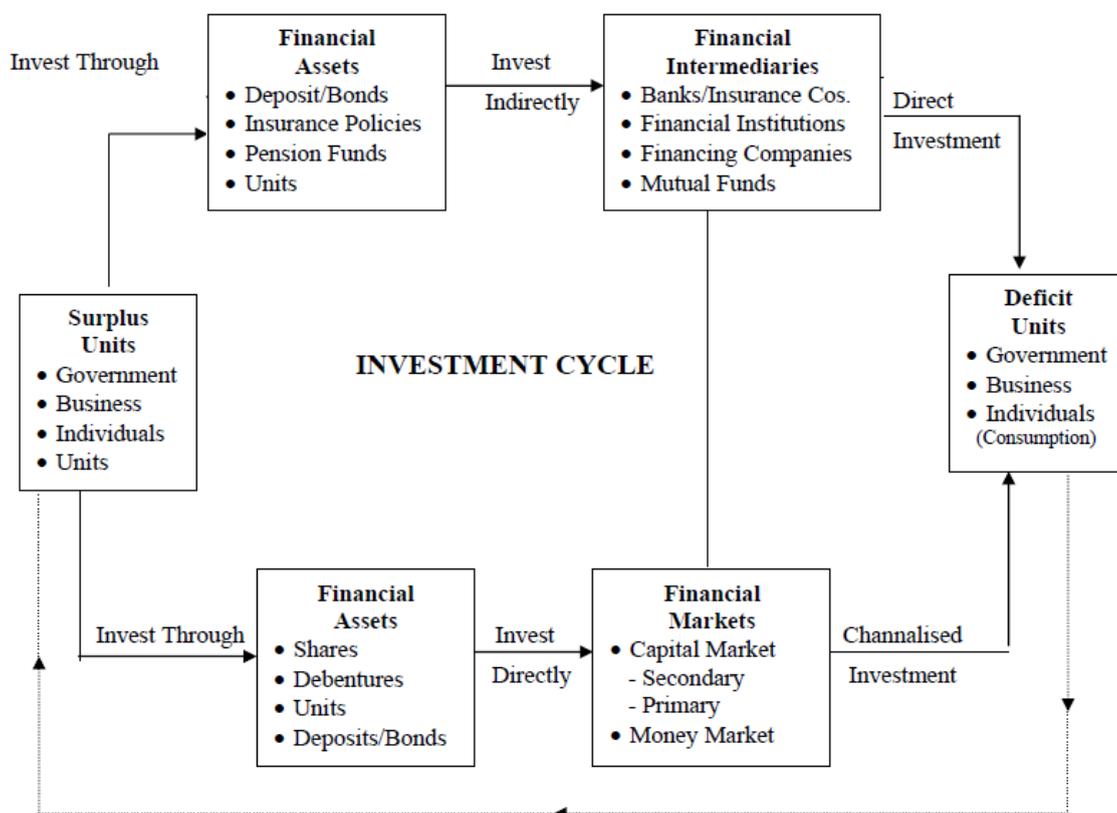
On the other end of the fund flow, Deficit Units seek funding for either investment or consumption purposes. Their investment and, at times, consumption patterns are shaped by their strategies concerning future earnings, which in turn are influenced by the existing capital stock, industry and economic conditions, government policies, and the potential opportunities for new investments. Government and the business sector are major borrowers, and their investment needs often exceed their savings. The role of the financial system is, therefore, to encourage savings and channel them into the economy through financial assets that offer greater productivity compared to physical assets.

Another aspect of the financial system in an economy is government intervention. The government establishes the rules governing the financial system, directing how markets operate, specifying permissible

financial instruments, and setting operational constraints for financial intermediaries. Government intervention serves two primary purposes: ensuring efficiency within the system and providing stability while instilling confidence. An efficient financial system is one where the total gains from lending, payment, and risk management are maximized.

It is essential to recognize the role of the financial system or sector in an economy, particularly as the economy expands. As discussed earlier, its primary role is resource mobilization. An efficient financial system enables the raising of significant amounts of capital through small contributions from a large number of investors. A company, for example, can raise Rs. 100 crore by issuing 10 crore shares, each subscribed to by investors making minimum contributions of Rs. 2000. Alternatively, mutual funds or financial institutions can be used. This allows large sums to be mobilized from small investors. Financial instruments issued to raise funds can have different maturity patterns to suit the needs of investors. To mitigate investment risk, the financial system offers a wide range of investment opportunities, enabling diversification of investments and, consequently, risk reduction.

Figure 1



1.3 Financial Markets

The financial market serves as a platform connecting numerous individuals looking to buy and sell financial products. The prices of these products are determined by the interplay of supply and demand forces within the market itself.

In essence, the financial market encourages savings within the economy and acts as an efficient conduit for implementing financial policies. In technical terms, it enables:

1. Capital generation (in capital markets).
2. Risk transfer (in derivatives markets).
3. Facilitation of international trade (in currency markets).

1.3.1 Types of Financial Market

A Financial Market can be described as the arena where financial assets are either generated or transferred. Unlike tangible transactions that involve the exchange of money for physical goods or services, financial transactions involve the creation or transfer of financial assets. Financial Assets or Financial Instruments represent a future claim to a sum of money and/or periodic payments in the form of interest or dividends.

1. Money Market: The money market serves as a wholesale debt market for low-risk, highly liquid, short-term instruments. Funds are accessible in this market for periods ranging from a single day to one year. Government entities, banks, and financial institutions primarily dominate this market.
2. Capital Market: The capital market is designed to provide financing for long-term investments. Transactions in this market typically have durations exceeding one year.
3. Forex Market: The Forex market handles multicurrency requirements through currency exchange. Funds are transferred in this market based on prevailing exchange rates. It is one of the most developed and globally integrated markets.
4. Credit Market: The credit market is where banks, financial institutions, and non-banking financial companies (NBFCs) extend short, medium, and long-term loans to both corporations and individuals.

1.4 Capital Market

The capital market is the domain for securities trading, enabling companies and governments to secure long-term financing. It functions as a marketplace where funds are borrowed or lent for durations exceeding one year.

Various categories of financial instruments are actively traded within the capital markets, including equity instruments, credit market instruments, insurance instruments, foreign exchange instruments, hybrid instruments, and derivative instruments.

The Capital Market is comprised of two main segments: The Primary Market and The Secondary Market. In the Primary Market, newly issued bonds and stocks are transacted, while the secondary market involves the buying and selling of pre-existing bonds and stocks. In its entirety, the Capital Market facilitates the acquisition of capital by enabling the trading of long-term financial assets. In summary, the Capital Market enables the acquisition of funds by engaging in the exchange of extended-term financial assets.

1.4.1 Primary Capital Market

The primary capital markets, also known as the New Issue Market or NIM, are where newly introduced securities are initially sold to the general public. This market is often referred to as the long-term debt market because the funds raised here are intended for long-term capital purposes.

The process of selling new issues in the primary capital market typically involves a syndicate of securities dealers who play a role in the process and receive a commission for their services. The price of the security offered in the primary capital market includes this dealer commission.

In cases of primary issues, investors directly purchase the issue from the company without the need for intermediaries. To do this, investors send the exact amount of money to the respective company, and upon receiving the funds, the company provides security certificates to the investors.

The funds generated through primary issues in the primary capital market are vital for companies. These funds are utilized by companies for establishing new ventures, expanding existing businesses, and modernizing operations. Additionally, the primary capital market plays a role in capital formation for the overall economy.

There are three methods for offering new issues in the primary capital market:

- (i) **Initial Public Offering (IPO):** An IPO refers to the initial sale of stock by a private company to the public. IPOs are commonly used by smaller, younger companies seeking capital for expansion, but they can also be employed by large privately owned companies looking to become publicly traded. Underwriting firms assist in determining the type of security to issue (common or preferred), the offering price, and the timing of the market entry.
- (ii) **Preferential Issue:** A preferential issue involves the issuance of stock available exclusively to designated buyers, such as promoters, their relatives, or institutional investors. This can be likened to a wholesale equity market, as retail investors or shareholders are not invited to participate.
- (iii) **Rights Issue:** A rights issue is a unique form of offering for existing companies. Existing shareholders receive the opportunity to purchase a specified number of new shares from the company at a predetermined price within a specific timeframe.

1.4.2 Secondary Capital Market

The secondary capital market pertains to securities that have already been issued through an initial public offering in the primary market. Typically, secondary markets involve the buying and selling of securities that were previously issued.

In the secondary capital market, these securities are generally sold and transferred from one investor to another, highlighting the importance of a high level of liquidity in this market. Additionally, transparency in secondary market transactions is crucial. Advancements in technology have significantly transformed the way trading occurs in the secondary market. In the past, investors had to physically gather at fixed locations to conduct transactions, but now trading in the secondary capital market has become more convenient for investors.

Notes: The secondary bond markets provide a platform for trading bonds that have already been issued in the primary market, while the secondary stock market facilitates the trading of stocks that have already been issued by the respective issuers. Treasury bills in the secondary market are also traded.

Trading in the secondary market holds significant importance within the capital market. An analysis of trends in the secondary market can offer insights into investors' preferences for liquidity. This reflects whether investors intend to invest their money for a short or long duration. It's worth noting that investors

in the capital market tend to favor shorter-term investments. However, investors in the secondary market can manage their investments effectively with the right strategy.

The secondary market value of a stock or bond differs from its face value due to fluctuating interest rates. The resale value of bonds in the secondary market depends on prevailing interest rates at the time of the sale. In a typical secondary market scenario, when interest rates decline, bond values rise, but when rates increase, bond values decrease.

1.5 Money Market

A money market can be described as a marketplace for short-term debt securities, typically having a maturity period of one year or less, often as short as 30 days. Money market securities are generally considered highly secure investments, offering relatively low interest rates, making them suitable for temporary cash holding or short-term financial goals.

The money market is primarily recognized as a platform where large institutions and governments handle their short-term cash requirements. Nevertheless, individual investors can also participate in this market through various types of securities.

1.5.1 Types of Money Market

The money market can be categorized into two main types: the organized money market and the unorganized money market.

- (i) **Organized money market:** This segment comprises commercial banks, financial institutions, and all institutions engaged in the trading of short-term assets.
- (ii) **Unorganized money market:** In addition to the organized money market, there exists a robust unorganized money market, particularly in developing countries that have yet to fully develop. In such nations, individuals and small businesses often choose to obtain loans from family members, moneylenders, informal lenders, etc., instead of seeking credit from established institutions regulated by monetary authorities.

1.5.2 Money Market Instruments

The money market can be defined as a market for short-term financial instruments and assets that closely resemble cash. Short-term, in this context, generally refers to a period of up to one year, often as brief as 30

days. The term "near substitutes for money" indicates that these financial assets can be swiftly converted into cash with minimal transaction costs.

Several key money market instruments are briefly discussed below:

- (i) **Call/Notice Money:** Call money refers to funds borrowed or lent on demand for very short periods, typically a day, known as "Call (Overnight) Money." If the borrowing or lending period ranges from more than a day up to 14 days, it is termed "Notice Money." These transactions do not require collateral security.
- (ii) **Treasury Bills:** Treasury Bills are short-term borrowing instruments of the government, with maturities of up to one year. They are issued at a discount to their face value and are repaid at face value upon maturity.
- (iii) **Certificates of Deposits (CDs):** CDs are negotiable money market instruments issued in dematerialized form or as Promissory Notes for funds deposited with eligible financial institutions for specified time periods. The issuance of CDs is regulated by directives from the Reserve Bank of India, with eligibility criteria for corporate issuers.
- (iv) **Commercial Papers (CPs):** CPs represents promissory notes evidencing debt obligations issued by corporations. They are issued at a discount to face value and are freely negotiable. Guidelines for issuing CPs are governed by directives from the Reserve Bank of India, including eligibility criteria based on the issuer's financial health, credit rating, and maturity periods.

These money market instruments serve as crucial tools for managing short-term funds and liquidity. Their values in the secondary market may differ from their face values due to fluctuations in interest rates, with bond values rising when interest rates fall and vice versa.

1.6 Financial Institutions

The financial sector plays a crucial role in the overall progress of a nation. At the heart of this sector are financial institutions that serve as intermediaries, facilitating the movement of resources from individuals and entities who save more than they spend to those who spend more than they earn. These financial institutions have historically been the primary source of long-term capital for the economy. They offer a diverse range of financial products and services to cater to the diverse requirements of the business sector.

Additionally, they extend support to emerging businesses, small and medium-sized enterprises, and industries located in underdeveloped regions.

A financial institution is an establishment that offers financial services to its customers or members. Any organization that gathers funds and invests them in assets like stocks, bonds, bank deposits, or loans qualifies as a financial institution.

There are primarily two categories of financial institutions:

- **Depository institutions:** These institutions not only receive deposits from customers but also provide interest on those deposits. They utilize these deposits to extend loans.
- **Non-depository institutions:** These institutions, on the other hand, do not pay interest on deposits and may have different mechanisms for funding their operations and investment activities.

Examples: Banks, Credit unions, Trust companies, Mortgage loan companies.

In contrast, non-depository institutions primarily engage in the sale of financial products. To clarify, these can be government or private entities that act as intermediaries between individuals who save and those who borrow, but they do not accept time deposits. These institutions finance their lending operations by either selling securities or offering insurance policies to the general public. Depending on the level of liquidity associated with their liabilities, these liabilities may fall into one or more definitions of money supply or may be categorized as near-money equivalents.

Examples: Insurance companies, Pension funds, Brokerage firms, Underwriting firms, Mutual fund companies, Investment trust.

Numerous financial institutions offer a combination of depository and non-depository services. Serving as financial intermediaries is arguably the most crucial financial service provided by these institutions. Government authorities usually subject most financial institutions to stringent regulatory oversight.

Finance companies, in particular, often benefit from excellent credit ratings, enabling them to secure loans at highly competitive market rates. Consequently, they can extend loans at interest rates not significantly higher than those offered by banks. Despite serving customers who typically don't meet bank credit criteria, these companies have a track record of low default rates. Finance companies, in general, tend to be sensitive to fluctuations in interest rates, as shifts in market interest rates directly impact their profitability.

1.6.1 Types of Financial Institutions

Financial institutions come in various forms, reflecting the diversity of financial systems across different economies. In India, the financial system encompasses the following categories of institutions:

- (i) Financial Authorities
- (ii) Commercial Banks
- (iii) Regional Rural Banks
- (iv) Non-banking Financial Companies
- (v) Co-operative Societies, etc.

Let us discuss these in detail:

1. Financial Authorities: Also known as financial regulators, they include:

- (a) Central Board of Direct Taxes (CBDT)
- (b) Central Board of Excise & Customs (CBE&C)
- (c) Reserve Bank of India (RBI)
- (d) Securities and Exchanges Board of India (SEBI)
- (e) Insurance Regulatory and Development Authority (IRDA).

2. Commercial Banks: The main commercial banks in India include:

State Bank of India (SBI) - State Bank of India is the largest and oldest commercial bank in India, with a vast network of branches and ATMs across the country.

HDFC Bank - HDFC Bank is one of the largest private sector banks in India, known for its strong retail and corporate banking services.

ICICI Bank - ICICI Bank is another prominent private sector bank in India, offering a wide range of financial services.

Punjab National Bank (PNB) - Punjab National Bank is one of the leading public sector banks in India, with a significant presence both nationally and internationally.

Bank of Baroda (BOB) - Bank of Baroda is another major public sector bank in India, known for its global presence and a wide range of banking products and services.

3. Regional Rural Banks (RRBs): On October 2, 1975, the Government of India established Regional Rural Banks (RRBs). These banks extend credit primarily to the economically disadvantaged segments in rural areas, including small and marginal farmers, agricultural laborers, artisans, and small entrepreneurs.

Initially, there were five RRBs, each sponsored by a different bank: Syndicate Bank, State Bank of India, Punjab National Bank, United Commercial Bank, and United Bank of India. RRBs enjoy several concessions provided by the Reserve Bank of India, such as lower interest rates on notes, refinancing facilities from NABARD (National Bank for Agriculture and Rural Development), reduced cash reserve ratio, lower statutory liquidity ratio, lower interest rates on loans from sponsoring banks, managerial and staff support from the sponsoring bank, and reimbursement of staff training expenses.

NABARD has the oversight and control of RRBs. It is responsible for setting policies, monitoring operations, providing refinancing facilities, assessing performance, and addressing any issues related to RRBs.

4. Non-banking Financial Companies: Non-Banking Financial Companies (NBFCs) are rapidly gaining significance within the Indian financial system. This diverse group of institutions, distinct from commercial and cooperative banks, engages in various forms of financial intermediation. These activities encompass receiving deposits, providing loans and advances, offering leasing and hire-purchase services, among others. NBFCs source funds directly or indirectly from the public and subsequently lend them to end consumers. They extend credit to a wide array of clients, including wholesalers, retailers, small-scale industries, and self-employed individuals. Consequently, NBFCs have expanded and diversified the array of financial products and services available in the financial sector.

The RBI registers various types of NBFCs, which include:

- (a) Equipment leasing company
- (b) Hire-purchase company
- (c) Loan company
- (d) Investment company.

Now, these NBFCs have been reclassified into three categories:

- (a) Asset Finance Company (AFC)
- (b) Investment Company (IC) and
- (c) Loan Company (LC).

5. Co-operative Societies: The overarching strategy concerning rural and agricultural credit revolves around ensuring farmers receive prompt and sufficient financing to enhance agricultural output and efficiency. The primary objective is to facilitate enhanced access to institutional credit for small-scale and

marginalized farmers, as well as other vulnerable segments of society, enabling them to embrace modern technology and improved farming practices. This has been a central focus of the policy.

India's Cooperative Movement boasts a rich historical legacy, and currently these societies consist of the following components:

- (a) The Primary Agricultural Co-operative Societies
- (b) District Central Co-operative Banks
- (c) State Co-operative Banks
- (d) National Co-operative Development Corporation (NCDC)
- (e) National Co-operative Union of India (NCUI)
- (f) National Agricultural Co-operative Marketing Federation of India (NAFED)
- (g) Tribal Co-operative Marketing Development Federation of India Ltd.
- (h) Indian Farmers Fertiliser Cooperative Limited (IFFCO)
- (i) Krishak Bharati Co-operative Limited (KRIBHCO)
- (j) National Bank for Agriculture and Rural Development (NABARD)
- (k) National Federation of State Co-operative Banks Limited (NAFSCOB)
- (l) Gujarat Cooperatives Milk Marketing Federation Ltd. (AMUL)
- (m) National Dairy Development Board (NDDB).

6. Credit Reporting and Debt Collection Companies: While Credit Reporting and Debt Collection may be somewhat fragmented, it encompasses businesses such as:

- (a) Trustman Credit Management Services
- (b) Pankaj Saraf

7. Insurance Companies: Numerous insurance companies operate in the Indian market, with the primary ones being:

- (a) General Insurance Corporation of India Ltd.
- (b) Life Insurance Corporation
- (c) New India Assurance Company
- (d) United India Insurance Company.

8. Merchant Banks: Merchant banks are institutions like:

- 1. Citibank
- 2. Bajaj Capital Limited

3. Standard Chartered Bank

9. Mutual Funds: It is a trust that collects money from a number of investors who share a common investment objective and invests the same in equities, bonds, money market instruments and/or other securities. And the income / gains generated from this collective investment is distributed proportionately amongst the investors after deducting applicable expenses and levies, by calculating a scheme's "Net Asset Value" or NAV. Simply put, the money pooled in by a large number of investors is what makes up a Mutual Fund.

10. Specialised Financial Institutions: These government enterprises are established to provide both financial and technical support to Indian industries. The roster of specialized financial institutions in India principally comprises:

- (a) Export-Import Bank of India
- (b) Board for Industrial & Financial Reconstruction
- (c) Small Industries Development Bank of India
- (d) National Housing Bank.

11. Venture Capitalists: Venture capitalists are entities specializing in venture capital investment. Venture capital, often referred to as VC, is a form of private equity funding primarily directed towards early-stage, promising, high-growth enterprises, with the goal of achieving returns through future events like an initial public offering (IPO) or the sale of the company.

Examples: Sequoia Capital India, Accel Partners, Matrix Partners India, Nexus Venture Partners, Lightspeed India Partners.

1.7 Financial Services

Financial services encompass the array of products and offerings provided by financial institutions, such as various types of banks, to facilitate a wide range of financial transactions and related activities within the finance sector. These activities include services like loans, insurance, credit cards, investment opportunities, money management, and the provision of information on topics like the stock market and market trends. The Gramm-Leach-Bliley Act, which was passed in the late 1990s, played a pivotal role in bringing the term "financial services" to the forefront. This act repealed previous laws that prohibited banks and financial institutions from entering sectors like insurance and investment. Consequently, numerous organizations offering these financial services merged under a unified banner, giving rise to a new category

known as Commercial Banking. Entities like Citibank emerged primarily as service providers in this transformed landscape.

While the financial services industry is highly profitable in terms of earnings, it does not constitute a substantial portion of the market, and it employs fewer people compared to some other industries. Some of the prominent service providers and commercial banks in this field include:

- a. Citibank
- b. HSBC
- c. Standard Chartered
- d. Citigroup
- e. Merrill Lynch
- f. Morgan Stanley
- g. ING (Investment)
- h. American Express (Credit Card)
- i. VISA (Credit Card)
- j. Allianz (Insurance)

1.7.1 Objectives or Functions of Financial Services

1. Fund Raising:

Financial Services play a crucial role in securing the necessary capital from a diverse range of investors, including individuals, institutions, and corporations. To achieve this goal, a variety of financial instruments are employed. Corporate entities, as well as individuals and other entities, seek these funds to meet their financial needs.

2. Funds Deployment:

A variety of financial services are accessible within financial markets, aiding participants in optimizing the profitable utilization of the capital they've raised. These services contribute to informed decision-making concerning the financing combination. Banking and financial service companies offer services such as bill discounting, debtor factoring, short-term fund placement in the money market, credit assessment, e-commerce, and debt securitization to facilitate effective fund management.

3. Specialized Services:

The financial services industry offers specialized offerings like credit assessment, venture capital investment, lease financing, factoring, mutual funds, merchant banking, stock lending, depository services, credit cards, housing finance, book building, and more. Additionally, these services are not

limited to traditional banking and insurance entities; stock exchanges, specialized and general financial institutions, non-banking finance companies, subsidiaries of financial institutions, banks, and insurance firms also participate in providing these services.

4. Regulation:

Various regulatory bodies oversee financial services activities. In India, entities like the Securities and Exchange Board of India (SEBI), Reserve Bank of India (RBI), and the Department of Banking and Insurance, Government of India, utilize a wide range of legislative measures to govern the operations of financial service institutions. The primary aim is to maintain an organized operation of the financial markets.

5. Economic Growth:

Financial services significantly contribute to expediting the pace of economic growth and development by efficiently gathering savings from a diverse group of individuals and directing these funds into productive investments.

1.8 Management of Risk in Financial Services

Risk management is a fundamental aspect of the financial services industry, essential for the stability and success of financial institutions. In this note, we will explore the key components of risk management in financial services, its significance, and the various types of risks that institutions must navigate.

1.8.1 Significance of Risk Management:

Financial institutions, including banks, investment firms, insurance companies and asset managers, play a pivotal role in the global economy. Effective risk management is crucial for several reasons:

- a. **Financial Stability:** Proper risk management ensures the stability of financial institutions, protecting depositors, investors, and stakeholders from catastrophic losses.
- b. **Regulatory Compliance:** Regulatory authorities impose stringent requirements on risk management to safeguard the financial system and maintain market integrity.
- c. **Reputation Management:** A strong risk management framework enhances an institution's reputation and fosters trust among clients and partners.

1.8.2 Types of Risks in Financial Services:

- a. **Credit Risk:** This is the risk of borrowers failing to repay their loans or debt obligations. Banks and financial institutions assess creditworthiness to mitigate this risk.
- b. **Market Risk:** Market risk includes the exposure to changes in interest rates, exchange rates, and asset prices. Traders, asset managers, and investors are particularly concerned with market risk.
- c. **Operational Risk:** Operational risk arises from internal processes, systems, or human error. It encompasses issues like fraud, technology failures, and compliance failures.
- d. **Liquidity Risk:** Liquidity risk pertains to an institution's ability to meet short-term financial obligations. It can lead to insolvency if not managed effectively.
- e. **Regulatory Risk:** Regulatory risk involves changes in laws and regulations that can impact the operations and profitability of financial institutions.
- f. **Reputational Risk:** The risk of damage to an institution's reputation due to negative public perception, often resulting from adverse events or misconduct.

1.8.3 Risk Management Framework:

- a. **Risk Identification:** The first step is identifying and assessing risks. Institutions use quantitative models, stress tests, and scenario analysis to identify potential threats.
- b. **Risk Measurement:** Quantifying risks is essential for proper management. Various metrics, such as Value at Risk (VaR), are used to measure and monitor risk exposure.
- c. **Risk Mitigation:** Financial institutions employ various strategies to mitigate risks, including diversification, hedging, setting risk limits, and maintaining capital reserves.
- d. **Risk Monitoring and Reporting:** Continuous monitoring and reporting of risks help institutions stay proactive in managing their exposure.
- e. **Compliance and Governance:** Establishing a strong risk management culture, along with robust governance structures, is essential for effective risk management.

1.8.4 Challenges in Risk Management:

- a. **Data Management:** Collecting, managing, and analyzing vast amounts of data is a challenge in risk management.
- b. **Regulatory Compliance:** Adhering to ever-evolving regulations requires significant resources and expertise.
- c. **Cybersecurity Threats:** The increasing reliance on technology exposes financial institutions to cyber threats, necessitating robust cybersecurity measures.

Risk management is a cornerstone of the financial services industry, integral to its stability, compliance, and reputation. Financial institutions must continually adapt their risk management practices to address evolving challenges in an ever-changing global financial landscape. A strong risk management framework helps navigate uncertainties, protect stakeholders, and foster long-term success.

1.9 Regulatory Framework of Financial Markets in India

The regulatory framework in India's financial markets plays a critical role in ensuring transparency, stability, and investor protection. It encompasses a range of regulations, oversight bodies, and market participants. This note provides an overview of the regulatory framework in India's financial markets.

1.9.1 Key Regulatory Authorities:

- **Reserve Bank of India (RBI):**

The RBI is the central bank of India and plays a pivotal role in regulating the country's monetary policy. It regulates and supervises banks, non-banking financial companies (NBFCs), and payment systems. The RBI also oversees foreign exchange control and manages the nation's foreign exchange reserves.

- **Securities and Exchange Board of India (SEBI):**

SEBI is the primary regulator for securities markets in India. It oversees stock exchanges, brokers, mutual funds, and other market intermediaries. SEBI enforces regulations to protect investors and maintain market integrity.

- **Insurance Regulatory and Development Authority of India (IRDAI):**

IRDAI regulates and supervises the insurance industry in India, ensuring fair practices, solvency, and consumer protection. It approves insurance products, licenses insurers, and sets capital adequacy standards.

- Pension Fund Regulatory and Development Authority (PFRDA):

PFRDA regulates and promotes the pension sector in India. It oversees pension funds, administrators, and other entities involved in the National Pension System (NPS).

- Ministry of Finance:

The Ministry of Finance is responsible for formulating fiscal policies and overseeing public finance management. It plays a key role in shaping the regulatory landscape through budgetary allocations and policy decisions.

1.9.2 Market Segments Covered:

- Banking and Financial Services:

The RBI regulates commercial banks, co-operative banks, NBFCs, and other financial institutions. It sets capital adequacy, liquidity, and lending standards to maintain financial stability.

- Securities Markets:

SEBI regulates stock exchanges, securities brokers, mutual funds, and depositories. It enforces listing and disclosure norms to protect investor interests.

- Insurance:

IRDAI oversees life and non-life insurance companies, ensuring they comply with underwriting and solvency regulations. It approves insurance products and premium rates.

- Pension:

PFRDA regulates and promotes the NPS, which is a voluntary long-term retirement savings scheme. It ensures transparency, portability, and choice for pension subscribers.

1.9.3 Challenges and Developments:

The regulatory framework in India's financial markets faces challenges like technological advancements, market complexity, and global integration. Regulatory bodies continually adapt to these challenges by introducing new regulations, enhancing surveillance systems, and promoting financial literacy.

Recent developments include the introduction of the Insolvency and Bankruptcy Code (IBC), which aims to expedite the resolution process for stressed assets, and initiatives to promote digital payments and fintech innovation.

The regulatory framework in India's financial markets is a crucial component of the nation's economic infrastructure. It aims to strike a balance between facilitating market growth and protecting the interests of investors and consumers. Regular updates and amendments to regulations demonstrate India's commitment to maintaining a robust and competitive financial market ecosystem.

1.10 Exercise

Answer the following Questions:

Q1 What are the three primary functions of the financial system within an economy?

Q2 Discuss the role of government intervention in the financial system. How does government intervention contribute to both efficiency and stability within the financial sector?

Q3 Explain the role of the primary capital market in the financial system. What are the three methods for offering new issues in the primary capital market?

Q4 Explain the role of financial institutions in the movement of resources within an economy, and why are they considered a vital source of long-term capital?

Q5 State the objectives of the Financial Services

Q6 What is the significance of risk management in the financial services industry, and why is it important for financial institutions?

Q7 Name two types of risks that financial institutions commonly face in their operations

Q8 Explain the key steps in a comprehensive risk management framework for financial institutions. How does each step contribute to the overall effectiveness of risk management?

Q9 What is the primary role of the Reserve Bank of India (RBI) in the Indian financial regulatory framework?

Q10 Which regulatory authority oversees the securities markets in India, including stock exchanges and mutual funds?

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Structure

- 2.1 Introduction to Financial Market Operations
- 2.2 Organizational Structure of Stock Exchanges in India
- 2.3 Functions of Stock Exchanges in India
- 2.4 Broking and trading in equity
- 2.5 Listing of Debt Instruments on Stock Exchange
- 2.6 Exercise

OBJECTIVES

- Explain the key components of financial markets
- Describe the Organizational Structure of Stock Exchanges in India
- Understanding the Functions of Stock Exchanges in India
- highlight regulations related to broking and trading in Equity and Debentures in India

1.1 Introduction

Financial market operations are the heartbeat of any economy, pulsating with the rhythm of economic activity and growth. These operations encompass a complex network of activities, institutions, and instruments that facilitate the flow of capital, allocation of resources, and risk management within a financial system. Understanding financial market operations is essential to grasp how economies function, as these markets influence interest rates, investment decisions, and the overall well-being of individuals, businesses, and governments.

Key Components of Financial Market Operations:

1. **Asset Exchange:** At the core of financial market operations lies the exchange of financial assets. These assets can take various forms, such as stocks, bonds, currencies, commodities, and derivatives. The primary function is to connect buyers and sellers, allowing them to trade these assets. For instance, a stock exchange serves as a marketplace where shares of publicly traded companies change hands.

2. **Price Determination:** Financial markets are dynamic environments where prices are continually changing. Prices of assets are determined by the interplay of supply and demand forces. These price movements reflect the collective wisdom of market participants and provide vital information for investors and businesses.
3. **Capital Allocation:** Financial markets play a pivotal role in allocating capital efficiently. Savers channel their funds into investments through these markets, and borrowers access the necessary capital. This allocation of resources supports economic growth and development by directing funds to productive enterprises.
4. **Risk Management:** Financial markets offer a range of instruments for managing risks. For instance, futures and options contracts provide a way to hedge against adverse price movements in commodities or securities. These risk management tools allow businesses to focus on their core activities without being overly exposed to market volatility.

The Participants:

- a. **Investors:** Investors form the bedrock of financial markets. They include individuals, institutional investors (such as pension funds and mutual funds), and foreign investors. Their objectives vary, from wealth creation and income generation to portfolio diversification and risk management.
- b. **Borrowers:** Businesses, governments, and individuals constitute the borrowing side of financial markets. They raise capital by issuing bonds, seeking bank loans, or issuing equity. Borrowers use these funds for various purposes, such as expanding operations, funding infrastructure projects, or buying homes.
- c. **Intermediaries:** Financial institutions, including banks, brokerage firms, and insurance companies, act as intermediaries. They facilitate transactions, provide liquidity, offer advisory services, and connect borrowers with lenders. Intermediaries enhance market efficiency and reduce information asymmetry.

Regulation and Oversight:

To maintain market integrity and protect investors, financial markets are subject to regulatory oversight. Regulatory bodies, such as the Securities and Exchange Commission (SEC) in the United States or the Securities and Exchange Board of India (SEBI), enforce rules and regulations governing market operations. These regulations ensure transparency, prevent fraud, and promote fair and orderly markets.

The Global Nature of Financial Markets:

In an era of globalization, financial markets are increasingly interconnected. Events in one part of the world can have ripple effects across markets globally. Technology has played a crucial role in this interconnectedness, enabling real-time trading and information dissemination. Traders, investors, and institutions now have access to a vast array of financial products and markets worldwide.

Financial market operations are the life force of modern economies. They enable the efficient allocation of capital, risk management, and price discovery. As financial markets continue to evolve and expand, understanding their operations and the role they play in the broader economy becomes increasingly important for businesses, investors, and policymakers alike. A well-functioning financial market system contributes to economic growth, stability, and prosperity.

2.2 Organizational Structure of Stock Exchanges in India

Stock exchanges serve as the central marketplace for buying and selling financial securities, and their organizational structure plays a crucial role in ensuring the orderly and transparent functioning of financial markets. In India, major stock exchanges, such as the National Stock Exchange (NSE) and the Bombay Stock Exchange (BSE), have a well-defined organizational framework that includes various components, each with its specific responsibilities. Let's delve into the organizational structure of stock exchanges in India.

Key Components of Organizational Structure:

Governing Body: At the highest level, a stock exchange is governed by a board of directors or governing body. This body is responsible for setting policies, making strategic decisions, and ensuring compliance with regulatory requirements. It typically includes representatives from various segments of the financial industry, including brokers, market experts, and public representatives.

Managing Director/CEO: The managing director or chief executive officer (CEO) is the top executive responsible for day-to-day operations. They implement the policies and decisions of the governing body and oversee the overall functioning of the exchange.

Market Operations: This department is responsible for the actual trading operations on the exchange. It includes market makers, trading specialists, and technology professionals who ensure that the trading platform operates smoothly and efficiently.

Market Surveillance: Market surveillance is a critical function that monitors trading activities for any irregularities or market abuses. This department plays a key role in maintaining market integrity and investor confidence.

Listing Department: Companies seeking to list their shares on the exchange interact with the listing department. This department reviews listing applications, ensures compliance with listing requirements, and oversees the admission of new securities to the trading platform.

Clearing and Settlement: Clearing and settlement is a crucial part of the stock exchange's operations. This department ensures that trades are settled correctly, securities are delivered, and funds are transferred promptly and accurately.

Compliance and Regulatory Affairs: Stock exchanges in India operate under the regulatory framework set by the Securities and Exchange Board of India (SEBI). The compliance and regulatory affairs department ensures that the exchange and its members adhere to all regulatory guidelines.

Investor Services: Providing investor services is essential for maintaining trust in the market. This department handles investor inquiries, complaints, and education initiatives to empower investors with knowledge about the market.

Technology and Infrastructure: In the modern era, technology plays a pivotal role in stock exchange operations. The technology and infrastructure department is responsible for maintaining and upgrading the exchange's trading platform, ensuring its reliability and security.

Broker Members: Stock exchanges have a network of broker members who are registered intermediaries authorized to execute trades on behalf of investors. These brokers play a critical role in facilitating trading and ensuring market liquidity.

Clearing Corporation: In India, stock exchanges are supported by clearing corporations that handle the clearing and settlement of trades. These entities guarantee the settlement of trades and manage risks associated with defaults.

Depositories: Depositories such as the National Securities Depository Limited (NSDL) and Central Depository Services Limited (CDSL) are central to the dematerialization and electronic transfer of securities. They interact closely with stock exchanges to ensure seamless settlement.

Market Participants: Beyond brokers, various other market participants, including market makers, institutional investors, retail investors, and listed companies, engage with the stock exchange to access capital, manage portfolios, and participate in the market.

The organizational structure of stock exchanges in India is designed to ensure the efficient, transparent, and secure functioning of financial markets. Each component of this structure plays a distinct role in maintaining market integrity, protecting investor interests, and facilitating capital formation. This well-defined structure contributes to the overall vibrancy and credibility of India's stock exchanges, making them essential pillars of the country's financial system.

2.3 Functions of Stock Exchanges in India

Stock exchanges are vital components of a country's financial system, serving as platforms where securities are bought and sold. In India, stock exchanges play a crucial role in capital formation, investment, and economic development. The functions of stock exchanges in India can be broadly categorized into primary and secondary functions, each contributing to the overall stability and growth of the financial market.

Primary Functions:

Capital Formation: One of the primary functions of stock exchanges is to facilitate the raising of capital by companies. When companies issue shares to the public through Initial Public Offerings (IPOs), these shares are listed and traded on stock exchanges. This process allows companies to access funds from a wide range

of investors, providing them with the capital needed for business expansion, research and development, and other growth initiatives.

Liquidity and Marketability: Stock exchanges provide liquidity to investors by offering a secondary market where they can easily buy and sell securities. This liquidity enhances the marketability of securities, making them more attractive to investors. Investors can convert their investments into cash quickly, contributing to financial market efficiency.

Pricing Mechanism: Stock exchanges employ a transparent and regulated pricing mechanism. The forces of supply and demand in the market determine the prices of securities, ensuring fair and equitable pricing. This pricing mechanism allows investors to make informed investment decisions based on market conditions and valuations.

Secondary Functions:

Continuous Pricing: Stock exchanges offer continuous pricing of securities during trading hours. This feature ensures that securities are traded at prevailing market prices, reducing price manipulation and providing a real-time valuation of investments.

Risk Reduction: Stock exchanges facilitate risk reduction through diversification. Investors can build diversified portfolios by investing in a variety of securities listed on the exchange. Diversification helps spread risk and minimize the impact of adverse market movements on an individual's investments.

Information Dissemination: Stock exchanges serve as sources of financial information. They disseminate company-related news, financial reports, and corporate announcements to the public and investors. This transparency helps investors make informed decisions and promotes market efficiency.

Regulatory Framework: Stock exchanges operate under the regulatory framework established by the Securities and Exchange Board of India (SEBI) and other relevant authorities. They enforce rules and regulations governing trading, listing, and investor protection. This regulatory oversight ensures fair and transparent market operations.

Corporate Governance: Stock exchanges in India promote corporate governance practices among listed companies. They require companies to adhere to corporate governance norms, including disclosure of

financial information, board composition, and shareholder rights. These practices enhance investor confidence.

Investor Education: Stock exchanges conduct investor education programs to enhance financial literacy. These programs help investors understand the functioning of the stock market, risk management, and investment strategies. Educated investors are more likely to make informed decisions.

Market Development: Stock exchanges play a role in the development of various financial instruments and market segments. They introduce new products, such as derivatives, Exchange-Traded Funds (ETFs), and bonds, expanding the range of investment options available to investors.

Economic Growth: By facilitating capital formation, investment, and efficient allocation of resources, stock exchanges contribute to the overall economic growth of the country. They encourage savings and channel these savings into productive investments, stimulating economic development.

In conclusion, stock exchanges in India perform a wide array of functions that go beyond mere trading. They serve as critical pillars of the financial system, fostering capital formation, providing liquidity, ensuring transparency, and promoting investor protection. The efficient operation of stock exchanges is essential for the growth and stability of the Indian economy, making them integral to the nation's financial landscape.

2.4 Broking and trading in equity

Stock brokers play a vital role in facilitating transactions within the securities market. They act as intermediaries, connecting buyers and sellers of securities, thus saving considerable time and expenses that would otherwise be required for individuals to find suitable counterparts. The presence of active stock brokers enhances market liquidity as they maintain constant communication with other brokers through either open outcry halls or computer trading systems. Some brokers even contribute to market creation by providing bid and ask quotes. This process of discovering buyers and sellers, a pivotal aspect of the stock market, is made possible with the assistance of stock brokers. Without the stock broking community, it would be impossible to conduct the immense volume of stock market transactions, which now amount to billions.

Another issue addressed by stock brokers is the credit risk associated with transaction counterparties. Brokers mitigate this risk to a significant extent by becoming members of clearing houses or corporations

and limiting their transactions to other members of these entities. Clearing houses or corporations typically guarantee trade performance even if a clearing house member fails to fulfill the contract. Given that brokers handle substantial sums of money, it is essential to regulate their activities. Regulation encompasses broker registration, capital adequacy requirements, record inspections, and penalties for regulatory violations. In this unit, we will delve into the regulations governing stock brokers and equity trading. Securities market transactions and stock brokers are subject to the Securities Contract (Regulation) Act of 1956, with stock brokers additionally being governed by SEBI Regulations and self-regulations. We will begin by exploring these regulations before discussing market practices related to stock market operations.

2.4.1 Regulation on Brokers and Sub-Brokers by SEBI

In 1992, SEBI introduced regulations governing brokers and sub-brokers. This section outlines some of the key regulations pertaining to these roles.

Registration of Stock Brokers

To operate as a broker and conduct securities transactions on behalf of investors, a member of a stock exchange must first register with SEBI. Stock brokers seeking certification must submit their applications through the stock exchange where they hold membership. SEBI considers various factors when evaluating certificate applications, including the following:

- a) Eligibility for membership in a stock exchange.
- b) Possession of the necessary infrastructure, such as sufficient office space, equipment, and manpower to effectively carry out their responsibilities.
- c) Prior experience in buying, selling, or dealing in securities.
- d) History of disciplinary proceedings under the rules, regulations, and by-laws of a stock exchange related to their activities as a stock broker, involving either themselves or their partners, directors, or employees.
- e) Suitability as a fit and proper person.

Registration of Sub-Brokers

Sub-brokers wishing to obtain a certificate must complete an application in Form B and include a recommendation letter from a recognized stock exchange-affiliated stock-broker, along with two references, including one from their banker. This application should be submitted to the stock exchange where the sub-broker intends to affiliate with the stock-broker. Upon receiving the application, the stock exchange will verify the provided information and confirm that the applicant meets the specified criteria for registration as outlined in the regulations.

The eligibility criteria for becoming registered as a sub-broker are as follows:

i) For individuals:

- a) The applicant must be at least 21 years of age.
- b) The applicant should not have a conviction for any offense involving fraud or dishonesty.
- c) The applicant must have passed at least a 12th standard or equivalent examination from an institution recognized by the Government.
- d) The applicant should be deemed a fit and proper person.

The Securities and Exchange Board of India (SEBI) may, in certain cases, relax the educational qualifications based on the applicant's experience.

ii) In the case of a partnership firm or a corporation, the partners or directors, as applicable, must adhere to the requirements specified in clauses (a) to (c) of the aforementioned sub-regulation (i).

General Obligations and Responsibilities of Brokers

Each stock-broker must maintain the following books of accounts, records, and documents:

- a) Register of transactions (Sauda Book).
- b) Clients ledger.
- c) General ledger.
- d) Journals.
- e) Cash book.
- f) Bank passbook.
- g) Documents register containing details of shares and securities received and delivered.
- h) Members' contract books, displaying information about all contracts entered into with other members of the same exchange or counterfoils or duplicates of confirmation memos issued to such other members.
- i) Counterfoils or duplicates of contract notes provided to clients.
- j) Written consent from clients for contracts entered into as principals.
- k) Margin deposit book.
- l) Registers of accounts of sub-brokers.
- m) An agreement with a sub-broker specifying the scope of authority and responsibilities of the stock broker and such sub-broker.

Stock brokers are required to inform the Board about the location where these books of accounts, records, and documents are maintained.

Following the conclusion of each accounting period, every stock broker should furnish, if requested, to the Board a copy of the audited balance sheet and profit and loss account within six months of the end of that accounting period.

Stock brokers must retain the books of account and other records for a minimum period of five years.

2.4.2 TRADING IN EQUITY

Trading systems vary from one exchange to another. In the following pages, we will describe the trading system employed by the National Stock Exchange (NSE). Students who wish to learn more about the trading systems of other Indian or international exchanges can visit the respective websites of those stock exchanges.

NSE operates using the 'National Exchange for Automated Trading' (NEAT) system, which is a fully automated, screen-based trading system. NEAT follows the order-driven market principle. NSE deliberately chose an order-driven system over a quote-driven system. This decision has helped reduce the bid-ask spreads not only on NSE but also on other exchanges, resulting in lower transaction costs. Before NSE came into existence, investors looking to trade securities not listed on their nearest exchange had to send orders through a chain of correspondent brokers to reach the appropriate exchange. This process led to uncertainty and high transaction costs. NSE has made it possible for investors to access the same market and order book, regardless of their location, at the same price and cost.

Market Types

The NEAT system comprises four types of markets:

- i) Normal Market: All orders that are of regular lot size or multiples thereof are traded in the Normal Market. For shares traded in the compulsory dematerialized mode, the market lot size is one. The Normal Market consists of various book types, where orders are categorized as Regular lot orders, Special Term orders, Negotiated Traded orders, and Stop Loss orders based on their order characteristics.
- ii) Odd Lot Market: The Odd Lot Market is for all orders with order sizes smaller than the regular lot size. An order qualifies as an odd lot order if its size is less than the regular lot size. These orders do not have any specific terms associated with them. In the odd-lot market, both the price and quantity of buy and sell orders must exactly match for a trade to occur. Currently, the odd lot market facility is used for the Limited Physical Market in accordance with SEBI directives.
- iii) Spot Market: Spot orders are similar to normal market orders, except they have different settlement periods compared to the normal market. These orders do not have any special terms associated with them. Currently, the Spot Market is used for the Automated Lending and Borrowing Mechanism (ALBM) session.

iv) Auction Market: Within the Auction Market, the exchange initiates auctions on behalf of trading members for reasons related to settlement. This market involves three participants:

- Initiator: The party who triggers the auction process is referred to as the initiator.
- Competitor: The party who places orders on the same side as the initiator is known as a competitor.
- Solicitor: The party who enters orders on the opposite side compared to the initiator is termed a solicitor.

Order Books

The NSE trading system offers members complete flexibility in the types of orders they can submit. Upon receipt, orders are assigned unique order numbers and time stamps, then promptly processed to identify potential matches. Each order is identifiable by its distinct order number and unique time stamp. If no match is found, the orders are organized into different "books." Orders are arranged in price-time priority in various books according to the following sequence:

Best Price

Within the same price, by time priority.

Price priority means that if two orders are entered into the system, the order with the best price receives higher priority. Time priority means that if two orders have the same price, the order entered first is given higher priority.

In the Capital Market segment, there are several types of books:

Regular Lot Book

The Regular Lot Book contains all regular lot orders that do not have any of the following attributes attached:

All or None (AON)

Minimum Fill (MF)

Stop Loss (SL)

Special Terms Book

The Special Terms book includes orders with specific terms attached, such as:

All or None (AON)

Minimum Fill (MF)

Note: As per SEBI directives, special term orders (i.e., AON and MF) are currently unavailable on the system.

Negotiated Trade Book

The Negotiated Trade book comprises all negotiated order entries captured by the system before they are matched with counterparty trade entries. These entries are matched only with identical counterparty entries and include additional order details like a counterparty code.

Stop-Loss Book

Stop Loss orders are held in the Stop-Loss Book until the specified trigger price in the order is reached or exceeded. Once the trigger price is met or surpassed, the order is released into the Regular Lot book.

The stop-loss condition is triggered under the following circumstances:

For a Sell Order: A sell order in the Stop Loss book is activated when the last traded price in the normal market reaches or falls below the trigger price of the order.

For a Buy Order: A buy order in the Stop Loss book is activated when the last traded price in the normal market reaches or surpasses the trigger price of the order.

Odd Lot Book

The Odd Lot Book contains all orders with quantities less than the marketable lot size in the system. The system attempts to match an active odd lot order with passive orders in the book. Currently, based on a directive from SEBI, the Odd Lot Market is used for orders with quantities less than or equal to 500 (quantity exceeding the market lot) for trading. This is referred to as the Limited Physical Market (LPM).

Spot Book

The Spot Lot Book includes all spot orders, which have only a different settlement period compared to other orders in the system. The system attempts to match an active spot lot order with passive orders in the book. Currently, the Spot Market book type is utilized for conducting the Automated Lending & Borrowing Mechanism (ALBM) session.

Auction Book

The Auction Book comprises orders entered for all auctions. The matching process for auction orders in this book is initiated only at the end of the solicitor period.

Order Matching Rules

The best buy order is matched with the best sell order. An order may partially match with another order, resulting in multiple trades. When matching orders, the best buy order has the highest price, while the best sell order has the lowest price. This is because the system considers all buy orders from the perspective of a seller and all sell orders from the perspective of buyers in the market. Therefore, the best buy order is the one with the highest price, and the best sell order is the one with the lowest price.

Members can proactively enter orders in the system, which will remain displayed until the full quantity is matched by one or more counter-orders and results in one or more trades or is canceled by the member. Alternatively, members can reactively enter orders that match with existing orders in the system. Orders that remain unmatched in the system are considered "passive" orders, while orders that come in to match existing orders are called "active" orders. Orders are always matched at the passive order price, ensuring that earlier orders take priority over later ones.

Order Conditions

A Trading Member can enter various types of orders based on their specific requirements. These conditions are broadly categorized into three groups: price-related conditions, and quantity-related conditions.

Price Conditions

Limit Price/Order: An order that permits the specification of the price when entering it into the system.

Market Price/Order: An order to buy or sell securities at the most favorable price available at the time the order is placed.

Stop Loss (SL) Price/Order: This type of order enables the Trading Member to place an order that becomes active only when the market price of the relevant security reaches or surpasses a predefined threshold price. Until that condition is met, the order remains dormant in the market.

For Sell Orders:

A sell order in the Stop Loss book is triggered when the last traded price in the normal market reaches or falls below the trigger price specified in the order.

For Buy Orders:

A buy order in the Stop Loss book is triggered when the last traded price in the normal market reaches or exceeds the trigger price stated in the order.

For example, if there's a stop-loss buy order with a trigger at 93.00, a limit price of 95.00, and the market's last traded price is 90.00, this order becomes active in the system only when the market price reaches or surpasses 93.00. Subsequently, it is added to the regular lot book with a time stamp reflecting the moment of activation and a limit order price of 95.00.

Quantity Conditions

Disclosed Quantity (DQ): An order with a disclosed quantity condition allows the Trading Member to reveal only a portion of the total order quantity to the market at any given time. For instance, if there is an order for 1000 units with a disclosed quantity condition of 200, it means that 200 units will be displayed to the market initially. Once these 200 units are traded, another 200 units are automatically released, and so on, until the full order is executed. The Exchange may establish a minimum disclosed quantity requirement periodically.

2.5 LISTING OF DEBT INSTRUMENTS ON STOCK EXCHANGE

Similar to equity, a company or institution that wishes to issue a debt instrument through a public offering must be officially listed on a stock exchange to enable trading. Depending on the regulations of the stock exchange, these debt instruments can either be listed alongside equity instruments or in a separate section of the stock exchange. To gain this privilege of listing their debt securities, the company or institution is required to pay a listing fee to the stock exchange. This fee can vary between different stock exchanges. (It's important to note that all Government securities and Treasury bills are automatically considered listed when they are issued.)

The procedure for applying for the listing of debt instruments closely resembles the process for listing shares. The issuer is obligated to provide regular information about itself, and the specific details regarding the type of information, the frequency of reporting, disclosure standards, etc., are outlined in the Listing Agreement. In fact, many exchanges utilize a common listing agreement for both equity and debt instruments. Failure to adhere to the terms of the listing agreement could result in the suspension or removal of debt and equity securities from the exchange, and in more severe cases, individuals responsible for violating stock exchange rules may face legal prosecution.

Just as is the case with equity shares, some exchanges may permit trading of debt instruments that are not officially listed under a designated category. This is done to facilitate trading for investors located across the country.

2.5.1 TRADING IN CORPORATE DEBT SECURITIES

Debt instruments are traded on stock exchanges in a manner that closely resembles the trading of equity instruments. The way this trading occurs can vary depending on the specific stock exchange involved. Debt instruments may either be traded alongside equity instruments, or a distinct trading segment may be designated for them.

For instance, the National Stock Exchange (NSE) has established a unique platform for the trading of debt securities known as the Wholesale Debt Market (WDM) segment. This segment commenced operations on June 30, 1994, and it primarily serves prominent market participants like banks and institutions. Within the NSE-WDM segment, a trading platform is provided for various debt securities, including Government securities, PSU bonds, corporate debentures, bonds issued by financial institutions, commercial papers, and more. Trading in debt securities within this segment is executed through the National Exchange for Automated Trading (NEAT) system, which is an automated system offering trading and reporting capabilities. The NSE's trading platform employs a screen-based, order-driven, and automated order matching system.

Similarly, the Bombay Stock Exchange (BSE) has introduced trading in all types of debt instruments within the Wholesale Debt Market (WDM) segment through its GILT system, which is an automatic online trading system. In this system, trading members and participants are identified as entities. Trading members, who are typically brokers, are admitted to the exchange with trading rights and are required to meet predetermined criteria for membership. These criteria include factors like capital adequacy norms, adequate infrastructure facilities, and periodic disclosure of information. Trading members on the BSE's GILT system execute trades for entities such as banks, financial institutions, corporate bonds, statutory corporations, and more. Participants, including banks and individuals, can engage in transactions involving debt securities, including Government securities, through BSE members who have been authorized to undertake debt security deals.

Intermediaries in Debt Trading

Much like equity instruments, the trading of debt instruments also involves the participation of intermediaries who are members of the stock exchange, commonly known as brokers. Just as with shares, it is exclusively brokers who are granted authorization to engage in debt instrument trading on the stock exchange. Investors are required to place their orders in the trading system exclusively through these brokers. Nevertheless, the specific obligations of brokers are contingent upon how trading is structured by

the stock exchange or exchanges involved. The stock exchanges have defined the maximum brokerage rates that trading members can charge for transactions involving debt securities.

Furthermore, in addition to adhering to the rules and regulations of the stock exchange, these brokers are also obligated to follow the directions and guidelines issued by the Securities and Exchange Board of India (SEBI). Similar to brokers operating in the equity segment, both the stock exchanges, in accordance with their Rules and Bye-Laws, and SEBI, pursuant to its Regulations, possess the authority to take action in response to any violation or breach of norms by their members.

2.5.2 SETTLEMENT OF TRADES IN DEBT SECURITIES

In contrast to the settlement of trades involving equity instruments, the responsibility for settling trades in the WDM segment of the NSE lies primarily with the participants themselves, with the exchange overseeing the settlement process. These trade settlements occur in Mumbai. They are settled on a gross basis, meaning that each individual transaction is settled independently, and there is no aggregation or netting of multiple transactions.

Settlement operates on a rolling basis without any account period settlement. Each trade order is assigned a specific settlement date when the order is initially placed, and this settlement date is used as a matching parameter. It is obligatory for all trades to be settled on the predefined settlement date. The exchange currently allows for settlement periods that range from same-day settlement (T+0) to a maximum of three working days (T+2).

On the scheduled settlement date, the Exchange furnishes data and information to the respective member or participant regarding the trades to be settled on that particular day. This information includes details about the security, counterparty, and the amount involved in each trade.

The exchange closely monitors the settlement of transactions by collecting settlement details from its members and participants. If there is a need to defer the settlement or cancel a trade, participants must obtain prior approval from the exchange. In the event of any dispute arising in relation to trades or settlement, the exchange has an established arbitration mechanism to resolve such issues. Since the settlement is bilateral and lacks a settlement guarantee mechanism, each participant has the option to set counterparty exposure limits in the trading system. This feature enables participants to mitigate counterparty risk by ensuring that all their trades remain within the exposure limits established for the respective counterparties.

2.6 Exercise

Answer the following Questions:

Q1 Explain the concept of price determination in financial markets and its significance.

Q2 Write a note on the Key Components of Financial Markets

Q3 How does the technology and infrastructure department contribute to the efficient functioning of stock exchanges in India, and what are some recent technological advancements in this area?

Q4 Explain the significance of market surveillance in maintaining market integrity and investor confidence, and provide examples of market irregularities that surveillance departments aim to detect and prevent.

Q5 How do stock exchanges in India contribute to the development of the country's financial market, and what role do they play in economic growth?

Q6 Can you explain the significance of transparency and information dissemination in stock exchanges, and how they impact investor confidence and market efficiency?

Q7 write a note on trading in corporate debt securities

Q8 Write a note on NEAT system in Stock Markets?

Q9 What is the primary responsibility for settling trades in the WDM segment of the NSE, and how does it differ from the settlement of equity instrument trades?

Q10 What measures can participants in the debt instrument market take to minimize counterparty risk, and why is this important in a bilateral settlement system?

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M.COM SEMESTER-III

Course: MANAGEMENT OF FINANCIAL SERVICE (MCMM22301T)

UNIT II: FINANCIAL MARKET OPERATIONS & SERVICES STOCK

(Chapter 3)

Depositories

Structure

- 3.1 Introduction to Depositories
- 3.2 Depository System
- 3.3 Functioning of a Depository
- 3.4 Switching over to Depository
- 3.5 Is Depository System Beneficial?
- 3.6 Selling and Buying of Dematerialised Share
- 3.7 Depository System in India
- 3.8 Technology and Depository
- 3.9 Legal Set up for Depositories in India
- 3.10 Exercise

OBJECTIVES

- Explain the concept of depositories
- Discuss the importance of depository
- Elucidate the functioning of depositories
- Describe the mechanism of dematerialisation appreciate involvement of technology in depository.

3.1 Introduction

One of the most notable developments in the latter part of the 20th century was the global expansion of financial markets, driven primarily by factors such as globalization, technological advancements, innovation, and increased trade activity. India, too, was not an exception to this trend, boasting one of the largest numbers of listed companies, a substantial investor base, and continually rising trade volumes. However, this ongoing growth in financial activities gave rise to various issues associated with stock trading. Many of these problems were a result of the traditional paper-based trading and settlement system, leading to concerns like theft or loss of share certificates.

The paper-based approach necessitated the handling of vast quantities of paperwork, resulting in higher costs and inefficiencies. The entire process, from purchasing shares through stock exchanges to obtaining properly endorsed certificates in the buyer's name, was undeniably intricate and time-consuming, plagued by a range of issues. The increasing number of investors participating in the capital market raised the risk of encountering problems related to stock delivery. Brokers faced elevated expenses and time constraints when rectifying these delivery issues, particularly when dealing with clients across different geographical locations.

The surge in trade volumes led to a substantial increase in back-office operations, which, in turn, restricted the growth potential of brokerage firms. Investors residing in remote areas, far from major urban centers, also experienced challenges when it came to settling their trades, limiting their opportunities, especially in participating in auction trading. The traditional practice of physically holding and trading securities acted as a bottleneck for the brokerage community in their capital market operations. Furthermore, investors faced higher risks, including delays in share transfers, the potential for forgery on various documents resulting in flawed deliveries, legal disputes, theft of share certificates, the presence of counterfeit certificates in the market, and damage or loss of share certificates during transit. As a result, the system of security transactions was not as investor-friendly as it should have been.

In this context, the introduction of dematerialized trading under a depository system was a highly welcomed development. This innovative financial service initially emerged in Germany and addressed many of the issues associated with traditional paper-based trading and settlement.

3.2 Depository System

The depository system's primary objective is to eliminate the extensive and burdensome paperwork associated with the paper-based system, offering the potential for "paperless" trading through advanced technology. This system functions as an institution responsible for maintaining electronic records of ownership of securities. As a result, the storage and management of physical certificates are entirely eradicated, resulting in a reduction of costs related to back-office operations, certificate transportation, and storage.

A Depository Participant, akin to a bank for securities, plays a crucial role in this system. When an investor transfers securities to a Depository Participant, the investor's account is credited, and their holdings are recorded in the depository system. Transactions such as buying and selling are updated in the investor's account without any physical transfer of paper certificates. In the depository system, the share certificates

owned by investors are dematerialized, meaning they are converted into electronic data and stored in computers by a Depository. These securities, registered in the investor's name, are then surrendered to the Depository Participant, who sends them to the respective companies for cancellation and subsequently credits the investor's depository account. These dematerialized securities appear as balances in the investor's depository account and are transferable, similar to physical shares. If an investor later wishes to convert these "demat" securities back into physical certificates, the Depository can facilitate this process, with the investor retaining beneficial ownership but the depository holding legal ownership. Consequently, benefits such as interest, dividends, rights, bonuses, and voting rights are retained by the investors.

Since the depository is responsible for transferring securities in its name, the depository's name is registered in the ownership register maintained by the company. This means that instead of multiple individual owners, the depository's name appears in the company's register. This system alleviates the difficulties currently faced by investors and offers the option to convert shares from electronic to physical form through a rematerialization process. The depository system has been well-established in many advanced countries and has played a significant role in global stock markets.

The constituents of the depository system include the

- depository itself,
- Depository Participants,
- companies/registrars, and
- investors.

However, we will focus on the first two components.

- **Depository:** The depository, functioning like a securities bank, handles dematerialized physical securities, facilitating faster, risk-free, and cost-effective settlements. It enables the surrender and withdrawal of securities through the dematerialization and rematerialization processes, maintains electronic records of investors' holdings, conducts settlements of securities traded in depository mode on stock exchanges, and manages settlement of off-market trades. In India, a depository must be established as a corporate entity under the Companies Act, 1956, and registered as a depository with SEBI (Securities and Exchange Board of India). It must develop secure data processing systems to prevent unauthorized access and establish a network connecting depository participants, issuers, and issuer agents. Even though the depository holds securities, it does not possess voting rights over the securities; those rights remain with the investors. Currently, India has two depositories, NSDL and CDSL.

- **Depository Participants:** on the other hand, act as representatives of investors within the depository system. Per SEBI guidelines, financial institutions, banks, custodians, stockbrokers, and others can become Depository Participants if they meet the prescribed requirements. DPs act as intermediaries between the depository and beneficial owners of securities. They must register under the SEBI Act and maintain ownership records in book-entry form for every beneficial owner. DPs are often the first point of contact for investors and play a critical role in facilitating dematerialization and other electronic transactions between investors and companies through the depository. Investors are typically required to initiate dematerialization requests through a DP as companies are not permitted to entertain such requests directly.

3.3 FUNCTIONING OF A DEPOSITORY

As previously mentioned, the depository system operates through a depository account. Let's explore what this entails.

Depository Account

An investor who wishes to convert their holdings into electronic form (dematerialize) must establish a depository account where all transaction details are recorded. Opening such an account is as straightforward as opening a bank account. Investors have the flexibility to open a depository account with any Depository Participant (DP) that suits their convenience. There are no restrictions on the number of depository accounts a person can open. However, if physical shares are jointly held, individuals must open a joint depository account by submitting the share certificates for dematerialization. A sole holder of share certificates cannot add additional names as joint holders during the dematerialization process.

A client can opt to open multiple accounts with the same DP and even choose to open accounts with more than one DP. However, a broker can establish only one Clearing Member (CM) account per card or stock exchange for clearing purposes, though they can maintain multiple beneficiary accounts. A clearing member is not permitted to hold personal securities in their clearing member account. Instead, brokers can engage in the depository system as clearing members only through a distinct Clearing Member account, which is solely for clearing purposes and not for holding their own securities. These securities in the clearing member account are not eligible for corporate actions. Therefore, brokers must open a separate beneficiary owner account to hold their investments.

Investors are not compelled to open an account with the same DP as their broker. Even if an investor has an account with another DP, they can carry out standard business transactions with their broker without a loss of operational efficiency. However, it's possible that opening an account with the broker's DP may offer

advantages, as some DPs may provide a special fee structure if the broker and their clients deal through them. To open an account, individuals must:

Complete an account opening form available with the DP.

Sign the DP-client agreement, which defines the rights and responsibilities of both the DP and the account holder.

Receive a client account number (client ID). This client ID, along with the DP ID, provides a unique identification in the depository system.

In a depository account, transactions are conducted through dematerialization (Demat) and rematerialization (Remat). These two, along with other related concepts, are discussed below.

i) Dematerialization (Demat)

Dematerialization, commonly known as "Demat," is a process in which an investor's physical share certificates are surrendered to the company through a DP. The company verifies these certificates, and if they are in order, the dematerialization is confirmed. Subsequently, the equivalent number of shares is electronically credited to the investor's account. This process, as mandated by SEBI, must be completed within 15 days. Dematerialization is also referred to as "immobilization" of securities, wherein physical existence of security certificates is abolished, and they are converted into electronic holdings.

ii) Rematerialization (Remat)

Rematerialization is the process of converting an investor's electronic holdings back into paper share certificates. This process is also conducted through a DP and must be completed within 30 days. After dematerialization, an investor has the option to switch to rematerialization, allowing them to regain physical possession of security scrips. The client of the DP must submit a request for rematerialization, which is then processed by the depository, registrar, and transfer agents. Once the process is complete, the investor receives the physical certificates.

iii) Fungibility

In the depository system, physical forms of securities lose their relevance, making securities "fungible." Previously, the Companies Act, 1956, required each specific physical security to have a distinctive number when issued or transferred. However, the concept of distinct numbering was removed by deleting section 83 of the Companies Act, 1956. Consequently, certificates no longer carry distinct numbers and become part of a "fungible mass." Dematerialized shares lack distinctive or certificate numbers, making them fungible. This means that a certain number of shares of a security are interchangeable with an equivalent

number of shares of the same security. All certificates for the same security become interchangeable, and the ownership is no longer associated with a specific certificate, similar to currency notes.

Each security held in dematerialized form is assigned a unique identity in the form of an International Securities Identification Number (ISIN), which is a 12-character long identification mark.

iv) Delivery vs. Payment

Having a depository for securities is not enough; the concept of "Delivery versus Payment" (DVP) must also be considered. DVP involves the simultaneous exchange of securities for funds between parties in a trade. While the depository system can handle the accounting of securities through book entry, the funds aspect needs to be managed by the banking system. Therefore, these two systems must be integrated to enable DVP. In India, DVP is contingent on having an efficient electronic funds transfer system, as the current payment systems are not yet fully upgraded, necessitating a significant improvement in interactions among various banking institutions.

3.4 SWITCHING OVER TO DEPOSITORY

Having briefly discussed the structure, components, and participants of the depository system, let's delve into the stages involved in transitioning from a scrip-based system to the depository system.

i) Selection of Depository Participant (DP)

Any investor looking to conduct transactions through the depository system must engage a depository participant (DP). This can be done by approaching a DP of the investor's choice and opening an account with them, similar to opening a bank account. The investor is then assigned a unique identification number known as the Client ID, serving as a reference point for all transactions with the DP.

Before dematerializing their holdings, every investor must enter into an agreement with the depository through a participant. This step is essential, whether the investor already possesses securities or is awaiting securities from a fresh issue. The investor can engage exclusively with the depository that accepts their securities in 'depository mode.' It's not mandatory for all eligible securities to be in depository mode or held by all depositories. The decision regarding whether to hold securities in the depository mode and, if so, with which depository or participant rests entirely with the investor.

ii) Submission of 'Demat' Request

After the agreement is established for dematerializing securities, and the account is opened, the investor submits an application to the depository participant using a form called the 'Dematerialization Request Form' (DRF), provided by the DP. The investor also surrenders their share certificates, duly canceled with the notation 'surrendered for dematerialization.' The DP will only accept certificates registered in the investor's name.

The request for dematerialization via the depository participants is sent to the depository through the connected depository network. Simultaneously, the DP submits the securities certificates to the issuing company or its Registrar of Transfer.

iii) Contacting the Company or Registrar of Transfer

The depository electronically informs the issuer or its 'Registrar and Transfer Agent' of the dematerialization request. The issuer or 'Registrar and Transfer Agent' is responsible for verifying the validity of the security certificates and confirming that the DRF was submitted by the individual recorded as a member in its Register of Members. Once the issuer or its Registrar is satisfied, they dematerialize the scrip and update their records.

iv) Confirmation of Dematerialization

Once the Registrar of Transfer or the relevant company is content with the dematerialization, they inform the depository of the completed dematerialization process, authorizing an electronic credit for that security in favor of the investor.

v) Crediting the Investor's Account

The DP credits the investor's account with the number of shares that have been dematerialized. The investor then holds these securities in electronic form. If a demat request is rejected, no such credit is given. Following the crediting of the account, the client receives the necessary information in the form of a statement, similar to a bank statement issued after bank transactions.

Option of Rematerialization

Investors also have the choice of converting their electronic holdings into share certificates by requesting the DP for a remat using a Rematerialization Request Form (RRF). Through a similar process, the company will issue new certificates to the investor for the shares being rematerialized.

3.5 IS DEPOSITORY SYSTEM BENEFICIAL?

The advent of the depository system is a clear indicator of the prosperity of the financial market, particularly the capital market. The depository system brings a level of order and discipline to the market. It is widely acclaimed for various reasons. One of the significant advantages is the speed at which depositories transfer benefits and rights to the transferee, thanks to its efficiency and automation. Additionally, the time lost in communication is minimal. This system helps prevent fraudulent encashment of dividend warrants and the loss of bonus or rights. Since the depository system is designed to be paperless, the physical exchange of share certificates is no longer necessary. This eliminates the risk of losing, damaging, stealing, or forging security certificates. Financial losses due to the loss of physical share certificates are a thing of the past.

The depository system offers benefits to all participants in the capital markets: the country, investors, intermediaries, and issuers. SEBI expressed its official expectations regarding the dematerialization of securities in the Annual Report 1996-97: "It is expected that as the network of depository participants and the proportion of securities dematerialized in the depository increases, the benefits of reduced risk and lower transaction costs will extend to the vast majority of market participants and lead to improved investor protection and services."

Advantages of the Dematerialized (Demat) System

Conducting transactions through the depository system offers several advantages over the traditional system of using physical share certificates. Some of the benefits include:

- Trading in the demat segment completely eliminates the risk of bad deliveries, reducing the associated costs and time required for rectification. This has led to a reduction in brokerage fees by several firms.
- In the case of transferring electronic shares, one saves on stamp duty (0.5%). Costs related to couriers, notarization, and the need for further follow-up with brokers for shares returned due to company objections are also eliminated.
- If share certificates are lost in transit or misplaced, the expenses related to obtaining duplicate certificates, such as indemnity bonds and newspaper advertisements (approximately Rs. 500), can be completely avoided in the demat form.
- Bonuses and rights can be directly credited to the depository account, eliminating the risk of loss in transit.

- Loans taken against demat shares may have lower interest charges compared to loans against physical shares, resulting in savings of about 0.25% to 1.5%. Some banks have already announced such benefits.
- RBI has increased the limit of loans against dematerialized securities used as collateral to Rs. 2 million per borrower, compared to Rs. 1 million per borrower for loans against physical securities.
- RBI has also reduced the minimum margin requirement to 25% for loans against dematerialized securities, whereas it's 50% for loans against physical securities.

The full-scale operation of the depository system, coupled with electronic funds payment and automated trading systems, has significantly altered perceptions about the safety of asset storage, risk management, market liquidity, and market credibility.

3.6 SELLING AND BUYING OF DEMATERIALISED SHARES

Trading in dematerialized securities closely resembles trading in physical securities. The primary distinction occurs during the settlement process, where, instead of physical delivery of securities, transfers are carried out through account adjustments. Investors cannot directly trade dematerialized securities with their Depository Participant (DP). Regardless of whether securities are held in physical or dematerialized form, trading on stock exchanges can only be conducted through a registered trading member (broker) of the stock exchange.

When an investor purchases securities from a stock exchange offering dematerialized securities, they may receive their delivery in dematerialized form. The option to deliver dematerialized shares in the physical segment is at the seller's discretion. If an investor intends to buy shares in electronic form, they must instruct their broker to purchase dematerialized shares from the stock exchange. After the order is executed, the investor must instruct their DP, using a provided standardized format, to receive the securities from their broker's clearing account.

Selling dematerialized shares on stock exchanges follows a procedure similar to that of selling physical shares. Under the depository system, instead of physically delivering shares to the broker, an investor instructs their DP to debit their account with the number of shares sold and credit the broker's clearing account. The DP requires a standardized delivery instruction format, which they provide.

Additional Services:

a) Pledging Dematerialized Shares: Dematerialized shares can be pledged, which is advantageous compared to pledging share certificates. When the loan is repaid, the investor can request the closure of the

pledge by instructing their DP through a standard format. The pledgee, upon receiving repayment and the request to close the pledge, will instruct their DP accordingly. Even locked-in securities can be pledged, and the pledgor remains the beneficial holder of those securities.

b) Initial Public Offerings: Credits for public offerings can be directly received in the demat account. Applicants for public issues conducted through the depository-eligible companies can specify the manner in which securities should be allotted. This involves mentioning their client account number and the DP's name and identification number. All allotments due to the investor will be credited to the required account.

c) Receipt of Cash/Non-Cash Benefits: In the case of corporate events such as rights, bonuses, or dividends, the depository provides client details with electronic holdings to the registrar as of the record date. The registrar calculates the corporate benefits for all shareholders, and the disbursement of cash benefits, like dividends and interest, is handled directly by the registrar. For non-cash benefits, the depository directly credits the securities entitlements in the depository accounts of clients who have opted for electronic allotment based on registrar-provided information.

d) Stock Lending and Borrowing: Securities in demat form can be easily lent or borrowed through the depository account. This process is facilitated through an approved intermediary with a special 'intermediary' account at a DP. Instructions for depositing or borrowing securities in electronic form are given to the DP through a standard format provided by the DP.

e) Transmission of Securities: Transmission of securities due to various legal reasons, such as death, lunacy, bankruptcy, or insolvency, can also be managed within the depository system. In the case of transmission, the claimant fills in a transmission request form supported by valid documents, using a form provided by the DP.

f) Freezing Account with DP: As a security measure, if an investor wishes to prevent any transactions in their account, they can advise their DP accordingly. The DP will ensure that the investor's account is completely frozen until further instructions are received.

Tax Considerations:

In the case of dematerialized holdings, the cost of acquisition and the period of holding for calculating capital gains tax are determined using the First In First Out (FIFO) method, as per an amendment to the Income Tax Act. The contract note serves as the proof of the cost of acquisition.

3.7 DEPOSITORY SYSTEM IN INDIA

In April 1996, the Governing Board of SEBI (Securities and Exchange Board of India) approved the draft of SEBI (Depositories and Participants) Regulations 1996. These regulations were officially announced by SEBI on May 16, 1996.

In 1996, the Indian government introduced the Depository Bill in the Lok Sabha to introduce paperless trading and to prevent issues like "bad delivery, theft, and forgery in share transfer and settlement."

The National Securities Depositories Ltd. (NSDL), promoted by entities such as the Industrial Development Bank of India, Unit Trust of India, and the National Stock Exchange, became the first registered depository in India. There was a significant debate regarding whether to have a central depository or multiple depositories. Ultimately, the multiple depository system was chosen because a single organization would not be capable of handling the extensive network required. To foster competition, the multiple depository system was deemed essential. Subsequently, another depository, the Central Depository Services Limited (CDSL), emerged in India. It received a certificate of commencement of business from SEBI on February 8, 1999. CDSL was established with the aim of providing convenient, reliable, and secure depository services at an affordable cost to all market participants. Leading stock exchanges such as the National Stock Exchange, Calcutta Stock Exchange, Delhi Stock Exchange, The Stock Exchange in Ahmedabad, among others, established connectivity with CDSL.

On November 29, 1996, a significant milestone was achieved in the Indian capital market. For the first time in the more than 100-year history of Indian stock exchanges, the National Stock Exchange witnessed trading in dematerialized securities of an Indian company, namely 'Reliance Industries.' The initial transactions were, as anticipated, at a premium compared to the prevailing price for physical delivery, owing to the advantages of quick settlement, clean deliveries, and exemptions from stamp duty. To enable shares of statutory bodies such as IDBI, SBI, UTI, public sector banks, and units of mutual funds to transact through depositories, the Government of India issued an ordinance to amend the Depository Act, ensuring the widespread adoption of the system.

The recent alterations in the functioning of the capital market have significantly enhanced its efficiency. Approximately 99% of settlements now take place via depositories. In addition to addressing issues like bad deliveries and paper-based transactions, this system has substantially reduced the time required for settlements. The Indian market has successfully achieved a T+3 settlement cycle through the efficient operations of NSDL and CDSL. As of May 2004, here are some noteworthy statistics regarding depositories in India:

Features	NSDL	CDSL
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DPs (no.)	216	220
Investors (lakhs)	53.53	6.71
Demat (qty- Crores)	8672	1428
Demat (Value Rs- Cr)	912812	103338
No. of Co.s (equity)	5311	4837

Operation of National Securities Depository Limited (NSDL)

NSDL, the first depository registered with SEBI in June 1996, is a collaborative effort by IDBI, UTI, and NSE. NSDL functions through a network of Depository Participants (DPs) who interact with investors. However, in compliance with the Depositories Act, NSDL is accountable to each individual investor who holds an account with the depository. It operates on a two-tier structure, where it manages the accounts of the DPs, who, in turn, manage the accounts of their clients. NSDL provides online software to DPs, granting them access to each account maintained by depository participants, enabling monitoring and control of their operations.

NSDL maintains online connectivity with registrars and transfer agents (R&T) of securities and conducts daily reconciliations of all account balances to ensure alignment between the number of issued and dematerialized securities in the depository. NSDL functions through DPs to perform various functions, including:

- a) Managing the withdrawal and surrender of securities to and from the depository.
- b) Maintaining investor holdings in electronic form.
- c) Effecting settlements of securities traded on the exchanges.
- d) Carrying out the settlement of off-market trades, i.e., trades not executed on the stock exchanges.

In addition to DPs, NSDL involves another organization, the National Securities Clearing Corporation Ltd. (NSCCL), responsible for the clearing and settlement system for its clearing members (CM) and investors to settle trades in the depository section. The process involves the following steps:

- i) The cycle of delivering and receiving securities in this market segment broadly mirrors the existing cycle for physical securities, from Wednesday to Tuesday, with the exception that both securities and funds are paid in and out on the same day, Tuesday.

- ii) In the physical segment, a seller delivers paper securities to their CM, who subsequently pays in such securities at the clearing house. In the depository segment, the seller instructs their DP to transfer securities from their DP account to the CM's pool account with the DP.
- iii) Before the specified pay-in time by NSCCL, the CM instructs their DP to move the necessary balance from the pool account to the delivery account.
- iv) NSDL transfers the balances from the CM's delivery accounts to NSCCL's settlement account within the depository, following the pay-in schedule for depository securities.
- v) Payout is received from NSCCL into the CM's account, from where the CM instructs their DP to distribute the securities to the buyers.

NSDL also offers stock lending and borrowing facilities to investors, subject to lending and borrowing regulations. Investors can receive corporate benefits through NSDL, with cash benefits like dividends and interest distributed by registrars, and securities entitlements managed by the depository based on registrar-provided information.

The NSDL fee structure is as follows:

i) Depository participants

Some of the important fee heads and charges are as under:

NSDL's Fee Structure	
Fee Type	Rate of Fees
Custody fee company	Rs. 6 per annum per total holding In a I
Transaction fee	Rs.10 per transaction (charged to seller only)
Pledge creation	Rs.25 per instruction
Securities borrowing	Rs. 25 per instruction
Rematerialisation	Rs. 10 per certificate
Dematerialisation	No charges
Security deposit	Rs. 10 lakh
Registration fee	Rs. 1.5 lakh

ii) Issuers and registrars

No charges apply

iii) Investors

Depository Participants (DPs) levy various fees on investors for services like opening accounts, closing accounts, dematerialization (Demat), rematerialization (Remat), custody, and market transfers (sale or

purchase). Some DPs may also request security deposits. Currently, these expenses are dissuading small investors from engaging with the depository. Moreover, the psychological fear of not having physical share certificates is also deterring investors from using depository services.

Sample Charges Imposed by DPs on Investors:

- a) Advance deposit of Rs. 1200 (valid for 2 years) and an annual account maintenance fee of Rs. 600.
- b) Transaction charges of 0.04% (Minimum Rs. 20) plus NSDL settlement charges.
- c) Transaction charge of 0.04% (Minimum Rs. 20).
- d) Rs. 15 per transaction plus NSDL settlement charge.
- e) Transaction charges of Rs. 60 for a value up to Rs. 1 lakh and 0.02% for a value exceeding Rs. 1 lakh.
- f) Account maintenance fees based on different tiers.
- g) Account maintenance fees vary among DPs, ranging from zero to Rs. 450 per annum, with the most common range being Rs. 200 to Rs. 300.
- h) Some DPs may require security deposits.
- i) Certain DPs may employ a cross-selling strategy, offering discounts to favored customers through their associated businesses.

iv) Companies

Companies desiring to dematerialize their securities need to invest between Rs. 20 lakh and Rs. 25 lakh to establish connectivity with the exchange. This amount is essentially an infrastructure investment rather than a fee.

3.8 TECHNOLOGY AND DEPOSITORY

After going through this lesson up to this point, it becomes evident that the concept of depositories is inseparable from technology. Depositories execute their functions through various intermediaries such as Depository Participants (DPs), issuing companies, Registrars and Transfer agents, and clearing houses. These depositories are electronically interconnected with these stakeholders via a satellite link. The regulations established by SEBI for depositories are also heavily reliant on technology. To enable seamless transfers between investors holding accounts in the two existing depositories in the country, the Securities and Exchange Board of India has mandated that all stock exchanges establish links with these depositories. SEBI has also instructed companies' registrars and transfer agents to promptly update registered ownership records within two hours of receiving a transfer request from the depositories.

The stock exchanges, once connected to both depositories, are also responsible for ensuring the smooth functioning of inter-depository transfers. This requires both depositories to establish connectivity with each other, and the National Securities Depository Limited (NSDL) and Central Depository Services Limited (CDSL) have signed an agreement for inter-depository connectivity. All of these critical operations are only possible through the utilization of technology.

The use of the internet offers user-friendly features and enhances control over the settlement process. Both depositories have effectively harnessed technology for the benefit of investors and to foster an investment culture in India.

Within NSDL, a Very Small Aperture Terminal (VSAT) serves as a crucial link, and its comprehensive integrated system is referred to as NEST (National Electronic Settlement & Transfer). To ensure uninterrupted services, NSDL maintains a three-level backup system:

Machine-level backup: The IBM mainframe at "Trade World" (NSDL's Mumbai office), where data is processed, has redundant components in its configuration. It includes a standby central processing unit (CPU) that can take over in case of the main system CPU failure. Data is protected with a redundant array of independent disks (RAID) setup, preventing data loss in case of a single-point failure. Network components like routers and communication controllers are equipped with online redundancy, preventing transaction loss in case of a failure.

Disaster backup site: NSDL has established a disaster backup site located about 175 km away from Mumbai. This site is equipped with an identical computer setup to the mainframe, ensuring uninterrupted operations even in the event of a disaster.

Backup in case of power failure: To ensure power continuity for the main systems, dual uninterrupted power supplies (UPS) are in place for the IBM mainframe and related components. These UPS units work in tandem, and if the primary UPS fails, the secondary UPS takes over instantaneously. Additionally, a backup diesel generator is available to prevent any interruption in operations due to power failure.

To safeguard investors, SEBI mandates that participants who maintain electronic records ensure the integrity of data processing systems at all times and take necessary precautions to prevent data loss, destruction, or tampering. If an investor loses their statement of holdings, they can inform their DP and obtain a duplicate statement. However, the loss of a statement of holdings does not impact the actual

holdings, which remain intact. Details of depository accounts are confidential, and strict systems and procedures are in place to protect investor information, ensuring it is accessible only to authorized individuals.

Information Technology and CDSL Schemes

i) easi - Electronic Access to Securities Information:

easi is a user-friendly service that allows Beneficial Owners (BOs) and Clearing Members (CMs) to access their demat accounts through an internet-enabled PC. They can obtain information about their holdings and transactions 24/7, seven days a week via CDSL's website, www.cdslindia.com. This service grants BOs and CMs real-time access to their demat accounts, eliminating the need to contact their DP for statements of account. easi also provides portfolio valuation, offering a convenient way for BOs to monitor their holdings and make informed decisions. BOs can utilize easi if their DP is registered for this facility. The registration process for easi is simple and can be completed on the CDSL website.

BOs can use easi for:

- a) Viewing, downloading, and printing details of holdings and transaction status on an almost real-time basis.
- b) Obtaining the valuation of holdings as of the previous day's closing price on the Bombay Stock Exchange (BSE).
- c) Printing or downloading statements of account as needed.

easi also generates an overdue report for CMs, allowing them to monitor the pay-in of securities. CMs can view the overdue status of pay-in instructions provided by clients and monitor client-level payouts through easi.

ii) easiest - Electronic Access to Securities Information and Execution of Secured Transactions:

easiest is another internet-based scheme that enables CMs and BOs to submit debit/credit transaction instructions for off-market, on-market, inter-depository, and early pay-in transactions. Subscribers to easiest also gain access to all the facilities and benefits offered by easi.

3.9 LEGAL SET UP FOR DEPOSITORIES IN INDIA

Safeguarding the interests of investors is a matter of utmost significance for SEBI, and to this end, it regulates the provisions of the Depositories Act, 1996. This statute serves as the guideline for depository operations in India. According to this Act, a depository must be a corporate entity and obtain a Certificate of Commencement of Business from SEBI. The Act outlines the Rights and Obligations of depositories, participants, issuers, and beneficial owners. Some key provisions include:

- A depository is required to enter into an agreement with one or more participants to act as its agents.
- All securities held by a depository must be in a fungible form.
- A depository is recognized as the registered owner of securities for facilitating transfers of ownership on behalf of beneficial owners. Beneficial owners are entitled to all rights and benefits pertaining to their securities held by a depository.
- Beneficial owners, with prior notice, can pledge or hypothecate securities held within the depository.
- Depositories are obligated to provide necessary information to beneficial owners and issuers.
- Depositories are responsible for indemnifying beneficial owners for any losses incurred due to the negligence of participants.
- Depositories are authorized to establish bylaws for related matters with prior approval from SEBI.

3.10 Exercise

Answer the following Questions:

Q1 Identify and state the similarities between depository account and bank account?

Q2 What is dematerialisation?

Q3 What do you understand by Fungibility of securities?

Q4 List four major reasons for emergence of depositories

Q5 List five DPs operating in India

Q6 List five important benefits of demat.

Q7 Briefly discuss the followings in relation with depositories:

- Pledging of securities,

- Stock lending,
- Transmission of securities.

Q8 Discuss the need of Depository System in a financial system.

Q9 Discuss the process of dematerialisation

Q10 What type of records are maintained by DPs?

References:

Khan M.Y, Indian Financial System, Tata McGraw Hill

SEBI : SEBI (Custodian of Securities) Regulations, 1996.

SEBI (Depositories and Participants) Regulations, 1996.

M.COM SEMESTER-III

Course: MANAGEMENT OF FINANCIAL SERVICE (MCMM22301T)

UNIT III: Fee Based Services I

(Chapter 4)

Issue Management

Structure

- 4.1 Introduction
- 4.2 Issue Management
- 4.3 Issue Manager and SEBI
- 4.4 Selecting Public Issue Proposal
- 4.5 Public Issue Management
- 4.6 Marketing the Issue
- 4.7 Pricing of Issues
- 4.8 Book Building
- 4.9 Safety Net Scheme or Buy Back Arrangement
- 4.10 Issue of Debt Instruments
- 4.11 Exercise

OBJECTIVES

- Discuss the process of fund raising through issue management ;
- Explain the pre-issue and post- issue management activities; and
- Discuss the legal environment for issue management.

4.1 Introduction

Both existing and new businesses acquire funds through a variety of channels to support their projects. One of the methods for obtaining funds involves the issuance of securities to raise capital. This can be accomplished through three distinct approaches:

Public Issue: The most commonly used means of raising funds from the general public is referred to as a public issue. In a public issue, a company issues a prospectus offering a specific number of shares at a predetermined price, which may be at par value or a premium, based on market demand (using the book

building mechanism). The prospectus is required to provide comprehensive information about the company to potential share purchasers. The Securities and Exchange Board of India has established guidelines to ensure that there are adequate disclosures in the prospectus, enabling investors to make well-informed investment decisions.

Right Issue: Right issues involve the issuance of new shares, granting existing shareholders the preemptive right to subscribe to these new shares. The number of additional shares offered is proportional to the capital already paid-up on the shares they currently hold at the time of the offer. Shareholders who receive this offer are not obligated to accept it; they have the option to transfer this right to another party. Right shares are often offered on favorable terms to shareholders, such as issuing shares with a face value of Rs. 10 at par value, even if the market price of the shares at the time of the offer is Rs. 15 or more.

Private Placement: Private placement is the direct sale of securities by a company to investors. It does not involve the issuance of a prospectus. Private placement encompasses shares, preference shares, and debentures. It is assumed that investors engaging in private placement possess the knowledge and experience required to evaluate the advantages and risks of their investment. Financial intermediaries play a crucial role in preparing an offer memorandum and negotiating with investors in private placement transactions. This method offers the benefits of speed and confidentiality. Private placement allows companies to access capital more swiftly compared to public issues, which can take six months to a year. Additionally, private placement is more cost-effective due to the absence of various mandatory and non-mandatory expenses associated with the primary market. Small public companies that cannot afford a public issue often opt for private placement. Moreover, the requirements of companies may be smaller than those stipulated for listing on different stock exchanges via a public issue. Finally, private placement is less influenced by the prevailing bull or bear market phases compared to the primary market. Institutional investors tend to have a more stable and continuous attitude towards the regular issuance of securities in the private placement market.

4.2 ISSUE MANAGEMENT

Issue management pertains to the oversight and administration of corporate securities, including equity shares, preference shares, debentures, or bonds. It encompasses the marketing of capital issues, both for existing companies (such as rights issues and share dilution through a letter of offer) and other financial matters. The process of issue management also involves several critical aspects. The decisions regarding the size and timing of public offerings in response to market conditions are typically guided by merchant bankers. Additionally, merchant bankers offer guidance to corporate entities on devising a robust capital structure that meets the approval of financial institutions, determining the amount and terms of public

offerings for various types of securities. They also advise the issuing company on whether to pursue a fresh issue, additional issue, bonus issue, right issue, or a combination of these strategies. In summary, managing public offerings is a complex and technical task that requires making strategic decisions and coordinating various stakeholders.

The management of public offerings involves the collaboration of various entities, including underwriters, brokers, banks, advertising agencies, printers, auditors, legal advisors, and registrars to the issue. Merchant bankers, operating at the highest level, take on the role of planning, coordinating, and supervising the entire offering process, directing various agencies to ensure the successful marketing of securities.

Issue management offers significant potential and opportunities in a growing economy where the capital market plays a crucial role in meeting the funding needs of industries. In the capital market context, issue managers are commonly referred to as merchant bankers or lead managers. While the term "merchant banking" encompasses a broad range of services such as project consultation, portfolio management, investment advice, mergers and acquisitions, and more, issue management is perhaps the most substantial and vital function within this domain. In fact, the terms "merchant banking" and "issue management" are often used interchangeably.

The importance of issue management for a merchant banker is evident in the definition of a "Merchant Banker" according to the Securities and Exchange Board of India (Merchant Banker) Rules & Regulations, 1992. It defines a merchant banker as a person engaged in the business of issue management, which includes arranging the sale, purchase, or subscription of securities, serving as a manager, consultant, advisor, or offering corporate advisory services related to issue management.

4.3 ISSUE MANAGER AND SEBI

Issue Managers must be registered with SEBI to carry out their activities in Issue Management, a requirement that has been in place since SEBI's establishment. SEBI has established Rules and Regulations for merchant bankers, which outline the prerequisites for registering issue managers and set standards for their professional conduct. In accordance with these regulations, issue managers are primarily obligated to meet the following conditions for registration:

1. The issue manager must be a corporate entity, not classified as a Non-Banking Financial Company as defined by the RBI.

2. They should possess the necessary infrastructure, including sufficient office space, equipment, and personnel, to effectively carry out their responsibilities.
3. The issue manager must employ a minimum of two individuals with the experience to conduct Merchant Banking activities.
4. They must meet the capital adequacy requirements, specifically maintaining a minimum net worth of Rs. 5 crores.
5. The issue manager should hold professional qualifications from a government-recognized institute in Law, Finance, or Business Management.

According to SEBI guidelines, a public or rights issue cannot proceed without the involvement of a Merchant Banker. Much like the pilots of aircraft, Merchant Bankers possess specialized skills necessary for managing financial issues, making them essential guides in this process. They act as financial architects, particularly in areas related to capital structuring, gearing, and financial planning for the company. In performing these functions, Merchant Bankers serve as financial architects.

They also act as investors and underwriters, underwriting and investing in the issues they manage. Companies often view issue managers as their partners, as Merchant Bankers may also serve as market makers in the issues they lead. They invest in, hold, and provide buying and selling quotes for the company's securities after listing. In this role, their association extends beyond issue management, resembling a partnership with the company.

Under SEBI guidelines, every Merchant Banker managing a Capital Issue is required to conduct Due Diligence and provide a Due Diligence Certificate to SEBI in a specified format. The Association of Merchant Bankers of India (AMBI) has defined a comprehensive due diligence guide for its members to aid in their due diligence process. While managing issues, they are obligated to interact with SEBI and submit offer documents. They are also required to file various reports related to the issues they oversee with SEBI. In essence, the Merchant Banker's role revolves around SEBI during issue management, making them akin to a satellite of SEBI.

Analogously, a Merchant Banker, when managing an issue, plays the role of Zubin Mehta, the renowned conductor, as they need to coordinate with numerous institutions and agencies. Much like a conductor of an orchestra, the Merchant Banker ensures that all stakeholders complete their tasks in a timely and coordinated manner to produce the desired outcome effectively.

The marketing of an issue represents a critical and perhaps the most vital aspect of Issue Management. The Merchant Banker makes a multitude of promises and commitments to prospective investors, effectively assuming the role of a dream merchant. According to SEBI Guidelines, any Public or Rights Issue exceeding Rs. 50 lakhs in size must be managed by a registered Merchant Banker. Since SEBI's inception, Issue Managers have been required to register with SEBI, and SEBI's 1992 Regulations for Merchant Bankers have established the rules, regulations, and codes of conduct governing their activities. These regulations also restrict the number of Issue Managers who can be associated with a particular issue.

4.4 SELECTING A PUBLIC ISSUE PROPOSAL

Before opting for a Public Issue proposal, the Merchant banker needs to take into account several key considerations:

Background of the Promoters/Management: The success of a company is greatly influenced by the background of its promoters and management. This includes factors such as their educational qualifications, business/technical expertise, financial capabilities, and reputation. The Merchant banker assesses the history of the group or existing company launching a new venture, particularly if they have a track record of success. Additionally, the performance of the group's associated businesses or holding company is scrutinized to see if they have fulfilled their promises made during previous public offerings. Financial strength in the group/associated concerns can also bolster investor confidence. It is crucial to investigate any pending litigation, defaults, or disputes involving the promoters with individuals, banks, or institutions.

Company Profile: The Merchant Banker must evaluate the company's history, the quality of its management, the industry it operates in, its product portfolio, and the business prospects of the proposed product. The profitability and sustainability of the project are assessed, and the financial health of the company is determined by examining its existing capital structure, debt-to-equity ratio, and various resources and provisions.

Project Profile: It is essential to ascertain whether the project has undergone evaluation by a Financial Institution and whether any financial institutions are participating in its financing. The involvement of an Institution in the project's appraisal and funding provides a level of certification regarding the project's viability.

Capital Market Position: If the group or associated concerns are already listed on stock exchanges, the Merchant Banker analyzes the pattern of their share price movements. The trading behavior of shares in

leading companies within the same industry is compared to the share quotations of group companies to assess share price stability.

Other Important Factors: Several additional factors influence project selection, including the general outlook of investors toward similar companies in the industry that are already listed, particularly those within the same group. The response of investors to previous Public Issues from similar companies also plays a role in decision-making. Additionally, the payment schedule for dividends from the Company and its associated concerns is considered. From the Merchant Banker's perspective, conducting a cost-benefit analysis is crucial before accepting an assignment for issue management.

These considerations are fundamental in the process of evaluating and selecting a Public Issue proposal.

4.5 PUBLIC ISSUE MANAGEMENT

Issue managers play a crucial role in raising funds through the public issuance of securities. Whether through mechanisms like book building or other methods, their involvement is pivotal in ensuring the success of the issue. They are engaged in every aspect of the process, which is why companies seeking to raise capital through a new issue carefully assess the competence and capabilities of the merchant banker. These professionals offer invaluable services in preparing and drafting the prospectus, determining the issue's pricing, marketing and underwriting, coordinating the activities of various agencies and institutions involved in the process, handling legalities, deciding the basis of allotment, completing the allotment, dispatching share certificates or refund orders, and, finally, getting the shares listed on stock exchanges, sometimes even serving as market makers. SEBI (Securities and Exchange Board of India) has issued a series of circulars to merchant bankers, categorizing these activities into two main groups: Pre-issue activities and Post-issue activities.

A) Pre-Issue Activities:

Memorandum of Understanding (MoU): According to Regulation 18(2), before undertaking any issue management, the lead manager (merchant banker) must enter into a MoU with the company issuing the securities. This MoU outlines their respective rights, liabilities, and obligations concerning the issue. A draft MoU is provided, and the lead manager can make necessary additions to define their relationship. Importantly, neither party should reserve any rights that would reduce their obligations under relevant laws and regulations.

Obtaining Appraisal Note: Once the contract for issue management is awarded, an appraisal note is prepared, either in-house or by external appraising agencies like financial institutions or banks. This appraisal note sheds light on the proposed capital expenditure for the project and its funding sources. The capital structure is determined considering the project's nature and size.

Appointment of Other Intermediaries: The lead manager ensures that all intermediaries appointed are registered with SEBI. Before advising the issuer on appointing these intermediaries, the lead manager must assess their capabilities. When necessary, the issuer should enter into a MoU with the intermediaries. The lead manager ensures the appointment of bankers to the issue at mandatory collection centers, which should include locations where stock exchanges are established.

Inter-se Allocation of Responsibilities: When multiple lead managers are involved in an issue, their responsibilities are clearly defined. If there is under-subscription, the lead manager responsible for underwriting arrangements is held responsible for invoking underwriting obligations.

Preparing Prospectus: The lead manager is responsible for providing comprehensive disclosures in the prospectus, complying with SEBI's Guidelines for Disclosure and Investor Protection. The application form should contain specific details and instructions for applicants.

Submission of Draft Offer Documents: The lead manager submits the draft offer document to SEBI and the stock exchange(s) where the issue is to be listed. After a period of 21 days from the document's release, a list of complaints received and any document amendments are reported to SEBI.

Launching a Public Issue: Once all legal requirements and permissions are in place, the lead manager initiates the marketing of the issue, involving press conferences, broker meetings, newspaper advertisements, and mobilizing brokers and sub-brokers. Announcements in newspapers are made ten days before the issue opens. Additionally, a certificate confirming the promoters' contribution must be obtained from a chartered accountant.

B) Post-Issue Activities:

After the issue's closure, the lead manager manages post-issue activities. This includes the finalization of the Basis of Allotment, the dispatch of share certificates, and refund orders, among other responsibilities.

SEBI mandates post-issue reports to be submitted by lead managers, including a 3-day and a 78-day post-issue monitoring report. The lead manager is expected to keep SEBI informed about important developments related to the issues they manage.

To ensure compliance with all rules and regulations, merchant bankers must designate a Compliance Officer, who also monitors compliance with the SEBI Insider Trading Regulations, 1992. It's crucial for lead managers to address any non-compliance issues related to the appointment of whole-time qualified company secretaries as required by the Companies Act.

4.6 MARKETING THE ISSUE

The Importance of an Aggressive Sales Campaign

Simply adhering to statutory regulations is insufficient in today's competitive market. An aggressive sales campaign has become a necessity. Modern investors are inundated with advertisements across various media channels such as television, radio, newspapers, brochures, and direct mail. Consequently, it's imperative to develop a marketing strategy aimed at reaching and persuading potential investors.

Packaging and Marketing the Offering

To ensure a successful marketing campaign for an offering, the lead manager must first identify the target market segments, whether they are retail investors, wholesale investors, or institutional investors. Subsequently, the focus should shift to regions where the management anticipates the highest number of subscriptions. If a company primarily operates in a specific region, it is advisable to concentrate marketing efforts in that area where the company enjoys name recognition. Additionally, the current market sentiment must be assessed before launching an offering. Even a reputable company's offering may not attract a favorable response if the market is in decline. Pricing of financial instruments should be determined by evaluating investors' expectations for the offering, as pricing influences the design of the capital structure. The final instruments should be made more attractive by incorporating unique features, such as a safety net, appealing payment terms, multiple conversion options, or attached warrants.

Mobilizing Underwriters, Brokers/Sub-Brokers, and Fund Arrangers

Efforts should be made to mobilize underwriters, brokers/sub-brokers, and fund arrangers to ensure the success of the offering. Simultaneously, the offer document should be educational and purposeful for retail

investors, providing relevant information required by regulations and otherwise. Institutional investors and high-net-worth individuals should receive in-depth research on the project, highlighting its uniqueness and advantages over similar projects in the same field.

Launching a Marketing Campaign

A high-impact advertising campaign is initiated to promote the public offering. Careful selection of the advertising agency is crucial, with a preference for agencies specializing in capital offerings. Advertising themes should be finalized in line with SEBI guidelines. A mix of media vehicles, including press, radio, television campaigns, and billboards, should be utilized. The lead manager should also organize press briefings, broker and investor conferences, especially in targeted regions.

Market Research and Investor Education

Certain market research organizations excel in conducting opinion polls by surveying a wide range of people in various regions. These organizations can be employed to gather data on investors' opinions and reactions regarding the public issue and the specific company. There is significant potential among investors in semi-urban and rural areas, who can be cultivated into a substantial investor base. Educating these individuals about the various investment opportunities is essential.

Brokers' and Investors' Conferences

As part of the issue campaign, brokers' and investors' conferences are arranged in metropolitan cities and other significant centers with substantial investor populations. Thorough planning is essential to ensure the success of such conferences. Conference materials like banners, brochures, application forms, and posters should be delivered to the conference venue on time. Invitations should be extended to key stakeholders, underwriters, and bankers in the respective regions, as well as investors' associations.

Timing of the Offering

The timing of the public issue is one of the most critical factors influencing its success. Unfavorable market conditions can result in under-subscription, even for an excellent company with a strong track record and appropriately priced shares. Additionally, an oversaturation of issues in the market simultaneously can

impact the success of a public offering. Therefore, the merchant bankers need to carefully consider the timing of the issue, taking into account various factors.

4.7 PRICING OF ISSUES

The June 1992 guidelines for capital issues, established by the Securities Exchange Board of India, have ushered in a new era in the capital market, allowing for the free pricing of issues. Companies, in collaboration with merchant bankers, now determine the pricing of their issues. The success of an issue hinges on finding the right premium. If the premium is set too low, the issue is likely to be oversubscribed, whereas an excessively high premium may lead to undersubscription and eventual failure. When deciding on the premium, the merchant banker must consider two critical factors:

Qualitative Factors: These encompass various aspects such as the industry's prospects, the track record of the promoters, the company's competitive advantage in exploiting business opportunities, and the company's growth compared to industry standards.

Quantitative Factors: These factors include metrics like earnings per share, book value, the average market price over two or three years, the company's history of dividend payments, profit margins, the composite industry price-earnings ratio, and the company's future prospects.

In addition to these considerations, both the lead manager and the company must evaluate whether the market can absorb the premium on the issue. This assessment depends on the prevailing conditions in the stock market at the time of the issue. It's worth noting that, in the past, premiums were determined in accordance with the guidelines of the Controller of Capital Issues. However, with the adoption of free pricing and the discontinuation of the Controller of Capital Issues office, there has been a surge in issues offered at a premium.

4.8 BOOK BUILDING

Book building is a method utilized to promote a public offering of a company's equity shares. The term "book building" derives from the process of collecting bids from investors based on a specified price range. The final issue price is determined after the closing date for bid submissions. The issuing company appoints a lead merchant banker to serve as a book runner, responsible for preparing the draft of the offer document (without mentioning the price) and obtaining SEBI's approval. A syndicate, consisting of capital market intermediaries such as eligible brokers, merchant bankers, or even mutual funds, is appointed to underwrite the issue. This syndicate approaches investors to gather their bids, collecting demand for securities at

various price levels, which is then consolidated and passed on to the book runner. The book runner compiles these bids from different investors to create an order book, which displays the demand for the company's shares at different price levels, ultimately guiding the pricing of the issue.

Procedure for Book Building:

The lead manager is tasked with coordinating all activities among the various intermediaries involved in the issue/system. The prospectus and application form must disclose the names of the brokers appointed by the issuer company, along with the names of other intermediaries like lead managers to the issue and registrars to the issue.

The company must advertise the issue widely, including the salient features of the offer document.

During the subscription period, applicants can place orders to subscribe to the securities through brokers at stock exchanges with online systems. Brokers must accept orders from all clients who place orders directly through them, and they send the application form along with payment to the registrar to the issue or place orders through a stockbroker under the online system.

Brokers are required to collect completed and signed client registration forms from applicants before placing orders in the system.

Before placing an order on behalf of clients, brokers must collect a margin amount equal to 100% of the application money from their clients. This margin money is deposited in a separate bank account called an Escrow Account with the clearinghouse bank for primary market issues.

Brokers are responsible for daily data downloads/forwarding to the registrar to the issue during the subscription period. This data should include only valid orders, including those that are canceled. On the closing date of the issue, the final status of received orders must be sent to the registrar to the issue/company.

After the issue closes, the regional stock exchange, along with the lead merchant banker and registrars to the issue, ensures that the basis of allocation is finalized in a fair and proper manner. The allocation details are then sent to member brokers.

Upon receiving the basis of allocation data, brokers must promptly inform their clients/applicants of the allocation. Brokers should refund the margin money collected earlier to applicants who did not receive an allocation within three days of receiving the allocation.

On the pay-in day, brokers must deposit the amount collected from clients in the separate bank account opened for primary issues with the clearinghouse/bank.

Upon receipt of the sum payable on application for the minimum subscription amount, the company should allocate shares to the applicants. Allotment of securities must be completed within 15 days from the closure of the issue; otherwise, interest at a rate of 15% will be paid to the investors. For applicants who have applied directly or by post to the registrar to the issue and have not received an allocation, the registrar will arrange to refund the application money within the prescribed timeframe.

4.9 SAFETY NET SCHEME OR BUY BACK ARRANGEMENT

In this arrangement, merchant bankers extend a repurchase option to individual investors in case the share's market price falls below the issue price after it is listed. Historically, there have been instances where shares issued at a premium have dropped below the issue price in the market. In such situations, if an investor has the option of a buyback or a safety net provided by the merchant banker, they can choose to exercise it to mitigate their losses. Any such safety net or share buyback provisions in a public issue must be prearranged by the issuing company in conjunction with the lead merchant banker and disclosed in the prospectus.

These buyback or safety net provisions are exclusively offered to original resident individual allottees. The buyback or safety net facility is limited to a maximum of 1000 shares per allottee and must remain valid for a minimum of six months from the last date of securities dispatch. The financial capability of the party providing the buyback or safety net facility must be disclosed in the draft prospectus.

To protect investors, some companies conducting public issues at a premium have introduced a safety net scheme. To illustrate, two examples of public issues with safety nets are outlined below:

Godrej Soaps Ltd.: This marked the first time a public issue was presented with a safety net to safeguard investing individuals from potential losses due to a drop in the market price of a premium share. In April 1993, Godrej Soaps Ltd. initiated a public issue of Rs. 99.12 crores at a premium of Rs. 130 per Rs. 10 share, which was not open to institutional investors. The merchant bankers, Kotak Mahindra Finance Ltd.,

introduced an inventive offer to repurchase shares from individual investors if they chose to opt out of the issue post-allotment. The key features of the safety-net scheme included:

A cap on the total number of shares to be repurchased, set at 10 lakh shares or approximately 15 percent of the public issue.

The buyback option remained open for six months from the date of listing.

Ballarpur Industries Ltd.: Another issue in April 1993 that featured a safety net was from Ballarpur Industries Ltd., a company within the Thaper Group. The company issued 61,50,000 equity shares of Rs. 10 each with a premium of Rs. 165 per share. One of the lead managers, M/s. HB Portfolio Leasing Ltd., extended a safety net to investors. Salient aspects of this safety-net scheme included:

Open to all resident Indian individual original allottees.

Limited to individual investors, with institutional investors excluded.

Under this scheme, HB Portfolio Leasing Ltd. purchased fully paid equity shares allotted at a price of Rs. 175 per share from individual investors.

4.10 ISSUE OF DEBT INSTRUMENTS

A company has the option to raise capital through debt instruments, either via a public issue or a rights issue. The basic procedures and arrangements for this process are akin to those followed in equity issuances. Nevertheless, SEBI (Disclosure and Investor Protection) Guidelines 2000 have outlined specific provisions that pertain to debt instruments, and some of the key aspects are elucidated below.

a) Content in Offer Document: The offer document for such issues should include the following details:

The interest rate for debentures, which can be determined freely by the issuing company.

Premium amount for conversion, the conversion timeline.

In the case of PCDs/NCDs, details about redemption amount, maturity period, yield upon redemption.

Comprehensive information about the offer terms, including the party offering to purchase, non-convertible portion of PCDs (khokhas), the discount at which the offer is made, and the effective price for investors due to this discount.

The existing and projected equity and long-term debt ratio.

Details on servicing existing debentures, payment of interest on term loans and debentures when due.

b) Credit Rating Requirement: All public or rights issues of debt instruments, irrespective of their maturity or conversion periods, can proceed only if credit ratings are obtained and disclosed in the offer document.

For issues of Rs 100 crore or more, ratings must be obtained from two distinct credit rating agencies. All

credit ratings, whether accepted or not, should be disclosed in the offer document. Additionally, all credit ratings acquired during the three years prior to the issue for any listed security of the issuer company should also be disclosed.

c) **Debenture Trustees:** If the issue pertains to debt with a maturity exceeding 18 months, the issuer must appoint debenture trustees, regardless of whether the debentures/bonds are secured. The names of these trustees should be mentioned in the offer document. A trust deed should be executed by the issuer company in favor of the debenture trustees within six months after the issue's closure. The trustees should be endowed with the necessary powers to safeguard the interests of debenture holders. They also have the right to appoint a nominee director on the company's board in consultation with institutional debenture holders.

d) **Asset Securities and Ranking:** The offer document should specify the assets on which security will be created and their order of charge ranking. It should detail the security/asset cover to be maintained, the basis for its calculation, the valuation methods, and the periodicity of such valuation. The security should be established within six months from the debenture issue date. In cases where no charge is to be created for debentures with a maturity of less than 18 months, the issuing company must comply with the provisions of the Companies (Acceptance of Deposits) Rules, 1975, as unsecured debentures/bonds are regarded as "deposits" for regulatory purposes.

e) **Asset Encumbrances and Permissions:** When filing the draft offer document, merchant bankers must provide certificates from their banks confirming that the assets on which security will be created are free from any encumbrances. Additionally, they should have obtained the necessary permissions to mortgage the assets from financial institutions or banks, where these assets are encumbered.

f) **Letter of Option:** In specific cases, a letter of option containing disclosures about credit rating, debenture holder resolutions, conversion options, rationale for conversion prices, and other terms as prescribed by SEBI should be filed with SEBI through an eligible merchant banker. This is required in scenarios such as the roll-over of non-convertible portions of partly convertible debentures (PCDs) or non-convertible debentures (NCDs) and the conversion of PCDs/FCDs into equity capital.

g) **Roll-Over of Debentures/Bonds:** In cases of roll-over of non-convertible portions of PCDs or NCDs, an option must be provided to debenture/bond holders who wish to withdraw from the scheme. Roll over can only occur when debenture/bond holders have expressed their affirmative consent, not merely in the

absence of a negative reply. A fresh credit rating should be obtained within six months before the redemption due date and communicated to debenture/bond holders before the roll-over.

h) Fully Convertible Debentures (FCDs): Companies are not allowed to issue fully convertible debentures with a conversion period exceeding 36 months unless it includes both "put" and "call" options. If conversion takes place at or after 18 months but before 36 months from the allotment date, the debenture holder should have the option to convert, in part or in full.

i) Restrictions on Use of Funds: Issuing debentures for the acquisition of shares or providing loans to any group company is not permissible. This restriction doesn't apply to fully convertible debentures providing conversion within 18 months. The premium amount and the conversion timeline should be determined by the issuing company and disclosed. The interest rate for debentures is at the discretion of the issuer company.

4.11 Exercise

Answer the following Questions:

Q1 Give points of distinction between:

- i) Private placement and Public Issue.
- ii) Right issue and Public Issue.

Q2 Mention a few points that the lead manager should ensure before giving the pre- Issue advertisement.

Q3 Discuss the various sources from which funds can be raised by both existing as well as new companies for implementing their projects.

Q4 Describe in detail the important aspects of the pre-issue activities.

Q5 In the growing competitive market simply complying with the statutory regulations is not enough, for any company, it needs to have an aggressive sales campaign also. Comment.

Q6 Explain in detail the process used for marketing a public offer of equity shares of a company

Q7 Write a note on Safety Net Scheme or Buy Back arrangement

Q8 State the factors merchant banker considers while deciding the premium for an issue

Q9 In context of Book Building, write a note on:

- Syndicate
- Book Runner

Q10 What are the key requirements for the content of an offer document in the context of issuing debt instruments, as specified by SEBI (Disclosure and Investor Protection) Guidelines 2000?

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M.COM SEMESTER-III

Course: MANAGEMENT OF FINANCIAL SERVICE (MCMM22301T)

UNIT III: Fee Based Services I

(Chapter 5)

CORPORATE ADVISORY SERVICES

Structure

5.1 Introduction

5.2 Need For Corporate Advisory Services

5.3 Fund Raising

5.4 Project Counselling, Pre-Investment Studies and Appraisal

5.5 Loan Syndication

5.6 Corporate Restructuring

5.7 Capital Structuring And Restructuring

5.8 Liason With Foreign Collaborators And Making Preparation For Joint Ventures

5.9 Exercise

OBJECTIVES

- Explain the meaning and scope of corporate advisory services;
- Identify various corporate advisory services;
- Understand the technicalities of main corporate advisory services

5.1 Introduction

Corporate Advisory Services is a comprehensive term that encompasses specialized guidance provided to corporate entities, aimed at ensuring optimal efficiency and effective management of financial and other resources. These services also assist in revitalizing established businesses and ailing units while helping existing units identify opportunities for growth and diversification. The overarching goal of these services is to provide long-term support for businesses and address weaknesses in areas related to finance, business, and legal matters. When establishing a new company, the next crucial step is consulting professional corporate advisors to gain a holistic understanding of the business and preemptively address potential future issues.

Corporate advisors, who are typically independent experts, contribute to the operational success of a business through their techniques and practices. In most cases, Merchant Bankers are the primary providers of these services. Corporate advisory services are a significant component of the services offered by merchant bankers and can encompass a wide range of topics beneficial to corporate entities, including financial matters, regulatory changes, policy adjustments, and shifts in the business environment. Therefore, the scope of corporate advisory services is extensive, covering areas such as economic policy, investment and financial management, as well as corporate laws and related legal aspects.

5.2 NEED FOR CORPORATE ADVISORY SERVICES

As the global landscape evolves rapidly, the company is keen on capitalizing on essential opportunities to avoid missing out. These opportunities could involve exploring expansion prospects, forming strategic partnerships, pursuing profitable mergers and acquisitions, and other strategies to enhance its current position. Managing the transactions and formalities associated with such endeavors requires professional handling, often necessitating the involvement of a specialized intermediary. These experts facilitate a seamless process, allowing the company to achieve its goals efficiently. Given that a company may have numerous intricate business processes to manage, many of which occur on a daily basis, a significant portion of these transactions may have multifaceted implications, encompassing both business and legal aspects. Therefore, it is essential to devise effective structures that serve the company's best interests, a task that benefits from the experience and expertise of knowledgeable professionals. This is where corporate advisory services come into play.

Before embarking on a business plan in various areas of interest to the company, there may be a need for specialized guidance. Activities in such scenarios require expert handling and are not typically efficiently managed by just anyone. They demand professionals with specific expertise in the respective service areas. In response to the challenges posed by the evolving business environment, companies often find it necessary to restructure their operations. Professional firms, including company secretaries, chartered accounting firms, law firms, investment banks, and other financial institutions with merchant banking licenses, can provide valuable advisory services. These services encompass a wide range of areas, including business advisory, restructuring advisory, and project advisory. Companies value the expertise that investment banks bring to the table when addressing these issues, recognizing that such services have historically been the domain of professional advisers.

In today's tech-driven era, technology has significantly streamlined corporate advisory work, making the process more efficient than ever before. Automation has reduced the burden on human resources and increased the overall efficiency of the process. The following sections discuss some of the primary corporate advisory services in detail.

5.3 FUND RAISING

One of the primary services offered by merchant bankers is to facilitate the raising of funds through the issuance of corporate securities, such as equity shares, preference shares, debentures, or bonds, for both new and existing companies, including rights issues. These fundraising methods can involve public offerings, private placements, and bought out deals.

In the case of public offerings, various entities, including underwriters, brokers, banks, advertising agencies, printers, auditors, legal advisors, and registrars to the issue, play crucial roles in making the offering successful. However, the merchant banker takes the central role in planning, coordinating, and overseeing the entire offering process, directing different agencies to ensure the successful marketing of securities. This involves decisions about the size and timing of the public offering, securing underwriting support, liaising with stock market entities, financial media, and arranging for the collection of applications nationwide through designated banks. Additionally, the merchant banker assists in obtaining stock exchange clearances and listing the securities.

In contrast, private placement involves offering stock to individual investors, corporate entities, or a small group of investors. Typically, institutional investors like banks and pension funds, as well as high-net-worth individuals, participate in private placement through a prescribed offer-cum-application form. Private placement does not require the issuance of a prospectus. To be considered a private placement, the value of the offer per person must be at least Rs 20,000 of face value of the securities, with allotment and refund timelines specified. Companies must maintain records of private placement offers and submit them to the Registrar within 30 days of the offer. Appointing a merchant banker is not mandatory for private placement since it involves a direct sale to a limited number of sophisticated investors with less complex legal requirements compared to public offerings.

In cases where a public offering is not feasible for raising capital, a bought out deal can be an option. In a bought out deal, the company initially places shares with a merchant banker (bought out dealer or sponsor) who will later offer them to the public. This approach allows the underwriter or merchant banker to purchase shares at a discounted price and then resell them at the prevailing market value, offering an

opportunity for earning a return on the deal. The company and the sponsor agree on a mutually acceptable time frame for taking the securities public, and the shares are listed on one or more stock exchanges. Such shares can be sold on 'over the counter' or other stock exchanges at an opportune time.

Bought out deals have distinctive features, including the involvement of promoters, sponsors, and co-sponsors. Sponsors often form a syndicate with other merchant bankers to share resources and distribute risk. Factors such as project evaluation, the promoter's reputation, market sentiment, and prospects for selling shares in the future influence the sale of securities in a bought out deal. These deals require merchant bankers to lock up their funds for a specified period. Listing occurs when the company's performance improves, and the project generates increased cash flows. The Securities and Exchange Board of India stipulates that only private companies can choose this method of issuing securities.

Bought out deals offer a quicker and cost-effective means of selling securities and allow promoters to set realistic prices with the sponsor's agreement. They also provide enhanced investor protection, as sponsors are thoroughly evaluated by promoters before the issue is offered. However, there is a concern among closely held companies that sponsors may gain control of the company due to their substantial share ownership. Bought out deals can be challenging to execute in unfavorable market conditions, potentially resulting in locked-up investments and losses for the sponsor. Additionally, there is a risk of manipulation through insider trading in bought out deals.

5.4 PROJECT COUNSELLING, PRE-INVESTMENT STUDIES AND APPRAISAL

The initial step in launching a business venture is the selection of a viable project, a task often taken on by merchant bankers due to their extensive expertise in various fields. Project counseling encompasses a range of subsidiary tasks. The following is a list of services falling under this category:

Identifying potential investment opportunities.

Offering guidance on project viability, which may involve project identification and counseling for establishing new units, expanding existing facilities, or improving current operations.

Selecting Technical Consultancy Organizations to prepare project reports and conduct market surveys.

Merchant bankers may also engage in the preparation of project reports or market surveys themselves.

Negotiating with foreign collaborators and making all necessary arrangements.

Assisting clients in preparing applications for financial assistance from Financial Institutions/Banks.

Aiding clients in obtaining government approvals for foreign technical and financial collaboration agreements.

Specifying the procedural aspects of project implementation.

Assisting in securing government consent for project implementation.

Recommending a suitable capital structure, including both general and specific features.

Evaluating the techno-economic soundness of the project and its marketing aspects.

Preparing project reports from a financial perspective, including financial engineering to determine the right financing mix, especially for short-term requirements.

Establishing the organizational and management structure for a robust and efficient project operation.

It's important to note that counseling is primarily focused on offering opinions and suggestions, and any in-depth analysis falls under the purview of specific services. The scope of project counseling is limited to explaining concepts, procedures, and legal requirements for client companies. If specific actions or compliance with statutory formalities are required to implement these suggestions, a different type of service, distinct from project counseling, must be provided by the merchant bankers.

Pre-investment studies are primarily intended for prospective investors. These studies provide objective and detailed feasibility assessments, aiming to equip clients with a solid foundation of facts and figures for evaluating various capital investment opportunities in terms of growth and profit prospects. Such studies encompass a thorough examination of environmental and regulatory factors, raw material sourcing, demand projections, and financial requirements. They assess the financial and economic viability of a project, assisting clients in identifying projects that capitalize on inherent strengths to enhance corporate profitability and long-term growth.

Project appraisal is essential due to the scarcity of resources and the existence of various project alternatives competing for resource allocation. Project selection should be rational, superior to others in terms of commercial significance (net financial benefit to project owners), or significant to the nation as a whole. Various appraisals conducted as part of project appraisal include:

Financial Appraisal: This involves evaluating the feasibility of new investment proposals, such as establishing new projects or expanding existing facilities. The analysis estimates the direct benefits and costs of a project at prevailing market prices, focusing on project profitability. Financial analysis considers the project's financial aspects, including sources of financing, and encompasses liquidity and capital structure analysis.

Technical Appraisal: Technical appraisal assesses project concepts, covering technology, design, plant scope, and infrastructure elements. It ensures that a project is well-designed, appropriately engineered, and

adheres to accepted standards. It also takes into account the availability of raw materials and machinery selection in alignment with local conditions.

Economic Appraisal: Economic appraisal evaluates the impact of a project on economic aggregates. It considers a broad range of costs and benefits, expressed in monetary terms or estimable monetary equivalents. Economic appraisal includes cost-benefit analysis, cost-effectiveness analysis, and scoring and weighting. It aids in defining problems and finding solutions that offer the best value for money, facilitating effective project management and evaluation.

Effective economic appraisal enhances decision-making, project management, and accountability, ensuring better financial management and value for money. It is an essential aspect of sound financial practices and is crucial in the decision-making process.

5.5 LOAN SYNDICATION

Loan syndication, also known as loan procurement and project finance service, involves a process where a consortium of banks and lenders collaborates to fund various segments of a loan for an individual borrower. This becomes necessary when a borrower requires a loan amount that exceeds the capacity of a single bank to provide or falls outside the risk tolerance of a single bank. The loan syndicate is created to facilitate the financing of such large loans, with each lender in the syndicate contributing a portion of the loan amount, thus spreading the lending risk. One lender typically acts as the manager, often referred to as the arranging bank, overseeing the loan on behalf of the other lenders in the syndicate. The syndicate may include various types of loans, each with distinct repayment terms negotiated between the lenders and the borrower. The liability of each lender is limited to their portion of the total loan, with all terms and agreements consolidated into a single loan agreement.

In the loan syndication process, one of the key functions is to secure funding from both Indian and international banks and financial institutions, including raising rupee and foreign currency loans. This also involves arranging bridge finance and resources to cover cost escalations or overruns. Merchant bankers play a specialized role in preparing project and loan applications to secure both short-term and long-term credit from various banks and financial institutions for project financing and working capital requirements. They may also assist in managing Euro-Issues and raising funds abroad.

The primary advantage of syndicated loans is that the borrower does not need to negotiate loan terms with each lender in the syndicate individually. Instead, they only need to engage with the arranging bank to

determine the loan's terms. The arranging bank then handles the task of establishing the syndicate, enlisting other lenders, and discussing the loan terms with them, including their respective credit contributions.

Since a syndicated loan involves multiple lenders, it can be structured with various types of loans and securities, offering flexibility in terms of interest rates, such as fixed or floating rates, which can better suit the borrower's needs. Borrowing in different currencies can also protect the borrower from currency risks resulting from external factors like inflation, government policies, and regulations.

Loan syndication is a means for borrowers to access substantial financing for capital-intensive projects, such as large equipment leasing, mergers, and projects in sectors like telecommunications, petrochemicals, mining, energy, and transportation, among others. Single lenders may not have the capacity to provide funding for such extensive projects, making syndication a viable approach.

Additionally, the participation of multiple lenders in financing a borrower's project enhances the borrower's reputation in the market. Borrowers who have successfully serviced syndicated loans in the past build a positive reputation among lenders, making it easier for them to access credit from financial institutions in the future.

To summarize, the loan syndication process includes steps performed by corporate advisors:

- a) Estimating total project costs.
- b) Developing a financing plan that aligns with the needs of the promoters, financial institutions, banks, government agencies, and underwriters.
- c) Preparing loan applications for financial assistance from term lenders, financial institutions, and banks, including pre-sanction negotiations.
- d) Selecting the institutions and banks for participation in financing.
- e) Following up on term loan applications with financial institutions and banks and obtaining their satisfaction for their respective participation shares.
- f) Arranging bridge finance.
- g) Assisting with the completion of formalities for drawing term finance, including legal documentation and inter-se agreements prescribed by participating financial institutions and banks.
- h) Assessing working capital requirements and preparing the necessary applications for submission to banks, as well as negotiating for the sanction of appropriate facilities.

The need for syndication arises when a single institution may be unwilling to meet the entire debt requirement of a project, or when there is a shortage of funds available from one lender. Merchant bankers who provide credit syndication services help save time for the borrower.

The modus operandi of syndication begins with the borrower approaching several banks willing to syndicate a loan, specifying the loan amount and tenor. The syndicator then seeks potential participant banks who may join the syndicate and communicates the desire to the corporate borrower. After reviewing bids from various banks, the borrower selects the bank offering the most favorable terms. The syndicator can either provide a firm commitment or a best-efforts basis. Best-efforts means that the syndicator is not obligated to provide the loan but will make reasonable efforts to arrange it. The borrower signs a 'clear market clause,' preventing them from seeking a syndicated loan from other banks during the documentation phase. In the interim period, the syndicate manager invites participation from banks through telexes or by providing an information memorandum on the company. The information memorandum is akin to a prospectus but less detailed and calls for meticulous preparation. The participant banks decide whether or not to join the syndicate after reviewing the prospects. The syndicate manager then prepares a common document to be signed by all syndicate members and the borrowing company, outlining the agreement's details concerning tenor, interest rates, prepayment clauses, security, covenants, warranties, and agency clauses.

5.6 CORPORATE RESTRUCTURING

Corporate restructuring involves the process of modifying various aspects of a company. This reorganization can be initiated for a variety of reasons, such as enhancing the company's competitiveness, adapting to challenging economic conditions, or repositioning the corporation to embark on a new direction. Corporate restructuring becomes necessary when a company reaches a point where its original structure can no longer effectively handle the company's operations and overall objectives. Merchant bankers offer their specialized services in the realm of corporate restructuring.

When a company aims to expand or thrive in a competitive business environment, it must undertake a process of restructuring to leverage its competitive advantages. This restructuring can take the form of internal growth or external growth. In essence, corporate restructuring is the method through which a company can streamline its business operations and fortify its position to attain its desired goals. Corporate restructuring encompasses three primary areas: restructuring the business portfolio, financial restructuring, and organizational restructuring.

5.6.1 Restructuring Business Portfolio

Corporate portfolio restructuring involves modifying or redefining a company's focus in response to internal and external challenges with the goal of creating value for its shareholders. This strategy typically entails divesting at least one business from the company's portfolio, although it can sometimes involve complex combinations of entering and exiting businesses. It is a vital aspect of strategic management within the field of corporate restructuring. Large, diversified organizations often employ business portfolio restructuring. For instance, an organization may simultaneously pursue growth by acquiring new businesses, employ a stability strategy for certain existing businesses, and divest others.

Formulating a coherent organizational strategy in large, diversified companies can be quite intricate, as it necessitates coordinating multiple business-level strategies to achieve overarching organizational objectives. Business portfolio models are tools designed to assist managers in addressing this challenge. These models help in analyzing the relative positioning of each of an organization's businesses within its industry and understanding the relationships among all the organization's businesses. Business portfolio restructuring can be accomplished through various means, such as business alliances, joint ventures, mergers, takeovers, and foreign franchises.

Three crucial decisions are involved in business portfolio restructuring:

Business Retention Criteria: This decision focuses on identifying businesses that should be retained. The criterion for retaining a business often revolves around its distinctive competence, emphasizing areas where the company has a competitive edge over others and where it can effectively manage the bargaining power of customers, suppliers, the threat of substitutes, and regulatory environments. This criterion is further bolstered by the concept of core competence, which comprises the core skills built up by a firm over time.

Divestment Strategies: Decisions about business divestment depend on the retention criteria. Profitable businesses may be sold to suitable buyers at attractive prices, with the proceeds reinvested in the core business. Businesses with the potential for higher profitability may be hived off as joint ventures with equity and management control offered to partners. In cases where prospects are bleak, the business may be sold, or if a buyer is not found, it may be closed down.

Diversification Choices: Diversification involves branching out into new business opportunities to maximize resource utilization and expand into new market segments. This strategy is considered when the current product or market offers limited growth opportunities. Diversification can be high-risk due to the

inherent uncertainties associated with entering new markets, making corporate advisory services valuable in evaluating risks and assessing the likelihood of a profitable outcome.

Diversification can take various forms, including horizontal diversification (offering new products to the existing customer base), vertical diversification (expanding within the production cycle), concentric diversification (introducing new products within the existing technology and marketing system), and conglomerate diversification (launching products or services unrelated to current offerings to appeal to a new customer group).

5.6.2 Financial Restructuring

Financial restructuring involves the process of reorganizing a company's financial structure. Historically, it primarily concerned reshuffling the debt-equity mix, but now encompasses various financial actions such as share buybacks, preferential allotments, and issuing warrants. The main objective of financial restructuring is to design a capital structure that minimizes costs while maximizing returns for equity holders, all while maintaining the company's liquidity without compromising profitability. Companies undertake financial restructuring for various reasons, often prompted by significant business challenges, and as a means to avoid bankruptcy or liquidation. Financial engineering is a useful tool in this process, drawing on insights from multiple fields, including economics, mathematics, computer science, and financial theory.

Three fundamental aspects of financial restructuring are critical in response to changing business environments:

Creating Shareholder Value: Creating value for shareholders is a key focus of financial restructuring. It involves optimizing decision-making to drive increased sales and leverage profit growth. In a globalized capital market, with increasingly influential institutional investors and a focus on corporate governance, maximizing earnings per share (EPS) and price-earnings (PE) ratios has become essential. Management's role includes selecting the right industry and improving earnings quality, driven by superior products, efficient processes, strong brands, effective organization, and visionary leadership. Corporate directors are under pressure to regularly measure and report shareholder value creation, which demands internal control procedures to encourage "value managers" within the organization. Merchant bankers play a pivotal role in advising companies on these strategies, using their technical expertise.

Debt-Equity Mix: The proportion of equity and debt in a company's capital structure is a crucial consideration in restructuring. Debt instruments entail committed cash flows through interest payments,

making them less attractive for companies with limited cash inflows. On the other hand, equity instruments offer non-dilution of controlling power, making them more favorable for firms generating strong returns. The debt-equity ratio plays a pivotal role in corporate restructuring decisions.

Competitive Cost Structure: A competitive cost structure is vital for a company's success. It encompasses the costs or expenses required to achieve the business's objectives, including raw material purchases, production, and packaging. A well-analyzed cost structure helps in determining the product's pricing and competitiveness in the market. Evaluating cost structures also allows a company to compare its costs to similar offerings in a competitive market, giving the organization an edge in capturing market share and maximizing profits. Reducing costs through various efforts is a critical component of achieving a competitive cost structure.

In summary, financial restructuring is a multifaceted process that involves optimizing the debt-equity mix, creating shareholder value, and achieving a competitive cost structure. It is a response to internal and external challenges, and it can be driven by compulsion or as part of a company's financial strategy. Merchant bankers play a crucial role in advising companies on these financial restructuring decisions.

5.6.3 Organizational Restructuring

Organizational restructuring is essential to facilitate and enact the aforementioned financial and business restructurings. Without appropriate changes in the organization, the entire restructuring program becomes ineffective. These changes require the collaboration of employees at all levels for the restructuring program to succeed. Organizational redesign is imperative. Alongside business and financial restructuring, the human aspect of the organization also necessitates an overhaul. This pertains to both the physical and intangible aspects of the organization.

In the absence of competitive pressures, organizations tend to expand with increasing levels, designations, pay scales, and workforce. These imbalances hinder human productivity, creativity, and competitiveness. Consequently, the organizational structures and processes require modification. The organizational structure should be critically evaluated to ensure its agility in responding to emerging situations. Organizational processes need to be fortified to enhance communication, information sharing, empowerment, teamwork, and problem-solving.

While the right structure, compensation systems, and career development mechanisms are vital in a dynamic environment, a healthy organizational culture is essential to maintain competitiveness. The

nucleus of this culture comprises core values, which can be derived from meeting the expectations of multiple stakeholders, including customers, dealers, vendors, shareholders, employees, government, and the public. Some common core values encompass customer satisfaction and delight, fair dealings, value creation, and innovation.

5.7 CAPITAL STRUCTURING AND RESTRUCTURING

The capital structure of a business unit is funded through a combination of owned capital, which includes the promoter's contribution and share issuances, and borrowed capital. The net worth represents the owned capital and comprises equity shares and retained profits. Equity share capital, as the fundamental component of a company's capital structure, represents risk capital. Equity shareholders hold ownership in the company, enjoy voting rights, participate in the company's management decisions, and have a vested interest in the company's residual assets. It's important to note that equity shares do not carry a guaranteed right to dividends, as the management can choose to skip dividend payouts. The primary considerations in determining the capital structure are achieving an appropriate debt-to-equity ratio and minimizing the cost of capital.

i) **Debt-Equity Ratio:** The debt-equity ratio is a leverage metric used to assess a company's financial leverage. It quantifies the relationship between the total liabilities and the shareholders' equity of a company, indicating the extent to which the company relies on debt versus equity for its operations. An increase in the debt-to-equity ratio suggests that the company is relying more on borrowed funds, which can pose long-term risks. A higher debt-to-equity ratio can be advantageous if the cost of debt is lower than the cost of equity, as it can lower the firm's weighted average cost of capital (WACC). However, companies with high debt-to-equity ratios may face challenges in securing additional funding from alternative sources, which can pose financial risks. On the other hand, a low debt-to-equity ratio indicates that a company has sufficient equity capital and does not require additional debt to finance its operations. The ideal debt-to-equity ratio depends on factors such as the company's nature, industry, and financial considerations. Excessive debt is considered risky, and maintaining a healthy balance is essential to fund business growth without endangering the company's financial stability.

ii) **Financing Decisions and Cost of Capital:** The cost of capital represents the expected returns or benefits a company anticipates from undertaking specific projects or investments, such as constructing a new manufacturing facility. The capital structure and cost of capital are closely linked in terms of a company's financial well-being. A well-balanced combination of capital structure and the specific cost of capital employed assists in making informed decisions about investments, optimizing the utilization of long-term

resources, and selecting equipment that provides the most long-term value to the core business operations. Failing to align the capital structure and cost of capital with business activities in a productive manner increases the risk of operational failure.

5.7.1 Capital Restructuring

Capital restructuring involves altering a company's capital structure, typically in response to changing business conditions or as a strategy to secure funding for growth initiatives. This process is usually triggered by a crisis, such as shifting market dynamics, a hostile takeover attempt, or the threat of bankruptcy. Before implementing capital restructuring, a thorough assessment of the company's liquidity and capital structure is imperative. This involves conducting financial modeling and analyzing the valuation of financial statements. The primary objective is to enhance the financial health and operational efficiency of the business to make it more attractive to investors. When executed effectively, capital restructuring can enhance the company's reputation in the market, thereby encouraging prospective, existing, and former customers to engage more with its products and services. It is essential to evaluate the current capital structure of the business to determine whether structural changes are genuinely warranted. Once the reasons for restructuring are identified, it becomes easier to determine the specific changes needed to maximize the benefits.

In practice, capital restructuring may encompass a thorough examination of the client company's capital structure to assess the extent of capitalization. If the capitalization involves issuing bonus shares from reserves, capital restructuring will involve preparing a comprehensive memorandum to ensure compliance with legal requirements regarding the extent of capitalization from reserves. In cases where the company possesses surplus capital, a proposal for share buybacks may be formulated. The process may also extend to recommending mergers, takeovers, and amalgamations aimed at modernizing and diversifying existing production systems and units. The primary focus in capital restructuring is on analytical aspects, aiming to recalibrate capital structure ratios, asset restructuring ratios, and debt service coverage, ultimately impacting the client corporate unit's capacity to generate funds.

Capital restructuring, like other business processes, demands meticulous attention to detail, the ability to anticipate and comprehend market shifts, and the proficiency to leverage this information effectively. Merchant bankers with extensive experience in this field can provide valuable services. A successful capital restructuring can position the business more favorably for growth, providing support during slow periods and helping maintain productivity during challenging circumstances. The primary goal of restructuring is to

bring about substantial changes in the current structure, operations, or debt of the company as a means of improving the overall business and mitigating or reducing financial challenges.

5.8 LIAISON WITH FOREIGN COLLABORATORS AND MAKING PREPARATION FOR JOINT VENTURES

Foreign collaboration, also known as a joint venture, refers to an agreement between two companies from different countries or two nations aimed at mutual cooperation and assistance. It involves a form of partnership established at the international level between countries. Before entering into a foreign collaboration, both entities must obtain prior approval from the domestic country's government authorities. Following the necessary approvals, the collaborating parties, including the resident and non-resident companies, come to a mutual agreement to form an alliance.

Collaborations can encompass various aspects of business, depending on the parties' preferences. They may involve foreign investment collaborations, where the foreign company provides financing through various means. This can include purchasing shares in the host country and receiving dividends on the held shares, providing long-term loans with interest, or extending credit facilities to the domestic company for procuring raw materials and other resources.

Another form of collaboration is technical collaboration, which focuses on transferring technology to the host country to bridge technological gaps between the collaborating parties. In such cases, the foreign company imparts technical expertise, know-how, and professional services, which are particularly popular in developing countries.

Marketing collaboration is yet another type of collaboration, involving the inflow of goods and services into the host country, potentially boosting exports. In this scenario, the foreign company engages in trading domestic company's goods and services, either within their home country or on a global scale.

Merchant banks and advisors play a crucial role in identifying potential foreign collaboration and joint venture partners abroad. They provide guidance on various aspects such as local laws, product risks, government regulations concerning shareholdings, exchange rates, taxation, dividends, incentives, subsidies, and more. Additionally, they offer assistance in negotiating foreign financial and technical collaboration agreements, ensuring alignment with government policies, rules, and regulations. These advisors also help in establishing corporate ventures in India in partnership with suitable foreign entities.

When an Indian company intends to form a partnership with a foreign company, both parties enter into a Joint Venture Agreement. This agreement encompasses terms related to confidentiality, non-disclosure of information during the negotiation phase of the joint venture.

5.9 Exercise

Answer the following Questions:

Q1 Discuss the need for Corporate Advisory Services. List these services.

Q2 What are Corporate Advisory Services? Explain the main Corporate Advisory Services provided by any such agency of your choice.

Q3 Why there is a need of Corporate Restructuring? Explain the major areas of Restructuring.

Q4 Write short notes on: a) Loan syndication and 2) Project appraisal

Q5 What is foreign collaboration, and how can it be defined?

Q6 Write a note on Various appraisals that are carried out as a part of project appraisal

Q7 What is loan syndication, and why does it become necessary in the world of lending?

Q8 How do merchant bankers contribute to the loan syndication process, and what are their roles in securing project financing?

Q9 What are the key aspects of corporate portfolio restructuring, and why is it particularly complex for large, diversified organizations?

Q10 Can you explain the three important decisions involved in business portfolio restructuring and how they impact a company's strategic direction and growth?

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UNIT – 4 Chapter 6 Credit Rating

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6.0 INTRODUCTION

Credit Rating reflects the payback abilities of individuals or companies. Indian credit rating industry mainly comprises of CRISIL, ICRA, FITCH, CARE, ONICRA, and SMERA. Companies, financial institutions, public sector enterprises, local bodies and others raise funds from the domestic as well as international money or capital market by issuing debt instruments which are rated by the rating agencies. Investors also like to make their investment decisions based on credit rating of instruments. Credit rating plays a significant role in all credit as well as investment decisions. Credit signifies status of ability to pay or reputation about solvency and capacity to pay. Rating is nothing but estimated worth or value in terms of symbolic grade given to a person's or organisation's ability to pay back the loans raised, with the help of financial position of the individual or organisation.

6.1 Concept of Credit Rating

A credit rating is an assessment of the creditworthiness of a borrower in general terms or with respect to a particular debt or financial obligation. It can be assigned to any entity that seeks to borrow money — an individual, corporation, state or provincial authority, or sovereign government. Evaluating the creditworthiness of an instrument comprises of both qualitative and quantitative assessments, making

credit rating far from a straightforward mathematical calculation. Credit rating may be defined as an expression, through use of symbols, of opinion about the quality of credit of the issuer of debt securities with reference to a particular instrument. As per the SEBI regulations, credit rating is nothing but an opinion regarding securities expressed in the form of standard symbol or in any other standardised form assigned by a credit rating agency. The symbol given by rating agency for credit rating indicates a credit character of that particular security and thus it only facilitates to take a view on credit risk pertaining to that security. Credit rating is considered predominantly in respect of debt instruments only. In addition to this, lenders like banks and non-banking finance companies use internally developed credit rating score models in assessing credit worthiness of their borrowers or depend on even rating agencies to get rating for the same. The companies which issue debt instruments cannot on their own rate instruments.

6.2 Credit Rating Agencies

A credit rating agency (CRA) is a company that rates debtors on the basis of their ability to pay back their interests and loan amount on time and the probability of them defaulting. CRAs were set up to provide independent evidence and research-based opinion on the ability and willingness of the issuer to meet debt service obligations, quintessentially attaching a probability of default to a specific instrument. Credit rating agencies in India came into existence in the second half of the 1980s. In India, CRAs are regulated by SEBI (Credit Rating Agencies) Regulations, 1999 of the Securities and Exchange Board of India Act, 1992.

6.3 SEBI's Detection for CRAs

1. The Securities and Exchange Board of India tightened disclosure standards for credit rating agencies while assigning ratings to companies and their debt instruments.
2. The regulator directed that rating agencies must now disclose the liquidity position of a company being rated.
3. If the rating is assigned on the assumption of cash inflow, the agencies would need to disclose the source of the funding.
4. Rating agencies must disclose their rating history and how the ratings have transitioned across categories.
5. Credit rating firms will also have to analyze the deterioration of liquidity and also check for asset liability mismatch.

6.4 FEATURES OF CREDIT RATING

A credit rating is a measure or estimate of the ability of an individual, company, or country to fulfill their financial commitments, based on previous borrowings and repayments. Credit ratings can influence a borrower's ability to obtain loans and the interest rates they will be charged. Here are some features and aspects associated with credit ratings:

1. Source of Rating:

Agencies: There are several prominent credit rating agencies (CRAs) that assess and assign ratings, such as Standard & Poor's (S&P), Moody's, and Fitch Ratings.

Internal Ratings: Some financial institutions develop internal credit rating systems to assess the risk of their exposures.

2. Scales: Ratings can range from 'AAA' or 'Aaa' (for the best quality borrowers) to 'D' or 'C' (for those that have defaulted on their obligations). The scales may vary between agencies, but typically, they have gradations that reflect varying levels of risk.

3. Types of Ratings:

Short-term and Long-term Ratings: Ratings can be assigned for short-term debts (like commercial paper) or long-term debts (like bonds).

Issuer Credit Rating: Represents the overall creditworthiness of the issuing entity.

Issue-specific Rating: Relates to a specific debt security or financial obligation of the issuer.

4. Components: Credit ratings often take into account factors like a borrower's income, assets, debt level, credit history, and economic conditions.

5. Purpose: Credit ratings can serve various stakeholders including investors, lenders, and the rated entities themselves. Ratings guide investment decisions by allowing investors to assess the credit risk associated with a particular debt security.

6. Dynamic Nature: Credit ratings are not static. They can be upgraded (if the borrower's financial health improves) or downgraded (if their situation deteriorates).

7. Country & Sovereign Ratings: Beyond companies and individuals, credit rating agencies also provide ratings for entire countries, which can influence the terms at which countries can borrow on international markets.

8. Influence on Borrowing Costs: A better credit rating usually translates to lower borrowing costs. Conversely, a lower rating can increase the interest rate a borrower must pay, reflecting the higher perceived risk to lenders or investors.

9. Default Probabilities: The lower the rating, the higher the implied probability of default. However, it's important to note that a credit rating is not a direct measure of probability of default but an ordinal ranking of creditworthiness.

10. Assessment of issuer's capacity to repay. It assesses issuer's capacity to meet its financial obligations i.e., its capacity to pay interest and repay the principal amount borrowed.

11. Guidance about investment-not recommendation. Credit rating is only a guidance to investors and not recommendation to invest in any particular instrument.

12. Based on data. A credit rating agency assesses financial strength of the borrower on the financial data.

13. Expressed in symbols. Ratings are expressed in symbols e.g. AAA, BBB which can be understood by a layman too.

14. Done by expert- Credit rating is done by expert of reputed, accredited institutions.

15. Not for company as a whole- Credit rating is done for a particular instrument i.e., for a particular class of debentures and not for the company as a whole, it is quite possible that two instruments issued by the same company may carry different rating.

16. Does not create a fiduciary relationship. Credit rating does not create a fiduciary relationship (relationship of trust) between the credit rating agency and the investor.

17. Not attestation of truthfulness of information provided by rated company. Rating does not imply that the credit rating agency attests the truthfulness of information provided by the rated company.

18. Rating not forever. Credit rating is not a one-time evaluation of risk. Which remains valid for the entire life of a security. It can change from time to time

6.5 BENEFITS OF CREDIT RATING

Credit rating offers many advantages which can be classified into:

- A. Benefits to investors.
- B. Benefits to the rated company.
- C. Benefits to intermediaries.
- D. Benefits to the business world.
- E. Other benefits

BENEFITS TO INVESTORS

1. **Assessment of risk-** The investor through credit rating can assess risk involved in an investment. A small individual investor does not have the skills, time and resources to undertake detailed risk evaluation himself. Credit rating agencies who have expert knowledge, skills and manpower to study these matters can do this job for him. Moreover, the ratings which are expressed in symbols like AAA, BB etc. can be understood easily by investors.
2. **Information at low cost-** Credit ratings are published in financial newspapers and are available from rating agencies at nominal fees. This way the investors get credit information about borrowers at no or little cost.
3. **Advantage of continuous monitoring-** Credit rating agencies do not normally undertake rating of securities only once. They continuously monitor them and upgrade and downgrade the ratings depending upon changed circumstances.
4. **Provides the investors a choice of Investment-** Credit ratings agencies helps the investors to gather information about creditworthiness of different companies. So, investors have a choice to invest in one company or the other.
5. **Ratings by credit rating agencies is dependable-** A rating agency has no vested interest in a security to be rated and has no business links with the management of the issuer company. Hence ratings by them are unbiased and credible.

BENEFITS TO THE RATED COMPANY

1. **Ease in borrowing**- If a company gets high credit rating for its securities, it can raise funds with more ease in the capital market.
2. **Borrowing at cheaper rates**- A favorably rated company enjoys the confidence of investors and therefore, could borrow at lower rate of interest.
3. **Facilitates Growth**-Encouraged by favorable rating, promoters are motivated to go in for plans of expansion, diversification and growth. Moreover, highly rated companies find it easy to raise funds from public through issue of ownership or credit securities in future. They find it easy to borrow from banks.
4. **Recognition of lesser-known companies**-Favorable credit rating of instruments of lesser known or unknown companies provides them credibility and recognition in the eyes of the investing public.
5. **Adds to the goodwill of the rated company**- If a company is rated high by rating agencies it will automatically increase its goodwill in the market.
6. **Imposes financial discipline on borrowers**- Borrowing companies know that they will get high credit rating only when they manage their finances in a disciplined manner i.e., they maintain good operating efficiency, appropriate liquidity, good quality assets etc. This develops a sense of financial discipline among companies who want to borrow.
7. **Greater information disclosure**- To get credit rating from an accredited agency, companies have to disclose a lot of information about their operations to them. It encourages greater information disclosures, better accounting standards and improved financial information which in turn help in the protection of the investors.

BENEFITS TO INTERMEDIARIES

1. **Merchant bankers' and brokers' job made easy**- In the absence of credit rating, merchant bankers or brokers have to convince the investors about financial position of the borrowing company. If a borrowing company's credit rating is done by a reputed credit agency, the task of merchant bankers and brokers becomes much easy.

BENEFITS TO THE BUSINESS WORLD

- 1. Increase in investor population-** If investors get good guidance about investing the money in debt instruments through credit ratings, more and more people are encouraged to invest their savings in corporate debts.
- 2. Guidance to foreign investors-**Foreign collaborators or foreign financial institutions will invest in those companies only whose credit rating is high. Credit rating will enable them to instantly identify the position of the company.

OTHER BENEFITS

- 1. Informed Decision-making:** Credit ratings provide lenders, investors, and other stakeholders with a standardized assessment of credit risk. This enables them to make more informed decisions when lending money or investing in securities.
- 2. Access to Capital Markets:** Companies with higher credit ratings can more easily access domestic and international capital markets for funding, and often at more favorable terms.
- 3. Lower Borrowing Costs:** Entities with higher credit ratings usually benefit from lower interest rates when borrowing since they are perceived as lower risk.
- 4. Credibility and Reputation** -A strong credit rating can enhance a company's or country's reputation in the financial market, signaling that it is a trustworthy borrower.
- 5. Investor and Consumer Confidence:** Good credit ratings can boost confidence among investors and consumers, which might increase investment in the country or company and help with sales and partnerships.
- 6. Benchmarking:** Credit ratings provide entities with a benchmark against which they can measure their financial health and creditworthiness.
- 7. Attract Foreign Investments:** Countries with better credit ratings can attract more foreign direct investment. Investors often look at the credit ratings of countries before making overseas investment decisions.
- 8. Risk Assessment for Investors:** Credit ratings help investors assess the risk associated with various investment opportunities, aiding in portfolio diversification.

9. Transparency: The process of obtaining a credit rating often requires a high degree of transparency from the entity being rated. This can result in better corporate governance and financial disclosure practices.

10. Capital Allocation: Credit ratings assist in the efficient allocation of capital in the economy. Funds flow towards those opportunities that offer a suitable return for a given level of risk, as indicated by credit ratings.

11. Predictive Value: Historical data has shown that entities with lower credit ratings have a higher likelihood of defaulting on their obligations compared to those with higher ratings.

12. Provides Discipline: The prospect of obtaining or maintaining a good credit rating can motivate entities to maintain prudent financial practices and fiscal discipline.

13. Standardization: With the global presence of major credit rating agencies, ratings provide a standardized measure of credit risk across countries and industries.

6.6 COMPULSORY CREDIT RATING:

Obtaining credit rating is compulsory in the following cases:

1. **For debt securities.** The Reserve Bank of India and SEBI have made credit rating compulsory in respect of all non-government debt securities where the maturities exceed 18 months
2. **Public deposits.** Rating of deposits in companies has also been made compulsory.
3. **For commercial papers (CPs).** Credit rating has also been made compulsory for commercial papers. As per Reserve Bank of India guidelines rating of P2 by CRISIL or A2 by ICRA or PP2 by CARE is necessary for commercial papers.
4. **For fixed deposits with non-banking financial institutions (NBFCs).** Under the Companies Act, credit rating has been made compulsory for fixed deposits with NBFs.

6.7 FACTORS CONSIDERED IN CREDIT RATING

1. **Issuer's ability to service its debt.** For this credit rating agencies calculate
 - a) Issuer Company's past and future cash flows.
 - b) Assess how much money the company will have to pay as interest on borrowed funds and how much will be its earnings.

- c) How much are the outstanding debts?
 - d) Company's short term solvency through calculation of current ratio.
 - e) Value of assets pledged as collateral security by the company.
 - f) Availability and quality of raw material used, favorable location, cost advantage.
 - g) Track record of promoters, directors and expertise of the staff.
2. **Market position of the company.** What is the market share of various products of the company, whether it will be stable, does the company possess competitive advantage due to distribution network, customer base research and development facilities etc.
 3. **Quality of management.** Credit rating agency will also take into consideration track record, strategies, competency and philosophy of senior management.
 4. **Legal position of the instrument.** It means whether the issued instrument is legally valid, what are the terms and conditions of issue and redemption; how much the instrument is protected from frauds, what are the terms of debenture trust deed etc.
 5. **Industry risks.** Industry risks are studied in relation to position of demand and supply for the products of that industry (e.g. cars or electronics) how much is the international competition, what are the future prospects of that industry, is it going to die or expand?
 6. **Regulatory environment.** Whether that industry is being regulated by government (like liquor industry), whether there is a price control on it, whether there is government support for it, can it take advantage of tax concessions etc.
 7. **Other factors.** In addition to the above, the other factors to be noted for credit rating of a company are its cost structure, insurance cover undertaken, accounting quality, market reputation, working capital management, human resource quality, funding policy, leverage, flexibility, exchange rate risks etc.

6.8 CREDIT RATING PROCESS

In India credit rating is done mostly at the request of the borrowers or issuer companies. The borrower or issuer company requests the credit rating agency for assigning a ranking to the proposed instrument. The process followed by most of the credit rating agencies is as follows:

1. **Agreement.** An agreement is entered into between the rating agency and the issuer company. It covers details about terms and conditions for doing the rating.
2. **Appointment of analytical team.** The rating agency assigns the job to a team of experts. The team usually comprises of two analysts who have expert knowledge in the relevant business area and is responsible for carrying out rating.
3. **Obtaining information.** The analytical team obtains the required information from the client company and studies company's financial position, cash flows, nature and basis of competition, market share, operating efficiency arrangements, managements track cost structure, selling and distribution record, power (electricity) and labour situation etc.
4. **Meeting the officials.** To obtain clarifications and understanding the client's business the analytical team visits and interacts with the executives of the client.
5. **Discussion about findings.** After completion of study of facts and their analysis by the analytical team the matter is placed before the internal committee (which comprises of senior analysts) an opinion about the rating is taken.
6. **Meeting of the rating committee.** The findings of internal committee are referred to the "rating committee" which generally comprises of a few directors and is the final authority for assigning ratings.
7. **Communication of decision.** The rating decided by the rating committee is communicated to the requesting company.
8. **Information to the public.** The rating company publishes the rating through reports and the press.
9. **Revision of the rating.** Once the issuer company has accepted the rating, the rating agency is under an obligation to monitor the assigned rating. The rating agency monitors all ratings during the life of the instrument

6.9 LIMITATIONS OF CREDIT RATING

1) **Biased Rating and Misrepresentations:-** In the absence of quality rating based on objectivity analysis credit rating is a curse for the capital market. To avoid biased rating or subjectivity in the credit rating process, executives working with Credit Rating Agency, who are involved in the process of credit rating, should have no links with the company or the persons interested in the issuer company so that they can make their report impartial and judicious recommendations for rating committee. Again, rating committee members should also be impartial and judicious in their decision making. The companies having lower grade rating do not advertise or use the rating while raising funds from the public. In such cases, the Credit Rating Agencies should themselves in the public interest, advertise the rating symbols assigned to such companies for public information and make the public aware of the poor financial position of such companies.

2) **Static study-**Rating is done on the basis of present and past data of the company and this is only a static study. Disclosure about the company's health through credit rating is one time exercise and any thing can happen after assignment of rating symbols to the company. Dependence for future results on the rating, therefore defeats the very purpose of risk indicativeness of rating. Subsequent to the allotment of credit rating many changes may take place in economic environment, political situation, government policy framework, etc. which may directly affect the working of a company. With such changes, the purpose for which credit rating was done gets defeated.

3) **Concealment of material information-**The company which has approached for credit rating may not provide all material information to the credit rating agency. In such cases, credit rating given by the credit rating agency may not reflect true picture of credit risk.

4) **Rating is no guarantee for soundness of the company-**Credit rating is done for a particular instrument to assess the credit risk. And therefore it cannot be construed as a rating for the quality of management of the company or its sound financial position.

5) **Down grade-**Once a company has been rated and if it is not able to maintain its satisfactory financial performance, credit rating agency would review the grade and down grade the rating resulting into impairing the image of the company.

Most of the limitations mentioned above can be overcome by taking precautions at every stage of credit rating process.

6.10 CREDIT RATING AGENCIES IN INDIA

There are six credit rating agencies registered under SEBI namely, CRISIL, ICRA, CARE, SMERA, Fitch India and Brickwork Ratings.

CRISIL

1. This full-service rating agency is the major credit rating agency in India, with a market share of more than 60%.
2. It is offering its services in financial, manufacturing, service, and SME sectors.
3. The headquarter of CRISIL is in Mumbai
4. The majority stake of CRISIL was held by the world's largest rating agency Standard & Poor's.

Credit Analysis and Research Limited Ratings (CARE) Ratings

1. Credit Analysis and Research Limited Ratings was established in 1993.
2. It is supported by Canara Bank, Unit Trust of India (UTI), Industrial Development Bank of India (IDBI), and other financial and lending institutions.
3. This is considered as the second-largest credit rating company in India.
4. The headquarter of Credit Analysis and Research Limited Ratings is in Mumbai

Small and Medium Enterprises Rating Agency (SMERA)

1. It is a rating agency entirely created for the rating of Small Medium Enterprises.
2. It is a joint enterprise by SIDBI, Dun & Bradstreet Information Services India Private Limited (D&B), and some chief banks in India.
3. The headquarter of SMERA is in Mumbai.
4. It has accomplished 7000 ratings.

ONICRA Credit Rating Agency

1. It was incorporated by Mr. Sonu Mirchandani in 1993
2. It investigates data and arranges for possible rating solutions for Small and Medium Enterprises and Individuals.
3. The headquarter of ONICRA Credit Rating Agency is located in Gurgaon
4. It has a broad experience in performing a wide range of areas such as Accounting, Finance, Back-end Management, Analytics, and Customer Relations. It has rated more than 2500 SMEs.

Fitch (India Ratings & Research)

1. Fitch Ratings is a global rating agency dedicated to providing the world's credit markets with independent and prospective credit opinions, research, and data.
2. The headquarter of Fitch Ratings is in Mumbai.

ICRA

It was created in 1991 by prominent financial institutions and commercial banks in India with a devoted crew of experts for the MSME sector

Moodys, which is considered as the International credit rating agency holds the major share.

6.11 SUMMARY

Credit rating is a technique of rating the borrower's expected capability and worth or reputation of solvency and ability and inclination of pay back the principal duty and interest when the obligation falls due. Credit rating is only a risk evaluation of a credit assignment and presently the debt instruments rated include debentures, fixed deposits and commercial papers. It is highly useful to investors, issuers, intermediaries and regulators. A number of factors contribute to the success of credit rating. The most dominating factor is the reputation and analytical credibility of the credit rating agency. Credit rating is an interactive process which involves a number of steps on the basis of assessment on which rating is assigned. Such rating, which is expressed in symbols, is subject to an upward or downward change. The recent developments in credit rating have brought in its fold the rating of equity, structured obligations, utilities, sovereign and municipalities. In India, credit rating business is regulated by SEBI.

SELF ASSESSMENT QUESTIONS

Short Questions

- 1) Write short notes on :
 - 1) Activities of CRISIL Ltd.
 - 2) Registration of Credit Rating Agency
 - 3) Rating symbols for short term debt instruments

Long Questions

- 1) What do you mean by Credit Rating ?
- 2) Explain the benefits of Credit Rating.
- 3) Are there any limitations of credit rating ? If yes, explain various limitations.
- 4) Explain the process of credit rating

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UNIT – 4 Chapter 7 MUTUAL FUNDS

Contents

- 7.0 Introduction
 - 7.1 Concept of Mutual Fund
 - 7.2 Features of Mutual Fund
 - 7.3 Organization of Mutual Fund
 - 7.4 Functions of Mutual Funds
 - 7.5 Objectives of Mutual Funds
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7.0 INTRODUCTION

A Mutual Fund is a trust that pools the savings of a number of investors who share a common financial goal. The money thus collected is then invested in capital market instruments such as shares, debentures and other securities. The income earned through these investments and the capital appreciation realized is shared by its unit holders in proportion to the number of units owned by them. Different investment avenues are available to investors. Mutual funds also offer good investment opportunities to the investors. Like all investments, they also carry certain risks. The investors should compare the risks and expected yields after adjustment of tax on various instruments while taking investment decisions. Investments in securities are spread across a wide cross-section of industries and sectors and thus the risk is reduced. Diversification reduces the risk because all stocks may not move in the same direction in the same proportion at the same time. Mutual fund issues units to the investors in accordance with quantum of money invested by them. Investors of mutual funds are known as unitholders. As per section 2(q) of Securities and Exchange Board of India (SEBI) (Mutual Funds)

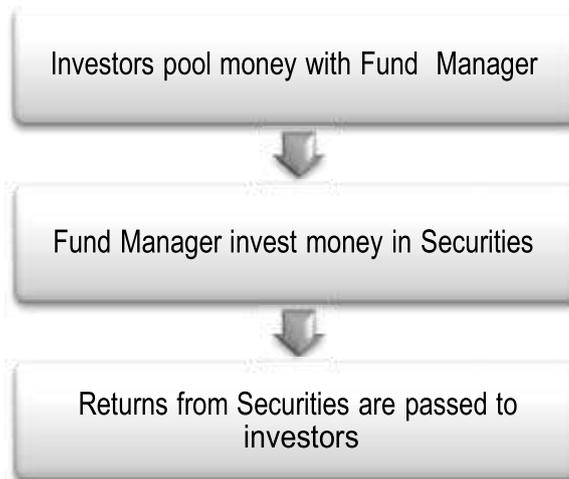
Regulations, 1996, "Mutual Fund" means a fund established in the form of a trust to raise monies through the sale of units to the public or a section of the public under one or more schemes for investing in securities, including money market instruments or gold or gold related instruments or real estate assets.

7.1 CONCEPT OF MUTUAL FUND

Mutual funds allow small investors to make investments. They can start even with a small amount. Money managers or large companies manage these funds. They choose the securities. The entire fund is thus a collection of various investments.

Mutual funds often have an objective. This objective is as per the company or investor's needs. It may range from capital appreciation to regular dividend gains. The individual must assess the different mutual fund types. They will have varying investment avenues. It is vital to choose the best as per their needs.

Mutual fund managers may choose different company shares or debt securities. They can also invest in physical assets. The investors thus share the total loss or profit for the mutual funds. It is as per their investments. The following flow chart describes broadly the working of a mutual fund



7.2 FEATURES OF MUTUAL FUND

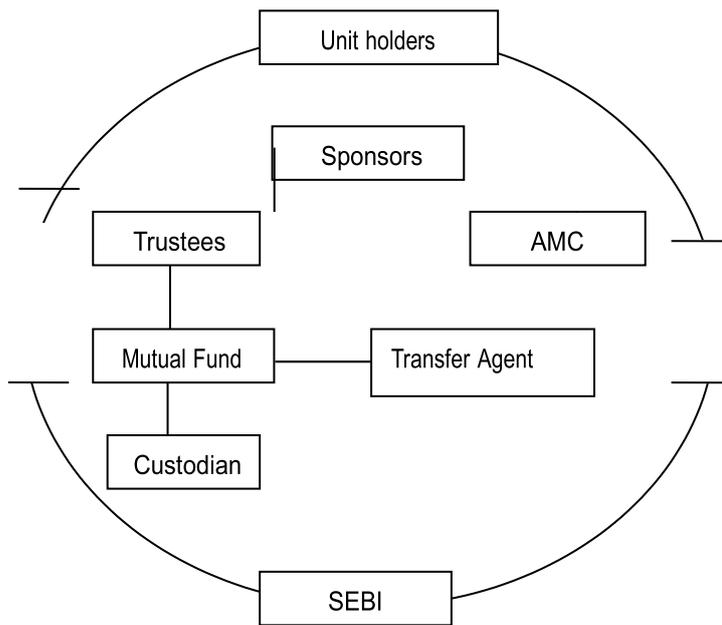
1. Convenience: Mutual funds offer investors convenience. They can complete their investments right from their laptop. It only follows the payment steps. Also, they don't have to compare the different securities themselves.

2. **Investment flexibility:** Mutual funds offer people to pay a total sum or make monthly payments. They can pick the fund as per their budget. It helps bring investor flexibility for payments.
3. **Liquidity:** Mutual funds are liquid. The investors may pull their savings. They can also stop their regular payment methods. They may receive their funds in a couple of days.
4. **Charges:** There is only a small expense ratio fee for mutual funds. The investor has to pay this to the company.
5. **Regulated:** Mutual funds are under SEBI monitoring. This body oversees the different companies. They have to register before they commence operations.
6. **Diversification:** Mutual funds often lower risks. The companies invest in various securities to improve investment gain.

7.3 ORGANIZATION OF MUTUAL FUND

In India, mutual funds are regulated by SEBI (Mutual Funds) Regulations, 1996. A mutual fund is set up in the form of a trust, which has sponsor, trustees, asset management company (AMC) and custodian. The trust is established by a sponsor or more than one sponsor who is like promoter of a company. The trustees of the mutual fund hold its property for the benefit of the unitholders. Asset Management Company (AMC) approved by SEBI manages the funds by making investments in various types of securities. Custodian, who is registered with SEBI, holds the securities of various schemes of the fund in its custody. The trustees are vested with the general power of superintendence and direction over AMC. They monitor the performance and compliance of SEBI Regulations by the mutual fund.

SEBI Regulations require that at least two thirds of the directors of trustee company or board of trustees must be independent i.e. they should not be associated with the sponsors. Also, 50% of the directors of AMC must be independent. All mutual funds are required to be registered with SEBI before they launch any scheme.



Asset management company” means a company formed and registered under the Companies Act, 1956 or 2013 and approved as such by the Securities and Exchange Board of India to manage the funds of a mutual fund.

“Unit” means the interest of the unit holders in a scheme, which consists of each unit representing one undivided share in the assets of a scheme;

Money market instruments provide for borrowers' short-term needs and give needed liquidity to lenders. Money market instruments include commercial papers, commercial bills, treasury bills, Government securities having an unexpired maturity up to one year, call or notice money, certificate of deposit, usance bills, and any other like instruments as specified by the Reserve Bank of India from time to time.

7.4 FUNCTIONS OF MUTUAL FUNDS

1. Investment management: Mutual funds manage the money for their investors. They pool the funds to different investment options.
2. Professional expertise: Mutual funds help investors use their professional expertise. Companies hire experts for portfolio management. It thus helps the investors gain better investment options.
3. Transparency: Mutual funds share the portfolio details with investors. It allows people to understand how their money is invested.

4. Risk management: Risk is another factor reduced with mutual funds. Mutual fund companies use several securities. They reduce investment risks for the people.
5. Easy investments: Mutual funds provide accessible investment options. Investors can easily select the best fund. Also, the process is easy with online payments and registrations.

7.5 OBJECTIVES OF MUTUAL FUNDS

1. Asset diversification: Mutual funds aim at diversifying. They help an investor choose several securities. They only have to invest the amount. The fund completely handles the rest asset diversification part. It helps earn from several investment domains.
2. Income generation: Mutual funds help investors in income generation. They can receive regular dividends. Several companies offer high dividends. It helps have another stable income source.
3. Safeguarding: Mutual funds provide a low-risk option. The presence of several securities makes it safer. That's why it leads to capital safeguarding.
4. Initiate growth: Capital gains in mutual funds help investors. This growth allows long-term savings.
5. Promote investments: Mutual funds provide an easy platform. Investors can complete their investments from home. It helps promote the saving and investment habit.

7.6 STRUCTURE OF MUTUAL FUNDS

1. Open-Ended Mutual Funds

These mutual funds are open-ended. It signifies that investors can buy or sell these units. They may do so at their convenience. These mutual fund types are common. The unit capital for such mutual funds is always changing. It varies if the company decides to buy back the existing units. The fund may also sell them. The investors have more convenience. They can sell or buy as per their financial needs. It provides better liquidity.

2. Close-Ended Mutual Funds

These types of mutual funds have a fixed time. It is usually a few years. The investors can only invest during the new fund offer period. They can subscribe during this issue. Also, these funds have limited units. The unit capital is the same. The investors cannot exit these funds or enter

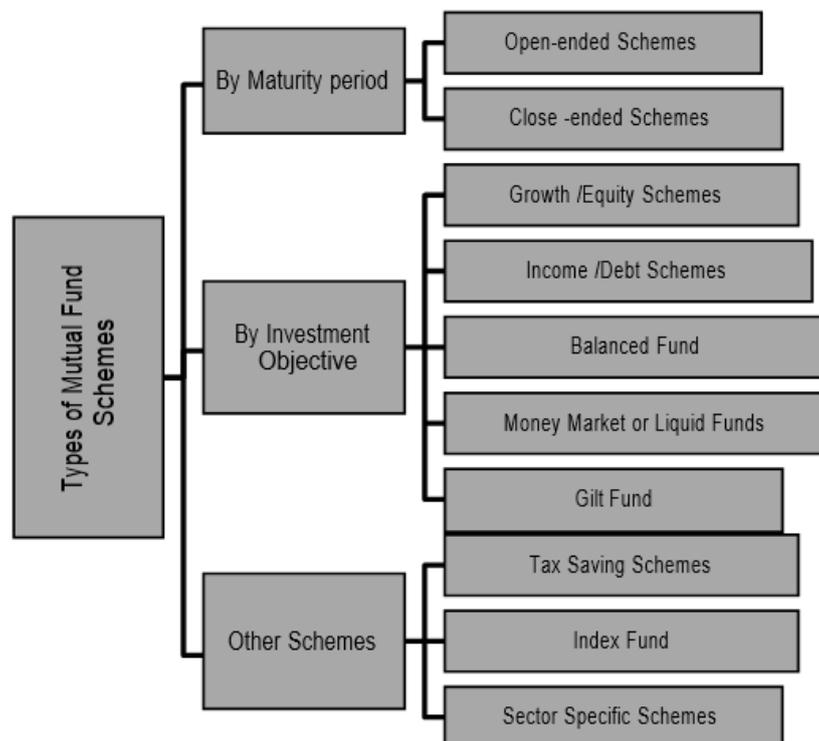
after the offering. However, the fund may be present on the stock exchange. It can allow trading.

3. Interval Schemes

These schemes have features of both the other types. Open trading is only allowed in specific time frames. It doesn't have regular mutual fund trading. One can enjoy some liquidity. These funds may also be present on stock exchanges.

7.7 TYPES OF MUTUAL FUNDS

The market allows different types of mutual funds in India. The investors may choose according to budget and goals. Wide variety of Mutual Fund Schemes exists to cater to the needs of the investors. There are over hundreds of mutual funds scheme to choose from. The charts given below will give an overview of various types of schemes:



A) By Maturity Period

A mutual fund scheme can be classified into open-ended scheme or close-ended scheme depending on its maturity period:

1. **Open - Ended Schemes:** An open-end fund is one that is available for subscription and repurchase all through the year. These do not have a fixed maturity. Investors can conveniently buy and sell units at Net Asset Value ("NAV") related prices which are declared on a daily basis. The key feature of open-end schemes is liquidity.
2. **Close - Ended Schemes:** These schemes have a pre-specified maturity period. One can invest directly in the scheme at the time of the initial issue. Depending on the structure of the scheme there are two exit options available to an investor after the initial offer period closes. Investors can transact (buy or sell) the units of the scheme on the stock exchanges where they are listed. The market price at the stock exchanges could vary from the net asset value (NAV) of the scheme on account of demand and supply situation, expectations of unit holder and other market factors. Alternatively some close-ended schemes provide an additional option of selling the units directly to the Mutual Fund through periodic repurchase at the schemes NAV; however one cannot buy units and can only sell units during the liquidity window. SEBI Regulations ensure that at least one of the two exit routes is provided to the investor.
3. **Interval Schemes:** Interval Schemes are that scheme, which combine the features of open-ended and close-ended schemes. The units may be traded on the stock exchange or may be open for sale or redemption during pre-determined intervals at NAV related prices.

B) By Investment objective

A scheme can also be classified as growth scheme, income scheme, or balanced scheme considering its investment objective. Such schemes may be open-ended or close-ended schemes as described earlier. Such schemes may be classified mainly as follows:

1. **Equity fund:** The aim of growth funds is to provide capital appreciation over the medium to long- term. Such schemes normally invest a major part of their corpus in equities. Such funds have comparatively high risks. These schemes provide

different options to the investors like dividend option, capital appreciation, etc. and the investors may choose an option depending on their preferences. The investors must indicate the option in the application form. The mutual funds also allow the investors to change the options at a later date. Growth schemes are good for investors having a long-term outlook seeking appreciation over a period of time. The Equity Funds are sub-classified depending upon their investment objective, as follows:

- Diversified Equity Funds
- Mid-Cap Funds
- Sector Specific Funds
- Tax Savings Funds (ELSS)

Equity investments are meant for a longer time horizon, thus Equity funds rank high on the risk-return matrix. Growth Schemes are also known as equity schemes. The aim of these schemes is to provide capital appreciation over medium to long term. These schemes normally invest a major part of their fund in equities and are willing to bear short-term decline in value for possible future appreciation.

Income Schemes: Income Schemes are also known as debt schemes. The aim of these schemes is to provide regular and steady income to investors. These schemes generally invest in fixed income securities such as bonds and corporate debentures. Capital appreciation in such schemes may be limited.

- **Balanced Schemes:** Balanced Schemes aim to provide both growth and income by periodically distributing a part of the income and capital gains they earn. These schemes invest in both shares and fixed income securities, in the proportion indicated in their offer documents (normally 50:50).
 - **Money Market Schemes:** Money Market Schemes aim to provide easy liquidity, preservation of capital and moderate income. These schemes generally invest in safer, short-term instruments, such as treasury bills, certificates of deposit, commercial paper and inter-bank call money.
2. **Debt funds:** The objective of these Funds is to invest in debt papers. Government authorities, private companies, banks and financial institutions are some of the major issuers of debt papers. By investing in debt instruments, these funds ensure low risk and provide stable income to the investors. These funds are not affected because of fluctuations in equity markets. However, opportunities of capital

appreciation are also limited in such funds. The NAVs of such funds are affected because of change in interest rates in the country. If the interest rates fall, NAVs of such funds are likely to increase in the short run and vice versa. However, long term investors may not bother about these fluctuations. Debt funds are further classified as:

- **Income Funds:** Invest a major portion into various debt instruments such as bonds, corporate debentures and Government securities.
 - **Monthly Income Plans (MIPs):** Invests maximum of their total corpus in debt instruments while they take minimum exposure in equities. It gets benefit of both equity and debt market. These scheme ranks slightly high on the risk- return matrix when compared with other debt schemes.
 - **Short Term Plans (STPs):** Meant for investment horizon for three to six months. These funds primarily invest in short term papers like Certificate of Deposits (CDs) and Commercial Papers (CPs). Some portion of the corpus is also invested in corporate debentures.
 - **Liquid Funds:** Also known as Money Market Schemes, These funds provide easy liquidity and preservation of capital. These schemes invest in short-term instruments like Treasury Bills, inter-bank call money market, CPs and CDs. These funds are meant for short-term cash management of corporate houses and are meant for an investment horizon of 1 day to 3 months. These schemes rank low on risk-return matrix and are considered to be the safest amongst all categories of mutual funds.
3. **Balanced funds:** As the name suggest they, are a mix of both equity and debt funds. They invest in both equities and fixed income securities, which are in line with pre-defined investment objective of the scheme. These schemes aim to provide investors with the best of both the worlds. Equity part provides growth and the debt part provides stability in returns. They generally invest 40-60% in equity and debt instruments. These funds are also affected because of fluctuations in share prices in the stock markets. However, NAVs of such funds are likely to be less volatile compared to pure equity funds.
 4. **Money Market or Liquid Fund:** These funds are also income funds and their aim is to provide easy liquidity, preservation of capital and moderate income. These schemes invest exclusively in safer short-term instruments such as treasury bills, certificates of deposit, commercial paper and inter-bank call money, government

securities, etc. Returns on these schemes fluctuate much less compared to other funds. These funds are appropriate for corporate and individual investors as a means to park their surplus funds for short periods.

5. Gilt Funds: These funds invest exclusively in government securities. Government securities have no default risk. NAVs of these schemes also fluctuate due to change in interest rates and other economic factors as is the case with income or debt oriented schemes.

c) By Other Schemes

1. Tax Saving Schemes: Tax-saving schemes offer tax rebates to the investors under tax laws prescribed from time to time. Under Sec. 80C (2) of the Income Tax Act, contributions made to any notified Equity Linked Savings Scheme (ELSS) are eligible for deduction. Pension schemes launched by the mutual funds also offer tax benefits. These schemes are growth oriented and invest pre-dominantly in equities. Their growth opportunities and risks associated are like any equity-oriented scheme.
 2. Index Schemes: Index schemes attempt to replicate the performance of a particular index such as the BSE Sensex or the NSE 50. The portfolio of these schemes will consist of only those stocks that constitute the index. The percentage of each stock to the total holding will be identical to the stocks index weightage. And hence, the returns from such schemes would be more or less equivalent to those of the Index.
 3. Sector Specific Schemes: These are the funds/schemes which invest in the securities of only those sectors or industries as specified in the offer documents. e.g. Pharmaceuticals, Software, Fast Moving Consumer Goods (FMCG), Petroleum stocks, etc. The returns in these funds are dependent on the performance of the respective sectors/industries. While these funds may give higher returns, they are riskier compared to diversified funds. Investors need to keep a watch on the performance of those sectors/industries and must exit at an appropriate time
4. Fund of Fund Scheme:-A scheme that invests primarily in other schemes of the same mutual fund or other mutual funds is known as a FoF scheme. An FoF scheme enables the investors to achieve greater diversification through one scheme. It spreads risks across a greater universe.

5. **Load or No Load Fund Scheme:-**A Load Fund is one that charges a percentage of NAV for entry or exit. That is, each time one buys or sells units in the fund, a charge will be payable. This charge is used by the mutual fund for marketing and distribution expenses. Suppose the NAV per unit is Rs.10. If the entry as well as exit load charged is 1%, then the investors who buy would be required to pay Rs.10.10 and those who offer their units for repurchase of the mutual fund will get only Rs.9.90 per unit. The investors should take the loads into consideration while making investment as these affect their yields/returns. However, the investors should also consider the performance track record and service standards of the mutual fund which are more important. Efficient funds may give higher returns in spite of loads. A no-load fund is one that does not charge for entry or exit. It means the investors can enter the fund/scheme at NAV and no additional charges are payable on purchase or sale of units.

7.8 HOW ARE MUTUAL FUNDS PRICED?

Most mutual funds have the Net Asset Value method for pricing. It allows them to check the daily prices. It's because the shares and other securities may fluctuate. The day trades can thus affect the mutual fund price.

1. NAV indicates the mutual fund price. It is the sum value of the mutual fund's cash and securities. The liabilities are deducted from this total. The final amount is after dividing it by the outstanding shares total.
2. The NAV also affects the returns. The mutual fund price may fall or improve in a day. It is as per the securities.
3. The different mutual funds may take the average of prices for three days. It depends on the funds.

7.9 PROS AND CONS OF MUTUAL FUND INVESTING

Pros of Mutual fund investing

1. **Advanced management:** Mutual funds often have expert managers. They manage the portfolio. It helps select the best investment options.
2. **Reinvestment:** Mutual funds often reinvest dividends. The investors can thus gain money from their initial income.

3. Safety: Mutual funds pool several investment options. This diversification provides better safety to investors.
4. Convenience: Mutual funds are helpful for investors. They have an easy option where they won't have to research every security.
5. Fair prices: Mutual funds often calculate the daily values. It helps investors understand their true price.

Cons of Mutual Fund Investing

1. High expense: Investors must watch for high expense ratios. They may be charged significantly by the fund companies.
2. Management abuses: Mutual funds are often at the management's prudence. They may window-dress the funds for a better image.
3. Tax inefficiency: Gains from fund value or other incomes may not be tax savers.
4. No guarantees: Mutual funds do not offer safety guarantees. Investors can still lose their money with low-risk funds.
5. Cash drags: Mutual funds often have a higher cash proportion. It is to fulfil sales and redemptions. This cash is often of no use. It doesn't earn any income.

7.10 MUTUAL FUND IN INDIA

A mutual fund is a type of investment vehicle that pools money from multiple investors to invest in a diversified portfolio of stocks, bonds, or other securities. In India, mutual funds are regulated by the Securities and Exchange Board of India (SEBI), and they have become a popular investment option for individuals. There are several mutual funds examples in India.

1. HDFC Equity fund: This is managed by the HDFC bank and invests in equity.
2. SBI Equity Hybrid fund: This fund has both debt and stock market investments.
3. HDFC Liquid Funds: This fund has investments in debt securities.

Types of Mutual Funds in India

1. Based on Asset Class

1. Equity Funds

Equity funds are also called stock funds as they invest primarily in stocks of various companies. These mutual funds are capable of bringing in high returns but they can also lead to major

losses when the prices of stocks go down. The performance of these shares directly influences the gains or losses one might get from their mutual fund investments.

2. Debt Funds

Debt mutual funds are less risky than equity funds and hybrid funds. They are thus suitable for individuals who are looking for low-risk investments and decent returns. Debt mutual funds invest in fixed-income securities such as government securities, money market instruments, corporate bonds, etc.

3. Hybrid or Balanced Funds

Hybrid or balanced mutual funds are a proper blend of both stock and bond funds. The ratio of this mixture can be fixed or variable for both assets. Investors who are ready to take more risks than debt funds but fewer risks than equity funds can opt for hybrid funds for decent returns.

2. Based on Structure

1. Open-Ended Funds

In open-ended mutual funds, trading of units takes place on a continuous basis. Therefore, investors can invest and redeem fund units at their convenience. Whenever fund houses decide to purchase or sell their existing units, the prices of their outstanding units tend to rise or fall.

2. Close-Ended Funds

Close-ended mutual funds are open for investment during their NFO (New Fund Offer) period. Furthermore, they come with a lock-in period of around 5-7 years before which investors cannot exit their investments. Close-ended funds are listed in stock exchanges to provide an exit option.

3. Based on Investment

1. ELSS/ Tax Saving Funds

Equity-linked Savings Schemes (ELSS) have a lock-in period of 3 years. These funds allow you to save on income tax under Section 80C. With ELSS funds, you can invest in a diversified range of stocks across sectors and market capitalisations.

2. Growth Funds

As the name suggests, investors opt for this mutual fund to increase their capital growth. This type of mutual fund promises high returns, along with major risks. Therefore, investors with a long term investment plan and high-risk appetite can opt for growth funds.

3. Pension Funds

Also known as superannuation funds, pension funds allow investors to save a huge amount for life after retirement. These mutual funds usually invest in low-risk government securities and bonds for stable returns.

4. Liquid Funds

Liquid mutual funds invest in certain debt securities that have a short maturity of up to 91 days. They do not have a lock-in period and offer high liquidity as per its name. Also, owing to their short maturity period, liquid funds are less risky investments than growth funds.

4. Based on Plans

1. Direct Plan

Direct plans involve buying mutual fund units directly from the AMC (Asset Management Company). Seasoned investors or those who are confident about picking mutual schemes without any third-party assistance usually prefer direct plans. These plans have a lower expense ratio.

2. Regular Plan

Regular plans are mutual fund plans which involve buying mutual fund units via a third-party. Beginner investors consider investing in regular plans due to the fund selection assistance offered by the brokers. However, the broker might charge a certain commission for their services and this could significantly increase the expense ratio, which in turn increases the overall cost of the fund.

5. Based on Investment Strategy

1. Active Investing

For active investing, a fund manager takes the decision regarding buying and selling of stocks. The primary aim of the fund manager is to provide benchmark-beating returns to the investor. Since a fund manager has a significant role to play, a certain amount is charged to the investor as a fund management fee.

2. Passive Investing

A fund manager has little role to play when it comes to passively managed funds or index funds. The fund manager only creates a portfolio of stocks (for passively-managed equity funds) that mirrors the performance of the underlying index, let's say Nifty 50. Passively-

managed funds are low-cost funds due to their significantly lower expense ratio compared to active funds.

7.11 SUMMARY

Mutual funds have reasonably gained popularity. People can invest even with their small savings. It helps provide a safer option. Investors have several options. They can start as per the risk and budget. One must evaluate the fund and its securities before investing. Mutual funds are investment vehicles that pool money from numerous investors to create a diversified portfolio of stocks, bonds, or other securities. Managed by Asset Management Companies (AMCs), mutual funds provide a way for individuals to participate in the financial markets with professional management. Mutual funds provide a convenient and accessible way for investors to participate in the financial markets while benefiting from professional management and risk diversification. Before investing in mutual funds, it's important for investors to assess their financial goals, risk tolerance, and investment horizon. It's also advisable to read the scheme-related documents and consult with a financial advisor if needed.

SELF ASSESSMENT

Short Questions:

1. What is a mutual fund?
2. Who regulates mutual funds in India?
3. What is the Net Asset Value (NAV) of a mutual fund?
4. Name three types of mutual funds.
5. What is a Systematic Investment Plan (SIP)?
6. Explain the role of Asset Management Companies (AMCs) in mutual funds.
7. What is the KYC process in the context of mutual funds?
8. Define the expense ratio in mutual funds.
9. How does diversification benefit investors in mutual funds?

10. What is a Systematic Withdrawal Plan (SWP) in mutual funds?

Long Questions:

1. How do mutual funds work, and what are the key benefits for investors?
2. Discuss the role of SEBI in regulating mutual funds in India.
3. Explain the different types of mutual funds available and the investment objectives they cater to.
4. What factors should investors consider before choosing a mutual fund for their investment?
5. Elaborate on the tax implications of investing in mutual funds in India.
6. Describe the process of KYC and its significance for investors in the context of mutual funds.
7. Compare and contrast equity funds, debt funds, and hybrid funds, highlighting their respective risk-return profiles.
8. How does a Systematic Investment Plan (SIP) work, and what are its advantages for investors?
9. Discuss the concept of Net Asset Value (NAV) and its importance in evaluating the performance of a mutual fund.
10. Examine the impact of the expense ratio on investors and explain how it is calculated in mutual funds.

UNIT -5 CHAPTER 8 ASSET SECURITIZATION

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Self Assessment Questions

8.0 INTRODUCTION

Asset securitization refers to the process of carefully examining assets to determine their suitability, value, and condition for a business's needs. When businesses are considering acquiring assets through a finance lease, they should scrutinize those assets to ensure they are a good fit. The process of securitization typically involves the creation of pool of assets from the illiquid financial assets, such as receivables or loans which are marketable. In other words, it is the process of repackaging or rebundling of illiquid assets into marketable securities. These assets can be automobile loans, credit card receivables, residential mortgages or any other form

of future receivables. Owing to the deregulation of the markets and competitive business environment in the market, banks and financial institutions have been under pressure to improve their financial performance. This is possible only if lending institutions are prepared to take more risk. In other words, such institutions will be able to earn more profit by undertaking more risk. The banks and financial institutions are required to deal with various types of risk such as market risk comprising of liquidity and interest rate risk, credit risk and currency risk, etc. They are required to design and implement an appropriate risk management system which will help them to quantify and control various types of risks. As banks and financial institutions are involved mainly in lending business, they have to deal with credit risk and liquidity risk of their lending portfolio. In this regard, banks and financial institutions can make use of asset securitisation as hedging instrument to Asset Securitisation manage both liquidity and credit risk of loan asset. With the help of such product, lending institutions will be able to sell loan asset thereby improving their liquidity position. The cash generated from such assets will be used to create either new loan assets or other assets. Similarly, lending institutions would like to sell loan assets for cash without recourse so as to pass on credit risk to the buyer of the loan assets. All this is possible by using asset securitisation product for loan asset portfolio. Asset securitisation has become very popular product in most of the developed countries. In developing countries like India asset securitisation is a new product which need to be encouraged by the Government and market regulator through an appropriate policy framework. The various aspects of asset securitisation are discussed below under various heads.

8.1 CONCEPT OF ASSET SECURITISATION

Asset securitisation is defined as a process whereby assets like loans and receivables are used to create and sell asset backed securities. By securitizing assets, a company essentially monetizes an illiquid asset by turning it into a liquid security that can be sold to investors. This can provide the company with immediate cash and remove the assets from its balance sheet. However, the company still services the assets and remains exposed to default risk. The assets which can be used for securitisation include receivables from the government departments, loan assets like housing loan and automobile loans, leased assets and credit card receivables etc. In fact, any asset can be considered for securitisation provided it is possible to forecast future cash flows to be generated from such assets with reasonable accuracy. In a nutshell, asset securitisation can be defined as the process which takes place when a lending institution's assets are removed in one way or another from the balance sheet of that lending institution and

are funded instead by investors who purchase an instrument created from these assets without recourse or with recourse towards seller of the asset (i.e., originator's of the asset). The yield to the investors is set at a market level appropriate to the characteristics and the quality of the asset pool. Thus, under asset securitisation a bank or lending institution like financial institution sells loan assets and receivables to an independent entity like special purpose vehicle (SPV) who pools and packages individual loans and receivables and creates securities against them, gets them rated and sells them to the investors at large through public offerings or private placements (Trustee). The future cash flow (to be received by originator of a loan) are remitted to the trustee who in turn pays agreed interest and principal amount to the investors as per the terms of an agreement. Thus, "Asset Securitisation is a synthetic technique of converting illiquid assets into liquid assets through the process of issuing securities to the investors by SPV" thereby providing market determined yield on such securities and marketability in respect of such instruments. The whole process of asset securitisation is beneficial to both lending institutions (originator's of loan) as well as to the investors.

8.2 FEATURES OF ASSEST SECURITISATION

1. **Pooling of Assets:** The process starts with the pooling of various types of financial assets, such as mortgages, auto loans, credit card receivables, or other forms of debt.
2. **Special Purpose Vehicle (SPV):**An SPV, also known as a special purpose entity (SPE) or bankruptcy-remote entity, is created to hold the pooled assets. The SPV is a separate legal entity, and its sole purpose is to issue the securities backed by the pooled assets.
3. **Tranching:** The pooled assets are divided into different tranches, each representing a different level of risk and return. Investors can then choose the tranche that best matches their risk tolerance and investment objectives.
4. **Securitization Process:** The assets held by the SPV are typically transferred to a trust, and the trust issues securities that are sold to investors. The cash flows from the underlying assets are used to pay interest and principal on the securities in a predetermined order of priority.
5. **Credit Enhancement:** To make the securities more attractive to investors, credit enhancement mechanisms may be employed. This could include overcollateralization (providing more collateral than the value of the securities), guarantees, insurance, or reserve accounts.

6. **Rating Agencies** The securities issued through asset securitization are often rated by credit rating agencies. The ratings reflect the creditworthiness of the securities and help investors assess the risk associated with each tranche.
7. **Market Liquidity:** Asset-backed securities (ABS) created through securitization can be traded on the secondary market, providing liquidity to investors. This liquidity is one of the key benefits of asset securitization.
8. **Diversification:** Investors can achieve diversification by investing in different tranches of asset-backed securities, spreading the risk across various types of assets and risk profiles.
9. **Originator's Role:** The originator of the assets may continue to service the loans or may transfer the servicing to a third party. The originator may retain an interest in the securitized assets, aligning their interests with those of the investors.

Asset securitization has been widely used in various financial markets to finance a range of assets, and it plays a crucial role in providing liquidity and efficient capital allocation. However, it is important to note that asset securitization can also pose risks, as seen during financial crises when certain types of asset-backed securities experienced significant value declines.

8.3 BENEFITS OF ASSET SECURITIZATION

Asset securitization offers several benefits to different stakeholders in the financial markets. Here are some of the key advantages:

1. **Liquidity Enhancement:** Asset securitization transforms illiquid assets, such as loans, into tradable securities. This process enhances liquidity in the market by creating a secondary market where these securities can be bought and sold.
2. **Capital Relief:** Originators of assets, such as banks or financial institutions, can achieve capital relief by transferring assets off their balance sheets through securitization. This allows them to free up capital for other lending activities and to meet regulatory capital requirements.
3. **Diversification:** Investors can achieve diversification by investing in different tranches of asset-backed securities, spreading risk across various types of assets and risk profiles. This diversification can lead to a more balanced and resilient investment portfolio.
4. **Lower Funding Costs:** Securitization allows originators to access funding at a potentially lower cost than traditional financing methods. By selling securities backed

by their assets, originators can tap into a broader investor base and often obtain better terms than if they relied solely on traditional bank loans.

5. **Credit Risk Transfer:** Through asset securitization, the credit risk associated with the underlying assets is transferred from the originator to the investors in the securities. This risk transfer can be appealing to originators looking to manage their credit exposure.
6. **Increased Originator's Capacity to Lend:** By securitizing assets and freeing up capital, originators can increase their capacity to lend. This can have positive effects on economic growth by facilitating increased lending to consumers and businesses.
7. **Customization of Risk Exposure:** The tranching process in securitization allows for the creation of securities with different risk and return profiles. Investors can choose tranches that align with their risk tolerance and investment objectives, allowing for a customized approach to risk exposure.
8. **Efficient Risk Management:** Originators can use securitization as a tool for efficient risk management. By transferring certain risks, such as interest rate risk or credit risk, to the capital markets, originators can focus on their core business activities.
9. **Access to Broader Investor Base:** Asset-backed securities attract a diverse range of investors, including institutional investors, hedge funds, and individual investors. This broadens the investor base for originators and contributes to market efficiency.
10. **Innovation and Financial Engineering:** The structure of asset-backed securities can be tailored to meet specific investor needs and market demands. Financial innovation in the field of securitization has led to the development of various structures, such as collateralized debt obligations (CDOs) and mortgage-backed securities (MBS).

While asset securitization offers these benefits, it's important to note that it also involves complexities and risks. The financial crisis of 2008, in part, was attributed to issues related to the securitization of subprime mortgages. Proper risk management, transparency, and regulatory oversight are crucial for the responsible and sustainable use of asset securitization.

8.4 PROCESS AND MECHANISM OF SECURITISATION

1. An institution like bank which own the assets and which wants to raise cash through securitisation is required to identify homogeneous loan assets. Such assets are pooled together by using parameters like type of credit facility, tenor of loan and nature of credit risks etc.

2. The receivables, representing cash flow from loans assets, are pooled together and are transferred to a newly formed independent institution called a special purpose vehicle (SPV) which will be created either in the form of a trust or a registered company.
3. SPV which is created specifically for securitisation issues the securities to the prospective investors. The securities so issued are known as pass or pay through certificates.
4. The securities are issued from pool of assets by SPV with or without recourse to the originator of loan asset.
5. In order to enhance credit worthiness and liquidity position, SPV enter into an agreement with non life insurance companies to absorb credit risk and obtain a line of credit from banks to make available cash for payment.
6. In order to make the issue attractive SPV obtains credit rating for securities to Asset Securitisation be issued from pool of assets from recognised credit rating agencies. This also improves liquidity for such instrument in the secondary market.
7. The securities are issued to the investors through public issue or by private placement. SPV take the help of merchant bankers for selling of these securities to the prospective investors.
8. Investor can hold these securities till its maturity. On maturity, securities are redeemed by the SPV (i.e. issuer) along with interest due on such securities. As many of these pass or pay through certificates are traded in the secondary market, investor can avail liquidity by selling such certificates in the secondary market.

8.5 PARTICIPANTS IN SECURITIZATION

- Primary Participants
- Secondary Participants

Primary Participants

1. **Originator** – It is basically the initiator of the securitization process. It sell the illiquid assets lying in its books to the special purpose vehicle.

2. **Special Purpose Vehicle (SPV)** – After purchasing the illiquid assets from the originator, the SPV makes an upfront payment to it. Then, it converts those illiquid assets into marketable securities and issue it to the investors.

- 3. The Investors** - Investors are the buyers of securitized papers which may be an individual, an institutional investor such as mutual funds, provident funds, insurance companies, mutual funds, Financial Institutions etc.

Secondary Participants

- 1. Obligors** - They are the parties who owe money to the originators. The amount due from the obligors is transferred to SPV which in turn passes it on to the investors of securitized instruments.
- 2. Rating Agency** - Since the securitization is based on the pools of assets rather than the originators, the assets have to be assessed in terms of its credit quality and credit support available. Credit Rating Agencies provide that.
- 3. Receiving and Paying agent (RPA)** - Also, called Servicer or Administrator, it collects the payment due from obligor(s) and passes it to SPV.
- 4. Agent or Trustee** - Trustees are appointed to oversee that all parties to the deal perform in the true spirit of the terms of agreement. Normally, it takes care of interest of investors who acquires the securities.
- 5. Credit Enhancer** – It provides additional comfort to the investors to whom the securitized instruments are issued in the form of additional collateral or third party guarantee such as letter of credit or surety bond.
- 6. Structurer** - It brings together the originator, investors, credit enhancers and other parties to the deal of securitization. Normally, these are investment bankers i.e. merchant bankers also called arranger of the deal. It ensures that the deal meets all legal, regulatory, accounting and tax laws requirements

8.6 MECHANISM OF SECURITIZATION

Administration of assets - The administration of assets then passes back to originator which collects principal and interest from the underlying assets and transfer it to SPV, which works as a conduit or channel.

- **Recourse to Originator** – In case of default in payment by the borrowers(obligors), the liability to pay transfers to the originator from the SPV.
- **Repayment of funds** – The SPV repays the invested amount to the investors in the form of interest and principal that arises from the assets pooled.

• **Credit Rating to Instruments** - Sometimes before the sale of securitized instruments, credit rating can be done to assess the risk of the issuer.

8.7 PROBLEMS IN SECURITIZATION

1. **Stamp Duty** - Stamp Duty is one of the major obstacles in India. Under Transfer of Property Act, 1882, a mortgage debt stamp duty may go up to 12% in some states of India and this impedes the growth of securitization in India.
2. **Taxation** - Taxation is another area of concern in India. In the absence of any specific provision relating to securitized instruments in Income Tax Act, experts' opinion differ a lot. Differences of opinion exist as to whether SPV as a trustee is liable to be taxed in a representative capacity or not.
3. **Accounting** - Confusion exists in accounting aspects also. Transfer of mortgaged assets to SPV is an off-balance sheet transaction in which the receivables are removed from the balance sheet of the originator. But, originator is still responsible for collecting the interest and principal amount from the obligors and transfer it to the SPVs. For this purpose, the experts say that the originator has to maintain accounting entries. Again, lack of clarity is there when the securitization is on non-recourse basis.
4. **Lack of standardization** - Every originator follows his own procedure for documentation and administration of the securitization process. So, having lack of standardization is another obstacle in the growth of securitization. • **Inadequate Debt Market** - Lack of existence of a well-developed debt market in India is another obstacle that hinders the growth of secondary market of securitized or asset-backed securities.
5. **Ineffective Foreclosure laws** - Since foreclosure laws are not supportive to lending institutions, this makes securitized instruments less attractive as lenders face difficulty in transfer of property if borrowers default.

8.8 ROLE OF SPECIAL PURPOSE VEHICLE (SPV)

The Special Purpose Vehicle (SPV) is created to purchase the assets from the Originator and issue securities against these assets. Such a structure provides a comfort to the investors that they are investing in a pool of assets which is held on their behalf only by the SPV and which is not subject to any subsequent deterioration in the credit quality of the originator. SPV may be created either as a trust or registered company. However, quite often SPV is structured as a trust to take advantage of tax benefits. By and large SPV is created by the originator of the loan asset. However, due to independent legal

entity ownership and management of SPV are independent of the originator. Due to the limited scope of its activities, it has no bankruptcy risk.

SPV should have the following characteristics :

1. A SPV must be capable of acquiring, holding and disposing of assets.
2. It would be an entity which would undertake only the activity of asset securitisation and no other activity.
3. It should be independent of bankruptcy of the originator (i.e. the bankruptcy of originator should not affect the interest of holders of instruments issued by SPV).
4. A SPV must be able to undertake multiple securitised transactions of asset securitisation

8.9 SECURITIZATION INSTRUMENTS

The following types of securities are structured in asset securitisation.

a) Pass and Pay Through Securities.

b) Asset and Mortgage Backed Securities

a) Pass and Pay Through Securities

The nature of the investors interest in the underlying assets determines whether a securitisation structure is a 'Pass Through' or Pay Through structure. Under pass through securities structure, the originator sells the assets to be securitised to the SPV. As a result assets are removed from the balance sheet of the originator. The originator acts as servicer and passes on the interest and principal amount collected. The seller of the asset (i.e. originator) transfer the entire cash flows accruing from the assets to the discharge of obligation. The sale of assets, to SPV improves the liquidity position and liquidity ratio of the originator. Pass through securities represent a direct claim of the investors on all that the SPV collects from Asset Securitisation these assets transferred to it. In other words, such securities carry proportional beneficial interest in the assets held by the SPV. In a pass through structure, the SPV issues 'pass through certificates' which are in the nature of participation certificates that enable the investors to take a direct exposure on the performance of the securitised assets. SPV also issues pay through securities. Such securities give investors only a charge against the securitised assets while the assets themselves are owned by the SPV. The SPV issues regular secured debt instruments. In other words pay through securities are essentially the obligations of the SPV which are discharged out of the receivables collected from transferred assets. Pay through structures permit de-

synchronisation of servicing of the securities from the underlying cash flows. Thus the SPV is given discretionary power to reinvest short term surplus according to its requirement. This structure enables SPV to offer wide range of instruments with different maturities and yields. Thus SPV is free to restructure the cash flow from the receivable into payments on several debt tranches with varying maturities.

4. **Pass Through Certificates (PTCs)** – This is a certificate given to the investors of securitized instruments that interest and principal amount will be paid to them. They are called PTCs because the interest and the principal amount is passed through from the borrowers to originators, then to SPVs, and finally to the investors.
5. **Pay Through Security (PTS)** – In this case, SPV issues new securities to the investors in place of a pass through certificate. These securities are generally considered safe securities from which interest and payment of the principal amount is almost assured
6. **Stripped Securities** - Stripped Securities are created by dividing the cash flows associated with underlying securities into two or more new securities such as:
 - (i) Interest Only (IO) Securities
 - (ii) Principle Only (PO) Securities

These are generally considered as volatile and less preferred by the investors

b) Asset and Mortgage Backed Securities

Securities issued by the SPV in a securitisation transaction are referred to as Asset Backed Securities (ABS) because investors rely on the performance of the assets that collateralise the securities. They do not take an exposure either on the previous owner of the assets (the Originator), or the entity issuing the securities (the SPV). Clearly, classifying securities as ‘asset-backed’ seeks to differentiate them from regular securities, which are the liabilities of the entity issuing them. In practice, a further category is identified – securities backed by mortgage loans (loans secured by specified real estate property, wherein the lender has the right to sell the property, if the borrower defaults). Such securities are called Mortgage backed Securities (MBS). The most common example of MBS is securities backed by mortgage housing loans. All securitised instruments are either MBS or ABS

8.10 PRICING OF THE SECURITIZED INSTRUMENTS

From Originator's Angle :-From originator's point of view, the instruments can be priced at a rate at which originator has to incur an outflow and if that outflow can be amortized over a period of time by investing the amount raised through securitization.

From Investor's Angle:-From an investor's angle security price can be determined by discounting best estimate of expected future cash flows using rate of yield to maturity of a security of comparable security with respect to credit quality and average life of the securities.

8.11 CRITERIA FOR INVESTMENT IN SECURITISED INSTRUMENTS

While investing funds in securitised papers, the following criteria can be used by the investors.

i) Safety (credit risk)

ii) Liquidity

iii) Rate of Return

i) **Safety of Investment:** In order to ensure safety of investment in securitised papers, it is better to use credit rating attached to such instruments. SPV prefer to have credit rating from recognised rating agencies for such instruments. Investment in securitised papers with higher credit rating will help to mitigate credit risk. This further can be eliminated by investing in securitised papers having with recourse characteristic.

ii) **Liquidity of Securitised Papers:** Investment decision is also influenced by liquidity or marketability of securitised instruments. Investor would like to invest in that securitised paper for which there is active secondary market. Because of good rating from rating agencies and backing of assets, securitised instruments are likely to carry more liquidity in the market. For this purpose there is a need to develop a good secondary market which will facilitate early transfer of assets to the buyer.

iii) **Rate of Return:** It has been observed in developed countries where securitisation has taken place, that Pass Through Certificates (PTC) have been fetching higher yield than the yield on government securities. This combined with a high degree of liquidity has made the PTCs instruments very popular among investors. To make these certificates "take off" in Indian

financial market such instruments must offer adequate rate of return, vis-à-vis, return on other comparable financial instruments. The return would have to be much higher to compensate for the lack of liquidity, at least initially, till an active secondary market is developed in these instruments.

8.12 WITH RECOURSE AND WITHOUT RECOURSE SECURITISATION

1. **With Recourse Securitisation:-**The lending institution engaged in securitisation or SPV may enjoy recourse to the seller of the asset in case of failure of customers to repay dues on due dates. In this case the lending institution (i.e. seller of the asset) is unable to pass on credit risk to SPV. In this case SPV enjoys lesser margin. Under this method seller becomes the servicer. He collects the cash flows from lessee, hire purchaser or borrower and pass on the cash to the SPV. The SPV merely passes the funds to the investors. In this arrangement, securitised assets creates off balance sheet liability to the seller of the assets.
2. **Without Recourse Securitisation:-**The securitisation without recourse will help the originator to sell the loan assets to the SPV with credit risk also. The collateral may be designed to have a bankruptcy structure to enjoy all the rights which the seller would have enjoyed on the leased/hire purchase in case of failure of the customers to pay lease rentals and hire purchase instalments. In other words SPV absorbs the credit risk. Assets in the nature of receivables which are designed as collateral are assigned in favour of SPV. By virtue of this assignment, SPV has a right to collect cash on due date from the borrowers who have defaulted in payment of cash.

8.13 SECURITIZATION IN INDIA

It is the Citi Bank who pioneered the concept of securitization in India by bundling of auto loans into securitized instruments. Thereafter many organizations securitized their receivables. Although started with securitization of auto loans it moved to other types of receivables such as sales tax deferrals, aircraft receivable etc. The important highlight of the scenario of securitization in Indian Market is that it is dominated by a few players e.g. ICICI Bank, HDFC Bank, NHB etc. Moreover, from 2019-20 onwards, the securitization volume has picked up in India. It is the Citi Bank who pioneered the concept of securitization in India by bundling of auto loans into securitized instruments. Thereafter many organizations securitized their receivables. Although started with securitization of auto loans it moved to other types of receivables such as sales tax deferrals, aircraft receivable etc. The important highlight of the

scenario of securitization in Indian Market is that it is dominated by a few players e.g. ICICI Bank, HDFC Bank, NHB etc. Moreover, from 2019-20 onwards, the securitization volume has picked up in India

8.14 SUMMARY

Asset Securitisation is a process wherein loan assets and future receivables arising on account of trade and business activities are packaged, underwritten and sold in the form of securities. The various parties namely the originator (seller of loan assets), trust or company (special purpose vehicle), merchant bankers, rating agencies and institutional investors etc. are involved in the process of securitisation. Securitisation of loan assets and receivables can be done with recourse or without recourse. Three instruments namely, pass through certificates, pay through certificates and stripped securities are used in the securitisation process. In India, the first securitisation deal was made in 1991 between ICICI Ltd. and Citi Bank to securitise loan assets of ICICI Ltd. Since then the market for securitisation has been growing slowly but steadily. Many commercial banks and housing finance companies have securitised their loan portfolio. India is likely to witness considerable growth in securitisation market in near future

SELF ASSESSMENT

SHORT QUESTIONS:

1. What is asset securitization?
2. Why do financial institutions engage in asset securitization?
3. Who regulates asset securitization in India?
4. What types of assets are commonly securitized in India?
5. How does asset securitization contribute to market development?

LONG QUESTIONS

1. Explain the process of asset securitization and its key participants.
2. What role does asset securitization play in mitigating risk for financial institutions?
3. Discuss the impact of asset securitization on credit expansion in the Indian financial market.
4. What challenges does the asset securitization market face in India, and how can these challenges be addressed?
5. How does the regulatory framework established by SEBI contribute to the growth and stability of the asset securitization market in India?

UNIT 7

CHAPTER 10 HOUSING FINANCE

- 10.0 Introduction
- 10.1 Framework for Housing Finance: An Overview
- 10.2 Home Loans: Distinguishing Features and Main Terms and Conditions
- 10.3 Securitisation of Housing Loans
- 10.4 Advantages of Housing Finance
- 10.5 Methods of Housing Finance
- 10.6 Tax Benefits That Boosts Housing Finance in India
- 10.7 Sources of Funds
- 10.8 Advantages of Housing Finance
- 10.9 Role of National Housing Bank
- 10.10 Statutory Provisions Regarding Regulation

SUMMARY

SELF ASSESSMENT QUESTIONS

10.0 INTRODUCTION

India's **national housing policy** insists on providing more dwelling houses to the citizens. It is only natural for the government to create institutions which can provide **housing finance**. At the international level, institutions such as World Bank and Asian Development Bank provides both grants and loans, especially soft loans for removing slums and for the creation of **housing colonies**. In fact in India, the World Bank has financed Sites and Service Schemes to a number of state governments, thereby, both housing and promotion of small scale industries are simultaneously encouraged. House construction, like any other economic activity, needs finance, which is essentially for medium to long term. In the past, in the absence of institutional sources of finance for housing, individuals used to depend on their own accumulated savings and borrowings from friends and relatives only for this purpose. But during the recent past,

various institutional sources of finance have emerged for house building activity. Insurance companies, banks, housing finance companies, cooperative institutions are the main sources for finance for the housing sector. Housing finance is to be clearly distinguished from finance (loans) against house property. In the latter case, loans are provided against the security of house property for any purpose, not necessarily for the construction/purchase of houses. On the other hand, housing finance connotes finance (or loans) for meeting the various needs relating to housing, namely, a) purchase of a flat or house b) acquisition of a plot, and construction of a house c) construction of a house d) extension of a house e) repairs, renovation and upgradation of a house/flat f) taking over housing loans from other banks/housing finance companies. Housing finance has a wider connotation and includes both direct and indirect finance made available for this purpose. Direct Finance includes finance made available to individuals, group housing societies, government agencies or employers who undertake construction of houses. Indirect Finance includes investments in/loans given to the agencies which provide housing finance, e.g., investment in the bonds issued by National Housing Bank, HUDCO, etc

10.1 FRAMEWORK FOR HOUSING FINANCE: AN OVERVIEW

Realizing the significance of the housing sector in the economy of the country a fine institutional framework has been set up in India during the last two decades. The establishment of National Housing Bank in 1988 as the apex bank in this area marked a new era in housing finance in India. This landmark event was followed by the entry of commercial banks and housing finance companies in a big way. National Housing Bank performs the functions as re-financing agency and also as the regulatory authority for the housing finance companies. Besides, it also provides direct financial assistance to the state and public sector authorities for undertaking housing and allied projects. Housing Finance Companies have been set up by leading commercial banks, Life Insurance Corporation of India, General Insurance Corporation of India, besides the private sector. Government of India has set up another corporation named Housing and Urban Development Corporation, while HDFC has been set up by banks and other financial institutions. Some of the leading commercial banks directly undertake housing finance also in a big way. Thus, a very competitive environment has emerged for providing housing finance. Cooperative institutions are also providing housing finance but to limited extent only. Housing finance provided by all these institutions falls in two broad categories, viz. (i) loans to individuals, and (ii) project finance. Project finance is provided by the National

Housing Bank, HUDCO, HDFC etc. to the Government sponsored bodies for undertaking projects relating to land development, infrastructure, slum re-development etc. However, the major portion of refinance provided by the National Housing Bank was in respect of loans to individuals. HUDCO, of course, provides the bulk of its assistance for urban infrastructure development schemes.

10.2 HOME LOANS: DISTINGUISHING FEATURES AND MAIN TERMS AND CONDITIONS

Home loans to individuals are mainly provided by banks and housing finance companies in India. These institutions have formulated their own schemes of financing and laid down their own terms and conditions, which differ from each other in respect of details. But the underlying features of all home loans are basically the same. The special features of home loans and main terms and conditions as prescribed by HDFC, a leading housing finance company, are as follows:

1) **Eligibility for Loan:** As housing loans are essentially for medium to long periods, and are repayable out of the future savings of the borrower, the latter's earning capacity and his ability to save is an important eligibility criterion. For this purpose, salaried people and others with regular incomes are preferred. Their present income and saving capacity is taken into account for this purpose. Lenders take into account the age of the borrower also. They insist that the Housing Finance salaried employees should have at least 5 years of service left and businessmen, professionals and self-employed must not be beyond a certain age, say 55 or 58 years. The remaining period of service or professional career indicates their income earning capacity in future to repay the loans. If the property is going to be purchased by more than one person, the proposed owners of the property to be purchased are required to be co-applicants.

2) **Amount of Loan:** The lenders allow the maximum amount of loan upto a certain percentage of the cost of the property including the cost of the land, say upto 85% or 90%. The remaining amount is required to be provided by the borrower himself. Subject to the above, the amount of the loan is determined according to repayment capacity of the borrower. For doing so, factors such as income, age, qualifications, number of dependents, spouse's income, assets, liabilities, stability and continuity of occupation and saving history are taken into account.

3) **Security for Loan:** Security for the loan normally is first mortgage of the property to be financed and/or such other collateral security as may be necessary. Interim security may be required, if the property is under construction. Insurance policies, guarantees from sound parties, pledge of shares and other investment may be the collateral or interim security.

4) **Fees and Charges:** (i) A processing fee @ 0.5% of the loan amount applied for is payable at the time of application, (ii) an administrative fee @ 0.5% of the loan sanctioned on acceptance of the offer, and (iii) an early redemption charge @ 2% of the amount being pre-paid.

5) **Interest Rates:** Lenders give an option to the borrowers to choose either a fixed rate of interest or a floating (or adjustable) rate of interest. A fixed rate of interest is fixed for the entire period of the loan, while a floating rate is re-set periodically, as the interest rates in general move. Floating interest rate is fixed 0.5% to 0.75% lower than the fixed interest rate. Floating interest rate is linked to the Retail Prime Lending Rate of the Bank/HFC. This rate is revised every three months from the date of first disbursement, if there is change in the Retail Prime Lending Rate. If the interest rate is changed, the amount of Equated Monthly Instalments will not change – the interest component in an EMI increases and the principal component reduces, resulting in an extension of the loan period and vice versa, if the interest rate is reduced. Most of the Banks/HFCs charge differential interest rates, based on the length of the loan period. As the period of loan increases, the rate of interest also increases. For example, the State Bank of India at present charges 8.5% on loans for 1 to 5 years, 9% on loans for 6 to 15 years and 9.25% on loans for 16 to 25 years. Some lending institutions charge differential rates based on the amount of the loan itself. For example, HDFC and ICICI charge 8.75% on loans upto Rs. 10 lakh and 8.50% on loans exceeding Rs. 10 lakh. Most of the institutions charge interest on monthly rests basis, while a few charge on daily or annual rests basis. Some lenders give an option to the borrowers to avail part of the loan under fixed rate and the balance under variable rate. An option is also given by some of the institutions to switch between the two options, after paying a nominal fee.

6) **Disbursement of the Loan:** Loans are disbursed after the property has been technically appraised, all legal documentation has been completed and the borrower has invested his own contribution in full. The loan may be disbursed in lump sum or in instalments depending upon the need of the borrower, and stage of construction. If the loan is for purchasing a house, loan may be disbursed directly to the seller of the property.

7) **Repayment Period:** Housing loans may be repaid over a maximum period of 20 years. But repayment is ordinarily not extended beyond the age of retirement (if the borrower is employed) or on attaining the age of 65 years, whichever is earlier.

8) **Equated Monthly Instalments:** Loans are usually repayable in monthly instalments of equal amounts, called Equated Monthly Instalments (EMIs). Each EMI has two components – interest and principal amount. As each instalment is paid, interest component is reduced and the component of principal increases. EMI is calculated using a formula that considers loan amount, interest rate and loan period as variables. Longer the loan period, smaller is the EMIs. Similarly, higher the rate of interest, higher is the EMIs. For the purpose of calculation of interest, lenders rely upon either monthly rest basis or annual rest basis. Under the monthly rest option, interest is calculated on monthly rest and principal repayments are credited at the end of every month. Under the annual rest option interest is calculated on annual rests. Principal repayments are credited at the end of the financial year.

9) **Repayment Options:** The lender often offers the following repayment options also to the borrower:

a) **Regressive Repayment Scheme:** The borrower pays larger amounts in the initial years and lower amounts in latter years. Such a scheme suits those who have to retire from service after a few years.

b) **Ballon Repayment Scheme:** Under this scheme, the borrower pays a lower EMIs in the initial years and a ballon repayment (as high as 30-40% of the loan) in latter instalments. Thus the major burden of repayment is shifted to latter years when the borrower expects higher earnings.

c) **Pre-payment:** If pre-payment clause is inserted, the lender allows prepayment of loans, after paying a fee or charge.

10.3 SECURITISATION OF HOUSING LOANS

In order to mobilise more resources for the housing sector, National Housing Bank has taken a new initiative by undertaking securitisation of home loans granted by housing finance companies and banks. Securitisation by NHB involves purchase of home loans backed by mortgages from housing finance companies and banks (called the originators) and transfer of the same to the investors for consideration. NHB acts as trustee for such investors and issues

Pass Through Certificates to the investors. As trustees, NHB arranges for collection of cash flows on the securitised loans and its distribution to the investors. It receives Trusteeship Fee for this purpose. The process of securitisation called Residential Mortgage-backed Securitisation (RMBS) is beneficial to both the originators and the investors. Originators augment their liquid resources immediately — they need not wait for long to realize the EMIs from their borrowers. Hence they can lend further on the basis of resources received on securitisation. For credit enhancement of the Pass Through Certificates (PTCs), originators provide to the trustees a collateral in the form of cash deposit or bank guarantee. The investors — institutions and individuals — get an additional avenue for investment of their excess funds with greater degree of security. The recovery of housing loans has generally proved to be very high and hence chances of bad debts are very insignificant. The investors get a return payable monthly. Till 2003-04 the NHB has completed ten securitisation transactions involving 35116 individual home loans originated by 6 housing finance companies and one public sector bank, aggregating Rs. 663.92 crore. NHB has also invested a small sum in these PTCs. The average collection efficiency in each securitised pool ranged between 95% to 99%. The total collections from the pools were adequate to service the investors. Therefore, necessity was not felt to tap the collaterals.

10.4 ADVANTAGES OF HOUSING FINANCE

1. Among the financial services, housing finance creates employment, both directly and indirectly.
2. Industries such as cement, brick manufacturing, sanitary products, electrical fittings and glass industries experience more demand due to house construction.
3. Rural housing develops not only rural areas but prevents migration of labor to urban areas.
4. Housing finance helps in creation of more houses which results in building up more infrastructure facilities, such as roads, electricity generation, drinking water facilities, etc.
5. Factories or industrial establishments create townships by providing more housing facilities to their employees. Housing finance thereby reduces congestion in urban areas.
6. Due to housing finance, there is a vertical expansion and re building of dilapidated houses and re modelling of the existing houses.

7. Housing facilities not only improve, they also reflect the culture of the country. Chandigarh city is an example for modern housing which has been built by a French architect.
8. Non conventional energy gets popularized due to modern housing facilities which is one of the major benefits of housing finance.

10.5 METHODS OF HOUSING FINANCE

Commercial banks and co-operative societies are providing housing finance. Life Insurance Corporation is also in the race for housing finance. While providing housing finance, the lender and borrower enter into an agreement under the Transfer of Property Act, whereby the house to be constructed is mortgaged along with the land to the creditors who is called mortgagee. The borrower is the mortgagor and he cannot sell the house to any third party until the loan is repaid. In other words, the financing institution has a charge on the property of the borrower until he repays the loan. When the **housing loan** is repaid, the mortgage is lifted and the ownership of the house is transferred to the owner. The owner has now an absolute right to transfer or sell to any party he likes. In the case of granting housing loan to existing houses for the purpose of rebuilding or expansion, the house will be mortgaged to the financing company, till the loan is repaid.

10.6 TAX BENEFITS THAT BOOSTS HOUSING FINANCE IN INDIA:

In order to encourage more house construction in India and to boost housing finance, the Income Tax Act provides concession to the assesses, under which INR. 30,000 can be availed as tax relief if housing loan was availed for house renovation work, and if loan was availed for construction purpose, the interest payment up to INR. 200,000 per year can be written off from the gross income and the principal paid is covered under section 80C while computing the income tax. Though the Kelkar Committee has recommended to the government to withdraw these concessions, it is doubtful as to how far government may agree to these recommendations. The Housing Finance Company is yet another form of non-banking financial company which is engaged in the principal business of financing of acquisition or construction of houses that includes the development of plots of lands for the construction of new houses. The Housing Finance Company is regulated by the National Housing Bank. Any non-banking finance company can operate as a housing finance company, subject to the fulfilment of basic requirements as specified in the Companies Act, 1956. The company should

obtain a certificate of registration (COR) from the National Housing Bank (NHB). The company conducting such business without a COR is an offense punishable under the provisions of the National Housing Bank Act, 1987, also the NHB can demand the winding up of such company. * The company should have its primary business of providing finance for housing, whether directly or indirectly. * The company should have minimum Net Owned Fund of Rs 10 Crore. Once these basic requirements are fulfilled, the company should comply with the following conditions to get registered as a Housing Finance Company. The affairs of the housing finance company should not be detrimental to the interest of the present and future depositors. The company shall be in such a position that it is able to meet the full claims of its present as well as future depositors as and when these accrue. The management of the company should not be prejudicial towards public interest or to the interest of its depositors. The Company should have an adequate capital structure and better income prospects. The certificate of registration shall not be prejudicial to the operation and growth of housing finance sector of the country. Housing Finance Policy Aspect India's national housing policy insists on providing more dwelling houses to the citizens. It is only natural for the government to create institutions which can provide housing finance. At the international level, institutions such as World Bank and Asian Development Bank provides both grants and loans, especially soft loans for removing slums and for the creation of housing colonies. In fact, in India, the World Bank has financed Sites and Service Schemes to a number of state governments, thereby, both housing and promotion of small-scale industries are simultaneously encouraged. In 2019, 'Infrastructure Leasing & Financial Services Limited' (IL&FS), India's leading infrastructure development Non-Banking Financial Company (NBFC) defaulted on its debt payments. Housing Finance Companies, including HDFC, Dewan Housing Finance Ltd (DHFL), PNB Housing Finance Ltd (PNBHFL) and LIC Housing Finance Ltd (LICHFL), had high exposure to IL&FS. As a result, the crisis triggered a liquidity crunch in the housing finance sector. The Reserve Bank of India (RBI), therefore, proposed to take over the regulation of Housing Finance Companies (HFCs) by amending the National Banking Act from the National Housing Bank (NHB). The NHB had been set up as an apex institution to regulate housing finance in 1988. The overall mandate given to the NHB is to make retail housing finance affordable to all sections of the society. The RBI, in November 2019, issued a notification withdrawing exemption given to HFCs which allowed the NHB to regulate them. HFCs came under the purview of the RBI through Section 111B of the RBI Act.

10.7 SOURCES OF FUNDS

Commercial banks and co-operative societies are providing housing finance. Life Insurance Corporation is also in the race for housing finance. While providing housing finance, the lender and borrower enter into an agreement under the Transfer of Property Act, whereby the house to be constructed is mortgaged along with the land to the creditors who is called mortgagee. The borrower is the mortgagor and he cannot sell the house to any third party until the loan is repaid. In other words, the financing institution has a charge on the property of the borrower until he repays the loan. When the housing loan is repaid, the mortgage is lifted and the ownership of the house is transferred to the owner. The owner has now an absolute right to transfer or sell to any party he likes. In the case of granting housing loan to existing houses for the purpose of rebuilding or expansion, the house will be mortgaged to the financing company, till the loan is repaid. NBFCs raise capital in the short-term (1-3 months) commercial paper (CP) market at a lower cost, as compared to the long term (5-10 years) nonconvertible debenture (NCD) market but face the risk of rolling over the CP debt at short frequencies of a few months. The frequent repricing exposes NBFCs to the risk of facing higher financing costs and, in the worst case, credit rationing.

10.8 ADVANTAGES OF HOUSING FINANCE

- 1) Industries such as cement, brick manufacturing, sanitary products, electrical fittings and glass industries experience more demand due to house construction.
- 2) Among the financial services, housing finance creates employment, both directly and indirectly.
- 3) Rural housing develops not only rural areas but prevents migration of labor to urban areas.
- 4) Factories or industrial establishments create townships by providing more housing facilities to their employees. Housing finance thereby reduces congestion in urban areas.
- 5) Housing finance helps in creation of more houses which results in building up more infrastructure facilities, such as roads, electricity generation, drinking water facilities, etc.
- 6) Due to housing finance, there is a vertical expansion and re building of dilapidated houses and re modelling of the existing houses.

- 7) Non conventional energy gets popularized due to modern housing facilities which is one of the major benefits of housing finance.
- 8) Housing facilities not only improve, they also reflect the culture of the country. Chandigarh city is an example for modern housing which has been built by a French architect

10.9 ROLE OF NATIONAL HOUSING BANK

National Housing Bank was set up in July 1988 under the National Housing Bank Act, 1987 as the apex bank in the field of housing finance. It is a wholly owned subsidiary of Reserve Bank of India. It is the principal agency to promote housing finance institutions at regional and local levels and to provide financial and other support to such institutions. It is vested with wide powers to regulate the housing finance companies in India. The functions undertaken by the Bank are divided into the following three categories :

- 1) Promotion and Development,
- 2) Financing, and
- 3) Regulation and Supervision.

1) **Promotion and Development** The promotional role of NHB includes the development and establishment of housing finance institutions at local and regional levels in the private and joint sectors by providing them financial and other support. To meet the growing need for trained personnel for housing finance sector, the Bank conducts training programmes for the housing finance companies. The Bank has also provided financial assistance and faculty support to the National Cooperative Housing Finance Federation for organising training programmes in the field of housing cooperatives.

2) **Financing** National Housing Bank provides both direct finance and indirect finance to the housing sector. Direct finance is granted to public agencies and local bodies. Indirect finance is provided by way of refinance to commercial banks, housing finance companies and cooperative institutions.

3) **Regulation and Supervision** National Housing Bank is the regulatory authority for the housing finance companies. It is vested with the following powers by the National Housing Bank Act: i) Power to Inspect: The Bank is empowered to cause an inspection to be made of any housing finance company to which it has granted any loan or assistance (Section 24). ii)

To regulate or prohibit issue of Prospectus or Advertisement soliciting deposits of money and to specify conditions subject to which any such prospectus/ advertisement may be issued (Section 30). iii) To collect information from housing finance companies and to issue directions (Section 31).

10.10 STATUTORY PROVISIONS REGARDING REGULATION

The Act contains other provisions also for regulation over housing finance companies. These are as follows:

a) Registration of Housing Finance Companies

A housing finance company is required to obtain a certificate of registration from the National Housing Bank for carrying on the business of housing finance. It must also have net owned funds of Rs. 25 lakh or such higher amount as may be fixed by the Bank. Net owned funds mean the aggregate of the paid up capital and free reserves as reduced by (i) accumulated balance of loss, (ii) deferred revenue expenditure, (iii) other intangible assets, (iv) investment in the shares of subsidiary companies, and (v) excess of book value of debentures, bonds, outstanding loans to subsidiaries over a prescribed percentage.

The National Housing Bank issues certificate of registration after it is satisfied that the conditions specified under Section 29A are fulfilled. These conditions include its solvency, satisfactory conduct of its operations, adequate capital structure, character of management, etc. The Bank may grant a certificate imposing certain conditions also and may cancel the same if the company fails to fulfil any of the prescribed conditions. In February 2002 the Bank raised the minimum requirement of net owned funds from Rs. 25 lakh to Rs. 2 crore for new companies seeking certificate.

b) Maintenance of Liquid Assets Section 29B requires every housing finance company to maintain liquid assets as follows: i) Invest in unencumbered approved securities an amount which shall not be less than 5% of the deposits outstanding at the close of business on the last working day of the second preceding quarter. It shall be maintained on a daily basis. The Bank may increase the above percentage up to 25%. Securities are to be valued at a price not exceeding their current market value ii) Invest in term deposits or certificates of deposit with a scheduled bank or deposits with National Housing Bank or invest in its bonds or partly in all of these, a sum which shall not be less than 10% (including the investments in approved securities described in (i) above) of deposits outstanding at the close of business on the last

working day of the second preceding quarter. This percentage may also be raised to 25% by the Bank. The Bank may also impose penalties in cases of defaults.

c) **Reserve Fund** Housing finance companies are required to transfer at least 25% of their net profits to the Reserve Fund every year.

d) **Power to Issue Directions** Under Section 30A, the Bank may determine the policy and give directions to housing finance companies relating to income recognition, accounting standards, provision of bad and doubtful debts, capital adequacy and deployment of funds.

e) **Power to prohibit Acceptance of Deposits** The Bank may prohibit any housing finance institution from accepting deposits if it fails to comply with any direction or order of the Bank or any provision of the Act. Bank may also prohibit any sale or transfer of its assets without its prior permission.

f) **Power to Conduct Special Audit** The Bank may order that a special audit of the accounts of the housing finance institution be conducted in relation to any transaction/class of transaction.

g) **Power to Order Repayment of Deposit** If a housing finance company defaults in repaying a deposit, the Bank may direct it to make its repayment.

h) **Power to file Winding up Petition** The Bank may apply for the winding up of the housing finance company in case the company is unable to pay its debts or a prohibition on accepting deposits has been in force for 3 months or continuance of company is considered against public interest.

Prudential Norms

National Housing Bank has prescribed the following Prudential Norms for the housing finance companies:

1) **Income Recognition:** Income on non-performing assets shall be recognised when it is actually received. Income from dividends on shares of companies and units of Mutual Funds shall be taken into account on cash basis. Income from bonds and debentures of companies and from Government securities or Government guaranteed securities may be taken into account on accrual basis, if interest is serviced regularly.

2) **Asset Classification:** Every housing finance company shall classify its assets into four categories, namely Standard, Sub-standard, Doubtful and Loss Assets. The meaning of these categories is the same as given in the prudential norms prescribed by Reserve Bank of India for banks and financial institutions. These companies shall make provisions also like the banks.

3) Concentration of Credit/Investments: The exposure norms for housing finance companies have been prescribed as follows:

i) An HFC can lend to any single borrower upto 15% of its owned funds and to a single group of borrowers upto 25% of its owned funds.

ii) An HFC can invest in the shares of another company up to 15% of its own funds and in the shares of a single group of companies upto 25% of its owned funds.

iii) For lending and investing together these limits are 25% and 40% respectively. Investments in debentures are treated as credit and not investment for this purpose.

4) Capital Adequacy Requirement: Every housing finance company is required to maintain a minimum capital adequacy ratio (consisting of Tier I and Tier II capital) not less than 12% of its aggregate risk-weighted assets and of risk adjusted value of off balance sheet items. Tier II capital shall not exceed 100% of Tier I capital. The method of ascertaining the capital adequacy requirement is the same as is applicable to commercial banks.

SUMMARY

Housing is an essential need of human beings. Moreover, housing sector has great economic significance for the economy of a country. Therefore, various institutional sources of finance has emerged in India for this sector. We have discussed the salient features of such loans and the main terms and conditions on which such loans are granted by these institutions. We have discussed the role of banks and housing finance companies which are the principal agencies for providing housing finance in India. HUDCO and HDFC are the two prominent institutions in this area. The National Housing Bank is the apex Bank. and regulatory authority for housing finance companies. We have discussed the promotional, financing and regulatory role of NHB in detail. The main provisions of National Housing Bank Act, the directives issued by it regarding acceptance of public deposits and the prudential norms prescribed by it are discussed in detail. Lastly, the new innovation of securitisation of housing loans is also highlighted

SELF ASSESSMENT QUESTIONS

Short Questions

- 1) What do you understand by Equated Monthly Instalments?
- 2) What consideration is kept in mind while determining EMIs? Explain.
- 3) What functions are undertaken by National Housing Bank?

Long Questions

- 4) Explain the statutory provision for maintenance of liquid assets by housing finance companies.

- 5) What are the various ways in which the commercial banks may participate in housing finance?
- 6) What do you understand by securitisation of housing loans? Explain its procedure and significance
- 7) What do you understand by Floating Rate of Interest? How is it determined? Explain its significance.

UNIT 7

CHAPTER 11 Credit Cards

- 7.0 Introduction
- 7.1 Meaning and Importance of Credit Card
- 7.2 Types of Credit Cards
- 7.3 Advantages of Best Credit Card
 - 7.3.1 Advantages of Credit Cards Business to Issuers
- 7.4 Disadvantages of Credit Cards Business
- 7.5 Credit Card Business Cycle

Summary

Self-Assessment Questions

7.0 INTRODUCTION

A credit card is a thin rectangular piece of plastic issued by a financial company that lets cardholders to borrow funds with which users can pay for the purchase of goods and services. Credit cards work on the condition that cardholders must pay back the borrowed money, plus interest, as well as any additional agreed-upon charges. A credit card provider may also enable them to borrow money in the form of cash advances. Issuers customarily pre-set the borrowing limits, based on an individual's credit rating. Most financial companies let the customer make purchases with credit cards, making them one of the most popular payment methodologies for buying consumer goods and services. Industries in the manufacturing sector grew because they produced tangible goods which satisfied physiological needs of human beings like food, shelter and clothing. As these basic needs were fulfilled there was a demand for improved satisfaction, and this led to a proliferation of variations in the same product and number of companies involved in their manufacture. The economic development of society and the sociocultural changes accompanying these changes, has led to the growth of service industry. Increasing affluence combined with increasing complexity of life and increasing insecurity has led to the phenomenon of credit cards. The credit cards provide convenience and safety in the purchasing process.

7.1 MEANING AND IMPORTANCE OF CREDIT CARD

The Credit card is generally known as “plastic money”, as these cards are made of plastic, is widely used by the consumers all around the world. The convenience and safety factors add value to these cards. The changes in the consumer behaviour led to the growth of credit cards.

Credit card is a document that can be used for purchase of all kinds of goods and services in the world. It is a card that identifies its owner as one who is entitled to purchase things without cash, purchase services without money and be eligible to get credit from a number of establishments. The cards issuer issues credit cards depending on the credibility of the customers and also enters into a tie-up with merchant establishments which are engaged in various fields of business activities. The issuer, for its convenience and for proper scrutiny sets up a credit limit on its card holders and a floor limit for its merchant establishments. The credit card offers the individual an opportunity to buy rail/air tickets, make purchases from shops, and stay at hotels when they need. A credit card also enables an individual to purchase certain products/services without paying for them immediately. He needs only to present the credit card at the cash counter and has to sign some forms. In short, he can make purchase against credit card without making immediate cash payment. Therefore, credit cards can be considered as a good substitute for the cash and cheques. However, these cards will be accepted only by those establishments which have consented to entertain, them. These establishments are known as Merchant Establishments. Most major credit cards, including Visa, MasterCard, American Express, and Discover, are issued by banks, credit unions, or other financial institutions. Many credit cards attract customers by offering incentives such as airline miles, hotel room rentals, gift certificates to major retailers, and cash back on purchases.

A credit card is a type of credit facility, provided by banks that allow customers to borrow funds within a pre-approved credit limit. It enables customers to make purchase transactions on goods and services. The credit card limit is determined by the credit card issuer based on factors such as income and credit score, which also decides the credit limit. Bonus tip: use the free credit score checker tool to check your current score.

The credit card information includes credit card number, cardholder’s name, expiration date, signature, CVC code, etc. The best part about a credit card is that it is not linked to a bank account. So, whenever you swipe your credit card, the amount is deducted from your credit card limit, not your bank account. You can use it to pay for food, clothes, take care of medical expenses, travel expenses, and other lifestyle products and emergency services.

7.2 TYPES OF CREDIT CARDS:

Many retail establishments come up with branded versions of credit cards, with the store's name emblazoned on the card, to generate customer loyalty. Such cards are easier to get for consumers and offer perks such as special discounts, promotional offers, and cashbacks. Secured credit cards are those that is to be secured with a security deposit. Such cards offer limited lines of credit that are equal in value to the security deposits. The credit card system can give a wide range of products and services. The varied uses of credit cards can be obtained from a spectrum of acceptance venues. Today's payment business is growing dramatically while consumer demand is driving the industry's growth, technology is making it possible to address that demand with a broader range of products and with the ability to support these products, at an expanded spectrum of points of interaction. The growth of service industry mainly depends on knowing the needs of the customer. These needs are taken care off by different card issuers which target different segments of customers. Thus there are generally four basic types of cards based on the issuers:

1. Travel and Entertainment Card, for example: Diners Club Card
2. Bank Card, for example: Citi Bank Card, Bob Card, ICICI Card, SBI Card, Etc.
3. Store or Retail Card for example: Sears Reobuck Card, Spencer's Card
4. Fuel Card, For Example: Mobil Card, Bharat Bob Card, Citi Bank- Indian Oil Card

There are many types of credit cards which are being used in India and in the World. These cards can be classified as follows depending on the geographical reach, usage pattern and the class of membership, etc

Category I: Based on mode of credit recovery

- a) Credit card (Revolving credit type)
- b) Charge card

Category II: Based on status of credit card

- a) Standard card
- b) Business card
- c) Gold card

Category III: Based on geographical validity

- a) Domestic usage card
- b) International usage card

Category IV: Based on Franchise/tie-up

- a) Proprietary card
- b) Master card
- c) VISA
- d) Domestic Tie-up card

Category V: Based on the category of the user

- a) Cards issued to Individuals
- b) Corporate cards

Category I: Based on Mode of Credit Recovery

a) Revolving credit type of credit card: This credit card is generally built around the revolving credit principle. Generally a limit is set to the amount of money one can spend in a month using the card. At the end of every month, the card holder has to pay a percentage of the outstanding credit (this may be from 5% to 10%). Interest is charged on the outstanding amount. The interest rate charged by the issuer may vary from bank to bank.

b) Charge Card: A charge card is a convenient instrument not a credit instrument. Instead of paying cash or cheque every time you make a purchase, this facility gives a consolidated bill for a specific period (usually a month). Bills are payable in full on presentation, so there are no interest charges and no preset spending limits either.

Category II: Based on Status of Credit Card

a) Standard Cards: It is a normal credit card generally issued by all card issuing banks, by which a card holder is able to purchase without having to pay cash immediately. It offers limited privileges to card holders when compared to the holders of other cards in this category. Some banks issue standard cards in the brand name as “ CLASSIC’ cards, etc.

b) Business Card: Business cards are generally issued to small partnership firms, solicitors, firms of CA's, tax - consultants, etc. These cards are given to the executives of a firm to make their business trips more and more convenient. It enjoys more credit limits and privileges than the STANDARD cards. These cards are issued in the name of "EXECUTIVE" card by some banks. These cards mainly serve the credit needs of business persons particularly when they are traveling

c) Gold Card: The Gold card is one which has got a high value for the elite. It Credit Cards offers the card holder some additional benefits and facilities which he can't enjoy with Standard or Executive cards. These cards will have more credit limits, more cash advance limits than the other cards.

Category III: Based on Geographical Validity

a) Domestic Card: These are generally available credit cards from most of the banks, and will be valid in India and Nepal only. They can't be used in rest of the countries. All the transactions will be in rupees only.

b) International Cards: This type of credit cards will be issued to persons who travel abroad frequently. These cards will be honoured in every part of the world except in India and Nepal. The card holder can make purchases in currencies such as Dollars etc., subject to RESERVE BANK OF INDIA AND FEMA rules and regulations.

Category IV: Based on Franchise/tie-up

a) Proprietary Card: Generally credit card issuers will have their own brand of credit card reflecting the name of the bank (example CANCARD of Canara Bank). These cards will be issued by the banks in addition to their other tie-up cards.

b) VISA: This is a type of credit card which can be issued by any bank, that is having tie-up with VISA International Corp., USA (The original Visa Card issuers). The banks which are issuing Visa Cards on franchise basis can avail the facilities of Visa network for their transactions.

c) Master Card: This is also a type of credit card having brand name as Master Card. The issuing bank has to obtain permission or franchise from the Master Card Corporation of USA. The franchised cards will be honoured by the establishments which are in the Master card network.

d) Domestic tie-up Cards: These are the cards issued by a bank having a tie-up with domestic credit card brands such as Can card and In card etc. (Example: Indian Overseas Bank has tie-up with Can card). These banks issue cards to users through the original banks. However, they can have the bank name on the card. They give credit to customers on similar lines as the original card issuers. Though there inspire of the existence exists all these types of cards in India, most of the issuing Banks have either tied up with Visa or Master or both the networks in order to have wider acceptability.

Category V: Based on the Category of the User

a) **Individual Cards:** This category of cards are issued to individual persons. Generally all the brands of cards will be given to individuals except Corporate cards.

b) **Corporate Cards:** This type of credit cards are issued to corporate companies and business firms only. These credit cards will be used by the executives and top officials of the firms. The cards bear the name of the firm. Bills will be paid by the firm to the banks. Now-a-days two more new types of cards came into market. They are: 1) mini credit cards, and 2) pre-paid credit cards. Mini Credit Card resembles a normal credit card in most ways except in size. It is about 40% smaller in size and provides the convenience of carrying. Sometimes, there may be some additional freebies attached to these cards. Standard chartered visa mini cards and ICICI Bank visa mini cards are examples of this type of cards. In case of pre paid card, a customer has to make the payments in advance and get the card charged. This means the customer is not getting credit facility from credit card and on the contrary he is paying his expenses before he actually spends. Presently oriental bank of commerce and IDBI Ltd. are offering these cards

7.3 ADVANTAGES OF BEST CREDIT CARD

Hassle-free shopping experience:-The benefit of having the best credit card is that it has made shopping easier and convenient. You no longer need to visit malls or stores to make purchases. With your credit card, you can make big purchases from the comfort of your home. It can help you avoid putting any burden on your monthly budget with a credit card.

Low-cost EMIs:- A credit card allows you to buy products and services on low-cost EMIs. Another option that has become popular is the Buy Now, Pay Later, which is ideal for salaried borrowers with fixed monthly incomes.

No need to carry cash:-Credit cards are the best alternative to cash, as it eliminates the need for carrying cash. Credit cards are accepted almost anywhere you go. If you do not have cash, you can simply use your Kotak Mahindra credit card to cover your expenses and repay the outstanding amount at the end of the month. The process of making a transaction is simple. All you have to do is swipe your card at the PoS terminal or enter your card details to make online payments.

Rewards, cashback, and offers: -The best credit card comes with rewards and cashback that fits your needs and requirements. Depending on your credit card issuer, your credit card comes with a host of special discounts, cashback, or rewards points for purchases made through it. Before getting a credit card, it is imperative to assess your needs. For instance, if you are a frequent traveller, it would be wise to choose a credit card that offers free airport lounge access or have travel insurance. Also, there are credit cards that offer special discounts on shopping, travel tickets, and accommodation.

Easy cash withdrawal:-Another benefit of having the best credit card is that it allows you to withdraw cash whenever the need arises. However, it is worth noting that using your credit card to withdraw cash follows a small fee that you will have to bear while repaying your outstanding amount.

Widely accepted: -The best thing about a credit card is that it is accepted worldwide, as it is the most common mode of payment across the world. You can use your Kotak Mahindra credit card to make international bookings and payments at airlines, restaurants, hotels, stores, and petrol pumps with ease. It makes your travels around the world convenient. However, using your credit card abroad can cost you high foreign transaction fees and high foreign exchange rates.

Meet emergencies:-If you are wondering what is a credit card, it is a type of loan that offers to cover the cost of emergencies for you and your family. For instance, you can use your credit card to pay your medical bills. It eliminates the worrying of arranging funds for your medical bills. Keep in mind that you will have to make on-time payments to avoid hefty interest charges and higher APR%.

Improves credit score:-Some people also use credit cards to improve their credit scores. Your credit score is a three-digit number that indicates whether or not you are a creditworthy borrower. It is considered as one of the crucial parameters to determine a borrower's eligibility.

When you repay your credit card bills on time, it leaves a positive impact on your credit score, allowing you to secure loans in the future.

Free Insurance Protection: -Some of the Indian and Foreign Banks depending on the type of card issued, insures the life of the cardholder free of cost for a particular sum. Citibank offers a complimentary personal accident insurance upto Rs. 20 lakhs in case of an air accident and up to Rs. 5 lakhs in case of any other accident to its international gold master card holders. BOB card issued by the Bank of Baroda extends insurance protection to add-on cardholders also. Its not only insures the cardholder against personal accident to the tune of Rs.10 lakhs in case of air travel or Rs. 5 lakhs in case of any other accident but also gives the benefit of personal accident cover to the add-on cardholder to the tune of Rs. 2 lakhs.

Emergency Cash Withdrawal: -All the credit card issuing banks provide emergency cash withdraw facility to its card holders Cardholder can withdraw emergency cash from 24 hour ATMs in all leading cities. The Indian Banks believe in not restricting cash withdrawing power only at a few automated and/or metropolitan locations, therefore, they allow the cardholders to draw cash from all notified branches of Indian Banks spread across the country.

Twenty-four hour Customer Service: -The revolutionary phone banking service ensures that the Indian and Foreign Banks are just a phone call away and courteous banking officers are standing by to assist the cardholder twenty four hours a day, seven days a week. Foreign Banks provide a world class service to card holders. One can call phone banking and ask for temporary credit line increase any, time in the day or night.

Photocard Option -A cardholder may choose to have his photograph and signature digitally imprinted on the front of his card in colour. So that he gets the extra recognition and security if he/ she losses the card. This facility is also provided by all foreign banks and most of the Indian banks.

Travel Privileges:-The banks provide travel assistance to their cardholders by offering a wide range of services like Airline and hotel bookings, discounted holiday packages, car rentals and more. For example, Bank of Baroda has entered into a tie-up with I.B.T.C. to provide Credit Cards these services and Hongkong Bank has a tie-up with SITA World Travels to provide the same services. Through SITA World Travel's vast network of offices, a package of exclusive travel services: Teleticketing, Special Holiday and Conference packages, International and

Domestic tickets and Car rental services etc. are provided to the cardholders who are travelers at SITA.

Temporary Credit Line Increase:-Indian and foreign banks provide a temporary credit line increase based upon the ability to pay back, as demonstrated by cardholder's financial resources and his past spending and payment patterns. This credit line can be increased by 25% for 3 months. The cardholder can ask for a temporary credit line increase from the Banks when he wants to buy jewellery, or consumer durables like a TV or a Refrigerator or to pay for vehicle repairs. He/she can also use this unique feature when there is a function in the family like weddings, anniversaries, birthdays or when a business or holiday trip goes beyond the budget.

Draft on Phone:-Credit cardholders of selected Indian banks and foreign banks can use their cards to pay for personal expenses where credit cards are not accepted yet. All that the cardholders have to do is to call the bank and instruct it to make payment for mutual funds, public issues, making down-payments, and paying telephone and electricity bills.

Choose when and how to Pay :-It is possible to purchase high-value items with the flexibility to plan your payments. All the Indian and foreign banks offer a revolving credit facility that allows the cardholder to get the things that he/she wants, when he/she needs them the most and pay as little as 5% of his total outstandings every month.

Buy anything on your Card:-The cards issued by Indian and foreign banks are welcomed at member establishments which are franchisees of Master Card and Visa Card across India and Nepal. The credit card can be used both for major occasions and also for everyday purchases like groceries, cosmetics, petrol and auto accessories. To buy high-value items also the card can be used. And even paying customs duties and hospital bills becomes so convenient with card.

Purchase Protection:-This facility protects the purchase against damage or loss due to fire and theft at no extra cost. The cardholder can claim the value of the product damaged or lost from the Insurance Company. This protection may be available for a specific period from the date of purchase of the product on the card.

Fuel Facility at Petrol Pumps:-Fuel facility at Bharat Petroleum outlets is provided by BOB card and likewise at Indian Oil petrol pumps, Citibank and Standard Chartered Cards are accepted. This is very convenient for cardholders at many major cities.

Emergency Medical Advance Facility:-Cardholders can draw cash in case of medical emergencies for meeting expenses on treatment at location other than their home town. This facility is available with all Indian and foreign banks depending on the type of cards issued by the bank. 10% to 20% discount on services at hospitals in leading cities across the country is offered to cardholders by Standard Chartered Bank. This facility covers special rates on medical facilities, diagnostic tests, check-ups, lab tests, nursing charges and professional fees.

Supplementary Cards:-As a cardholder of any Indian or foreign bank one can obtain a maximum of two supplementary cards for his immediate family members at the prevailing card fee.

Hotels Discount Facility:-Cardholders can receive membership to clubs at a special price. The programme also earns some points on every rupee charged, every time the cardholder dine or stay at the hotel. Specifically, 25 points for every Rs.1,000 spend plus an extra 10% points credited to the cardholder's account if he uses his card along with his hotel club card. These points can also be exchanged for Airline tickets, hotel stays and consumer products ranging from Microwave oven to Ray-ban sun glasses. Cardholder can also earn points by using the services of select airlines who have a tie-up with the respective bank.

Joint Credit card and ATM Facility:-Foreign and Indian banks alike have introduced a joint credit card so that the cardholder can also access his personal accounts with the Bank (Savings/Current) through the ATMs.

Validity and Renewal of the Card

The cardholder can use the card within the validity period only. A new card is sent by Indian and foreign banks once in every 2-3 years before the expiry of the old card. The fees and the eligibility criteria from credit cards varies from one bank to another. It is cheaper to get a card made from Indian banks compared to foreign banks. All the above facilities/services are not necessarily offered by each and every credit card organisation in toto. Different organisations may be offering different services to different types of cardholders. Similarly, the degree and amount of facilities may also be different in the case of different organisations and may keep changing from time to time.

7.3.1 ADVANTAGES OF CREDIT CARDS BUSINESS TO ISSUERS

Apart from the advantages to users of credit cards, there are also advantages to credit card issuers. Some of the advantages to issuers are:

- 1) The reasons for more and more banks jumping into this credit card business is the high profitability that this business offers. For instance, banks charge a 2.5% commission from establishments selling goods and services through credit cards. There are instances of banks charging as much as 7% to high margin merchant establishments like Antique shops.
- 2) For the customers, banks offer a credit period of 30 to 45 days, but charge 2.5% per month on all outstandings. Thus, a single purchase transaction through credit card, assuming the customer does not pay within the stipulated credit period, will fetch a commission much more than the lending rate of many banks.
- 3) Apart from the above financial yields, the issuers can also improve their name and image by serving huge number of credit cardholders. This may also promote the regular banking of the issuers. So the issuers can very well improve their turnover, and thereby profitability, image and regular banking by improving the credit card business.

7.4 DISADVANTAGES OF CREDIT CARDS BUSINESS

After listing the uses/benefits of the credit cards, let us see, whether the credit card has any drawbacks to the user or not. There are some drawbacks, though these are very few when compared to the advantages. Some of the drawbacks are:

- 1) It is a waste of money to subscribe to credit card if the utility of the card is less.
- 2) It may lead to some unnecessary purchases. Since the user need not pay instantly, it may tempt them to purchase some products/services which are not required/needed at the time of their shopping.
- 3) If the repayment of the credit used is not done properly it may lead to more overdraft, finally it may drag the user into financial problems.
- 4) Sometimes the recovery agents appointed by some issuers, may pressurise the users to pay the outstanding dues. This may lead to loss of mental peace to the user.
- 5) Since most of the honouring merchant establishments offer only the products/ services at a higher cost than outside the user may pay more of his precious money unnecessarily

7.5 CREDIT CARD BUSINESS CYCLE

Credit cards enable the holder to make purchases, avail the services at various designated Merchant Establishments (MEs) like Departmental Stores, Star Hotels, Indian Airlines, Railways, etc., who will accept all valid credit cards in lieu of cash payment. In this way, the cardholder can avoid the risk of carrying cash. When a cardholder purchases anything, he presents his credit card to the Merchant establishment instead of paying cash. The retailer checks the number on the card against the hot list or warning bulletin provided to him by the bank. This is the authenticity test which proves whether the cardholder is the genuine owner of the card or not. The cardholder is also required to sign on the voucher, and the signature has to tally with the one on the credit card. The merchant establishment has to then present the necessary sales vouchers to the bank which in turn reimburses it for the customer's purchases. The bank charges a commission from the merchant establishment, rates of which vary from bank to bank. After the completion of this procedure, it sends the bill to the cardholder and receives the money. The credit card operating cycle comprises of the following six steps:

- 1) Cardholder purchases goods/services and gives credit card;
- 2) Merchant Establishment delivers goods after taking credit card and noting the number and taking signatures on some forms.
- 3) Merchant Establishment raises the bill for the purchase and sends it to the credit card issuing Bank for payment.
- 4) Issuing Bank pays the amount to the Merchant Establishment.
- 5) Issuing Bank raises the bill on the credit cardholder and sends it for payment.
- 6) Credit cardholder makes the payment to the Issuing Bank.

SUMMARY

Credit card business is fast catching up in the country. The potential available for the business in a country like India is really vast. Credit card business is going to be a major segment of banking business in our country also. It is going to be a major profit centre for every bank. The credit card is now an opportunity of our everyday life. The choices available in the market are many and most cards offer different features. In addition to credit, credit cards provide various other facilities and services like free insurance protection, emergency cash withdrawal, draft on phone, temporary credit-line increase, choose when and how to pay, buy anything on your

card, purchase protection, fuel facility at petrol pumps, emergency medical advance facility, hotel discount facility, ATM facility, etc. Various benefits are available through credit cards to the cardholders as well as to the operating agencies. In India, many Indian and foreign banks are offering credit cards. There are many innovations that are gaining more and more popularity in the payment business like- Smart Card, Debit Card and E-Commerce, etc.

SELF ASSESSMENT QUESTIONS

- 1) Write a brief note on the history of Credit Cards.
- 2) Explain the concept of credit card and the process involved in it.
- 3) What are the various benefits that are available to Credit Cardholders and to the Issuing Banks?
- 4) Write a brief note on new trends in the payment business.
- 5) What are the additional facilities besides providing credit that the credit cards offer to their customers

UNIT 7

CHAPTER 12 Venture Capital

- 12.1 Introduction
- 12.1 Meaning and Definition of Venture Capital
- 12.2 Features of Venture Capital
- 12.3 Disadvantages of Venture Capital Funding
- 12.4 Guidelines for Venture Capital Companies
- 12.5 Venture Capital Funding Process
- 12.6 Structure of Venture Capital Firms and Funds
- 12.7 Dimensions of Venture Capital
- 12.8 Stages of Financing Offered in Venture Capital
- 12.9 Types and Sources of Financing by Lifecycle Stage
- 12.10 Modes of Financing

SUMMARY

SELF ASSESSMENT QUESTIONS

12.1 INTRODUCTION

‘Venture Capital’ is an important source of finance for those small and medium- sized firms, which have very few avenues for raising funds. Although such a business firm may possess a huge potential for earning large profits in the future and establish itself into a larger enterprise. But the common investors are generally unwilling to invest their funds in them due to risk involved in these types of investments. In order to provide financial support to such entrepreneurial talent and business skills, the concept of venture capital emerged. In a way, venture capital is a commitment of capital, or shareholdings, for the formation and setting-up of small scale enterprises at the early stages of their lifecycle.

12.1 MEANING AND DEFINITION OF VENTURE CAPITAL

The term venture capital comprises of two words, namely, ‘venture’ and ‘capital’. The term venture literally means a course or proceeding, the outcome of which is uncertain but which is uncertain but which is attended by the risk of danger of ‘loss’. On the other hand, the term capital refers to the resources to start the enterprise. However, the term venture capital can be understood in two ways.

According to narrow sense, the capital which is available for financing the new business ventures is called venture capital. Generally, it involves lending finance to the growing companies.

In the broad sense, venture capital is the investment of long-term equity finance where the venture capitalist earns his returns primarily in the form of capital gain. It is under the assumption that the entrepreneur and the venture capital would act as partners. It is a commitment of capital for the formation and setting up of small scale enterprises specializing in new ideas or new technologies. Venture capital does not deal in financing the enterprise which is engaged in trading, broking, investment or financial services and agency or liaison work. It is generally considered as a high risk capital. Venture capital is not an injection of funds into new firm but also an input of the skills need to set up the firm, design its marketing strategy, organize and then manage it.

A venture capitalist (also known as a VC) is a person or investment firm that makes venture investments, and these venture capitalists are expected to bring managerial and technical expertise as well as capital to their investments. A venture capital fund refers to a pooled investment vehicle (often an LP or LLC) that primarily invests the financial capital of third-party investors in enterprises that are too risky for the standard capital markets or bank loans. Venture capital is also associated with job creation, the knowledge economy and used as a proxy measure of innovation within an economic sector or geography. The term Venture Capital fund is usually used to denote Mutual funds or Institutional investors. They provide equity finance or risk capital to little known, unregistered, highly risky, young and small private business, specially in technology oriented and knowledge intensive business.

Venture Capital termed as long-term funds in equity or semi- equity form to finance hi-tech investment in novel technology based projects with display potential for significant growth and financial return.”

According to Jame Koloski Morris, “ Venture capital is defined as providing seed, startup, and first stage financing and also funding expansion of companies that have already demonstrated their business potential but do not yet have access to the public securities market or to credit-oriented institutional funding sources, Venture Capital also provides management in leveraged buy out financing”.

12.2 FEATURES OF VENTURE CAPITAL

- 1) **For New Entrant:** Venture Capital investment is generally made in new enterprises that use new technology to produce new products, in expectation of high gains or sometimes, spectacular returns.
- 2) **Continuous Involvement:** Venture capitalists continuously involve themselves with the client’s investments, either by providing loans or managerial skills or any other support.
- 3) **Mode of Investment:** Venture capital is basically an equity financing method, the

investment being made in relatively new companies when it is too early to go to the capital market to raise funds. In addition, financing also takes the form of loan finance/ convertible debt to ensure a running yield on the portfolio of the venture capitalists.

4) Long-term Capital: The basic objective of a venture capitalist is to make a capital gain on equity investment at the time of exit, and regular return on debt financing. It is a long-term investment in growth-oriented small/medium firms. It is a long-term capital that is injected to enable the business to grow at a rapid pace, mostly from the start-up stage.

5) Hands-On Approach: Venture capital institutions take active part in providing value-added services such as providing business skills, etc., to investee firms. They do not interfere in the management of the firms nor do they acquire a majority / controlling interest in the investee firms. The rationale for the extension of hands-on management is that venture capital investments tend to be highly non-liquid.

6) High risk- return Ventures: Venture capitalists finance high risk-return ventures. Some of the ventures yield very high return in order to compensate for the heavy risks related to the ventures. Venture capitalists usually make huge capital gains at the time of exit.

7) Source of Finance: Venture capitalists usually finance small and medium-sized firms during the early stages of their development, until they are established and are able to raise finance from the conventional industrial finance market. Many of these firms are new, high technology-oriented companies.

8) Liquidity: Liquidity of venture capital investment depends on the success or otherwise of the new venture or product. Accordingly, there will be higher liquidity where the new ventures are highly successful.

Advantages of Venture Capital Funding

Venture capital is popular in different parts of the country as it plays a significant role in fostering industrial development by exploiting vast and untapped potentialities. The advantages of securing a VC are that:

- 1) Even in the situation when an entrepreneur having a good project idea but no previous entrepreneurial track record to leverage the firm, handles customers and bankers, venture capital can help the entrepreneurs in successful launch of their projects.
- 2) Rapid growth of technology across the globe has led to the growth of technology in India but indigenous technology has been slack due to unwillingness of the people to take entrepreneurial risks.
- 3) Venture capital has gained importance as it solves the sickness of a company.
- 4) As the venture capitalists are ready to lend their expertise and standing to the entrepreneur,

the local groups and multinational companies can easily enter into joint ventures.

5) Venture capitalists are also helpful to a large number of smaller units under which they are able to upgrade their technology to meet the demands of the major industrial units.

6) Venture capitalists are also playing a significant role in tapping the potentiality of service sector. Thus, venture capital is booming to exploit the potential of Indian economy.

12.3 DISADVANTAGES OF VENTURE CAPITAL FUNDING

The disadvantages of venture capital are as follows:

- 1) Securing a deal with a VC can be a long and complex process.
- 2) Person will be required to draw up a detailed business plan, including financial projections for which the entrepreneur may need professional help. Support from his local business link may be available for this.
- 3) If he gets through the deal negotiation stage, he will have to pay legal and accounting fees whether or not he becomes successful in securing funds.
- 4) Since the venture capitalist is taking the risk, the management control may get out of the entrepreneur.
- 5) He will also be forced to partner the benefits, such as the profit he got from the business, with the venture capitalist.

12.4 GUIDELINES FOR VENTURE CAPITAL COMPANIES

The Government of India has issued the following guidelines for various venture capital operating in the country.

- 1) The financial institutions, Stat Bank of India, scheduled banks and foreign banks are eligible to establish venture capital companies or funds subject to the approval as may be required from the Reserve Bank of India.
- 2) The venture capital funds have a minimum size of Rs. 10 crore and a debt equity ratio of 1:1:5. If they desire to raise funds from the public, promoters will be required to contribute minimum of 40% of the capital.
- 3) The guidelines also provide for NRI investment up to 74% on a non-reportable basis.
- 4) The venture capital funds should be independent of the parent organization.
- 5) The venture capital funds will be managed by professionals and can be set-up as joint ventures even with non-institutional promoters.
- 6) The venture capital funds will not be allowed to undertake activities such as trading, broking and money market operations but they will be allowed to invest in leasing to the extent of 15% of the total funds deployed. The investment on revival of sick units will be treated as a part of venture capital activity.

7) A person holding a position of being a full time chairman, chief executive, or managing director of a company will not be allowed to hold the same position simultaneously in the venture capital fund/ company.

8) The venture capital assistance should be extended to the promoters who are new, and are professionally or technically qualified with inadequate resources.

12.5 VENTURE CAPITAL FUNDING PROCESS

Obtaining capital for a project through this route is very difficult. It involves many steps, which a prospective entrepreneur has to adopt when he approaches an investor. They are:

1) Making a Deal (Deal Origination): A continuous flow of deals is essential for the venture capital business. Deals may originate in various ways. Referral system is an important source of deals. Deals may be referred to the VCs through their parent organizations, trade partners, industry associations, friends, etc. The venture capital industry in India has become quite proactive in its approach to generating the deal flow by encouraging individuals to come up with their business plans carry out initial screening of all projects on the basis of some broad criteria.

For example the screening process may limit projects to areas in which the venture capitalist is familiar in terms of technology, or Product, or market scope. The size of investment, geographical location and stage of financing could also be used as the broad screening criteria.

2) Evaluation or Due Diligence: Once a proposal has passed through initial screening, it is subjected to a detailed evaluation or due diligence process. Most ventures are new and the entrepreneurs may lack operating experience. Hence a sophisticated, formal evaluation is neither possible nor desirable. The VC thus rely on a subjective but comprehensive evaluation. VCFs evaluate the quality of the entrepreneur before appraising the characteristics of the product, market or technology. Most venture capitalists ask for a business plan to make an assessment of the possible risk and expected return on the venture.

3) Investment Valuation: The investment valuation process is aimed at ascertaining an acceptable price for the deal. The valuation process goes through the following steps.

i) Projections on future revenue and profitability.

ii) Expected market capitalization.

iii) Deciding on the ownership stake based on the return expected on the proposed investment.

iv) The pricing thus calculated is rationalized after taking into consideration various economic scenarios, demand and supply of capital, founders/ management team's track record, innovation/unique Selling Propositions (USPs), the product/ Service size of the potential market, etc

4) Deal Structuring: Once the venture has been evaluated as viable, the venture capitalist and the investment company negotiate the terms of the deal, i.e., the amount, form and price of the investment. This process is termed as deal structuring. The agreement also includes the protective covenants and earn-out arrangements. Covenants include the venture capitalists' right to control the invest company and to change its management if needed, buy back arrangements, acquisition, making Initial Public Offerings (IPOs), etc. Earn-out arrangements specify the entrepreneur's equity share and the objectives to be achieved. Venture capitalists generally negotiate deals to ensure protection of their interests. They would like a deal to provide for a return commensurate with the risk, influence over the firm through board membership, minimizing taxes, assuring investment liquidity and the right to replace management in case of consistent poor managerial performance.

5) Post-Investment Activities and Exit: Once the deal has been structured and agreement finalized, the venture capitalist generally assumes the role of a partner and collaborator. He also involves in shaping of the direction of the venture. This may be done via a formal representation on the board of director, or informal influence in improving the quality of marketing, finance and other managerial functions. The degree of the venture capitalist's involvement depends on his policy. It may not, however, be desirable for a venture capitalist to get involved in the day-to-day operation of the venture. If a financial or managerial crisis occurs, the venture capitalist may intervene and even install a new management team. Venture capitalists typically aim at making medium- to long- term capital gains. They generally want to cash-out their gains in five to ten years after the initial investment. They play a positive role in directing the company towards particular exit routes.

A venture capitalist can exit in four ways.

i) Initial Public Offerings (IPOs): When the company is making good profits and the market condition is conducive, the venture capitalists offer their shareholding to the public, the advantage of this exit route is that the shares can be priced at premium in time with the market trend and will bring them good fortune. However, there are some disadvantages like high cost of issue, lower demand, etc.

ii) Acquisition by Another Company: Another strategy is to sell their holdings to another company who are interested to expand their business in this line. The advantage of this strategy is that they can negotiate the deal and results into transfer of controlling interest, the existing promoters may play defensive strategies for fear of loss of control. Sometimes the negative reputation of the acquiring company may bring down the business of the acquired company also.

iii) Repurchase of the Venture Capitalist's Share by the Investee Company: If the promoters have enough cash at their disposal, they can buy-back the shares from the venture capitalists so that they can retain their control over the company. However, if the company is enjoying good reputation in the market, the venture capitalists may demand a hefty amount as compensation for their exit.

iv) Purchase of VCs Share by a Third Party: Venture capitalists can sell their holdings through private placements to one or more third parties. Here also there is a chance of loss of control to the existing promoters, who may play some defensive strategies. However, compared to the public offer, this will be a cheaper route for exit.

12.6 STRUCTURE OF VENTURE CAPITAL FIRMS AND FUNDS

Venture capital firms are typically structured as partnerships, the general partners of which serve as the managers of the firm and will serve as investment advisors to the venture capital funds raised. Venture capital firms in the United States may also be structured as limited liability companies, in which case the firm's managers are known as managing members. Investors in venture capital funds are known as limited partners. This constituency comprises both high net worth individuals and institutions with large amounts of available capital, such as state and private pension funds, university financial endowments, foundations, insurance companies and pooled investment vehicles, called fund of funds or mutual funds.

12.7 DIMENSIONS OF VENTURE CAPITAL

Venture capital in India is available in four forms:

- 1) Equity Participation:** The venture capital finances up to 49% of the equity capital and the ownership remains with the entrepreneur.
- 2) Conventional Loan:** Under this, a lower fixed rate of interest is charged to the unit till its commercial operation. After normal rate of interest is paid, loan is to be repaid as per the agreement.
- 3) Conditional Loan:** A conditional loan is repayable in the form of royalty ranging between 2 and 15% after the venture is able to generate sales and no interest is paid on such loans.
- 4) Income Notes:** The income note combines the features of conventional and conditional loans in a way that the entrepreneur has to pay both interest and royalty on sales at low rates.

12.8 STAGES OF FINANCING OFFERED IN VENTURE CAPITAL

There are typically six stages of financing offered in Venture Capital, that roughly correspond to these stages of a company's development:

1. **Seed Money:** Low level financing needed to prove a new idea (often provided by "angel investors").

2. **Start-up:** Early stage firms that need funding for expenses associated with marketing and product development.
3. **First-Round:** Early sales and manufacturing funds.
4. **Second – Round:** Working capital for early stage companies that are selling product, but not yet turning a profit.
5. **Third- Round:** Also called Mezzanine financing, this is expansion money for a newly profitable company.
6. **Fourth- Round:** Also called bridge financing, 4th round is intended to finance the “going public” process.

12.9 TYPES AND SOURCES OF FINANCING BY LIFECYCLE STAGE

1) Seed Financing: During the developments stage of a venture’s lifecycle, the primary source of funds is in the form of seed financing to determine whether the idea can be converted into a viable business opportunity. The primary source of funds at the development stage is the entrepreneur’s own assets. As a supplement to this limited source, most new ventures will also resort to financial bootstrapping, i.e., creative methods, including barter, to minimize the cash needed to fund the venture. Money from personal bank accounts and proceeds from selling other investments are likely sources of seed financing. It is quite common for founders to sell personal assets (e.g., an automobile or a home) or secure a loan by pledging these assets as collateral. Although it can be risky, entrepreneurs often use personal credit cards to help finance their business, Family members and friends also provide an important secondary source of seed financing; they may make loans to the entrepreneur or purchase an equity position in the business. (It is often said that family and friends invest in the entrepreneur rather than in a product or service) Such financing is usually relatively inexpensive, at least compared with more formal venture investing. While there are a few professional and business angel investors that engage in seed-stage investing, they are not a typical source of financing at this stage.

2) Start-Up Financing: Start- up financing coincides with the start-up stage of the venture’s lifecycle; this is financing that takes the venture from having established a viable business opportunity to the point of initial production and sales. Start-up financing is usually targeted at firms that have assembled a solid management team, developed a business model and plan and are beginning to generate revenues. Depending on the demands placed on the entrepreneur’s personal capital during the seed stag, the entrepreneur’s remaining assets, if any, may serve as a source of start-up financing, family and friends may continue to provide financing during start-up. However, the start-up venture should begin to think about the advantages of approaching other, more formal, venture investors.

Venture Capital: Although sales or revenues begin during the start-up stage, the use of financial capital is generally much larger than the inflow of cash. Thus, most start-up stage ventures need external equity financing. This source of equity capital is referred to as venture capital, which is early stage financial capital often involving substantial risk total loss. The flip side of this risk of total loss is the potential for extraordinarily high returns when an entrepreneurial venture is extremely successful. Venture capital investors will require the venture, if it has not yet done so, to organize formally in order to limit the risk assumed by venture investors to the amount invested.

Two primary sources of formal external venture capital for start-up stage ventures are:

i) Business Angels: Business angels are wealthy individuals, operating as informal or private investors, who provide venture financing for small businesses. They may invest individually or in joint efforts with others. While business angels may be considered informal investors, they are not uniformed investors. Many business angels are self-made entrepreneur multi-millionaires, generally well educated, who have substantial business and financial experience. Business angels typically invest in technologies, products and services in which they have a personal interest and previous experience.

ii) Venture capitalists (VCs): They are individuals who join in formal, organized venture capital firms to raise and distribute venture capital firms typically invest the capital they raise in several different ventures, in an effort to reduce the risk of total loss of their invested capital.

3) First Round Financing: The survival stage in a venture's lifecycle is critical to whether the venture will succeed and create value or be closed and liquidated. First round financing is external equity financing typically provided by venture investors during the venture's survival stage to cover the cash shortfalls when expenses and investments exceed revenues. While some revenues begin during the start-up stage, the race for market share generally results in a cash deficit, Financing is needed to cover the marketing expenditures and organizational investments required to bring the firm to full operation in the venture's commercial market. Depending on the nature of the business, the need for first-round financing may actually occur near the end of the start-up stage.

Survival stage ventures seek financing from a variety of external sources, For example, both suppliers and customers become important potential sources of financing.

i) Trade Credit: Financing provided by suppliers in the form of delayed payments due on purchases made by the venture.

ii) Small Business Administration (SBA): It was established by the federal government to provide financial assistance to small businesses.

iii) **Government Assistance Programs:** Financial support, such as low- interest rate loans and tax incentives provided by State and Local Governments to help small businesses.

iv) **Commercial Banks:** Financial intermediaries that take deposits and make business and personal loans.

4) Second Round Financing: The major sources of financing during the rapid growth stage come from business operations, suppliers and customers, commercial banks and financing intermediated by investment bankers. Most ventures upon reaching the rapid revenue growth stage, find that operating flows, while helpful, remain inadequate to finance the desired rate of growth. Rapid growth in revenues typically involves a prerequisite rapid growth in inventories and accounts receivable, which requires significant external funding. Because inventory expenses are usually paid to collecting on the sales related to those inventories, most firms commit sizable resources to investing in “working capital.”

Later Stage Financing: Even when the business of the entrepreneur is established it requires additional finance, which cannot be secured by offering shares by way of the public issue. Venture capital funds prefer later stage financing as they anticipate income at a shorter duration and capital gains subsequently. Later stage financing may take the following forms:

i) **Expansion Finance:** Expansion finance may be needed by an enterprise for adding production capacity once it has successfully gained market share and expects growth in demand for its product. Expansion of an enterprise may take the form of an organic growth or by way of acquisition or takeover. In the case of organic growth the entrepreneur retains maximum equity holdings of the entrepreneur and the venture capitalist could be in much higher proportion depending upon factors such as the net worth of the acquired business, its purchase price and the amount already raised by the company from the venture capitalists.

ii) **Replacement Finance:** In this form of financing, the venture capitalist purchases the shares from the existing shareholders of the company who are willing to exit from the company. Such a course is often adopted with the investors who want to exit from the investee company, and the promoters do not intend to list its shares in the secondary market, the venture capitalist perceives growth of the company over 3 to 5 years and expects to earn capital gain at a much shorter duration.

iii) **Turn Around:** When a company is operating at a loss after crossing the early stage and entering into commercial production, it may plan to bring about a change in its operations by modernising or expanding its operations, by addition to its existing products or deletion of the loss-making products, by reorganising its staff or undertaking aggressive marketing of its

products, etc. For undertaking the above steps for reviving the company, infusion of additional capital is needed. The funds provided by the venture capitalist for this purpose are called turnaround financing. In most of the cases, the venture capitalist which supported the project at an early stage may provide turnaround finance, as a new venture capitalist may not be interested to invest his funds at this stage. Turn around financing is more risky proposition. Hence the venture capitalist has to judge in greater depths the prospects of the enterprise to become viable and profitable. Generally substantial investment is required for this form of financing. Besides providing finance, the venture capitalist also provides management support to the entrepreneur by nominating its own directors on the Board of the company to effectively monitor the progress of recovery of the company and to ensure timely' implementation of the necessary measures.

iv) Buyout Deals: A venture capitalist may also provide finance for buyout deals. A management buyout means that the shares (and management) of one set of shareholders, who are passive shareholders, are purchased by another set of shareholders who are actively involved in the operations of the organisation. The latter group of shareholders buyout the shares from the inactive shareholders so that they derive the full benefit from the efforts made by them towards managing the enterprise. Such shareholders may need funds for buying the shares, venture capitalist provide them with such funds. This form of financing is called buyout financing.

EXIT ROUTES

The venture capital company/fund after financing a venture capital undertaking nurtures it to make it a successful proposition, but it does not intent to retain its investment therein forever. As the venture capital undertaking starts its commercial operations and reaches the profit-earning stage, the venture capitalist endeavours to disinvest its investments in the company at the earliest. The primary aim of the venture capitalist happens to realize appreciation in the value of the shares held by him and thereafter to finance another venture capital undertaking. This is called the exit route. There are several alternatives before venture capitalist to exit from an investee company, as stated below:

i) Initial Public Offering: When the shares of the investee company are listed on the stock exchange(s) and are quoted at a premium, the venture capitalist offers his holdings for public sale through public issue.

ii) Buy back of Shares by the Promoters: In terms of the agreement entered into with the investee company, promoters of the company are given the first opportunity to buy back the

shares held by the venture capitalist, at the prevailing market price. In case they refuse to do so, other alternatives are resorted to by the venture capitalist.

12.10 MODES OF FINANCING

The venture capital funds provide finance to venture capital undertakings through different modes/instruments which are traditionally divided into: (i) equity, and (ii) debt instruments. Investment is also made partly by way of equity and partly as debt. The VCFs select the instrument of finance taking into account the stage of financing, the degree of risk involved and the nature of finance required. These instruments are detailed below:

a) Equity Instruments: Equity instruments are ownership instruments and bestow the rights of the owner on the investor/VCFs. They are: i) Ordinary Shares on which no dividend is assured. Non-voting equity shares may also be issued, which carry a little higher dividend, but no voting rights are enjoyed by the investors. There may be different variants of equity shares also, e.g. deferred equity shares on which the ordinary shares rights are deferred till a certain period or happening of an event. Moreover, preferred ordinary shares carry an additional fixed income.

ii) Preference Shares carry an assured dividend at a specified rate. Preference shares may be cumulative/non-cumulative, participating preference shares which provide for an additional dividend, after payment of dividend to equity shareholders. Convertible preference shares are exchangeable with the equity shares after a specified period of time. Thus, the venture capital fund can select the instrument with flexibility.

b) Debt Instruments: VCFs prefer debt instruments to ensure a return in the earlier years of financing when the equity shares do not give any return. The debt instruments are of various types, as explained below:

i) **Conditional Loans:** On conditional loans, no interest rate as lower rate of interest and no payment period is prescribed. The VC funds, recover their funds, along with the return thereon by way of a share in the sales of the undertaking for a specified period of time. This percentage is pre-determined by VCFs. The recovery by the VCFs depends upon the success of the business enterprise. Hence, such loans are termed as ‘conditional loans’

ii) **Convertible Loans:** Sometimes loans are provided with the stipulation that they may be converted into equity at a later stage at the option of the lender or as agreed upon between the two parties.

iii) **Conventional Loans:** These loans are the usual term loans carrying a specified rate of interest and are repayable in instalments over a number of years.

iii) Sale of Enterprise to another Company: Venture capitalist can recover his investments in the investee company by selling the holdings to outsider who is interested in buying the entire enterprise from the entrepreneur.

iv) Sale to New Venture Capitalist: A venture capitalist can sell his equity holdings in the enterprise to a new venture capital company, who might be interested in buying the ownership portion of the venture capital. Such sale may be distress sale by the venture capitalist to realise the investments and exit from the enterprise. Alternatively, such sale may be for inducting a willing venture capitalist who wishes to take the existing liability in the company to provide second round of funding.

v) Self-liquidating Process: In case of debt financing by the venture capitalist, the process is self-liquidating in nature, as the principal amount, along with interest is realised in instalments over a specified period of time.

vi) Liquidation of the Investee Company: If the investee company does not become profitable and successful and incurs losses, the venture capitalist resorts to recover his investment by negotiation or settlement with the entrepreneur. Failing which the recovery is resorted to by means of winding up of the enterprise through the court.

SUMMARY

In this unit we have explained the meaning and distinguishing features of Venture Capital. It has been rightly designated as “high risk, high reward” capital. Venture Capital is provided to venture capital undertakings at different stages of their life cycle, which have been duly explained. Venture capital takes the form of equity, conventional loans, conditional loans and convertible loans. A venture capitalist divest his investments in the investee company at the earliest possible opportunity. There are several exit routes for him, which we have explained.

In India, Venture Capital Funds/Companies are of recent origin and are regulated by Securities and Exchange Board of India (SEBI). SEBI has issued detailed regulations for this purpose, which have been explained in detail. Similarly, SEBI has also issued regulations for Foreign Venture Capital Investors. Incomes of Venture Capital Funds/ Companies have been granted exemption from taxation under the Income Tax Act. In the end, the Venture Capital Funds/Companies established in India by all India Financial Undertakings have been described. Besides, there are a number of venture capital funds set up by other institutions and Indian and foreign investors.

SELF ASSESSMENT QUESTIONS

SHORT QUESTIONS

1. What do you understand by Venture Capital?
2. Describe distinguishing features of Venture Capital.
3. What do you understand by Exit Routes?
4. Explain the various stages at which the venture capitalist provide finance.

LONG QUESTIONS

5. Distinguish between conditional loans and convertible loans and explain their significance.
6. What do you understand by Exit Routes? Enumerate the important exit routes and explain the important ones.
7. What are Investment Restrictions imposed by SEBI on venture capital funds in India.
8. Explain the provision of Income Tax Act, granting tax concessions to venture capital funds in India

UNIT 8

CHAPTER 13 FACTORING, FORFAITING AND BILL DISCOUNTING

13.0 Introduction

13.1 Factoring

13.1.1 Meaning and Definition of Factoring

13.1.2 Objectives of Factoring

13.1.3 Types of Factoring

13.1.4 Process of Factoring (Factoring Mechanism)

13.1.5 Features (Nature) of Factoring

13.1.6 Functions of a Factor

13.1.7 Advantages of Factoring

13.1.8 Limitations of Factoring

13.2 Forfaiting

13.2.1 Meaning of Forfaiting

13.2.2 Characteristics of Forfaiting

13.2.3 Advantages of Forfaiting

13.2.4 Difference between Factoring and Forfaiting

13.3 Bills discounting

13.3.1 Advantages of Bill Discounting/Bill Financing

13.3.2 Difference between Bill Discounting and Factoring

13.0 INTRODUCTION

The deregulation of the various markets, globalization and cut throat competition both in domestic and international markets have posed serious challenges to the banks and Financial Institutions, and NBFCs like how to manage various risks, improve capital adequacy ratio, manage portfolio of earning assets, improve spread and non-interest income etc. These

challenges can be converted into opportunities by using innovative business strategies. In this regard, banks and financial institutions can make use of Factoring, Forfaiting, Bill discounting, Asset Securitization, etc. as a part of business strategy to manage both liquidity and credit risks of loan assets. With the help of such product, lending institutions can sell receivables, loan assets, etc. thereby improving their liquidity position. The various aspects of these products as well as developments in global and Indian markets are discussed in this unit.

13.1 FACTORING

When a firm sells goods on credit, cash is not received immediately. This means there is a time gap between sale of goods/services and receipt of cash out of such sale. The outstanding amounts get blocked for a period. This period depends upon the credit period allowed to buyers. The outstanding amounts are called 'Debtors' or 'Accounts Receivables'. If the debts are not collected in time, the firm will be handicapped due to lack of sufficient working capital. The other side is that if the debts were collected speedily the amount could be used productively. Further, it is very difficult to collect debts. Moreover, there is the problem of defaults (i.e. bad debts). In short, debtors or accounts receivables involve risks. So, business enterprises are always looking for selling the debtors for cash, even at a discount. This is possible through a financial service. Such a financial service is known as factoring. Factoring is one of the oldest forms of commercial finance. Some scholars trace its origin to the Roman Empire. Some others trace its origin even further back to Hammurabi, 4000 years ago.

13.1.1 MEANING AND DEFINITION OF FACTORING

Like securitisation factoring also is a financial innovation. Factoring provides resources to finance receivables. It also facilitates the collection of receivables. The word factor is derived from the Latin word *facere*. It means to make or do or to get things done. Factoring simply refers to selling the receivables by a firm to another party. The buyer of the receivables is called

the factor. Thus factoring refers to the agreement in which the receivables are sold by a firm (client) to the factor (financial intermediary). The factor can be a commercial bank or a finance company. When receivables are factored, the factor takes possession of the receivables and generally becomes responsible for its collection. It also undertakes administration of credit i.e. credit control, sales accounting etc. Thus, factoring may be defined as selling the receivables of a firm at a discount to a financial organisation (factor). The cash from the sale of the receivables provides finance to the selling company (client). Out of the difference between the face value of the receivables and what the factor pays the selling company (i.e. discount), it meets its expenses (collection, accounting etc.). The balance is the profit of the factor for the factoring services. Factoring can take the form of either a factoring agreement or an assignment (pledging) agreement. The factoring agreement involves outright sale of the firm's receivables to a finance company (factor) without recourse. According to this agreement the factor undertakes the receivables, the credit, the collection task, and the risk of bad debt. The firm selling its receivables (client) receives the value of the receivables minus a commission charge as compensation for the risks the factor assumes. Thereafter, customers make direct payments to the factor. In some cases receivables are sold to factor at a discount. In this case factor does not get commission. The discount is its commission. From this its expenses and losses (collection, bad debt etc.) are met. The balance represents the profit of the factor. In an assignment (pledging) agreement, the ownership of the receivables is not transferred; the receivables are given to a finance company (factor) with recourse. The factor advances some portion of the receivables value, generally in the range of 50 – 80%. The firm (client) is responsible for service charges and interest on the advance (due to the factor) and losses due to bad debts. According to this arrangement, customers make direct payment to the client. It should be noted that both factoring and securitisation provide financing source for receivables.

In factoring, the financing source is the factor. But in securitisation, the public (investors) who buys the securities is the factoring source.

13.1.2 OBJECTIVES OF FACTORING

Factoring is a method of converting receivables into cash. There are certain objectives of factoring. The important objectives are as follows:

1. To relieve from the trouble of collecting receivables so as to concentrate in sales and other major areas of business.
2. To minimize the risk of bad debts arising on account of non-realisation of credit sales.
3. To adopt better credit control policy.
4. To carry on business smoothly and not to rely on external sources to meet working capital requirements.
5. To get information about market, customers' credit worthiness etc. so as to make necessary changes in the marketing policies or strategies.

13.1.3 TYPES OF FACTORING

There are different types of factoring. These may be briefly discussed as follows:

1. **Recourse Factoring:** In this type of factoring, the factor only manages the receivables without taking any risk like bad debt etc. Full risk is borne by the firm (client) itself.
2. **Non-Recourse Factoring:** Here the firm gets total credit protection because complete risk of total receivables is borne by the factor. The client gets 100% cash against the invoices (arising out of credit sales by the client) even if bad debts occur. For the factoring service, the client pays a commission to the factor. This is also called full factoring.

3. **Maturity Factoring:** In this type of factoring, the factor does not pay any cash in advance. The factor pays clients only when he receives funds (collection of credit sales) from the customers or when the customers guarantee full payment.

4. **Advance Factoring:** Here the factor makes advance payment of about 80% of the invoice value to the client.

5. **Invoice Discounting:** Under this arrangement the factor gives advance to the client against receivables and collects interest (service charge) for the period extending from the date of advance to the date of collection.

6. **Undisclosed Factoring:** In this case the customers (debtors of the client) are not at all informed about the factoring agreement between the factor and the client. The factor performs all its usual factoring services in the name of the client or a sales company to which the client sells its book debts. Through this company the factor deals with the customers. This type of factoring is found in UK.

7. **Cross boarder factoring:** It is similar to domestic factoring except that there are four parties,

a) Exporter,

b) Export Factor,

c) Import Factor, and

d) Importer.

It is also called two-factor system of factoring. Exporter (Client) enters into factoring arrangement with Export Factor in his country and assigns to him export receivables. Export Factor enters into arrangement with Import Factor and has arrangement for credit evaluation & collection of payment for an agreed fee. Notation is made on the invoice that importer has to make payment to the Import Factor. Import Factor collects payment and remits to Export Factor

who passes on the proceeds to the Exporter after adjusting his advance, if any. Where foreign currency is involved, factor covers exchange risk also.

13.1.4 PROCESS OF FACTORING (FACTORING MECHANISM)

The firm (client) having book debts enters into an agreement with a factoring agency/institution. The client delivers all orders and invoices and the invoice copy (arising from the credit sales) to the factor. The factor pays around 80% of the invoice value (depends on the price of factoring agreement), as advance. The balance amount is paid when factor collects complete amount of money due from customers (client's debtors). Against all these services, the factor charges some amounts as service charges. In certain cases, the client sells its receivables at discount, say, 10%. This means the factor collects the full number of receivables and pays 90% (in this case) of the receivables to the client. From the discount (10%), the factor meets its expenses and losses. The balance is the profit or service charge of the factor. Thus, there are three parties to the factoring. They are the buyers of the goods (client's debtors), the seller of the goods (client firm i.e., seller of receivables) and the factor. Factoring is a financial intermediary between the buyer and the seller.

13.1.5 FEATURES (NATURE) OF FACTORING

From the following essential features of factoring, we can understand its nature:

1. Factoring is a service of financial nature. It involves the conversion of credit bills into cash. Account receivables and other credit dues resulting from credit sales appear in the books of account as book credits.
2. The factor purchases the credit/receivables and collects them on the due date. Thus, the risks associated with credit are assumed by the factor.

3. A factor is a financial institution. It may be a commercial bank or a finance company. It offers services relating to management and financing of debts arising out of credit sales. It acts as a financial intermediary between the buyer (client debtor) and the seller (client firm).

4. A factor specialises in handling and collecting receivables in an efficient manner.

5. Factor is responsible for sales accounting, debt collection, credit (credit monitoring), protection from bad debts and rendering of advisory services to its clients.

6. Factoring is a technique of receivables management. It is used to release funds tied up in receivables (credit given to customers) and to solve the problems relating to collection, delays and defaults of the receivables.

13.1.6 FUNCTIONS OF A FACTOR

Factor is a financial institution that specialises in buying accounts receivables from business firms. A factor performs some important functions. These may be discussed as follows:

1. **Provision of finance:** Receivables or book debts is the subject matter of factoring. A factor buys the book debts of his client. Generally, a factor gives about 80% of the value of receivables as advance to the client. Thus, the nonproductive and inactive current assets i.e. receivables are converted into productive and active assets i.e. cash.

2. **Administration of sales ledger:** The factor maintains the sales ledger of every client. When the credit sales take place, the firm prepares the invoice in two copies. One copy is sent to the customers. The other copy is sent to the factor. Entries are made in the ledger under open-item method. In this method each receipt is matched against the specific invoice. The customer's account clearly shows the various open invoices outstanding on any given date. The factor also gives periodic reports to the client on the current status of his receivables and the amount

received from customers. Thus, the factor undertakes the responsibility of entire sales administration of the client.

3. Collection of receivables: The main function of a factor is to collect the credit or receivables on behalf of the client and to relieve him from all tensions/problems associated with the credit collection. This enables the client to concentrate on other important areas of business. This also helps the client to reduce cost of collection.

4. Protection against risk: If the debts are factored without resource, all risks relating to receivables (e.g., bad debts or defaults by customers) will be assumed by the factor. The factor relieves the client from the trouble of credit collection. It also advises the client on the creditworthiness of potential customers. In short, the factor protects the clients from risks such as defaults and bad debts.

5. Credit management: The factor in consultation with the client fixes credit limits for approved customers. Within these limits, the factor undertakes to buy all trade debts of the customer. Factor assesses the credit standing of the customer. This is done on the basis of information collected from credit relating reports, bank reports etc. In this way the factor advocates the best credit and collection policies suitable for the firm (client). In short, it helps the client in efficient credit management.

6. Advisory services: These services arise out of the close relationship between a factor and a client. The factor has better knowledge and wide experience in the field of finance. It is a specialised institution for managing account receivables. It possesses extensive credit information about customer's creditworthiness and track record. With all these, a factor can provide various advisory services to the client. Besides, the factor helps the client in raising finance from banks/financial institutions.

13.1.7 ADVANTAGES OF FACTORING

A firm that enters into factoring agreement is benefited in a number of ways. Some of the important benefits of factoring are summarised as follows:

1. **Improves efficiency:** Factoring is an important tool for efficient receivables management. Factors provide specialised services with regard to sales ledger administration, credit control etc. Factoring relieves the clients from botheration of debt collection.

2. **Higher credit standing:** Factoring generates cash for the selling firm. It can use this cash for other purposes. With the advance payment made by factor, it is possible for the client to pay off his liabilities in time. This improves the credit standing of the client before the public.

3. **Reduces cost:** The client need not have a special administrative setup to look after credit control. Hence it can save manpower, time and effort. Since the factoring facilitates steady and reliable cash flows, client can cut costs and expenses. It can avail cash discounts. Further, it can avoid production delays.

4. **Additional source:** Funds from a factor is an additional source of finance for the client. Factoring releases the funds tied up in credit extended to customers and solves problems relating to collection, delays and defaults of the receivables.

5. **Advisory service:** A factor firm is a specialised agency for better management of receivables. The factor assesses the financial, operational and managerial capabilities of customers. In this way the factor analyses whether the debts are collectable. It collects valuable information about customers and supplies the same for the benefits of its clients. It provides all management and administrative support from the stage of deciding credit extension to the customers to the final stage of debt collection. It advocates the best credit policy suitable for the firm.

6. Acceleration of production cycle: With cash available for credit sales, client firm's liquidity will improve. In this way its production cycle will be accelerated.

7. Adequate credit period for customers: Customers get adequate credit period for payment of assigned debts.**8. Competitive terms to offer:** The client firm will be able to offer competitive terms to its buyers. This will improve its sales and profits.

13.1.8 LIMITATIONS OF FACTORING

The main limitations of factoring are outlined as below:

1. Factoring may lead to over-confidence in the behaviour of the client. This results in overtrading or mismanagement.
2. There are chances of fraudulent acts on the part of the client. Invoicing against non-existent goods, duplicate invoicing etc. are some commonly found frauds. These would create problems to the factors.
3. Lack of professionalism and competence, resistance to change etc. are some of the problems which have made factoring services unpopular.
4. Factoring is not suitable for small companies with lesser turnover, companies with speculative business, companies having large number of debtors for small amounts etc.
5. Factoring may impose constraints on the way to do business. For non - recourse factoring most factors will want to pre- approve customers. This may cause delays. Further, the factor will apply credit limits to individual customers.

13.2 FORFAITING

Generally, there is a delay in getting payment by the exporter from the importer. This makes it difficult for the exporter to expand his export business. However, for getting immediate

payment, the concept of forfeiting shall come to the help of exporters. The concept of forfeiting was originally developed to help finance German exports to Eastern block countries. In fact, it evolved in Switzerland in mid 1960s.

13.2.1 MEANING OF FORFAITING

The term 'forfait' is a French word. It means 'to surrender something' or 'give up one's right'. Thus forfeiting means giving up the right of exporter to the forfaitor to receive payment in future from the importer. It is a method of trade financing that allows exporters to get immediate cash and relieve from all risks by selling their receivables (amount due from the importer) on a 'without recourse' basis. This means that in case the importer makes a default the forfaitor cannot go back to the exporter to recover the money. Under forfeiting the exporter surrenders his right to a receivable due at a future date in exchange for immediate cash payment, at an agreed discount. Here the exporter passes to the forfaitor all risks and responsibilities in collecting the debt. The exporter is able to get 100% of the amount of the bill immediately. Thus he gets the benefit of cash sale. However, the forfaitor deducts the discount charges and he gives the balance amount to the exporter. The entire responsibility of recovering the amount from the importer is entrusted with the forfaitor. The forfaitor may be a bank or any other financial institution. In short, the non-recourse purchase of receivables arising from an export of goods and services by a forfaitor is known as forfeiting. Forfeiting is not the same as international factoring. The tenure of forfeiting transaction is long. International factoring involves short term trade transactions. In case of forfeiting, political and transfer risks are also borne by the forfaitor. But in international factoring these risks are not borne by the factor.

13.2.2 CHARACTERISTICS OF FORFAITING

The main characteristics of forfeiting are:

1. It is 100% financing without recourse to the exporter.

2. The importer's obligation is normally supported by a local bank guarantee (i.e., 'Aval').
3. Receivables are usually evidenced by bills of exchange, promissory notes or letters of credit.
4. Finance can be arranged on a fixed or floating rate basis.
5. Forfaiting is suitable for high value exports such as capital goods, consumer durables, vehicles, construction contracts, project exports etc.
6. Exporter receives cash upon presentation of necessary documents, shortly after shipment.

13.2.3 ADVANTAGES OF FORFAITING

The following are the benefits of forfaiting:

1. The exporter gets the full export value from the forfaitor.
2. It improves the liquidity of the exporter. It converts a credit transaction into a cash transaction.
3. It is simple and flexible. It can be used to finance any export transaction. The structure of finance can be determined according to the needs of the exporter, importer, and the forfaitor.
4. The exporter is free from many export credit risks such as interest rate risk, exchange rate risk, political risk, commercial risk etc.
5. The exporter need not carry the receivables into his balance sheet.
6. It enhances the competitive advantage of the exporter. He can provide more credit. This increases the volume of business.
7. There is no need for export credit insurance. Exporter saves insurance costs. He is relieved from the complicated procedures also.
8. It is beneficial to forfaitor also. He gets immediate income in the form of discount. He can also sell the receivables in the secondary market or to any investor for cash.

13.2.4 DIFFERENCE BETWEEN FACTORING AND FORFAITING

Forfaiting and factoring have similarities. Both have similar features of advance payment and non-recourse dealing. But there are some differences between them.

THE DIFFERENCES ARE AS FOLLOWS:

FACTORING	FORFAITING
1. Used for short term financing.	1. Used for medium term financing.
2. May be with or without recourse.	2. Always without recourse.
3. Applicable to both domestic and export receivables.	3. Applicable to export receivables only.
4. Normally 70 to 85% of the invoice value is provided as advance.	4. 100% finance is provided to the exporter.
5. The contractor is between the factor and the seller.	5. The contract is between the forfaitor and the exporter.
6. Other than financing, several other things	6. It is a financing arrangement only. like sales ledger administration, debt collection etc. is provided by the factor.
7. A bulk finance is provided against a resulting number of unpaid invoices.	7. It is based on a single export bill from only a single transaction.
8. No minimum size of transaction is value specified	8. There is a minimum specified transaction

13.3 BILLS DISCOUNTING

Meaning of Bills Discounting

Bill discounting is book debt financing. This is done by commercial banks. The supplier or seller of goods draws a bill of exchange on the buyer or debtor for the invoice price of the goods sold on credit. It is drawn for a short period of 3 to 6 months. Sometimes it is drawn for 9 months. After drawing the bill, the seller hands over the bill to the buyer. The buyer accepts the same. This means he binds himself liable to pay the amount on the maturity of the bill. After accepting the bill, the buyer (drawee) gives the same to the seller (drawer). Now the bill is with the drawer. He has three alternatives. One is to retain the bill till the due date and present the bill to the drawee and receive the amount of the bill. This will affect the working capital position of the creditor. This is because he does not get immediate payment. The second alternative is to endorse the bill to any creditors to settle the business obligation. The third or last alternative is to discount the bill with his banker. This means he need not wait till the due date. If he is in need of money, he can discount the bill with his banker. The banker deducts certain amount as discount charges from the amount of the bill and balance is credited in the customer's (drawer's or holders) account. Thus the bank provides immediate cash by discounting trade bills. In other words, the banker advances money on the security of bill of exchange. On the due date, the banker presents the bill to the drawee and receives payment. If the drawee does not make payment, the drawer has to make payment to the banker. Here the bank is the financier. It renders financial service. In short, discounting is a **financial service**.

13.3.1 ADVANTAGES OF BILL DISCOUNTING/BILL FINANCING

1. It offers high liquidity. The seller gets immediate cash.
2. The banker gets income immediately in the form of discount.
3. Bills are not subject to any fluctuations in their values.

4. Procedures are simple.

5. Even if the bill is dishonoured, there is a simple legal remedy. The banker has to simply note and protest the bill and debit in the customer's account.

6. The bills are useful as a base for the maintenance of reserve requirements like CRR and SLR.

13.3.2 DIFFERENCE BETWEEN BILL DISCOUNTING AND FACTORING

Bills Discounting	Factoring
1. Finance alone is provided	1. In addition to the provision of finance, several other services like maintenance of sale
2. Advances are made against bills.	2. Receivables are purchased by assignment
3. Drawer or holder is the collector of receivables.	3. Factor is the collector of receivables.
4. It is individual transaction-oriented.	4. Bulk finance is provided (i.e., based on whole turnover).
5. It is not an off-balance sheet method of finance.	5. It is off-balance sheet method finance.
6. Stamp duty is charged on bills.	6. No stamp duty is charged on invoices.
7. The grace period for payment is usually 3 days	7. The grace period is higher.
8. Does not involve assignment of debts.	8. It involves assignment of debts.
9. Bills discounted may be rediscounted.	9. Debts purchased cannot be rediscounted; several times before the due date. they can only be refinanced.
10. It is always with recourse	. 10. It may be with or without recourse

SUMMARY

In this unit we have discussed the financial services namely Factoring, Forfaiting, Bill Discounting and Asset Securitisation. Factoring involves financing and collection of accounts

receivables in domestic as well as international trade. This service is rendered by the factor who provides finance against book debts, collects cash against receivables, undertakes sales ledger administration, provides protection against bad debts, etc. There are three parties to a factoring contract: buyer of goods, who has to pay for goods bought on credit terms, seller of goods, who has to realize credit sales from buyer. and the factor, who acts as an agent and realizes the sales from the buyer. Forfaiting is a source of trade finance which enables exporters to get funds from the forfaiter on transferring the right to recover the debts from the importer. It denotes the purchase of trade bills or promissory notes by a bank or financial institution, without recourse to seller. Bill discounting is a source of short-term trade finance. It is known as acceptance credit, where an party accepts liability of trade towards third Party. Asset Securitization is a process wherein financial assets like loan assets are packaged, underwritten and sold in the form of securities. The various parties namely the originator (seller of loan assets), trust or company (special purpose entity), merchant bankers, rating agencies and institutional investors etc. are involved in the transactions of securitization. It can be done with recourse or without recourse. Two instruments namely, pass through certificates or pay through certificates are used in the securitization process. Commercial banks as well as housing finance companies have shown preference for mortgage-backed securitization. India has witnessed significant growth in the recent past in the size of securitization market.

SELF- ASSESSMENT QUESTIONS

SHORT QUESTIONS

1. What do you mean by factor and factoring services?
2. What do you mean by without recourse and maturity factoring?
3. Explain the advantages and disadvantages of factoring services.
4. What do you mean by rediscounting of bills?

LONG QUESTIONS

5. Explain the various types of export factoring arrangements.
6. Define forfaiting services? How are forfaiting services different from factoring services?
7. Explain the benefits of finance through bill discounting.
8. Explain the mechanism of factoring services.

Unit 9 chapter 15 life insurance

15.0 Introduction

15.1 Features of Insurance

15.2 Nature of Insurance

15.3 Risk, Peril and Hazard

15.4 Classification of Risks

15.5 Insurable Risks

15.6 Need of Insurance

15.7 Basic Principles of Insurance

15.8 Classification of Insurance

15.9 Life Insurance

Summary

Self-assessment questions

15.0 Introduction

Insurance is a technique involving collection of small amounts of premium from many individuals and companies out of which losses suffered by a few are reimbursed. In this method the individual insured who is exposed to uncertain and accidental loss is able to get protection through payment of a small but definite cost, namely premium. Insurance is a technique involving collection of small amounts of premium from many individuals and companies out of which losses suffered by a few are reimbursed. In this method the individual insured who is exposed to uncertain and accidental loss is able to get protection through payment of a small but definite cost, namely premium. Life insurance is a policy which covers the risk of premature death. If, during the term of the policy, the life insured dies, the policy promises to pay a death benefit. Life insurance policies are legal contracts where, against the coverage offered by the insurance company, you are supposed to pay a premium for availing the coverage. Moreover, besides premature death, many life insurance plans also cover survival to the end of the policy tenure wherein a maturity benefit is paid. Life insurance is an arrangement through which a person can plan for the continuation of

income when uncertainties and certainties (i.e.) illness or accident and death or old age disrupt or destroy his ability to earn his livelihood. Therefore the insurance is

- I. The business of insurance is related to protection of human life, human created assets, human disability and business liabilities possessed by human beings which have a definite value, and
- II. Assets and human life generate benefit and income for the owner and his/her family members, and
- III. Loss of assets / human life for any reason stops the benefits and income to the owner and family members respectively, and
- IV. Results in falling of living standards in the family, quality of life and future growth of the associated family members, and
- V. Insurance is a mechanism that helps to reduce such adverse consequences through pooling, spreading and sharing of risk. Thus life insurance business is complimentary to the government efforts in social management

15.1 Features of insurance

- I. Insurance is a method of risk transfer. In insurance the losses of the unfortunate few are shared by fortunate many. The loss of an individual is shared by all those who are likely to face the same situation of loss. In other words, insurance is the pooling of future unexpected losses by transfer of such risks to the insurers who agree to indemnify insured for such losses, to provide other preliminary benefits on their occurrence or to render services connected with the risk. This definition indicates the basic characteristics of insurance, viz. **Risk pooling**: insurers pool the risk i.e. the spreading of losses of unfortunate few over the entire group. In process actual loss is substituted by average loss.
- II. **Risk transfer**: risk transfer takes place when an insurer agrees to pay loss that may occur and the uncertainty of financial result has been transferred to insurer from insured. For this insured pays premium to the insurer.
- III. **Indemnification**: insured is re-established to his or her approximate financial position prior to the occurrence of the loss. An individual pays a premium while purchasing a policy and can make a claim if insured event occurs. The main functions of insurance are risk transfer by creation of common pool whereby losses of the few are met by the

contributions of many. And charging equitable premiums i.e. the premium charged to each risk must reflect the severity of risk brought to the pool. If it is set too low losses will be made and if too high, business will lose competitive edge.

Insurance policies are contracts whereby insurance companies (insurers) promise the insured's that they will pay the financial loss suffered by the insured in the event of occurrence of insured event and to get this promise insured pays premium (consideration) to the insured.

15.2 Nature of insurance

1) **Insurance in terms of the relationship between the insured & the insurer – Transfer device:** According to this school, insurance may be defined as the transfer of pure risk from the insured to the insurer the insured is the person or firm or company confronted by risk and the insurer is a person or firm or company, which specializes in the assumption of risk. The primary business of the insurer is risk assumption for a fee.

2) **Technical:** This school of thought defines insurance in terms of techniques or mechanics it involves. According to prof mehr & cammack, insurance is a device for reducing risk by combining a sufficient number of exposure units to make their individual losses collectively predictable. The predictable loss is then shared proportionately by all units in the combination. Therefore, it implies both that uncertainty is reduced & losses are shared. Further, it is said that a device will be deemed insurance if

(i) it implies the law of large numbers so that the requirement of future funds to cover losses are predictable with reasonable accuracy.

(ii) it provides some definite method for raising these funds by levies against the units covered by the scheme. In short, the essential features of insurance are the manner in which losses are predicted & shared.

3) **Combination:** According to the third school of thought, prof. Willet defines insurance as a social device for making accumulations to meet uncertain losses of capital, which is carried out through the transfer of risks of many individuals to one person or to a group of persons. Wherever there is accumulation for uncertain losses, or wherever there is transfer of risk, there is one element of insurance, only when these are joined with the combination of risk in a group is the insurance complete. Another way to state this is to say that “insurance is a transfer of risk with the added features of (i) combination of risks (ii) an estimate of future

losses”. Although each of the authors have defined insurance differently but they are all thinking about virtually the same thing when they use the term insurance the essence of the insurance scheme is that it is a

- I. Accumulation of funds
- II. It involves a group of risks
- III. Transfer of risk to the whole group

15.3 Risk, Peril And Hazard

Risk:- There are many definitions of risk, **risk** may be defined as possibility of loss, uncertainty of loss or risk is a combination of hazards. Generally we use word **peril** to mean the event that causes loss and the factors which have an effect on the outcome of loss. E.g. a house is constructed on a beach and there is a risk of cyclone. ‘**peril**’ is a prime cause of loss which is often beyond the control of human e.g. fire, lightening, flood, earthquake, theft, accident, explosion, etc. Therefore cyclone is a cause of loss and the houses are constructed on beach influences the outcome. **Hazard** is a condition that increases the chance and size of loss. Thus the proximity of the house to sea is a hazard. Factors that have an effect on the outcome are called hazards. They increase intensity of perils resulting into loss.

Hazards are of two types viz. Physical hazard and moral hazard.

- I. **Physical Hazard:-**It is a condition that arises from the physical characteristics of an object that increases the probability / severity of loss from given perils. Physical hazards include such fact as icebergs (hazard for ships), earth faults (hazard for earthquake), dense forests (hazard for fire), etc.
- II. **Moral Hazard:-**Moral hazards arise from the attitude of the insured. Insured intentionally does things to bring about loss or make a dishonest claim. Moral hazards are acts of dishonest individuals.

Proximate Cause:-Proximate cause means the effect of the cause is active and which sets in motion a chain of events between the occurrence of covered perils and damage or destruction of the property. E.g fire starts in the house due to lpg explosion in the kitchen and spreads to the bedroom and firefighting team spray the water that causes considerable damage to the furniture, curtains and fabric. The entire loss is covered including damage due to water because fire is proximate cause of loss. In this case fire is the proximate cause of loss even though the forceful use of water has also caused losses.

15.4 Classification of risks

Risk can be classified into various categories viz. Objective risk and subjective risk; financial risks and non-financial risks; pure risk and speculative risk; fundamental risk and particular risk, etc.

- I. **Objective risk and subjective risk** :-Objective risk is mainly related to groups of objects exposed to loss. Objective risk is defined as the relative variation of actual from probable or expected loss. Subjective risk on the other hand refers to the mental state of individual who experiences doubt or worry as to the outcome of a given event. Both definitions of risks concerned with events that may or may not produce financial loss.
- II. **Financial risk and non-financial risks**:-The loss measurable in terms of money or financial terms is called as financial risk. E.g. in case of damage to the business property due to fire or flood where by the owner suffers financial losses due to damage to the property is a **financial risk**. In situations where the loss cannot be counted in financial terms e.g. choosing life partner, selection of career, etc. Are known as **non-financial risk**. In other words we cannot measure sorrow, grief, despair, embarrassment in terms of money. That is called non-financial loss.
- III. **Pure risk and speculative risk**:-**Pure risk** is a situation where the outcome can either be a loss or no loss, e.g. a person will die or survive; fire catches the house or does not catch a fire, motor meets an accident or does not, theft from shop or no theft, etc. No one can gain from this situation.
- IV. **Speculative risk** is a situation that involves loss or gain., e.g. suppose you have purchased stocks of infotech; when market will be in boom you will book profit; if it is sluggish you will lose. Insurance cover is not available for speculative risks. Generally, only pure risks are insurable as they create financial insecurity to individual, family, business concerns, industries, etc.
- V. **Fundamental risks and particular risks**

This classification is connected with cause and effect of risks.

Fundamental risks usually arise from causes outside the control of human. E.g. flood, volcano's, famine and other natural disasters. It is not proper to limit

fundamental risk to naturally happening perils only. War, political intervention, social change, etc. Are also fundamental. Fundamental risk affect large number of individuals at a time. Particular risks are the risks which are of impersonal origin and widespread in effect. E.g. fire, flood, theft, etc. These are insurable risks whereas fundamental risks which are of personal origin are uninsurable.

15.5 Insurable risks

Insurable risks include personal risk, property risk and liability risks.

I. Personal risks

These risks have direct impact on individual. Personal risks relate to the loss of ability to **Of** earn income and include premature death, dependent old age, sickness or disability and unemployment losses. These risks are of greatest potential severity. The risk with greatest severity is loss of income for the individual or family unit because the most valuable asset of individual is his income earning ability. Therefore the first and foremost risk is risk of dying early. Second is the risk of living too long. Third is risk of unemployment and fourth risk of illness/disability.

- a) **Risk premature death:** in any life insurance product naturally the first and foremost contingency covered is contingency of death. Death is certain but when it will occur is always uncertain. Untimely death creates substantial financial problems to the dependents. In the event of such untimely death of breadwinner, life insurance makes funds available to protect the family.
- b) **Risk of living too long:** second important contingency is contingency of living too long. It is a fact that the mortality rates are decreasing all over the world. Therefore this contingency that one must anticipate to take care of post retirement needs of insured and the spouse.
- c) **Risk of unemployment:** the most serious single economic problem faced by industrial employees is risk of unemployment. In united states unemployment insurance is provided under four major programmes. So far such type of coverage is not available in india.
- d) **Risk of illness/disability:** another important contingency is the contingency of total disability. Unlike death and retirement becoming disabled is only a possibility. But it is a devastating one because it not only partially or totally eliminates an individual's ability to earn living but also entails additional cost of

rehabilitative therapy and purchase of special equipment to cope up with the new limitation. Therefore the need to cover this contingency is very important.

ii. Property risks

Individual owning property is exposed to property risk i.e. the risk of property damaged or lost or destroyed because of fire, lightning, flood, cyclone, earthquake or any other natural disasters. There are normally two types of losses associated with destruction or theft of property i.e. direct loss and consequential loss.

- a) **Direct loss:** it is a financial loss that results from physical damage, destruction or theft of the property. E.g. if a shop is destroyed by fire, the physical damage to the shop is a direct loss.
- b) **Consequential loss:** it is a financial loss that results due to occurrence of direct physical damage or theft. In addition to physical damage, the shop would lose profit for some months or rent till the shop is reconstructed.

iii. Liability risks

These risks are of great importance because under the law of the land you can be held legally liable if your act results in serious bodily injury or property damage to someone else. A court of law may order you to pay substantial damages to the person/ persons you have injured. E.g. motorist is legally liable if he meets an accident due to negligent driving. Another example can be of a business firm which can be held liable for defective products that may harm or injure customers. This is known as product liability. Professionals like engineers, brokers, accountants can be sued by clients due to alleged acts of malpractices. This is known as professional liability. In case of liability risk, there is no maximum limit with respect to the amount of the loss. One has a right to sue the motorist for any amount. E.g. your car has actual cost of rs. 5,00,000 the maximum physical damage; loss is rs. 5 lakh but due to negligent driving causing accident resulting to severe bodily injury to someone he may sue you for any amount ranging from rs. 1,00,000 to rs. 1 crore. Secondly court of law can order to place lien on your income and financial assets to satisfy legal judgment. Thirdly legal defense costs are very high and without liability risk coverage, bearing substantial legal expenses is very difficult for individuals and business firms.all the insurable risks are not only faced by individuals but also by the society therefore they may be handled by using four major methods viz. Risk

avoidance, risk control, risk retention and insurance. Generally preferable and practical method of handling risks is “insurance”.

15.6 Need of insurance

- I. **To provide security and safety:-** the life insurance provides security against premature death and payment in old age to lead the comfortable life. Similarly in general insurance, the property can be insured against any contingency i.e. fire, earthquake etc.
- II. **To provide peace of mind:-** the uncertainty due to fire, accident, death, illness, disability in the human life, it is beyond the control of the human beings. By way of insurance, he may be compensated financially but not emotionally. The financial compensation provides not only peace of mind but also motivates to work more and more.
- III. **To eliminate dependency:-** on the death of the breadwinner, the consequences need not be explained. Similar to the destruction of property and goods the family would suffer a lot. It could lead to reduction in the standard of living or begging from relatives, friends or neighbours. The economic independence of the family is reduced. The insurance is the only way to assist and provide them adequate at the time of sufferings.
- IV. **To encourage savings:-** life insurance provides protection and investment while general insurance provides only protection to the human life and property respectively. Life insurance provides systematic saving because once the policy is taken then the premium is to be regularly paid otherwise the amount will be forfeited.
- V. **To fulfill the needs of a person:-** a) family needs b) old age needs c) re-adjustment needs d) special needs: education, marriage, health
- VI. **To reduce the business losses:-** in business the huge amount is invested in the properties i.e. building and plant and machinery. These properties may be destroyed due to any negligence, if it is not insured no body would like to invest a huge amount in the business and industry. The insurance reduced the uncertainty of business losses due to fire or accidents etc.
- VII. **To identify the key man:-** key man is a particular man whose capital, expertise, energy and dutifulness make him the most valuable asset in the business and whose absence will reduce the income of the employer tremendously and upto that time

when such employee is not substituted. The death or disability of such valuable lives will prove a more serious loss than that fire or any hazard. The potential loss to be suffered and the compensation to the dependents of such employee require an adequate provision, which is met by purchasing an adequate life policies.

- VIII. **To enhance the limit:-** the business can obtain loan but pledging the policy as collateral for the loan. The insured persons are getting more loan due to certainty of payment at their death.
- IX. **Welfare of employees:-** the welfare of the employees is the responsibility of the employer. The employer is supposed to look after the welfare of the employees. The provisions are being made for death, disability and old age. Though these can be insured through individual life insurance but an individual may not be insurable due to illness and age. But the group policy will cover his insurance and the premium is very low in group insurance. The expenditure paid on account of premium will be allowable expenditure.

15.7 Basic principles of insurance

A contract is an agreement. It includes a set of promises that are imposed by law and for breach of promises law provides a remedy. Hence insurance is under the purview of contract act. Non life insurance policies are contracts of indemnity and involves insurable interest of insured. Basic principles of insurance are utmost good faith, insurable interest, indemnity, subrogation and contribution. Before proceeding to the classification of insurance, let's review the principles of insurance.

- I. **Utmost good faith:-**insurance contract is done on utmost good faith i.e. in a contract of insurance, there is an implied condition that each party must disclose every material fact known to him. A representation is a statement made by an applicant (proposer) for insurance before the contract is effected. A misrepresentation of material fact makes the contract voidable at the option of insurer. Like misrepresentation , concealment has also the same legal effect. A concealment is defined as a failure of applicant to reveal the facts when obligated to speak. Applicant should not conceal the facts, even if the disclosure of the same may result into rejection of application. E.g. in case of fire insurance material facts are information regarding construction of the building, nature of goods stored, nature of process carried on, location, etc. To give one more example in case of accident insurance, one

should give information regarding type of vehicle, nature of operation, tonnage, etc. In motor and in case of burglary, nature of goods, security arrangements, etc.

- II. **Principle of insurable interest :-**insurable interest exists only if insured would suffer economic loss in the event of damage or destruction of insured object. For e.g. insurance of house or shop; damage to the house will result into financial loss to the owner. It is also necessary that insurable interest must exist at the time of loss. Secured creditors have insurable interest in the property for which they have given loan. To illustrate, mr. Iyer cannot purchase insurance of mr. Shah's house and collect the insurance claim if house is damaged. By doing this mr. Iyer will be profiting from the insurance.
- III. **Principle of indemnity:-**this principle argues that individual should not be permitted to make profit from the contract but should be re-established to the same financial conditions that existed prior to the occurrence of loss. In other words, insurance company agrees to pay not more than the actual amount of loss suffered by the insured. There are two fundamental purposes involved; first is to prevent the insured from making profits from occurrence of loss and second is to reduce moral hazard.
- IV. **Subrogation:-**another provision under the insurance contract which is preventing insured from making profits is subrogation. Subrogation means substitution of the insurer in place of insured for the purpose of claiming indemnity from third party for a loss covered by insured. E.g. a negligent car driver fails to stop at red signal and smashes into the car causing damage worth rs. 10000. If he has comprehensive car insurance then insurance company will pay physical damage expenses and then make an effort to collect the cost of damage from negligent driver who caused accident.
- V. **Contribution:-**it is the right of insurer who have paid a loss under a policy to recover a proportionate amount from other insurers who have covered the liability for the same loss. E.g. a house is insured against the fire with two insurance companies under two different fire insurance policies with sum insured rs. 20000. Fire occurs in the house causing loss of rs. 20000 then in the event of loss the insurer who paid full claim has a right to recover rs. 10000, the proportionate amount of claim paid, from the other insurer.
- VI. **Deductibles:-**deductible is a provision by which a specified amount is subtracted from the loss payment otherwise payable to the insured. Deductible is used to

eliminate small claims and the administrative expense of adjusting these claims. Deductible is the amount of the loss which the insured has to bear in each and every claim and in return substantial premium savings are possible. Insurance company shall be liable only when the amount of loss exceeds the 'deductible', e.g. a policy with rs.100 deductible would mean that policyholder has to bear rs.100 of each and every claim under the policy. You may choose a higher deductible to lower your premium. But it is not advisable to opt for a higher deductible to reduce the premium outgo. One should make an informed decision by giving due consideration to policy coverage, service offered by insurer and such other aspects discussed above rather than basing the decision solely on the premium outgo. And one should know that no decision is an informed decision unless that decision is based on the correct and complete understanding of the policy wordings.

15.8 Classification of insurance

Insurance may be classified according to the type of coverage. The conventional classification of insurance is life insurance and non-life insurance. Life insurance coverage can be further divided into life and health insurance. Non-life or general insurance is further classified into 2 categories property insurance and liability insurance. General insurance is again classified into commercial line of insurance i.e. for industry, small sector industry so also commercial organizations and personal line of insurance for individuals, professionals.

I. Life insurance

Under the purview of this class of insurance, the risks associated with human life in general can be covered up to the limit specified called sum assured. A person can insure his or her life and his health against the contingencies like death, disability, surviving too long. In event of his death, his dependents will be reimbursed to the full amount that he was insured for. Or if the insured person meets with an accident or suffers from an illness that cripples him forever, he will be compensated with the complete sum assured anyway since he may not be able to lead a normal life again. In case, the accident is not that severe, he should be able to recover after medical treatment and rehabilitation. If he has opted for medical cover, then his medical expenses, treatment and medication will be paid for by his insurance policy. Life insurance is designed to be an effective and efficient means of planning for adverse financial consequences in the event of untimely death of income earner for the average family.

II. Non-life insurance (general insurance)

General insurance includes non-life insurance contracts. These include the following

Personal line of insurance

1. property insurance
2. health insurance
3. accident insurance
4. liability insurance covers
5. fire insurance 1. Fire insurance
6. marine insurance
7. personal accident insurance
8. motor vehicle insurance

15.9 Life insurance

During the life span of an individual his needs may vary. At different stages of life cycle his needs are different. Also changes in the economic and social environment greatly influence the needs, choices and expectations of customers. To make a product marketable, it must satisfy needs and expectations of customers. Insurers have launched a varied range of products viz. From traditional highly risk oriented term assurance plan to highly investment oriented plans. These new plans are becoming increasingly popular because they offer living benefits such as long-term care, critical illness covers and investment oriented plans tailored to cater to the ageing population, which helps policyholders to maintain their standard of living. Insurance company's success results from how well its products and services meet the needs of customers. In order to reach the maximum possible customers having diverse needs, products must be differentiated. Product features that are used to differentiate them include, maximum and minimum face values i.e. Sum assured, principal and supplementary benefits of the policy, embedded or in built options available under the policy, the possible riders being included to increase death benefits and flexibility, premium paying modes available, policy term, settlement of the policy may be arranged and the other provisions under the policy. All these product features constitute life insurance product design.

Meaning

Life insurance is a financial protection in case of early death of a person. It is an assurance to the insured to receive insured sum of money in lieu of premiums paid by him, either on death or maturity of the policy, whichever is earlier. Thus, life insurance offers dual benefit

1. Financial protection to the dependents in case of death and
2. Investment opportunity to the insured in case of his survival. Though the loss of life cannot be compensated by the insurance cover, still the money received by family members provides them financial help to arrange for the basic amenities of decent living.

Definitions of life insurance

Some of the definitions of insurance given by popular authors are as follows-

According to **section 2 of the indian insurance act, 1938**-“life insurance business is the business of effecting contracts upon human life.”

According to j. H. Maggee-“the life insurance contract embodies an agreement, in which, broadly stated, the insurer undertakes to pay a stipulated sum upon the death of the insured, or at some designated time to a designated beneficiary”. Thus, life insurance is a contract between the insurer and the insured where the latter pays consideration in the form of premium either periodically or in lump sum to receive the amount of money or annuity, either on death or maturity of policy, whichever is earlier. So in either case the premiums paid by the insured are returned by the insurer to the insured in case of survival and to the nominees in case of death of insured.

Life insurance product designs have 3 broad attributes

- I. Kind of contingencies covered: various contingencies like death, accident, disability, living too long.
- ii pattern of premium payment : single, level-annual, half yearly, quarterly, monthly, limited term.
- Iii. Pattern of benefits received: participating in profits, non-participating, tax, death/survival benefit, accident benefit, etc.

Features of life insurance

1. The individual whose life is covered under the policy is called the life insured or life assured
2. The individual who pays the premium for the policy is called the policyholder
3. The policyholder and the life insured can be same or different. When you buy a life insurance policy on your life, you are the policyholder and life insured. However, when you buy a policy on the life of your spouse or dependent child, you would be the policyholder but the life insured would be the spouse or the dependent child
4. Every life insurance policy has a specified duration and coverage level which you can choose
5. There are different types of life insurance plans and each plan has a different benefit structure

Advantages of life insurance

Following are the advantages of taking a life insurance policy

- 1) covers risk of death.
- 2) financial support to the dependents.
- 3) serves as a channel of investment and provides pay back in case of survival of policy holder at the time of maturity.
- 4) life insurance policy serves as collateral for raising loan from the financial institutions.
- 5) it provides rebate under sec 80c and hence offers tax benefits.
- 6) life insurance cover helps to fulfill various responsibilities of the insured as financial safety to dependents in case of death, sufficient money at the time of retirement etc.

Disadvantages of life insurance

Following are the disadvantages of life insurance policy

- 1) certain policies are payable only on death,. Hence insured does not gain anything during his lifetime.

- 2) surrender values are very less. Even the premium payable is not fully recovered.
- 3) it is very difficult to choose the right insurance company. It is difficult to decide whether to take up a policy with public sector or private sector insurance company. In public sector there is only one giant player lic and no other choice available.
- 4) the choice of policy is difficult. All policies as whole life policy, term life policy etc. Have their pros and cons.

Parties to the contract of life insurance

In a contract of life insurance following parties are involved

- 1) **Proposer/Policyholder-** The person who initiates the purchase of policy and makes an offer to the insurer for the same is the proposer. He has access to all the information related to the policy. He names the beneficiaries of the policy. He has also got the right to change the beneficiaries
- 2) **Insured-** The person on whose life the policy is taken is called the insured. Sum assured becomes payable on the death of the insured. All the information to be disclosed while taking the life insurance cover is in relation to the insured.
- 3) **Beneficiary-** The person who is named as the 'nominee' of the sum assured in case of death of insured is the beneficiary. He/she is the one who will get total amount of policy in the event of death of the insured. A. The proposer and the insured can be the same person. For instance, husband takes his own life policy and places his wife as the nominee. Here, husband is both the proposer and the insured. Wife is the beneficiary. In another example, husband takes life insurance cover of his wife. Here, husband is the proposer as well as the beneficiary; wife is the insured.
- 4) **Insurance Company-** The financial institution that enters into a contract with the insured to compensate him in case of happening of an event or maturity of policy, in lieu of premiums received in the form of consideration is the insurance company. These institutions are governed and regulated by insurance statutes of a country.
- 5) **Agent/ Broker-** These are the intermediaries that serve as a link between the insurer and the insured. They are the middlemen who disseminate policy information to the stakeholders.

They offer products to the customers in the market on behalf of the insurance company and thus promote the business and reach of insurance.

6) Underwriter- These are the professionals who evaluate the risks of insuring a particular person. On the basis of their evaluation report premium payable is calculated. They inspect all the factors as age, medical history, current medical reports, and health issues etc. That might affect his life expectancy.

7) Medical Examiner- The health care professional who examines the proposer medically and submits his report is the medical examiner. He is neither the employee nor the agent of insurance company. Rather he is a third party who aids insurance company with respect to medical examination of the proposed policyholder.

Summary

Life insurance is a contract between the insurer and the insured where the latter pays consideration in the form of premium either periodically or in lump sum to receive the amount of money or annuity, either on death or maturity of policy, whichever is earlier. So in either case the premiums paid by the insured are returned by the insurer to the insured in case of survival and to the nominees in case of death of insured. Life insurance contracts fall in the category of assurance contract. It is assured that sum insured shall be paid back either in case of death or maturity of policy, whichever is earlier. General principles of contract as offer and acceptance, competency of parties to contract, free will of parties, consideration and lawful object are applicable to life insurance contract as well. But for these life insurance contracts are also governed by specific principles. The offer and acceptance is subject to disclosure of all material facts as supported by the principle of utmost good faith. Insurable interest must be present at the time of taking life insurance policy. A person has unlimited insurable interest in his own life. Principle of warranty refers to certain conditions which must be fulfilled to make insurer liable to pay on the policy taken. Warranties may be expressed or implied. Principle of "causa proxima" states that the cause of loss should be direct and not 'distant' or 'remote'. But in case of death, insurer is bound to pay the policy amount usually irrespective of the cause. So the principle of proximate cause is less relevant in life insurance except in cases of suicide or deaths due to war operations. Contracts of life insurance can be assigned as well as nominated. When all the rights are transferred from the insured to the assignee either for consideration or out of love and affection, it is called assignment. When the person is named as beneficiary in the insurance policy and the sum insured is transferred

to him on the event of death of insured, it is called nomination. In the contract of life insurance major participants involved are- the proposer, the insured, the beneficiary and the insurance company. The underwriter and the medical examiner also have a role to play. Each party is assigned specific rights and duties. The insured has a prominent duty to act in utmost good faith and disclose all material facts while the insurer has the major duty of honoring the claim when due. Similarly right to claim sum insured is the major privilege of insured. Insurance company too has right of subrogation and right of cancellation of payment in case payment of premium is not made or other terms and conditions are disobeyed. The business of life insurance is undertaken both in the public as well as private sector of india. There are 24 life insurance companies in india. In fact life insurance corporation incepted in 1956 is the only company in the public sector, remaining 23 are in the private sector. Lic has a four-tier structure operating at the central level, zonal level, divisional level and branch level. The progress of life insurance in india has been gradual and steady. In 1818, first life insurance company, oriental life insurance company, was started in india. It was established by europeans in calcutta. In 1870 first indian life insurance company, bombay mutual life assurance society started its business in india. In 1956 insurance sector was nationalized. Life insurance corporation (lic) was formed by an act of parliament called the lic act, 1956 with a capital of rs. 5 crores contributed by government of india.

Self assessment questions

Short questions

- 1) Distinguish between a pure risk and speculative risk.
- 2) Discuss the concept of insurance with illustration.
- 3) Explain the terms hazard and perils. Distinguish between moral hazard and physical hazard.
- 4) What are the important functions of insurance?
- 5) Write a note on broad classification of insurance.

Long questions

1. What is life insurance? Give its features.
2. Who are the participants to the business of life insurance? Explain their rights and duties.
3. Explain the principles applicable of life insurance contracts.

4. What is principle of insurable interest?

UNIT 9 CHAPTER 16 NON LIFE INSURANCE

16.0 Introduction

16.1 Importance of Non-Life Insurance Policy

16.2 Features of Non-Life Insurance Policy:

16.3 The Benefits of Non-Life Insurance Policy

16.4 Difference Between Life Insurance and Non-Life Insurance

16.5 Types of Non-Life Insurance (General Insurance)

16.6 Marine Insurance

16.7 Fire Insurance

16.8 Miscellaneous Insurance

Summary

Self Assessment Questions

16.0 INTRODUCTION

Insurance in India can be divided into life and non-life. General insurance is highly popular as these policies provide financial compensation when losses occur. These losses can be caused due to various incidents like accidents, diseases, fire, natural or man-made mishaps, etc. Risk in simple terms is uncertainty of occurrence of a loss. The definition of non-life insurance is, the losses that are incurred from a specific financial event are compensated to the insured this is called non-life insurance. General insurance, property insurance and casualty insurance are other names of non-life insurance. It can be defined as any insurance that is not related to life insurance. People, legal liabilities and properties are covered under a non-life insurance policy. There are some examples of non-life insurance policies that completely justify the meaning of the term. General insurance policy examples are homeowners policies, motor insurance policies, marine insurance, damage coverage from fire, calamities, theft, travel insurance or any online breach incident related to cyber security. It is very difficult to measure the amount of damage caused by online incidents as the

probability of occurrence of these risks is extremely difficult to ascertain. However, these can be covered with the help of a non-life insurance policy.

Policies of non-life available in India:

The types of non-life insurance policies in India are:

1. Marine insurance
2. Home insurance
3. Travel insurance
4. Health insurance
5. Motor insurance
6. Commercial insurance

Is Non-Life Insurance Different From General Insurance?

No, general insurance is not different from non-life insurance, both are typically the same. General insurance or non-life insurance provides coverage to people, legal liabilities and properties.

16.1 IMPORTANCE OF NON-LIFE INSURANCE POLICY

1. Financial security at the time of need is one of the major upsides of buying a non-life insurance policy.
2. The insurance company will bear the cost of a financial liability. Thus, such risks are carried over to the insurance company from the policyholder.
3. Peace of mind related to possible financial crises.

16.2 FEATURES OF NON-LIFE INSURANCE POLICY:

Non-life policies features include the following:

1. The amount specified in the policy is the sum insured which, during the policy period, symbolizes the insurer's maximum liability for claims. The insurer may specify the available amount of sum insured.

2. The policy period of a non-life insurance plan is usually short, i.e., one year. The duration can be longer depending upon the type of insurance.
3. The premium of the policy is paid right before the insurance company issues the policy. When an application for insurance is received by the company, they assess the risk involved depending upon the type of cover required. For example, under health insurance, the age, medical history, and current medical status of a person will be taken into account before the insurance policy is issued.
4. Any claim is not fully borne by the insurance company. The policyholder needs to pay a small share, this share is called a deductible.
5. If no claims are made under a general insurance policy, then the policyholder is awarded a discount called No Claim Bonus. This is a cumulative discount on the premium of the policy that increases till it reaches a certain number.

16.3 THE BENEFITS OF A NON-LIFE INSURANCE POLICY ARE:

1. In case of health insurance, financial help is provided at the time of a medical emergency.
2. It is mandatory by law to buy a third-party motor insurance policy. It can take care of the compensation to be paid to the third party in case of damage to property or life.
3. Home insurance covers the residential property of the policyholder against many unforeseen incidents, like fire, burglary, natural calamities, riots, etc.
4. Travel insurance plans offer insurance coverage to senior citizens and children as well. These help with issues like loss of baggage, accidents, loss of documents, etc. in a foreign land.
5. Commercial insurance benefits the businesses with policies like employee benefits insurance, shopkeepers insurance, property and marine insurance, etc.

16.4 DIFFERENCE BETWEEN LIFE INSURANCE AND NON-LIFE INSURANCE:

Comparison basis	Life insurance	General insurance
Definition	Life insurance protects against life risks where the insured individual is promised by the insurance company for uncertainties and ambiguities of life-related to death.	The insured individual is promised to be compensated by the insurance company for the damage caused due to an unfortunate circumstance or any loss. The valuable things of people are protected by general insurance.
Policy Period	Long-term	Short-term
Nature of the policy	Life insurance is acknowledged as an investment, and it is not a contract of indemnity.	Whereas general insurance can be termed as indemnity's contract.
The insured	The policyholder receives the benefits of the insurance coverage.	The policyholder and the other people insured under the policy get the benefits of the insurance coverage.
Claims	The sum assured is paid at the maturity of the policy or death of the policyholder	Claim is processed as per the damage or financial loss suffered by the policyholder.
Cost of the policy	Depends upon the amount of sum assured offered by the insurance policy	Depends upon the value of the insured asset
Maturity	Life insurance provides a lump sum amount of sum assured at the time of maturity or in case of death of the policyholder.	Non-life insurance policies offer financial protection to a person for health issues or losses due to damage to an asset.

16.5 TYPES OF NON-LIFE INSURANCE (GENERAL INSURANCE)

General Insurance- General Insurance includes non-life insurance contracts. These include the following-

1. Property Insurance
2. Liability Insurance Covers
3. Marine insurance
4. Fire insurance
5. Personal Accident Insurance
6. Motor Vehicle Insurance

1. PROPERTY INSURANCE

Property Insurance business may be classified under three broad heads viz. Fire, marine or Miscellaneous Insurance. General insurance businesses are generally contracts of indemnity and are totally different from Life insurance contracts. Within the framework of the policy of the general insurance the insured is indemnified or provided with compensation in the event of operation of an insured peril. The essentials of normal contract are equally applicable to general insurance contracts. Property Insurance covers insurances of building, motor vehicles, marine & aviation, boilers machinery, furniture, fixtures, cash in transit, crop, cattle, etc.; whereas Liability insurance covers public liability (Third Party liability), Product Liability and Professional Indemnity. Property insurance is designed to indemnify the insured for loss or damage to buildings, furniture or other personal property due to different ways in which property can be damaged. Property may be damaged due to fire, theft, engineering, breaking glasses, etc. The standard cover used by almost all the business and households is of Fire Insurance.

FEATURES OF PROPERTY INSURANCE

In property there is a specific sum insured. The subject matter insured is described in concrete terms. The claim in the event of loss occurring is payable to the insured named in the policy and the sum assured is the limit of indemnity under the policy. A valid claim can arise only during the period of policy. In Personal and commercial lines of insurance the most important

insurance cover to protect buildings, property and other assets is of fire insurance. Second important cover is Marine Insurance that deals with Marine Cargo and Marine Hull. Hull insurance deals with the insurance of ships while cargo deals with goods and merchandise. In Miscellaneous insurance a large number of classes of insurance other than fire and marine are covered. Under miscellaneous insurance cover there are many types of covers viz. Motor Insurance which is major business under this class, Engineering Insurance, Liability Insurance, Burglary Insurance, Accident Insurance, Aviation Insurance, Personal insurance, etc. This is a specialized branch of insurance and distinct from insurance related to property and persons. One of the most serious financial risks covered by insurance is that of loss through legal liability for harm caused to others. Each person has some legal rights. Violation of person's legal rights is called as legal wrong. A crime, a breach of contract and tort are three broad classes of legal wrong. A criminal is punishable by fine, imprisonment or death and torts is legal injury to another that arises when a person's rights are wrongfully invaded, like right to be free from personal injury, to enjoy personal privacy, etc. For torts the law allows remedy in the form of money damages. Torts are generally classified into intentional torts, absolute liability and negligence. We are mainly interested here with protection against the financial consequences of civil action arising out of only one of these torts i.e. negligence. Negligence can result in substantial liability. Negligence is the failure to exercise the degree of care required by the law.

2. LIABILITY INSURANCE

There are numerous types of liability exposures which fall broadly into Public liability, product liability and professional indemnity. These exposures arise out of different functions performed and standards of care required of persons or organizations.

This policy covers the amount which the insured becomes legally liable to pay as damages to third parties as a result of accidental death, bodily injury, loss or damage to the property belonging to a third party.

The salient features of Liability insurance are:

- 1) There is no specific sum insured in respect of this class of insurance instead there are only limits of liability like limit per accident, limit per individual and limit per period.

- 2) There is no specific subject matter insured which can be identified for purpose of liability insurance. The insurance is taken only in respect of the liability that may arise out of the insured's business or profession.
- 3) The claimant invariably happens to be other than the insured.
- 4) The claim only in respect of the legal liability that has to be established by the litigant/claimant third party against the insured. Such liability should be an enforceable one at law.
- 5) Claims can arise even after the expiry of the policy so long as the loss causing event has happened during the policy period.

Public Liability Insurance:-This insurance covers the amount which the insured becomes legally liable to pay as damages to third parties as a result of accidental death, bodily injury, loss or damage to the property belonging to a third party. The legal cost and expenses incurred in defending the case with prior consent of the insurance company are also payable subject to certain terms and conditions. One can insure more than one unit situated in different locations under a single policy.

The policy offers a benefit of Retroactive period on continuous renewal of policy whereby claims reported in subsequent renewal but pertaining to earlier period after first inception of the policy, also become payable.

There are three types of Public Liability Policies.

- 1) Public Liability Non Industrial Risk - For offices, hotels, cinema houses, hospitals, schools etc.
- 2) Public Liability Industrial Risk - For godowns , warehouses and factories.
- 3) Public Liability Insurance Act 1991 - This is a mandatory policy to be taken by owners, users or transporters of hazardous substance as defined under Environment (Protection) Act 1986 in excess of the minimum quantity specified under the Public Liability

Product Liability:-This covers various types of legal liabilities arising out of goods sold or supplied. The product liability policy is a contract of indemnity and it is one of the strict legal liability. If the insured is found liable at law then alone the insurers undertake to indemnify him. The insured's moral obligation is not covered.

This policy covers all sums (inclusive of defence costs) which the insured becomes legally liable to pay as damages as a consequence of

- a) accidental death/ bodily injury or disease to any third party.
- b) accidental damage to property belonging to a third party.

Arising out of any defect in the product manufactured by the insured and specifically mentioned in the policy after such product has left the insured's premises.

The policy offers coverage in the following cases:

The defect in the product may be a manufacturing defect or may, even be due to faulty packaging, delivery specifications or instructions as to the usage of the product. It also covers the sales turnover of the company – both domestic and/or exports.

The policy is on a claims made basis i.e. the claims must arise and be made in writing on the insurance company during the policy period.

The policy does not cover any liability for product recall, product guarantee, pure financial loss such as loss of goodwill or loss of market.

The policy also does not pay for the cost incurred for repairing or reconditioning or modifying the defective part of the product.

Professional Indemnity:-The cover is granted to professionals like Doctors, Engineers, Chartered Accountants, Architects, etc. to cover liability falling on them as a result of errors and omissions committed by them whilst rendering professional service.

The policy covers all sums which the insured professional becomes legally liable to pay as damages to third party in respect of any error and/or omission on his/her part committed whilst rendering professional service. Legal cost and expenses incurred in defence of the case, with the prior consent of the insurance company, are also payable, subject to the overall limit of indemnity selected.

Only civil liability claims are covered. Any liability arising out of any criminal act or act committed in violation of any law or ordinance is not covered.

Other types of liability insurance extend to cover the third party liability e.g. motor third party liability, pedal cycle, television , etc.

Contractual Liability:-Contractual Liability is one's liability that may be assigned to another by contract. An employer under certain circumstances may employ a contractor to do certain portions of a job and the contractor may in turn subcontract it to another. When an action for damages arises, the employer (Principal or contractor) may be joined as a co-defendant in an action against the contractor/subcontractor as the case may be; an action can also be brought independently against the principal contractor. In order to avoid such situation the contractor/ subcontractor may be required to hold the principal/contractor harmless against any action in negligence by third parties.

Employer-employee Liability:-Employers are subject to the law of negligence with respect to employment not covered by workmen's compensation act. This act does not cover unorganized labor like farm workers or who work on daily wages. It is necessary that employer should provide a safe place to work or employer must warn employees of danger or the employer must employ individuals reasonably competent to carry out their tasks, failing in such duties give rise to liability.

The policy covers statutory liability of an employer for the death of or bodily injuries or occupational diseases sustained by the workmen arising out of and in course of employment.

Any employer whether as a Principal or contractor engaging "workmen" as defined in WC Act to cover his liability to them under statute and at common law. Employer can cover Employees who do not qualify as "Workmen" under separate table.

This policy provides cover to pay all sums which the insured is legally liable, to pay the employees in respect of personal injury by accident or diseases arising out of and in the course of the employment . So also the insured's liability arising either under common law or the laws set out in the schedule Workmen's Compensation Act 1923. And the costs or expenses incurred by the insured with the consent of the company, to defend any claims paid in addition.

The policy does not offer any protection if the liability arises due to any injury by accident or disease directly attributable to war and nuclear risk or insured's liability to employees of contractors to the insured or any liability of the insured which attaches by virtue of an agreement.

16.6 MARINE INSURANCE

Marine insurance is the oldest form of insurance. It is also called Transportation Insurance. Generally all trades depend heavily upon the availability of insurance for successful and expeditious handling. Marine insurance has been originated from England in the 16th century. At that time goods were transported by ocean way. Marine insurance came into existence in order to protect, if the ship or cargo were lost as a result of ocean. Due to engine failure ship gets driven by storm and breaks up by the pressure of waves grinding it against rocks and sand. Fires are very frequent and low visibility cause collision. Goods are sometime lost due to negligence, dishonesty or incompetence of the crew handling them or fault in vessel management. Marine Insurance is the contract between insurer and insured. Marine insurance gives protection against fortuitous losses that occur during marine adventure. Marine insurance business means the business of effecting contracts of insurance upon vessels of any description including cargoes, freight and other interest which may be legally insured in or in relation to such vessels, cargoes and freights, goods, merchandise and property of whatever description insured for any transit by land or water or both and whether or not including warehouse risks or similar risks in addition to or as incidental to such transit and includes any other risks customarily included among the risk insured against, marine policy. Marine insurance covers maritime perils i.e. perils consequent on or incidental to navigation like fire, collision, standing, sinking, storm, tempest, gale, typhoon, hurricane, etc. War perils and certain other additional perils may be covered by payment of suitable additional premium.

Classification of Marine Insurance

From the above definition we can classify marine insurance in 4 categories viz. Hull insurance, Cargo insurance, Freight insurance & Liability insurance.

On the basis of period of cover marine policies are further classified into:

- 1) **Time Policy:** Time policy is for fixed period usually not exceeding twelve months.
- 2) **Voyage Policy:** Voyage policy is operative for the period of the voyage. It protects cargo from warehouse to warehouse.
- 3) **Mixed Policy:** Mixed policy covers the subject matter for the voyage and some period of time thereafter e.g. while subject matter is in port.

4) **Building Risk Policy:** Building risk policy provides protection while the vessels are under construction.

a) **Marine Hull Insurance**

Marine Hull Insurance is a specialised type of cover and hence needs appropriate understanding. Big and small ships are to be covered against maritime perils. Ships need protection when they are under construction and even after its construction when they are in operation and during their lifetime till they are in use. The main buyers of these insurance policies are ship builders and ship owners. Hull Insurance is a unique field wherein underwriter's function is of a developmental and technical nature and servicing of insurance. Therefore, along with development function he should have technical expertise on this, specialised branch of insurance. There is a direct contact between ship owners – Clients and the Hull Underwriters. Normally there is no agent or broker involved in servicing of Hull Insurance, therefore; hull underwriters perform the function as a Broker to the client in Indian Market. Hull Underwriters have greater accountability in meeting the requirements of a suitable cover for their clients. Besides constant consultation and counselling the Hull Underwriters in India are to perform personalised service to shipping community in Indian Market. This insurance covers vessel itself. The policy may cover ship only during a given period i.e. hulls, machinery, material and other ancillary interest of ocean going vessels of all types i.e. small fishing vessels, tugs, salvage vessels, ferry/steamers, launches, yatches and other pleasure crafts, lighter crafts, iron cargo boats, etc. The cover granted is so formulated as to meet the requirements of the individual ship owner and protects the ship owner against Partial Loss. Total Loss (actual or constructive) ship's proportion of General Average and salvage charges etc. The policy also covers Sue and Labour expenses and ship owners' liability towards other vessels arising from collisions. Normally, only $\frac{3}{4}$ of the collision liability is covered under the Hull and Machinery policy and the remaining $\frac{1}{4}$ is covered with the protection and Indemnity Clubs. Sometimes the collision liability is fully covered under the Hull Policy.

Marine hull policies are not assignable without the insurer's consent because the ownership and management of a ship are important factors considered for acceptance and rating . Though the ship is sold or transferred to new owner, the hull policy is not allowed to be transferred to the new owner. In the event of change of ownership the policy shall be

cancelled and a refund of premium made for the unexpired portion. The policy may be assigned only if the insurer approves the new owner.

Premium Reducing: Should a vessel be lost soon after the risk was attached, the owner in fact, loses the premium, which would have covered him for the entire period of the year. This policy covers premium on the Hull and Machinery, Freight and Disbursement interests including premium on premium reducing policy following total loss of the vessel. The amount of indemnity is reduced by 1/12th monthly.

Loss of Hire Policy: This covers loss of hire suffered by the ship owners if the vessel, which is given a charter, is laid-up for repairs following a casualty covered under terms of the Hull and Machinery Policy.

b) Marine Cargo Policies

It protects cargo against various types of loss. Generally the policy is written for a specified voyage. Cargo insurance means export and import of shipment including sending by air and registered post. Coastal shipment by steamer or shipment by smaller vessels in Indian water and inland vessels of different types or goods in transit by rail/road/port. Marine cargo policies are freely assignable without prior consent of insurer provided assignee has acquired insurable interest in the subject matter insured or at least expects to acquire the insurable interest. Under Marine Cargo policy when insured goods are in transit the ownership of goods frequently changes and it becomes necessary to ensure that the benefit of the policy should pass on to the new owner. Even blank endorsement on balance of the policy is sufficient for negotiation and so is a negotiable instrument.

Due to high claims ratio, Marine cargo class of insurance warrants special care and sound knowledge about the nature of various goods and merchandise, type of damages to which cargos are susceptible and port conditions prevailing all over the world.

Cargo Insurance covers the following risks related to loss of damage reasonably attributable to fire and explosion, Vessel or craft being stranded grounded, sunk or capsized., Overturning or derailment of land conveyance, Collision or contact of vessel craft or conveyance with any external object other than water, Discharge of cargo at the port of distress, Earthquake, volcanic eruption or lightning

- c) **Freight Insurance:-**The amount that is paid for transport of goods and use of vessel is called as freight. If the ship sinks, the freight is lost. In other words, the hull owner gets the freight on the safe delivery of cargo otherwise he will lose the expenses incurred and profit. In the event of damage of hull leading to destruction of cargo in that case it cannot be delivered. Owner of cargo has an interest in freight arising from the obligation to make payment of transport charges.
- d) **Legal Liability Insurance:-**Marine policies include liability hazards viz. personal injuries, loss of life or damage to property other than vessels. Therefore protection and indemnity (P & I) clause is generally added to the hull policies. Secondly these policies covering hull, the hull owner is protected against Third party liability claims that may arise due to collision. Running down clause is intended to give protection in case ship owner is held liable for negligent operation of the vessel, which is proximate cause of damage to certain property of others. The vessel owner if fails to exercise proper degree of care in operation of ship may be legally liable for damage to the other ship and for loss of freight revenues.

The use of aeroplane as a mode of transport is increasing every year and the risks associated with it are high. Aircrafts ranging from small craft to jumbo jet due to their specialized and technical nature, the high potential cost of accidents is associated with all aviation risks. All these aircrafts are insured in the aviation insurance market. Generally the policies are All Risks policies subject to certain restrictions. Usually a comprehensive cover is issued for aircraft (hull) i.e. insurance of aircraft against loss or damage, the liabilities to passengers and liabilities to third party ; liabilities for freight, mail, etc. carried; insurance of pilots, crew and ground staff against personal accident risks; Insurance of pilots and other crew members against loss of professional licences, etc.. Normally corporate aircraft owners, large commercial airlines, private owners and flying clubs purchase these policies.

16.7 FIRE INSURANCE

As compared to marine insurance, fire insurance is of comparatively recent origin. Fire is ignition under accidental circumstances. Generally almost all the material objects are vulnerable to fire. Vulnerability of wood is more than steel structure. Fire causes huge losses due to material damage. Therefore it is necessary to take some preventive measures to avoid or reduce fire losses and protect the property against pecuniary losses. Fire Insurance is

governed by All India Fire Tariff effective from 31.3.2001 issued by Tariff Advisory Committee, a Statutory Body. The tariff contains among other things, the rates to be charged for different types of risks. These risks have been codified and a great deal of simplification has been brought about by applying the principle of one risk-one rate, especially for industrial and manufacturing risks. Insurers are permitted to charge rates higher than those given under the tariff. The minimum premium will be Rs. 50/- per policy for dwellings and small sector industries and Rs. 100/- for all other sectors.

Objective

The objective of fire insurance policy is to provide compensation to the insured in the event of damage to the property insured. The scope of standard fire policy is limited to the damage caused to the property by fire, lightning or explosion, viz. explosion of gas cylinder or boilers used for domestic purposes. But in reality there are number of different ways in which property can be damaged and to meet these extra perils special perils can be included to the standard policy. These perils are flood, earthquake, aircraft, explosion, collision, etc.

Three physical conditions lead to fire viz. there must be flammable gas or vapour, presence of oxygen, and there should be source of heat e.g electrical spark, flame, etc. There are greater chances of fire where these three factors are present. These are damages covered under fire policy. In addition to these three, fire policy covers following damages also:

- 1) Damages done by fire fighting force while executing their duties
- 2) Damages to property during removal from burning building
- 3) Property demolished by fire brigade to prevent from fire propagation risk
- 4) Damage due to water in extinguishing fire
- 5) Damage due to falling walls and smoke damage caused by fire

Fire insurance policy is suitable for the owner of property, one who holds property in trust or in commission; individuals/financial institutions who have financial interest in the property. All immovable and movable property located at a particular premises such as buildings, plant and machinery, furniture, fixtures, fittings and other contents, stocks and stock in process along with goods held in trust or in commission including stocks at suppliers/ customer's premises, machinery temporarily removed from the premises for repairs can also be insured.

Perils Covered Under Standard Fire Policy

Along with the basic coverage against loss or damage by occasional fire, the standard fire and special perils policy provides protection from a host of other perils such as

Perils Covered

- 1) Fire
- 2) Lightening Explosion/Implosion
- 3) Aircraft Damage Loss, Destruction or damage caused by Aircraft, other aerial or space devices and articles dropped there from excluding those caused by pressure waves.
- 4) Riot, Strike, Malicious and Terrorism Damage (RSMTD) Loss of or visible physical damage or destruction by external violent means directly caused to the property insured
- 5) Impact Damage. Loss of or visible physical damage or destruction caused to the property insured due to impact by any Rail/ Road vehicle or animal by direct contact not belonging to or owned by the Insured or any occupier of the premises or their employees while acting in the course of their employment or damage caused by sprinkler leakage, overflow, leakage of water tanks, pipes etc.
- 6) Subsidence and Landslide including Rock slide In addition to these perils covered under standard fire policy, the special fire policy also included following perils
- 7) Missile Testing operations
- 8) Bush Fire

The policy may be extended to cover earth quake, fire and shock; deterioration of stock in the cold storages following power failure as a result of insured peril, additional expenditure involved in removal of debris, architect, consulting engineers' fee over and above the amount covered by the policy, forest fire, spontaneous combustion and impact damage due to own vehicles.

Exclusions

Following exclusions are applicable to the fire policies:

Perils not covered are War and allied perils, Ionising radiations and contamination by radioactivity, Pollution or Contamination

Role of Fire Insurance

In case of a partial loss, Insurance Company shall effect payment for repairs and replacement. In case of policy with reinstatement value clause, cost of reinstatement will be paid on completion of reinstatement subject to overall limit of the sum insured. Insurance company may at its option, also repair or replace the affected property instead of paying for the cost of restoration.

Any loss or damage to material and property causes hardship and results in national waste. Monetary relief is essential to rebuild and renew the property damaged to bring back the business to its normal course. It is here that fire insurance plays its role. The after effects of fire may be drastic. Therefore, one has to take fire insurance to safeguard the property. Since the standard fire and special perils policy covers many risks in addition to fire, coverage of the property under this policy is recommended.

16.8 MISCELLANEOUS INSURANCE

This is a broad field of insurance and covers whatever is not covered under fire, marine, and life insurance. In other words, all other insurances like engineering, rural, social insurance and personal insurances like mediclaim, accident insurance, etc. fall under miscellaneous insurance. To illustrate, burglary insurance is a major business in this class which covers the loss of property, money and securities due to burglary robbery and other crimes. Glass insurance offers broad coverage for glass breakage in the covered building or Jewellery and valuables insurance provides cover for loss or damage to jewellery and valuables, belonging to all the family members residing in the house caused by any accident or misfortune anywhere in India. Following are the examples of miscellaneous insurance

- 1) Burglary Insurance
- 2) Jewellers Block Policy

- 3) Bankers Indemnity Policy
- 4) Money Insurance
- 5) Shopkeepers Policy
- 6) Householders Policy
- 7) Suhana Safar Policy
- 8) All Risk Insurance Policy
- 9) Mediclaim Policy
- 10) Overseas Mediclaim Policy
- 11) Personal Accident Policy

16.9 MOTOR VEHICLE INSURANCE

Motor Vehicles Act was passed in 1939 and amended in 1988. Earlier many pedestrians were hit by motor vehicles and were killed or injured. They did not get any compensation for their loss. In order to protect the interest of such people, the Motor Vehicles Act, 1939, introduced compulsory insurance. The insurance of motor vehicles against damage is not mandatory but the insurance of third party liability arising out of the use of motor vehicles in public places is compulsory. No motor vehicle can run in a public place without third party insurance. Motor insurance, also called the vehicle insurance covers all financial losses arising out of usage of vehicle in the public places. It covers damages caused not only to the vehicle but also provides accidental cover to the owners of vehicles while driving and passengers and also cover third party legal liability, that is , damages to the third party in person or to property. Motor insurance gives protection against both natural as well as man-made calamities. But for Motor Vehicle insurance, it is very important to buy a personal accident insurance policy as well. A contingency like accident can happen any time. The injury too can vary from a minor one to a serious one and even to death. Such an event can lead to a financial crisis in the family and hence accidental insurance can provide financial cover for the same. There are several other benefits that are provided in accident insurance policy as accidental hospitalization cover, Hospital Confinement Allowance, and Medical Expense Cover etc. Motor Vehicle insurance is a contract by which the insurance company undertakes the risk of any loss to the owner or operator of a vehicle which he may incur through damage to

property or persons as a result of an accident. Other than traffic collisions motor insurance may protect the insured from incurring any financial losses that arise due to damage or even theft of the vehicle. Motor insurance vary in the types of risk they cover subject to the various legal regulations in a particular region.

Motor Vehicle insurance covers the following-

1. Own Damage (OD) : The damages to the motor vehicle on account of following reasons are covered under OD section of the Motor Insurance policy:

i. Fire, Explosion, Self- Ignition, Lightning

ii. Burglary/Housebreaking /Theft

iii. Riots and Strikes

iv. Natural calamities as Earthquake, Floods, Storm, Cyclone, Hurricane, landslides etc.

v. Accidents due to external factors

2. **Third Party (TP) Liability:** This policy covers the Third-Party Liability that arises against the owner of the vehicle. Third Party Insurance is a statutory requirement. The owner of the vehicle becomes legally liable for any injury or damage to third party's life or property due to accident with his vehicle.

3. **Compulsory Personal Accident Cover (CPA):** This policy provides compensation to the owner/driver of the vehicle in case of bodily injury/death in direct relation to the vehicle and also covers in case the person is engaged in mounting/dismounting the vehicle or is travelling in it as a passenger.

The policy cover can be extended to include other risks by paying extra premium.

Risks not covered under Motor Vehicle Insurance

Following risks are however not covered under the Motor Vehicle Insurance-

Routine and normal wear and tear of the vehicle on account of its usage.

- Depreciation of the vehicle.
- Breakdown of machinery of vehicle.
- Depreciation and wear and tear of consumables of vehicle like tyres and tubes.

- Any damage or loss outside the stated geographical boundary.
- Loss arising due to driving under intoxication (DUI) due to influence of alcohol or drugs.
- Loss caused by person driving without the driving license.
- Loss due to nuclear risks and war.
- Losses due to racing
- Deliberate accidental damage.

Importance of Motor Vehicle Insurance

Following points highlight the importance of motor vehicle insurance-

- i. Third party motor vehicle insurance is mandatory under law. It is not a choice but a mandate. A person driving without third party cover is penalized under Motor Vehicle Insurance Act 1988.
- ii. Accident is an unforeseen event. Neither the probability nor the timings can be determined of such mishaps. But insurance cover gives financial compensation during such times and saves from bearing expensive damages.
- iii. In case of damage to the person or property of the third party, motor vehicle insurance saves a person from his financial liability towards the third party.
- iv. Purchasing a vehicle is an expensive affair. The loss or damage of vehicle also proves very expensive unless protected with an insurance cover.
- v. The motor vehicle insurance not only covers accidental losses but also other contingencies as theft, fire etc.

Types of Motor Vehicle Insurance

There is a wide range of motor vehicles running on Indian roads and hence there is a broad range of motor insurance policies available to suit the needs of vehicle owners. Two-wheelers usually include scooters and motor bikes, three wheelers include the auto-rickshaws while the four wheelers consist of a range of personal vehicles as cars and jeeps,

and commercial vehicle as buses, trucks, trolleys taxis etc. On the basis of category of vehicles, motor insurance policies are classified as follows-

1. Car insurance
2. Two wheelers insurance
3. Commercial vehicle insurance

16.10 ACCIDENTAL INSURANCE

As per the World Health Organization, accident related deaths, are known to be the eighth leading cause of death and the first largest cause of death among children aged 5-14 and adults in the age 15-29. As per the statistics of Ministry of Road Transport and Highways road accidents in India kill almost 1.5 lakh people annually. Accordingly, India accounts for almost 11% of the accident related deaths in the World. An accident is “an event which is wholly unexpected not intended or designed.” Accident or accidental death means “a sudden, unintended and fortuitous external and visible event.” The personal accident insurance policy states that, if at any time during the ‘period of insurance’, the ‘insured’ sustains any bodily injury directly due to accident caused by external violent and visible means, then the insurer shall pay to the insured or his legal personal representative(s), as the case may be, the ‘capital sum assured’, forth, in the policy, in case of specified contingencies such as death, Permanent Total Disablement, Permanent Partial Disability, Temporary Total Disablement etc.

Some important terms

Accidental Death: Death resulting from “bodily injury solely and independently due to any other cause except illness, directly resulting from, or medical or surgical treatment rendered necessary for such injury, resulting in death of the insured person within 12 months from the date of accident.”

Bodily Injury: “Accidental physical bodily injury solely and directly caused by external, violent visible cause.”

Capital Sum Insured: It means the monetary amounts shown in the policy of insured person(s) which is the maximum limit of insurer’s liability against said insured person.

Insured Person: The person(s) named as insured person which includes self, family and the dependent parents.

Period of Insurance: The “time period for which the contract of insurance is valid as shown in the Policy Schedule.”

Permanent Total Disablement: The bodily injury that “totally, irrecoverably and absolutely prevents a person from engaging in any kind of occupation”.

Permanent Partial Disability: The bodily injury that results in “total, irrevocable, absolute and continuous loss of or impairment of a body part or sensory organ specified under the Table of Benefits”.

Temporary Total Disablement: The bodily injury that “prevents from engaging in an occupation for a period not exceeding 104 weeks since the date of injury to the time a person is fit enough to resume his/her occupation as certified by a Medical Professional.”

Coverage of accident insurance policy

Following are covered under accident insurance-

Death: If a person dies due to an accident it is covered under personal accident policy. His legal representatives can claim the sum assured under the policy.

Disability: Disability is classified as-

Permanent Total Disability (PTD) - This disability is permanent and irrecoverable for instance, paralysis, loss of sight in both eyes, loss of both hands and both feet or one hand and one foot. The person becomes incapable of undertaking any occupation as it is total disability. Full compensation which is equal to the sum insured is payable.

Permanent Partial Disability: The disability is not total, but partial. The compensation is paid proportionately to the disability based on doctor’s certificate and specifications mentioned in the policy.

Temporary total disablement: This type of disablement is total but for temporary period of time. Here the payment is made on weekly basis.

Carriage of dead body: The cost of carrying the dead body from the place of accident to the residence of insured are compensated. It is based as a percentage of sum assured.

Education amount for children: In case of death of the insured as well in case of permanent disability, accident insurance cover may provide for education of children who are below the age of 25 years. Maximum of two children are compensated.

Alteration of the house- In case of permanent disablement any expenditure incurred by the insured in alternation of his house to enable his free movement in the house is reimbursed up to a certain specified limit.

Exclusions from accident insurance policy

In the following cases no compensation is payable to the insured in case of death or bodily injury

- i. From deliberate self-injury
- ii. suicide
- iii. Death or Injury under influence of drugs or alcohol
- iv. Mounting/ dismounting while travelling in any balloon or aircraft other than as passenger.
- v. Injury or death due to some disease or
- vi. From any breach of law while committing a criminal offence
- vii. From service in the armed forces or
- viii. Resulting from child birth or pregnancy.

SUMMARY

Non-life insurance, also known as property and casualty insurance, provides financial protection against specific risks and losses that may occur to property, assets, or liability. Unlike life insurance, which covers the risk of death, non-life insurance focuses on protecting individuals and businesses from various perils. Types of Non-Life Insurance: Property Insurance: Covers damage or loss to physical property, such as homes, buildings, and contents, due to events like fire, theft, or natural disasters. Casualty Insurance: Provides liability coverage for individuals and businesses, protecting against legal responsibilities for injuries or property damage to others. Health Insurance: Covers medical expenses and related costs for individuals in case of illness or injury. Motor Insurance: Includes coverage for vehicles against accidents, theft, and liability for bodily injury or property damage caused by the insured vehicle. Travel Insurance: Protects against financial losses due to trip cancellations, medical emergencies, or other unforeseen events during travel. Miscellaneous Insurance: Encompasses a range of specialty coverages, such as aviation insurance, marine insurance, and others tailored to specific risks. Premiums and Coverage: Policyholders pay premiums to the insurance company in exchange for coverage. Coverage details, including limits and exclusions, are outlined in the insurance policy. Underwriting and Risk Assessment: Insurance companies assess the risk associated with insuring a particular individual, property, or business before issuing a policy. Underwriters use various factors, such as the insured's history, property details, and risk exposure, to determine premiums and coverage terms. Claims Process: In the event of a covered loss, policyholders can file a claim with the insurance company. The insurer investigates the claim and, if valid, compensates the policyholder based on the terms of the policy. Reinsurance: Insurance companies often

purchase reinsurance to share the risk with other insurers and limit their exposure to large losses. Regulation: Non-life insurance is subject to regulatory oversight to ensure financial stability, consumer protection, and adherence to industry standards. Market Dynamics: Insurance companies compete based on premiums, coverage options, and customer service. Market conditions, economic factors, and regulatory changes influence the industry's dynamics. Emerging Trends: Technology, data analytics, and artificial intelligence are increasingly being used to enhance underwriting processes, risk management, and customer experience in the non-life insurance sector. Non-life insurance plays a crucial role in mitigating financial risks associated with various perils, providing individuals and businesses with protection against unforeseen events and potential financial losses.

SELF ASSESSMENT QUESTIONS

Short Questions:

1. What is non-life insurance?
2. Give an example of a non-life insurance policy.
3. What does property insurance cover?
4. Define "premium" in the context of insurance.
5. How does reinsurance work in non-life insurance?
6. Name three types of non-life insurance.
7. What is the purpose of underwriting in the insurance industry?
8. Explain the claims process in non-life insurance.
9. Why do insurance companies use actuaries?
10. What role does regulation play in the non-life insurance sector?

Long Questions:

1. Discuss the key differences between life insurance and non-life insurance.
2. Examine the impact of emerging technologies, such as artificial intelligence, on the non-life insurance industry.
3. Describe the underwriting process in non-life insurance and its significance in risk management.
4. Explore the role of reinsurance in mitigating risk for insurance companies.

5. Discuss the factors that influence the pricing of premiums in non-life insurance.
6. Explain the concept of liability insurance and provide examples of situations where it would be applicable.
7. How does the claims settlement process contribute to the overall customer experience in non-life insurance?
8. Analyze the role of government regulations in ensuring fair practices and consumer protection in the non-life insurance market.
9. Discuss the challenges and opportunities facing the non-life insurance industry in the current economic and technological landscape.
10. Explore the importance of data analytics in assessing and managing risks in non-life insurance

UNIT 10

CHAPTER 17 INSURANCE BROKING SERVICES

17.1 Introduction

17.2 Insurance Agent and Insurance Broker

17.3 Different Kinds of Insurance Brokers

17.4 Benefits of An Insurance Broker

17.5 Registration of An Insurance Broker

17.6 Role of Insurance Broker

Summary

Self Assessment Questions

17.1 INTRODUCTION

Insurance is a very crucial part of financial planning as it helps in reducing the liabilities which might arise from an unfortunate event. However, purchasing a suitable insurance policy is quite a daunting task as any wrong decision might affect your finances. Hence, there are insurance brokers who help the prospects to decide the best policy as per their needs and financial requirements. An insurance broker is a middleman between insurance companies and people who are in search of purchasing insurance policies. They are experts who help people in buying the suitable insurance policies as per their needs and requirements. The insurance brokers also suggest and guide people about the nitty-gritties of the policies which are beyond the understanding of the layman. An insurance broker gets their license under Insurance Regulatory and Development Authority of India (IRDAI) and provides advice-giving services to their clients on the matters related to insurance. In short, an insurance broker is a professional who is expert in insurance and risk management and they work on behalf of their client to

provide them the best possible services related to life or general insurance. They help you in explaining the terms and conditions, inclusions, exclusions and various upfront and hidden costs of insurance policies.

17.2 INSURANCE AGENT AND INSURANCE BROKER

Until 2002 in India, insurance was mainly sold by the insurance agents. Insurance agent is a legal representative of the insurance company who solicits or induces the person to apply for insurance and the insurance becomes effective only if the application is approved by the insurance company. After getting approval from insurance company agent delivers the contract to the applicant. For procurement of business, agent gets compensation in the form of commission from insurance company. Insurance agent represents insurance company i.e. supplier of insurance whereas insurance broker is someone who legally represents the insured. In real world the word 'Broker' applies to a wide range of firms covering a wide range from Multi National Companies to High Street Broker. Insurance Brokers are a set of intermediaries who can solicit and procure insurance business of life insurance, general insurance, or both. They are essentially independent intermediaries and legally represent the insured or their clients who are prospective buyers. Their work starts with recommending the risk plan and will continue to serve the client till the settlement of the claim. Insurance agent works for a single insurer whereas broker works with many insurers. Though the broker is representative of insured, he is paid commission from the insurer with whom he places the business. A Broker is an individual or a proprietor, partnership firm or a company formed under companies Act, 1956 or a Cooperative Society Registered under the cooperative societies Act, 1912 under any law for the registration of cooperative societies. A Broker can get associated with many companies but cannot act as an agent of any insurer. By virtue of his position he could obtain a good deal for the prospects on favourable terms. Insurance Brokers act as financial consultants to their clients. They advise their prospective clients – with full disclosures and

transparency – and provide all material information related to the insurance product in order to enable the clients to take an informed decision. After the customer purchases the insurance product, the broker coordinates with the insurance company and the customer for policy and claim servicing.

Difference Between Insurance Agent and Broker

Insurance Agent represents a particular insurance company to sell its products to customers. They rely on the company for servicing demands of the customers and are less trained to understand the complex insurance products. Insurance agents are locally available and they can have a good personal bond with the customers.

An insurance broker represents the buyer and offers them policies from different companies. The broker has to have a bachelors degree and undergo 50 hours of training to get the broking license from the authorities. Besides marketing of insurance products, they also offer claims consultancy and risk management services to their customers.

17.3 Different Kinds of Insurance Brokers

Direct Brokers

Direct brokers are the kind of insurance broker licensed by the IRDAI, who helps their clients in getting insurance coverage, provides claim consultancy and also offer risk management services for a remuneration or a fee. A direct broker offers advisory insurance services which are apt for their clients as they have detailed and updated knowledge of the overall insurance market and products. These kinds of brokers also help their clients in negotiating for claims and e-insurance policies. There are three categories of direct brokers, such as:

1. Direct Broker (Life)

2. Direct Broker (General)
3. Direct Broker (Life & General)

The main functions of direct insurance brokers are:

- Gather information on available insurance products and business in India.
- Offer advisory to clients on insurance coverage and other similar features.
- Obtaining detailed information of the client's business and risk management philosophy;
- Familiarizing himself with the client's business and underwriting information so that this can be explained to an insurer and others;
- Rendering advice on appropriate insurance cover and terms;
- Maintaining detailed knowledge of available insurance markets, as may be applicable;
- Submitting quotation received from insurer/s for consideration of a client;
- Providing requisite underwriting information as required by an insurer in assessing the risk to decide pricing terms and conditions for cover;
- Acting promptly on instructions from a client and providing him written acknowledgements and progress reports;
- Assisting clients in paying premium under section 64VB of Insurance Act, 1938;
- Providing services related to insurance consultancy and risk management;
- Assisting in the negotiation of the claims; and Maintaining proper records of claims.

Composite Insurance Brokers

As per IRDAI, composite broker means an insurance broker which is registered by the authority, who for a remuneration and/or a fee, solicits and arranges insurance and or re-insurance for their clients located in India or abroad. They are responsible for providing claims consultancy, risk management services, permitted under IRDAI (Insurance Brokers) Regulations, 2018.

The main functions of composite insurance brokers are:

- Procuring detailed information of the client's business and risk management philosophy.
- Offering advice on appropriate insurance cover and terms.
- Maintaining proper record of claims.
- Helps in negotiating claims.
- Providing services such as insurance consultancy and risk management.

Reinsurance Brokers

A reinsurance broker functions similarly like a direct insurance broker with the only difference that direct brokers help their clients in buying insurance, whereas reinsurance brokers work with insurers to sell reinsurance.

A reinsurance broker is paid in the form of a fee or commission and involved in negotiating the best rates or contracts while obtaining the best-suited policies available in the market. Reinsurance means insurance for insurance companies.

The main functions of reinsurance brokers are:

- Keeping updated knowledge of the reinsurance market.
- Selling reinsurance related products.

- Negotiating with a reinsurer for the best rates on behalf of the client.
- Deliver risk management services.
- Maintaining the database of solvency ratings of each reinsurer.
- Familiarizing himself with the client's business and risk retention philosophy; |
- Maintaining clear records of the insurer's business to assist the re-insurer/(s) or others;
- Rendering advice based on technical data on the reinsurance covers available in the international insurance and the reinsurance markets;
- Maintaining a database of available reinsurance markets, including solvency ratings of individual re-insurers; | Rendering consultancy and risk management services for re-insurance; | Selecting and recommending a re-insurer or a group of re-insurers;
- Negotiating with a re-insurer on the client's behalf; | Assisting in case of commutation of reinsurance contracts placed with them; | Acting promptly on instructions from a client and providing it written acknowledgements and progress reports;
- Collecting and remitting premiums and claims within such time as agreed upon;
- Assisting in the negotiation and settlement of claims;
- Maintaining proper records of claims; and Exercising due care and diligence at the time of selection of re-insurers and international insurance brokers having regard to their respective security rating and establishing respective responsibilities at the time of engaging their services.

17.4 Benefits of An Insurance Broker

- Multiple insurance product options from different insurance companies
- Factual comparison between insurance policies

- Gets better offerings from insurance companies, hence results in premium costs saving
- Claim assistance
- Provides risk management assessment, strategy and assistance.
- Helps in saving time, effort and energy.
- Well-equipped with the best available insurance products.
- Helps you to assess the level of risk and provide ways to manage it.
- Offers expert advice on various insurance policies and helps you to choose right amount of coverage.
- Helps you in claim advocacy and claim settlement process and liaise with the insured to negotiate for the best possible claim outcome.
- Have the ability to negotiate competitive premiums on your behalf.

17.5 Registration of An Insurance Broker

Eligibility Criteria

Following are the entities which are eligible to apply for the insurance broker license in India:

- Company registered under the provisions of the Companies Act, 2013
- Registered co-operative society incorporated as per the norms of the Co-operative Societies Act, 1912
- Limited Liability Partnership (LLP) registered under the Limited Liability Partnership Act, 2008
- Any other individual or company that is allowed to conduct the business related to an insurance broker.

Regulates and License Insurance Brokers in India

Insurance Brokers are regulated and licensed by the [Insurance Regulatory and Development Authority \(IRDAI\)](#). Brokers can register on the website of IRDAI and apply for license in any one of the following categories – Direct (Life, Non-Life or Both), Composite and Reinsurance. Brokers are required to renew their licenses periodically (three years).

17.6 Role of Insurance Brokers

Insurance Brokers, being consultants for their client's insurance needs, need to gather information and understand the profile of the clients. Brokers negotiate with the insurance companies on behalf of their clients in order to come up with customized solutions including best terms and premium options for the clients. Insurance Brokers help mitigate risks by proposing risk management strategies based on the client profile. These risks may include credit risks, legal liabilities, accidents, natural disasters etc. Unlike stock market where the demand for stocks is fluctuating, in insurance market the demand for insurance products is relatively fixed. Generally people are not very keen to purchase insurance. They are aware of quite a few common forms of insurance i.e. Life Insurance and in Non-life Insurance category Motor Insurance and Third Party insurance but probably not aware of the considerable range of covers which the insurance market offers. They know that insurance is needed, but still are reluctant to purchase insurance. The root cause of this attitude is they have to pay the premium now just for the possibility of occurrence of insured event sometime in future and they do not receive any immediate tangible benefit. All that they get is the insurance policy - which contains that promise. Secondly the policy document which is drafted in legal lingo that is very difficult to understand for ordinary people. Insurance contracts are contingent financial assets so both the parties to contract generally do not want to face contingency which leads to only unpleasant circumstances, which the insured would rather not think about. Barring some

investment oriented life insurance contracts, both parties would feel that it should never come into effect. There is no wonder that most insurance covers for individuals and also for industrial concerns/corporates are bought as a result of either compulsion or persuasion. So far as the individuals are concerned under non-life category, motor insurance is mandatory for individuals who own vehicle, therefore with increasing number of vehicles the scope of motor insurance also increases. There are many insurers who offer motor insurance and very often the vehicle owner does not know how to find the best insurer. Here the broker is able to find the best combination of prices and conditions for the particular circumstances of his client among the many offers. While doing so he ensures that the insurer is financially sound. After selling the policy if the insured meets with an accident, the broker should guide him and extend help to complete the formalities of lodging a claim on his insurer and possibly advise and extend assistance in making an uninsured loss claim against the other party. Broker should precisely start with educating his clients about the available insurance products in the market and their uses to him in his peculiar circumstances. The client, will often need prompting to consider the need to insure his possessions against loss and to make sure that his family would have a continuing income not only in the event of his death but also if he were involved in an accident or suffered a major illness. The broker's job does not merely end up by offering his client the kind of cover he requires. He must be in touch with his client to ensure that the insurances he has bought are adequate to cover all his risk in view of increased income, enhanced business, family size, physical conditions, etc. By keeping track of developments in client's life, the broker should remind his client to make sure that the sums insured on his policies are adequate, he should also emphasise the need of some additional cover to take care of additional liability. For individuals, the broker should offer a package of several insurances in one policy offering various options which will meet the needs of majority of the general public at competitive rate. It is the broker's skill to search the market to find as close an

approximation to suit his client's needs, choices, preferences and if not then he may influence insurers to create a 'tailor-made' policy at a reasonable premium, provided it is offered by an insurer in whose security and reputation the broker has absolute confidence. Otherwise however attractive the cover may be, its value diminishes if there will be unwarranted delays in claims settlement, and it is worthless if the insurer becomes insolvent.

Summary

To summarize, Insurance Brokers are consultants for your insurance needs. They will research the best insurance products and advise you on choosing the best-suited option for you. Insurance Brokers are regulated and licensed by the regulatory body IRDAI. Make sure your broker is well-qualified and registered with the IRDAI.

Before making a decision on buying any insurance products, go through the terms and conditions, scope of cover and exclusion. Ask the insurance broker to disclose the full facts of the insurance product you are considering. Most of us even today conceive the idea that insurance is sold only by insurance agents but its not so, insurance brokers are also there in this business. Insurance agent is a legal representative of the insurance company who solicits or induces the person to apply for insurance and the insurance becomes effective on the acceptance of the application by the insurance company. Insurance broker is a legal representative of the insured. Insurance brokers are a set of intermediaries who can solicit and procure insurance business of life insurance, general insurance or both. Their work starts from recommending of the risk plan and continues till the settlement of the claim. In this unit we have also explained the functions of different types of brokers, and also the insurance market dynamics. The role played by the insurance broker are varied such as finding the best combination of prices and conditions for the particular circumstances of the client, keeping in touch with the client to ensure that the insurances he has bought are adequate to cover all his

risks, keeping track of the developments in his client's life etc. The code of conduct which serves as a guide to insurance brokers and other persons concerned with their conduct has also been dealt with. We have also discussed the Regulations laid down by the Insurance Regulatory and Development Authority for protecting the interests of the policyholders

SELF ASSESSMENT QUESTIONS

- 1) What do you mean by an insurance broker?
- 2) Explain about the different types of brokers and the functions carried out by each of them.
- 3) Discuss the role of insurance brokers.