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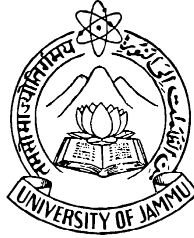

SELF LEARNING MATERIAL
FOR
M.COM. FOURTH SEMESTER
For the examination to be held in the year 2021

COURSE NO. : M.COM-FE 417 **LESSON NO. 1 TO 20**

FINANCE GROUP **UNIT I-IV**

MANAGEMENT OF FINANCIAL SERVICES

Course Co-ordinator :
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MANAGEMENT OF FINANCIAL SERVICES

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SYLLABUS

M.COM FOURTH SEMESTER (NON-CBCS)

FINANCE GROUP

MANAGEMENT OF FINANCIAL SERVICES

Course No. M.COM-FE417 | Maximum Marks: 100

Duration of Examination: 3 hours | (a) Semester Examination: 80

(b) Sessional Examination: 20

(Syllabus for the examinations to be held in the year 2021, 2022, 2023)

OBJECTIVE:

To familiarize students with the full range of financial services including banking, insurance, leasing, debt securitization and house financing.

UNIT-I INTRODUCTION

Lesson No. 1 to 5 **Page No. 1 - 123**

Meaning of financial services; Classification of financial services industry; Scope of financial services; Causes of financial innovation; New financial products and services; Innovative financial instruments; Challenges facing the financial services sector; Present scenario of financial services in India; Management of risk in financial services- Concept of risk, types of risk and risk management.

UNIT-II BANKING AND INSURANCE

Lesson No. 6 to 10 **Page No. 124-256**

Meaning and definition of a bank; Types of banks; Functions of commercial banks; Concept and nature of merchant banking; Functions of merchant banker; Merchant banking regulations; Parameters of evaluating a merchant banker; Features of merchant banking in India; Insurance- meaning, characteristics and functions of insurance; Pre-requisites for the success of insurance; Limitations of insurance; Scope and classification of insurance; Principles of insurance.

UNIT-III LEASE FINANCING

Lesson No. 11 to 15 **Page No. 257-352**

Concept and essentials of leasing; Classification of leasing; Steps involved in leasing transaction; Advantages of leasing; Limitation of leasing; Legal aspects of leasing; Contents of a lease agreement; Income tax provisions relating to leasing; Sales tax provisions pertaining to leasing; Accounting treatment of lease; Structure of leasing industry in India; problem of leasing; Prospects of leasing.

UNIT-IV DEBT SECURITISATION AND HOUSING FINANCE

Lesson No. 16 to 20 **Page No. 353-451**

Concept of Securitisation; Securitisation vs factoring; Modus operandi of securitisation; Structure for securitisation/ types of securities; Securitisable assets; Benefits of securitisation; Securitisation and banks; Conditions for successful securitisation; Securitisation abroad; Securitisation in India; Causes for the unpopularity of securitization in

India; House financing-introduction; National housing bank; Housing finance system in India; New developments in house financing.

BOOKS RECOMMENDED:

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

NOTE FOR PAPER SETTING:

The paper consists of two sections. Each section will cover the whole of the syllabus without repeating any question in the entre paper.

Section A: It will consist of short answer type questions with answer to each question within 200 words. Eight questions shall be set by the examiner and six shall be attempted by the candidate. Each question will carry 4 marks, total weightage shall be 24 marks.

Section B: It will consist of essay type questions with answer to each question within 800 marks. Six questions shall be set by the examiner and atleast one from each unit and the candidate will be required to attempt four questions. Each question will carry 14 marks. Total weightage shall be 56 marks.

MODEL QUESTION PAPER

SECTION-A

Note:- Attempt any six questions. Each question carries 4 marks. Answer to each question should be within 200 words.

1. What is the scope of financial services?
2. Explain risk management?
3. Explain the concept and nature of merchant banking?
4. Explain the role of SEBI in regulating the merchant banking operations in India?
5. Explain the accounting aspects of leasing transactions?
6. What are the various problems and prospects in leasing?
7. Explain the stages involved in the working of securitisation?
8. What are various conditions for successful securitisation? What are the causes for the unpopularity of the securitisation in India?

SECTION-B

Note:- Attempt any four questions. Each question carries 14 marks. Answer to each question should be within 800 words.

1. Explain fund and non-fund based services?
2. Explain new financial products and services?
3. Explain various types of banks?
4. Explain various kinds of insurance?
5. Explain the structure of leasing industry in India?
6. What are the provisions relating to leasing?
7. Explain the structure and benefits of securitisation?
8. Explain the various functions of NHB?

UNIT-I **LESSON NO. 1**

INTRODUCTION TO FINANCIAL SERVICES

CLASSIFICACTION AND SCOPE OF FINANCIAL SERVICES

STRUCTURE

1.1 Introduction

1.2 Objectives

1.3 Meaning of Financial Services

  1.3.1 Functions of Financial Services

  1.3.2 Characteristics or Nature of Financial Services

  1.3.3 Importance of Financial Services

1.4 Classification of Financial Services industry

  1.4.1 Capital Market Intermediaries

    1.4.1.1 Industrial securities market

    1.4.1.2 Government securities market

    1.4.1.3 Long-term loans market

  1.4.2 Money Market Intermediaries

1.4.2.1 Call money market

1.4.2.2 Commercial bills market

1.4.2.3 Treasury bills market

1.4.2.4 Short-term loan market

1.5 Scope of Financial Services

1.5.1 Asset/Fund Based Services

1.5.2 Non-Fund Based/Fee Based Services

1.6 Summary

1.7 Glossary

1.8 Self Assessment Questions

1.9 Lesson End Exercise

1.10 Suggested Readings

1.1 INTRODUCTION

The Indian financial services industry has undergone a metamorphosis since 1990. Before its emergence the commercial banks and other financial institutions dominated the field and they met the financial needs of the Indian industry. It was only after the economic liberalisation that the financial service sector gained some prominence. Now this sector has developed into an industry. In fact, one of the world's largest industries today is the financial services industry.

Financial service is an essential segment of financial system. Financial services are the foundation of a modern economy. The financial service sector is indispensable for the prosperity of a nation. It is the presence of financial services that enables a country to improve its economic condition whereby there is more production in all the sectors leading to economic growth. The benefit of economic growth is reflected on the people in the form of economic prosperity wherein the individual enjoys higher standard of living. It is here the financial services enable an individual to acquire or obtain various consumer products through hire purchase. In the process, there are a number of financial institutions which also earn profits. The presence of these financial institutions promotes investment, production, saving etc.

Financial services cover a wide range of activities. They assume a significant place in the socio-economic environment of any country. Banking services are believed to be the oldest financial services existing in our country. The traditional financial services provided by the banks were in the form of opening deposits accounts and offering loans and advances. It basically means all those kinds of services provided in financial or monetary terms, where the essential commodity is money. These services include: Leasing, Hire purchase, Venture capital, Merchant banking, Insurance, housing finance, Mutual funds, factoring, stock broking and many others.

Financial service industries are of eight types. These are facilitating type financial service, investment oriented financial service, promotion oriented financial service, return or income oriented financial service, linking type financial service, trade oriented financial service, credit oriented financial service and performance appraisal service.

Facilitating type of financial service include hire-purchase finance companies which facilitate consumers in the purchase of consumer goods while lease companies facilitate traders in the purchase of capital goods. Hence, they come under facilitating type.

Investment oriented financial service are merchant bankers promote investment by helping investors in fulfilling various formalities such as issue of shares and debentures. They also advice the promoters on the quantum of capital raised through issue of different types of securities.

Promotion oriented financial service helps in promoting new ventures when taken up by the venture capital companies. Underwriters also help in the sale of securities which promote companies. The bankers also help entrepreneurs through project finance. Hence, they all come under promotion type.

Return or Income oriented financial services helps to those investors who want to take risks yet but want to ensure a reasonable return for their investment. Mutual fund companies are the best source which comes under this type of financial services.

Linking type of financial services includes promoters, investors, public, foreign investors and government which are linked by certain companies such as merchant bankers. They not only link these people but also ensure that each one is satisfied with his/her return on investment. The merchant bankers act as the brain in coordinating the various entities.

Trade oriented financial services helps in increasing the sales, both domestically and abroad. Numerous factors play a major role in financing the traders by financing a major part of the value of the traded goods. Forfaiting companies do the same while selling goods across the borders.

Credit oriented financial service provide credit to consumers. Credit card companies and even hire purchase companies come under this category.

Performance appraisal services enable the public to know the financial strength of companies before investment. We have credit rating companies which provide ratings on the basis of the performance of the companies from various aspects. Thus, the strength of companies is known beforehand which will not only help the companies to get more finance but also to improve their performance in course of time.

1.2 OBJECTIVES

After studying this lesson, you shall be able to understand:

- the meaning of financial services;
- importance of financial services;
- classifications of financial services industry; and
- scope of financial services.

1.3 MEANING OF FINANCIAL SERVICES

The Indian financial service industry has undergone a metamorphosis since 1990. During the late seventies and eighties, the Indian financial service industry was dominated by commercial banks and other financial institutions which cater to the requirements of the Indian industry. Infact the capital market played a secondary

role only. The economic liberalization has brought in a complete transformation in the Indian financial services industry.

Prior to the economic liberalization, the Indian financial service sector was characterized by so many factors which retarded the growth of this sector. Some of the significant factors were:

(i) Excessive controls in the form of regulations of interest rates, money rates etc.

(ii) Too many controls over the prices of securities under the erstwhile Controller of Capital Issues.

(iii) Non-availability of financial instruments on a large scale as well as on different varieties.

(iv) Absence of independent credit rating and credit research agencies.

(v) Strict regulation of the foreign exchange market with too many restrictions on foreign investment and foreign equity holding in Indian companies.

(vi) Lack of information about international developments in the financial sector.

(vii) Absence of a developed Government securities market and the existence of stagnant capital market without any reformation.

(viii) Non-availability of debt instruments on a large scale.

However, after the economic liberalisation, the entire financial sector has undergone a sea-saw change and now we are witnessing the emergence of new financial products and services almost every day. Thus, the present scenario is characterized by financial innovation and financial creativity and before going deep

into it, it is imperative that one should understand the meaning and scope of financial services.

In general, all types of activities which are of a financial nature could be brought under the term “financial services”. The term “financial services” in a broad sense means “mobilising and allocating savings”. Thus, it includes all activities involved in the transformation of saving into investment.

The “financial service” can also be called “financial intermediation”. Financial intermediation is a process by which funds are mobilised from a large number of savers and make them available to all those who are in need of it and particularly to corporate customers. Thus, financial services sector is a key and very vital for industrial developments. A well developed financial services industry is absolutely necessary to mobilise the savings and to allocate them to various investable channels and thereby to promote industrial development in a country.

Hence, financial services refer to services provided by the finance industry. Finance industry consists of a broad range of organisations that deals with the management of money. These organisations include banks, credit card companies, insurance companies, consumer finance companies, stock brokers, investment funds and some government sponsored enterprises. In general, all types of activities which are of financial nature may be regarded as financial services. In a broad sense, the term financial services means mobilisation and allocation of savings. Thus, it includes all activities involved in the transformation of savings into investment.

1.3.1 Functions of Financial Services

1. Facilitating transactions (exchange of goods and services) in the economy.
2. Mobilizing savings (for which the outlets would otherwise be much more limited).

3. Allocating capital funds (notably to finance productive investment).

4. Monitoring managers (so that the funds allocated will be spent as envisaged).

5. Transforming risk (reducing it through aggregation and enabling it to be carried by those more willing to bear it).

1.3.2 Characteristics or Nature of Financial Services

1. **Intangibility**: Financial services are intangible. Therefore, they cannot be standardised or reproduced in the same form. The institutions supplying the financial services should have a better image and confidence of the customers. Otherwise, they may not succeed. They have to focus on quality and innovation of their services. Then only they can build credibility and gain the trust of the customers.

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

3. **Inseparability:** Both production and supply of financial services have to be performed simultaneously. Hence, there should be perfect understanding between the financial service institutions and its customers.

4. **Perishability:** Like other services, financial services also require a match between demand and supply. Services cannot be stored. They have to be supplied when customers need them.

5. **Variability:** In order to cater a variety of financial and related needs of different customers in different areas, financial service organisations have to offer a wide range of products and services. This means the financial services have to be tailor-made to the requirements of customers. The service institutions differentiate their services to develop their individual identity.

6. **Dominance of human element:** Financial services are dominated by human element. Thus, financial services are labour intensive. It requires competent and skilled personnel to market the quality financial products.

7. **Information based:** Financial service industry is an information based industry. It involves creation, dissemination and use of information. Information is an essential component in the production of financial services.

1.3.3 Importance of Financial Services

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

1. **Economic growth:** The financial service industry mobilises the savings of the people, and channels them into productive investments by providing various services to people in general and corporate enterprises in particular. In short, the economic growth of any country depends upon these savings and investments.

2. **Promotion of savings:** The financial service industry mobilises the savings of the people by providing transformation services. It provides liability,

asset and size transformation service by providing huge loan from small deposits collected from a large number of people. In this way financial service industry promotes savings.

3. **Capital formation:** Financial service industry facilitates capital formation by rendering various capital market intermediary services. Capital formation is the very basis for economic growth.

4. **Creation of employment opportunities:** The financial service industry creates and provides employment opportunities to millions of people all over the world.

5. **Contribution to GNP:** Recently the contribution of financial services to GNP has been increasing year after year in almost countries.

6. **Provision of liquidity:** The financial service industry promotes liquidity in the financial system by allocating and reallocating savings and investment into various avenues of economic activity. It facilitates easy conversion of financial assets into liquid cash.

7. **Minimizing the risks:** The risks of both financial services as well as producers are minimized by the presence of insurance companies. Various types of risks are covered which not only offer protection from the fluctuating business conditions but also from risks caused by natural calamities. Insurance is not only a source of finance but also a source of savings, besides minimizing the risks. Taking this aspect into account, the government has not only privatized the life insurance but also set up a regulatory authority for the insurance companies known as IRDA, 1999 (Insurance Regulatory and Development Authority).

8. **Maximising the Returns:** The presence of financial services enables businessmen to maximize their returns. This is possible due to the availability of credit at a reasonable rate. Producers can avail various types of credit facilities for acquiring assets. In certain cases, they can even go for leasing of certain assets of very high value. Factoring companies enable the seller as well as producer to increase their turnover which also increases the profit. Even under stiff competition, the producers will be in a position to sell their products at a low margin. With a higher turnover of stocks, they are able to maximize their return.

9. **Benefit to Government:** The presence of financial services enables the government to raise both short-term and long-term funds to meet both revenue and capital expenditure. Through the money market, government raises short term funds by the issue of Treasury Bills. These are purchased by commercial banks from out of their depositors' money. In addition to this, the government is able to raise long-term funds by the sale of government securities in the securities market which forms apart of financial market. Even foreign exchange requirements of the government can be met in the foreign exchange market.

10. **Promotion of Domestic and Foreign Trade:** Financial services ensure promotion of domestic as well as foreign trade. The presence of factoring and forfaiting companies ensures increasing sale of goods in the domestic market and export of goods in the foreign market. Banking and insurance services further contribute to step up such promotional activities.

11. **Balanced Regional development:** The government monitors the growth of economy and regions that remain backward economically are given fiscal and monetary benefits through tax and cheaper credit by which more investment is promoted. This generates more production, employment,

income, demand and ultimately increases prices. The producers will earn more profits and can expand their activities further. So, the presence of financial services helps backward regions to develop and catch up with the rest of the country that has developed already.

1.4 CLASSIFICATION OF FINANCIAL SERVICES INDUSTRY

The financial intermediaries in India can be traditionally classified into two:

1. Capital market intermediaries and
2. Money market intermediaries.

The capital market intermediaries consist of term lending institutions and investing institutions which mainly provide long term funds. On the other hand, money market consists of commercial banks, co-operative banks and other agencies which supply only short term funds. Hence, the term "financial services industry" includes all kinds of organizations which intermediate and facilitate financial transactions of both individuals and corporate customers.

1.4.1 Capital Market Intermediaries

Absence of capital market acts as a deterrent factor to capital formation and economic growth. Resources would remain idle if finances are not funneled through the capital market. The **importance of capital market** can be briefly summarised as follows:

(i) The capital market serves as an important source for the productive use of the economy's savings. It mobilises the savings of the people for further investment and thus, avoids their wastage in unproductive uses.

(ii) It provides incentives to saving and facilitates capital formation by offering suitable rates of interest as the price of capital.

(iii) It provides an avenue for investors, particularly the household sector to invest in financial assets which are more productive than physical assets.

(iv) It facilitates increase in production and productivity in the economy and thus, enhances the economic welfare of the society. Thus, it facilitates 'the movement of stream of command over capital to the point of highest yield' towards those who can apply them productively and profitably to enhance the national income in the aggregate.

(v) The operations of different institutions in the capital market induce economic growth. They give quantitative and qualitative directions to the flow of funds and bring about rational allocation of scarce resources.

(vi) A healthy capital market consisting of expert intermediaries promotes stability in values of securities representing capital funds.

(vii) Moreover, it serves as an important source for technological upgradation in the industrial sector by utilising the funds invested by the public.

Thus, a capital market serves as an important link between those who save and those who aspire to invest their savings.

The capital market is a market for financial assets which have a long or indefinite maturity. Generally, it deals with long-term securities which have a maturity period of above one year. Capital market is divided into three namely, Industrial securities market, Government securities market and Long-term loans market.

1.4.1.1 Industrial securities market: As the very name implies, it is a market for industrial securities namely: (i) Equity shares or ordinary shares, (ii) Preference shares, and (iii) Debentures or bonds. It is a market where industrial concerns raise their capital or debt by issuing appropriate instruments. It can be further subdivided into two. They are (i) Primary market or New issue market and (ii) Secondary market or Stock exchange.

(i) **Primary market:** Primary market is a market for new issues or new financial claims. Hence, it is also called New Issue Market. The primary market deals with those securities which are issued to the public for the first time. In the primary market, borrowers exchange new financial securities for long-term funds. Thus, primary market facilitates capital formation. There are three ways by which a company may raise capital in a primary market. They are Public issue, Rights issue and Private placement. Public issue is the most common method of raising capital by new companies is through sale of securities to the public. It is called public issue. Rights issue is carried out when an existing company wants to raise additional capital, securities are first offered to the existing shareholders on a pre-emptive basis. It is called rights issue. And lastly, Private placement is a way of selling securities privately to a small group of investors.

(ii) **Secondary market:** Secondary market is a market for secondary sale of securities. In other words, securities which have already passed through the new issue market are traded in this market. Generally, such securities are quoted in the Stock Exchange and it provides a continuous and regular market for buying and selling of securities. This market consists of all stock exchanges recognised by the Government of India. The stock exchanges in India are regulated under the Securities Contracts (Regulation) Act, 1956. The Bombay Stock Exchange is the principal stock exchange in India which sets the tone of the other stock markets.

1.4.1.2 Government securities market: It is otherwise called Gilt-edged securities market. It is a market where Government Securities are traded. In India, there are many kinds of Government securities like short-term and long-term. Long-term securities are traded in capital market while short-term securities are traded in the money market. Securities issued by the Central Government, State Governments, Semi-government authorities like City Corporations, Port Trusts,

etc. Improvement Trusts, State Electricity Boards, All India and State level financial institutions and public sector enterprises are dealt in capital market.

Government Securities are issued in denominations of Rs. 100. Interest is payable half-yearly and they carry tax exemptions also. The role of brokers in marketing these securities is practically very limited and the major participant in this market is the 'commercial banks' because they hold a very substantial portion of these securities to satisfy their SLR requirements.

The secondary market for these securities is narrow since, most of the institutional investors tend to retain these securities until maturity.

The Government Securities are in many forms. These are generally (i) Stock certificates or inscribed stock, (ii) Promissory notes and (iii) Bearer bonds which can be discounted.

Government Securities are sold through the Public Debt Office of the Reserve Bank India (RBI) while Treasury Bills (short-term securities) are sold through auctions.

Government Securities offer a good source of raising inexpensive finance for the Government exchequer and the interest on these securities influences the prices and yields in this market. Hence, this market also plays a vital role in monetary management.

1.4.1.3 Long-term loans market: Development banks and commercial banks play a significant role in this market by supplying long-term loans to corporate customers. Long-term loans market may further be classified into: (i) Term loans market, (ii) Mortgages market and (iii) Financial guarantees market.

(i) **Term loans market:** In India, many industrial financing institutions have been created by the Government both at the national and regional levels to

supply long-term and medium-term loans to corporate customers directly as well as indirectly. These development banks dominate the industrial finance in India. Institutions like IRBI (The Industrial Corporation of India Ltd.), IFCI (Industrial Finance Corporation of India), and other state financial corporations come under this category. These institutions meet the growing and varied long-term financial requirements of industries by supplying long-term loans. They also help in identifying investment opportunities, encourage new entrepreneurs and support modernisation efforts.

(ii) **Mortgages market:** The mortgages market refers to those centers which supply mortgage loan mainly to individual customers. A mortgage loan is a loan against the security of immovable property like real estate. The transfer of interest in a specific immovable property to secure a loan is called mortgage. This mortgage may be equitable mortgage or legal one. Again, it may be a first charge or second charge. Equitable mortgage is created by a mere deposit of title deeds to properties as security, whereas in the case of a legal mortgage the title in the property is legally transferred to the lender by the borrower. Legal mortgage is less risky.

Similarly, in the first charge, the mortgager transfers his interest in the specific property to the mortgagee as security. When the property in question is already mortgaged once to another creditor, it becomes a second charge when it is subsequently mortgaged to somebody else. The mortgagee can also further transfer his interest in the mortgaged property to another. In such a case, it is called a sub-mortgage.

The mortgage market may have primary market as well as secondary market. The primary market consists of original extension of credit and secondary market has sales and resales of existing mortgages at prevailing prices.

In India, residential mortgages are the most common ones. The Housing and Urban Development Corporation (HUDCO) and the Life Insurance Corporation (LIC) play a dominant role in financing residential projects. Besides, the Land Development Banks provide cheap mortgage loans for the development of lands, purchase of equipment, etc. These development banks raise finance through the sale of debentures which are treated as trustee securities.

(iii) Financial guarantees market: A guarantee Market is a centre where finance is provided against the guarantee of a reputed person in the financial circle. Guarantee is a contract to discharge the liability of a third party in case of his default. Guarantee acts as a security from the creditor's point of view. In case the borrower fails to repay the loan, the liability falls on the shoulders of the guarantor. Hence, the guarantor must be known to both the borrower and the lender and he must have the means to discharge his liability.

Though there are many types of guarantees, the common forms are: (i) Performance guarantee, and (ii) Financial guarantee. Performance guarantees cover the payment of earnest money, retention money, advance payments, non-completion of contracts, etc. On the other hand, financial guarantees cover only financial contracts.

In India, the market for financial guarantees is well organised. The financial guarantees in India relate to: (i) Deferred payments for imports and exports, (ii) Medium and long-term loans raised abroad and (iii) Loans advanced by banks and other financial institutions.

These guarantees are provided mainly by commercial banks, development banks, Governments, both Central and States and other specialised guarantee institutions like ECGC (Export Credit Guarantee Corporation)

and DICGC (Deposit Insurance and Credit Guarantee Corporation). This guarantee financial service is available to both individual and corporate customers. For a smooth functioning of any financial system, this guarantee service is absolutely essential.

1.4.2 Money Market Intermediaries

Money market is a market for dealing with financial assets and securities which have a maturity period of up to one year. In other words, it is a market for purely short-term funds. The money market may be subdivided into four. They are:

1.4.2.1 Call money market: The call money market is a market for extremely short period loans say one day to fourteen days. So, it is highly liquid. The loans are repayable on demand at the option of either the lender or the borrower. In India, call money markets are associated with the presence of stock exchanges and hence, they are located in major industrial towns like Mumbai, Kolkata, Chennai, Delhi, Ahmedabad, etc. The special feature of this market is that the interest rate varies from day-to-day and even from hour-to-hour and centre-to-centre. It is very sensitive to changes in demand and supply of call loans.

1.4.2.2 Commercial bills market: It is a market for bills of exchange arising out of genuine trade transactions. In the case of credit sale, the seller may draw a bill of exchange on the buyer. The buyer accepts such a bill, promising to pay at a later date the amount specified in the bill. The seller need not wait until the due date of the bill. Instead, he can get immediate payment by discounting the bill.

In India, the bill market is underdeveloped. The RBI has taken many steps to develop a sound bill market. The RBI has enlarged the list of participants in the bill market. The Discount and Finance House of India was set-up in 1988 to promote secondary market in bills. In spite of all these, the growth of the bill market is slow in India. There are no specialised agencies for discounting bills. The commercial banks play a significant role in this market.

1.4.2.3 Treasury bills market: It is a market for treasury bills which have "short-term" maturity. A treasury bill is a promissory note or a finance bill issued by the Government. It is highly liquid because its repayment is guaranteed by the Government. It is an important instrument for short-term borrowing of the Government. There are two types of treasury bills namely: (i) Ordinary or Regular and (ii) *Ad hoc* treasury bills popularly known as *"ad hocs"*.

Ordinary treasury bills are issued to the public, banks and other financial institutions with a view to raising resources for the Central Government to meet its short-term financial needs. *Ad hoc* treasury bills are issued in favour of the RBI only. They are not sold through tender or auction. They can be purchased by the RBI only. *Ad hocs* are not marketable in India but holders of these bills can sell them back to RBI. Treasury bills have a maturity period of 91 days or 182 days or 364 days only. Financial intermediaries can park their temporary surpluses in these instruments and earn income.

1.4.2.4 Short-term loan market: It is a market where short-term loans are given to corporate customers for meeting their working capital requirements. Commercial banks play a significant role in this market. Commercial banks provide short-term loans in the form of cash credit and overdraft. Overdraft facility is mainly given to business people, whereas cash credit is given to industrialists. Overdraft is purely a temporary accommodation and it is given in the current account itself. But, cash credit is for a period of one year and it is sanctioned in a separate account.

1.5 SCOPE OF FINANCIAL SERVICES

The scope of financial services is very wide. This is because it covers a wide range of services. The financial services can be broadly classified into two: (i) Asset / Fund based services and (ii) Non-Fund services (or fee-based services).

1.5.1 Asset / Fund Based Services

1. **Equipment leasing / Lease financing:** A lease is an agreement under which a firm acquires a right to make use of a capital asset like machinery etc. on payment of an agreed fee called lease rentals. The person (or the company) which acquires the right is known as lessee. He does not get the ownership of the asset. He acquires only the right to use the asset. The person (or the company) who gives the right is known as lessor.

2. **Hire purchase and consumer credit:** Hire purchase is an alternative to leasing. Hire purchase is a transaction where goods are purchased and sold on the condition that payment is made in installments. The buyer gets only possession of goods. He does not get ownership. He gets ownership only after the payment of the last installment. If the buyer fails to pay any installment, the seller can repossess the goods. Each installment includes interest also.

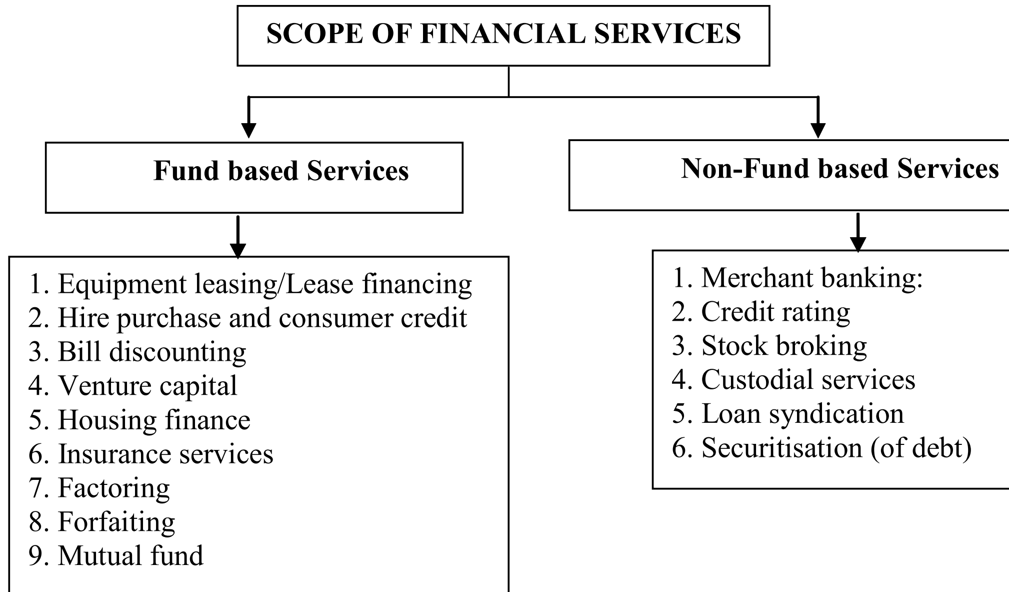
3. **Bill discounting:** Discounting of bill is an attractive fund based financial service provided by the finance companies. In the case of time bill (payable after a specified period), the holder need not wait till maturity or due date. If he is in need of money, he can discount the bill with his banker. After deducting a certain amount (discount), the banker credits the net amount in the customer's account. Thus, the bank purchases the bill and credits the customer's account with the amount of the bill less discount. On the due date, the drawee makes payment to the banker. If he fails to make payment, the banker will recover the amount from the customer who has discounted the bill. In short, discounting of bills mean giving loans on the basis of bills of exchange.

4. **Venture capital:** Venture capital simply refers to capital which is available for financing the new business ventures. It involves lending finance to the

growing companies. It is the investment in a highly risky project with the objective of earning a high rate of return. In short, venture capital means long term risk capital in the form of equity finance.

5. **Housing finance:** Housing finance simply refers to providing finance for house building. It emerged as a fund based financial service in India with the establishment of National Housing Bank (NHB) by the RBI in 1988. It is an apex housing finance institution in the country. Till now, a number of specialised financial institutions/companies have entered in the field of housing finance. Some of the institutions are HDFC, LIC Housing Finance, Citi Home, Ind Bank Housing etc.

Chart 1.1: Scope of Financial Services



6. **Insurance services:** Insurance is a contract between two parties. One party is the insured and the other party is the insurer. Insured is the person whose life or property is insured with the insurer. That is, the person whose risk is insured is called insured. Insurer is the insurance company to whom risk is transferred by the insured. That is, the person who insures the risk of insured is called insurer. Thus insurance is a contract between insurer and insured. It is a contract in which the insurance company undertakes to indemnify the insured on the happening of certain event for a payment of consideration. It is a contract between the insurer and insured under which the insurer undertakes to compensate the insured for the loss arising from the risk insured against. According to Mc Gill, "Insurance is a process in which uncertainties are made certain". In the words of Jon Megi, "Insurance is a plan wherein persons collectively share the losses of risks". Thus, insurance is a device by which a loss likely to be caused by uncertain event is spread over a large number of persons who are exposed to it and who voluntarily join themselves against such an event. The document which contains all the terms and conditions of insurance (i.e. the written contract) is called the "insurance policy". The amount for which the insurance policy is taken is called "sum assured". The consideration in return for which the insurer agrees to make good the loss is known as "insurance premium". This premium is to be paid regularly by the insured. It may be paid monthly, quarterly, half yearly or yearly.

7. **Factoring:** Factoring is an arrangement under which the factor purchases the account receivables (arising out of credit sale of goods/services) and makes immediate cash payment to the supplier or creditor. Thus, it is an arrangement in which the account receivables of a firm (client) are purchased by a financial institution or banker. Thus, the factor provides finance to the client (supplier) in respect of account receivables. The factor undertakes the responsibility of

collecting the account receivables. The financial institution (factor) undertakes the risk. For this type of service as well as for the interest, the factor charges a fee for the intervening period. This fee or charge is called *factorage.*

8. **Forfaiting:** Forfaiting is a form of financing of receivables relating to international trade. It is a non-recourse purchase by a banker or any other financial institution of receivables arising from export of goods and services. The exporter surrenders his right to the forfaiter to receive future payment from the buyer to whom goods have been supplied. Forfaiting is a technique that helps the exporter sells his goods on credit and yet receives the cash well before the due date. In short, forfaiting is a technique by which a forfaitor (financing agency) discounts an export bill and pay ready cash to the exporter. The exporter need not bother about collection of export bill. He can just concentrate on export trade.

9. **Mutual fund:** Mutual funds are financial intermediaries which mobilise savings from the people and invest them in a mix of corporate and government securities. The mutual fund operators actively manage this portfolio of securities and earn income through dividend, interest and capital gains. The incomes are eventually passed on to mutual fund shareholders.

1.5.2 Non-Fund Based / Fee Based Services

1. **Merchant banking:** Merchant banking is basically a service banking, concerned with providing non-fund based services of arranging funds rather than providing them. The merchant banker merely acts as an intermediary. Its main job is to transfer capital from those who own it to those who need it. Today, merchant banker acts as an institution which understands the requirements of the promoters on the one hand and financial institutions, banks, stock exchange and money markets on the other. SEBI (Merchant Bankers) Rule, 1992 has defined a merchant banker as, "any person who is engaged in the business of issue management either by making arrangements regarding

selling, buying or subscribing to securities or acting as manager, consultant, advisor, or rendering corporate advisory services in relation to such issue management".

2. **Credit rating**: Credit rating means giving an expert opinion by a rating agency on the relative willingness and ability of the issuer of a debt instrument to meet the financial obligations in time and in full. It measures the relative risk of an issuer's ability and willingness to repay both interest and principal over the period of the rated instrument. It is a judgement about a firm's financial and business prospects. In short, credit rating means assessing the creditworthiness of a company by an independent organisation.

3. **Stock broking**: Now stock broking has emerged as a professional advisory service. Stock broker is a member of a recognized stock exchange. He buys, sells, or deals in shares / securities. It is compulsory for each stock broker to get himself / herself registered with SEBI in order to act as a broker. As a member of a stock exchange, he will have to abide by its rules, regulations and bylaws.

4. **Custodial services**: In simple words, the services provided by a custodian are known as custodial services (custodian services). Custodian is an institution or a person who is handed over securities by the security owners for safe custody. Custodian is a caretaker of a public property or securities. Custodians are intermediaries between companies and clients (i.e. security holders) and institutions (financial institutions and mutual funds). There is an arrangement and agreement between custodian and real owners of securities or properties to act as custodians of those who hand over it. The duty of a custodian is to keep the securities or documents under safe custody. The work of custodian is very risky and costly in nature. For rendering these services, he gets a remuneration called custodial charges.

Thus custodial service is the service of keeping the securities safe for and on behalf of somebody else for a remuneration called custodial charges.

5. **Loan syndication**: Loan syndication is an arrangement where a group of banks participate to provide funds for a single loan. In loan syndication, a group of banks comprising 10 to 30 banks participate to provide funds wherein one of the banks is the lead manager. This lead bank is decided by the corporate enterprises, depending on confidence in the lead manager. A single bank cannot give a huge loan. Hence a number of banks join together and form a syndicate. This is known as loan syndication. Thus, loan syndication is very similar to consortium financing.

6. **Securitisation (of debt):** Loans given to customers are assets for the bank. They are called loan assets. Unlike investment assets, loan assets are not tradable and transferable. Thus loan assets are not liquid. The problem is how to make the loan of a bank liquid. This problem can be solved by transforming the loans into marketable securities. Now loans become liquid. They get the characteristic of marketability. This is done through the process of securitisation. Securitisation is a financial innovation. It is conversion of existing or future cash flows into marketable securities that can be sold to investors. It is the process by which financial assets such as loan receivables, credit card balances, hire purchase debtors, lease receivables, trade debtors etc. are transformed into securities. Thus, any asset with predictable cash flows can be securitised. Securitisation is defined as a process of transformation of illiquid asset into security which may be traded later in the opening market. In short, securitization is the transformation of illiquid, non- marketable assets into securities which are liquid and marketable assets. It is a process of transformation of assets of a lending institution into negotiable instruments. Securitisation is different from factoring. Factoring involves transfer of debts without transforming debts into marketable

securities. But securitisation always involves transformation of illiquid assets into liquid assets that can be sold to investors.

1.6 SUMMARY

Financial Services is a term used to refer to the services provided by the finance market. Financial Services is also the term used to describe organizations that deal with the management of money. Examples are the Banks, investment banks, insurance companies, credit card companies and stock brokerages. The basic characteristics of financial services are that they are intangible in nature. For financial services to be successfully created and marketed, the institutions providing them must have a good image and the confidence of its clients. Financial services are the economic services provided by the finance industry, which encompasses a broad range of businesses that manage money, including credit unions, banks, credit-card companies, insurance companies, accountancy companies, consumer-finance companies, stock brokerages, investment funds etc. The major categories of financial institutions include central banks, retail and commercial banks, internet banks, credit unions, savings and loans associations, investment banks, investment companies, brokerage firms, insurance companies and mortgage companies. There are different types of financial institutions, such as banks, trust companies and credit unions. All financial institutions provide free information about their services, including account types and features, and debit and credit cards. Presence of financial services enables a country to improve its economic condition. Economic growth is reflected on the people by the higher standard of living. Financial services enable individual to acquire various consumer products through hire purchase, factoring or other means. Financial services are fundamental to economic growth and development. Banking, savings and investment, insurance, and debt and equity financing help private citizens save money, guard against uncertainty, and build credit, while enabling businesses to start up, expand, increase efficiency, and compete in local and international markets.

1.7 GLOSSARY

- **Bearer Bonds:** A bearer bond is a bond or debt security issued by a business entity such as a corporation, or a government. As a bearer instrument, it differs from the more common types of investment securities in that it is unregistered—no records are kept of the owner, or the transactions involving ownership.
- **Credit Card Services:** A credit card is a payment card issued to users (cardholders) to enable the cardholder to pay a merchant for goods and services based on the cardholder's promise to the card issuer to pay them for the amounts plus the other agreed charges.
- **Financial services:** Financial Services is a term used to refer to the services provided by the finance market. Financial Services is also the term used to describe organizations that deal with the management of money.
- **FOREX:** Foreign Exchange (FOREX) refers to the foreign exchange market. It is the over-the-counter market in which the foreign currencies of the world are traded. It is considered the largest and most liquid market in the world.
- **Forfaiting:** The forfaiter is the individual or entity that purchases the receivables, and the importer then pays the receivables amount to the forfaiter. A forfaiter is typically a bank or a financial firm that specializes in export financing
- **GNP:** Gross national product (GNP) is a broad measure of a nation's total economic activity. GNP is the value of all finished goods and services produced in a country in one year by its nationals.
- **HDFC:** The Housing Development Finance Corporation
- **IRDA:** IRDA stands for Insurance Regulatory and Development Authority. It is an agency run by Government of India. It regulates insurance industry in India.

- **Leasing Services: A lease** is a contract outlining the terms under which one party agrees to rent property owned by another party. It guarantees the lessee, also known as the tenant, use of an asset and guarantees the lessor, the property owner or landlord, regular payments from the lessee for a specified number of months or years.
- **LIC:** Life Insurance Corporation
- **Merchant Banking Services:** Merchant banks provide financial services including underwriting, loan services, fundraising services, and financial advising to high net-worth individuals and small/mid-sized corporations.
- **Portfolio Management:** Portfolio Management is defined as the art and science of making decisions about the investment mix and policy, matching investments to objectives, asset allocation for individuals and institutions, and balancing risk against performance.
- **Promissory Notes:** It is a signed document containing a written promise to pay a stated sum to a specified person or the bearer at a specified date or on demand.
- **SEBI:** Securities Exchange Board of India
- **Stock Certificates:** A stock certificate is the physical piece of paper representing ownership in a company. Stock certificates will include information such as the number of shares owned, the date, an identification number, usually a corporate seal and signatures.

1.8 SELF ASSESSMENT QUESTIONS

Q1. What do you mean by financial services?

Q2. What are the various functions of financial services?

Q3. What are the various characteristics of financial services ?

Q4. What are the importances of financial services?

Q5. Explain primary market?

Q6. Explain capital market?

Q7. Explain government securities?

Q8. Explain term loans market?

Q9. Explain mortgages market?

Q10. Explain financial guarantees market?

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1.9 LESSON END EXERCISE

Q1. What are the various types of financial services?

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Q2. What is the scope of financial services?

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Q3. Explain various capital market intermediaries?

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Q4. Explain various money market intermediaries?

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Q5. Explain the scope of financial services?

Q6. What is the importance of capital market?

1.10 SUGGESTED READINGS

1. Bansal, L.K., Merchant Banking and Financial Services, Unistar Books Pvt. Ltd., Chandigarh.
2. Bhole, L.M., Financial Institutions and Markets, Tata McGraw Hill, New Delhi.
3. Chandra, P., Financial Management, Tata McGraw Hill, New Delhi.
4. Ferrell, O.C. and Others, Marketing Strategy, Vikas Publishing House.
5. Khan, M.Y., Financial Services, Tata McGraw Hill, New Delhi.
6. Kothari, C.R., Investment Banking and Customer Service, Arihand Publishers, Jaipur.
7. Machiraju, H.R., Merchant Banking, New Age International Publishers, New Delhi.

UNIT-I **LESSON NO. 2**

INTRODUCTION TO FINANCIAL SERVICES

FINANCIAL INNOVATION

STRUCTURE

2.1 Introduction

2.2 Objectives

2.3 Causes of Financial Innovation

2.4 New Financial Products and Services

2.5 Summary

2.6 Glossary

2.7 Self Assessment Questions

2.8 Lesson End Exercise

2.9 Suggested Readings

2.1 INTRODUCTION

Financial Innovation is something that is seen by an individual as a new way by which finance can generate returns, redistribute risk and fuel the economy. Among all the adventures of the mankind, financial innovation is the one which is very unique. Financial innovation like innovation elsewhere in business is an ongoing process whereby private parties experiment to try to differentiate their products and services, responding to both sudden and gradual changes in the economy. Surely, innovation ebbs and flows with some periods exhibiting bursts of activity and others witnessing a slackening or even backlash. However, financial innovation should always be a regular ongoing part of a profit maximizing economy.

Financial innovation can be defined as the act of creating and then popularising new financial instruments as well as new financial technologies, institutions and markets. It includes institutional, product and process innovation.

Institutional innovations relate to the creation of new types of financial firms (such as specialist credit card firms like MBNA, discount broking firms such as Charles Schwab, internet banks and so on).

Product innovation relates to new products such as derivatives, securitised assets, foreign currency mortgages and so on.

Process innovation relates to new ways of doing financial business including online banking, phone banking and new ways of implementing information technology and so on.

According to Stephen A. Ross, "Financial innovation means new financial products (financial assets and derivative instruments) better suited to the circumstances of the time and to the markets in which they trade, and strategies that primarily use these financial products."

According to Simon Nixon, “Innovation can solve many credit bottlenecks but only if policy makers wean themselves off their symbiotic relationship with banks.”

Financial Innovation is commonly defined as “Advances over time in the financial instruments and payment systems used in the lending and borrowing of funds. These changes, which include innovations in technology, risk transfer and credit and equity generation have increased available credit for borrowers and given banks new and less costly ways to raise equity capital.”

The concept of financial innovation is related to making and promoting new financial products and services, developing new processes to facilitate financial activities, to interact with customers and to design new structures for financial institutions. However, it must be noted that innovation in financial services is very different than innovation in a physical product environment. Most innovations can and will be copied by competitors. It is a structural approach that is needed, with a continuous attention to skills development and a multidisciplinary team. Financial innovation across countries is also significantly correlated with innovation in the manufacturing sector. Indicator of financial innovation is also focused on the process rather than on specific outputs of financial innovation, which can take many forms, such as new securities or products, new screening, monitoring and risk management tools or new types of institutions and markets.

In Indian markets, lot of financial innovations has taken place. Modern era is the era of globalisation. Globalisation has brought the various countries of the world closer than before. As a result of globalization cross-border exchange of goods, services, capital, technology, ideas, information and people has taken place. Now as a result of globalisation, the world has become a global village. MNCs have started operating in a number of countries and mobility of labour and capital has increased manifold. India too is affected by Liberalisation, Privatisation and

Globalisation (LPG).It has led to the integration of the Indian economy and the financial markets with the global markets.

As the recent Rajan report noted, "India's financial sector is at a turning point. There are many successes- the rapidity and reliability of settlement at the NSE or the mobile phone banking being implemented around the country indicate that much of the system is at the Internet age and beyond. There is justifiable reason to take pride in this. Yet much needs to be done."

The Indian financial markets are not fully developed yet; there is great scope of growth and expansion. Limited financial instruments availability has affected the investors' ability to hedge against risk. Several steps have been taken by the RBI and other organisations like SEBI, to meet the growing needs of the Indian markets and to promote innovation.

2.2 OBJECTIVES

After studying this lesson, you shall be able to understand:

- the causes of financial innovations; and
- new financial products and services.

2.3 CAUSES OF FINANCIAL INNOVATIONS

There are a numerous factors that have lead to financial innovation on the markets. Few of the key ones are listed below :

1. **Economic Crisis:** Economic crisis has led to reforming the regulation of the financial sector, and this may have some impact on financial innovation. Deregulation in the financial markets had led to the development of new instruments. New instruments developed, led to further regulation in the

financial markets. This had led the financial institutions to compete in the international markets.

2. **Uncertainty:** With the growing market developments, there has been established a relationship between the risks associated with the assets and the interest and exchange rates. Asset values have become volatile and in order to protect them financial institutions have developed variety of products to hedge risks. Increased volatility of interest rates, inflation, equity prices, and exchange rates are therefore major factors.

3. **Advancement in IT Sector:** The advancements in the information and telecommunication sector have led to new financial innovations, the protection and the management of which are challenging and require closer examination. IT revolution has drastically reduced the cost of financial transactions. It has led to the development of certain financial products where pricing is needed on real time basis which is not possible without advanced data processing software. In short, advances in computer and telecommunication technologies have contributed a lot in financial innovation.

4. **Development of social networks:** Twitter, Facebook and YouTube are all being used to offer new financial services, increase the interaction with the customer and collect new ideas from outside the financial institution. These media allow collecting, in real time, feedback and ideas that can be used to start a company's innovation processes. There is very much data traffic, so there is an urgent need to create new organizational structures to effectively coordinate the various inflows of information and the tracking of the external idea towards absorption or rejection.

5. **Globalisation & Securitisation:** With international trade and investment, demand for international financial services has increased. Due to this development, a number of new financial products have emerged.

6. **Other factors:** In addition to above factors, other factors are also major drivers for financial innovations such as financial intermediary competition, greater sophistication and educational training among professional market participants, incentives to get around existing regulation and tax laws and changing global patterns of financial wealth.

2.4 NEW FINANCIAL PRODUCTS AND SERVICES

Today, the importance of financial services is gaining momentum all over the world. In these days of complex finance, people expect a Financial Service Company to play a very dynamic role not only as a provider of finance but also as a departmental store of finance. With the injection of the economic liberation policy into our economy and the opening of the economy to multinationals, the free market concept has assumed much significance. As a result, the clients both corporates and individuals are exposed to the phenomena of volatility and uncertainty and hence they expect the financial service company to innovate new products and service so as to meet their varied requirements.

As a result of innovations, new instruments and new products are emerging in the capital market. The capital market and the money market are getting widened and deepened. Moreover, there has been a structural change in the international capital market with the emergence of new products and innovative techniques of operation in the capital market. Many financial intermediaries including banks have already started expanding their activities in the financial services sector by offering a variety of new products. As a result, sophistication and innovations have appeared in the arena of financial intermediations. Some of them are discussed below:

1. **Merchant Banking:** A merchant banker is a financial intermediary who helps to transfer capital from those who posses it to those who need it. Merchant banking includes a wide range of activities such as management of customer's securities, portfolio management, project counseling and appraisal, underwriting of shares and debentures, loan syndication, acting as banker for the refund orders, handling interest and dividend warrants etc. Thus, a merchant banker renders a host of services to corporate and thus promotes industrial development in the country.

2. **Loan Syndication:** This is more or less similar to "consortium financing". But, this work is taken up by the merchant banker as a lead manager. It refers to a loan arranged by a bank called lead manager for a borrower who is usually a large corporate customer or a Government Department. The other banks who are willing to lend can participate in the loan by contributing an amount suitable to their own lending policies. Since a single bank cannot provide such a huge sum as loan, a number of banks join together and form a syndicate. It also enables the members of the syndicate to share the credit risk associated with a particular loan among them.

3. **Leasing:** A lease is an agreement under which a company or a firm acquires a right to make use of a capital asset like machinery, on payment of a prescribed fee called "rental charges". The lessee cannot acquire any ownership to the asset, but he can use it and have full control over it. He is expected to pay for all maintenance charges and repairing and operating costs. In countries like the U.S.A., the U.K. and Japan equipment leasing is very popular and nearly 25% of plant and equipment is being financed by leasing companies. In India also, many financial companies have started equipment leasing business. Commercial banks have also been permitted to carry on this business by forming subsidiary companies.

4. **Mutual Funds:** A mutual fund refers to a find raised by a financial service company by pooling the savings of the public. It is invested in a diversified portfolio with a view of spreading and minimizing risk. The fund provides investment avenues for small investors who cannot participate in the equities of big companies. It ensures low risk, steady returns, high liquidity and better capital appreciation in the long run.

5. **Factoring:** Factoring refers to the process of managing the sales ledger of a client by a financial service company. In other words, it is an arrangement under which a financial intermediary assumes the credit risk in the collection of book debts for its clients. The entire responsibility of collecting the book debts passes on to the factor. His services can be compared to a *del credre agent* who undertakes to collect debts. But, a factor provides credit information, collects debts, monitors the sales ledger and provides finance against debts. Thus, he provides a number of services apart from financing.

6. **Forfaiting:** Forfaiting is a technique by which a forfaitor (financing agency) discounts an export bill and pay ready cash to the exporter who can concentrate on the export front without bothering about collection of export bills. The forfaitor does so without any recourse to the exporter and the exporter is protected against the risk of non-payment of debts by the importers.

7. **Venture Capital:** A venture capital is another method of financing in the form of equity participation. A venture capitalist finances a project based on the potentialities of a new innovative project. It is in contrast to the conventional "security based financing". Much thrust is given to new ideas or technological innovations. Finance is being provided not only for 'start-up capital' but also for 'development capital' by the financial intermediary.

8. **Custodial Services:** It is another line of activity which has gained importance, of late. Under this, a financial intermediary mainly provides services to clients, particularly to foreign investors, for a prescribed fee. Custodial services provide agency services like safe keeping of shares and debentures, collection of interest and dividend and reporting of matters on corporate developments and corporate securities to foreign investors.

9. **Corporate Advisory Service:** Financial intermediaries particularly banks have set up corporate advisory service branches to render services exclusively to their corporate customers. For instance, some banks have extended computer terminals to their corporate customers to that they can transact some of their important banking transactions by sitting in their own office. As new avenues of finance like Euro loans, GDRs etc. are available to corporate customers. This service is of immense help to the customers.

10. **Securitisation:** Securitisation is a technique whereby a financial company converts its ill-liquid, non-negotiable and high value financial assets into securities of small value which are made tradable and transferable. A financial institution might have a lot of its assets blocked up in assets like real estate, machinery etc. which are long term in nature and which are non-negotiable. In such cases, securitisation would help the financial institution to raise cash against such assets by means of issuing securities of small values to the public. Like any other security, they can be traded in the market. it is best suited to housing finance companies whose loans are always long term in nature and their money is locked up for a considerable long period in real estates. Securitisation is the only answer to convert these ill-liquid assets into liquid assets.

11. **Derivative Security:** A derivative security is a security whose value depends upon the values of other basic variables backing the security. In most cases, these variables are nothing but the prices of traded securities. A derivative security is basically used as a risk management tool and it is resort to cover the risk due to price fluctuations by the investments manager. Just like a forward contract which is a derivative of a spot contract, a derivative security is derived from other trading securities backing it. Naturally the value of a derivative security depends upon the values of the backing securities. Derivative helps to break the risks into various components such as credit risk, interest rates risk, exchange rates risk and so on. It enables the various risk components to be identified precisely and priced them and even traded them if necessary. Financial intermediaries can go for derivatives since they will have greater importance in the near future. In India some forms of derivatives are in operation.

12. **New Products in Forex Market:** New products have also emerged in the forex markets of developed countries. Some of these products are yet to make full entry in Indian markets. Among them, the following are the important ones:

    (a) **Forward Contracts:** A forward transaction is one where the delivery of a foreign currency takes place at a specified future date for a specified price. It may have a fixed maturity for e.g. 31st May or a flexible maturity for e.g. 1st to 31st May. There is an obligation to honor this contract at any cost; failing which, there will be some penalty. Forward contracts are permitted only for genuine business transactions. It can be extended to other transactions like interest payments.

(b) **Options:** As the very name implies, it is a contract wherein the buyer of the option has a right to buy or sell a fixed amount of currency against another currency at a fixed rate on a future date according to his option. There is no obligation to buy or sell, but it is completely left to his option. Options may be of two types namely call options and put options. Under call options, the customer has an option to buy and it is the option to sell under put options. Options trading would lead to speculation and hence there are many restrictions in India.

(c) **Futures:** It is a contract wherein there is an agreement to buy or sell a stated quantity of foreign currency at a future date at a price agreed to between the parties on the stated exchange. Unlike options, there is an obligation to buy or sell foreign exchange on a future date at a specified rate. It can be dealt only in a stock exchange.

(d) **Swaps:** A swap refers to a transaction wherein a financial intermediary buys and sells a specified foreign currency simultaneously for different maturity dates-say, for instance, purchase of spot and sale of forward or vice versa with different maturities. Thus swaps would result in simultaneous buying and selling of the same foreign currency of the same value for different maturities to eliminate exposure risk. It can also be used as a tool to enter arbitrage operations, if any, between two countries. It can also be used in the interest rate market also.

13. **Lines of Credit (LOC):** It is an innovative funding mechanism for the import of goods and services on deferred payment terms. LOC is an arrangement of financing institution / bank of one country with another

institution / bank / agent to support the export of goods and services to as to enable the importers to import no deferred payment terms. This may be backed by a guarantee furnished by the institution / bank in the importing country. The LOC helps the exporters to get payment immediately as soon as the goods are shipped, since, the funds would be paid out of the pool account with the financing agency and it would be debited to the account of the borrower agency / importer whose contract for availing the facility is already approved by the financing agency on the recommendation of the overseas institution. It acts as conduct of financing which is for a certain period and on certain terms for the required goods to be imported. The greatest advantage is that it saves a lot of time and money on mutual verification of bonafides, source of finance etc. It serves as a source of forex.

2.5 SUMMARY

Financial products refer to instruments that help you save, invest, get insurance or get a mortgage. These are issued by various banks, financial institutions, stock brokerages, insurance providers, credit card agencies and government sponsored entities. The emergence of numerous financial innovations will change the structure of the financial market. Financial innovation can be defined as making and promoting new financial products and services, developing new processes to facilitate financial activities, to interact with customers and to design new structures for financial institutions. It is widely accepted that innovation, in general, improves productivity and stimulates economic growth. However, it is less clear how financial innovation impacts the real economy. Such volatility and excessive risk exposure can increase the likelihood and losses of economic and financial crises. Financial instruments are financial contracts between interested parties. They can be created, traded, modified and settled. There are different types of financial instruments, viz, currency, share and bond. Financial products refer to instruments that help you

save, invest, get insurance or get a mortgage. These are issued by various banks, financial institutions, stock brokerages, insurance providers, credit card agencies and government sponsored entities. Financial innovation has been a continuous and integral part of growth of the capital markets. Greater freedom and flexibility have enabled companies to reinvent and innovate financial instruments. Many factors such as increased interest rate, volatility, frequency of tax and regulatory changes etc. have stimulated the process of financial innovation. The deregulation of financial service industry and increased competition within investment banking also led to increased activities to design new products, develop better processes, and implement more effective solution for increasingly complex financial problems. Financial instrument is a combination of characteristics such as promised yield liquidity, maturity, security and risk. The process of financial innovation involves creating new instruments and technique by unpackaging and rebinding the same characteristics in different fashion to suit the constantly changing needs of the issuers and the investors. At times it leads to introduction of revolutionary new products such as swap, mortgage, and zero coupon bonds to finance leveraged buyouts. Sometimes it involves the piecing together of existing products and process to fit in a particular set of circumstances. Many companies consider the types of securities (debt and equity), and a handful of simple financial institutions (banks or exchanges). However, there is a range of financial products, types of financial institutions and a variety of processes that these institutions employ to do business.

2.6 GLOSSARY

- **Derivatives:** A derivative is a financial security with a value that is reliant upon, or derived from, an underlying asset or group of assets. The derivative itself is a contract between two or more parties, and its price is determined by fluctuations in the underlying asset.

- **MBNA:** America Bank, National Association.

- **NSE:** National Stock Exchange of India Ltd.
- **RBI:** Reserve Bank of India
- **SEBI:** Securities Exchange Board of India
- **Securitization:** It is the conversion of an asset, especially a loan, into marketable securities, typically for the purpose of raising cash by selling them to other investors.
- **SIP:** Systematic Investment Plan (SIP) is an investment vehicle offered by mutual funds to investors, allowing them to invest small amounts periodically instead of lump sums. The frequency of investment is usually weekly, monthly or quarterly.

2.7 SELF ASSESSMENT QUESTIONS

Q1. What is financial innovation ?

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Q2. What is institutional innovation ?

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Q3. What is product innovation ?

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Q4. What is process innovation ?

Q5. What is merchant banking ?

Q6. What is loan syndication ?

Q7. What is leasing ?

Q8. What are mutual funds ?

Q9. What is factoring ?

Q10. What is forfeiting ?

Q11. What is venture capital ?

Q12. What are custodial services ?

Q13. What are corporate advisory services ?

Q14. What you mean by securitisation ?

Q15. What is derivative security ?

Q16. What are lines of credit ?

2.8 LESSON END EXERCISE

Q1. Explain financial innovation in detail.

Q2. What are the causes of financial innovation?

Q3. Explain new financial products and services?

Q4. Explain new products in forex market?

2.9 SUGGESTED READINGS

1. Bhatia, B.S., and Batra, G.S., Financial Services, Deep & Deep Publishers, New Delhi.

2. Bansal, L.K., Merchant Banking and Financial Services, Unistar Books Pvt. Ltd., Chandigarh.

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INTRODUCTION TO FINANCIAL SERVICES

INNOVATIVE FINANCIAL INSTRUMENTS

STRUCTURE

3.1 Introduction

3.2 Objectives

3.3 Concept of Financial Instruments

3.4 Characteristics of Financial Instruments

3.5 Innovative Financial Instruments

3.6 Summary

3.7 Glossary

3.8 Self Assessment Questions

3.9 Lesson End Exercise

3.10 Suggested Readings

3.1 INTRODUCTION

Financial instruments are financial contracts of different nature made between institutional units. These comprise the full range of financial claims and liabilities between institutional units, including contingent liabilities like guarantees, commitments, etc. Financial asset is defined as any contract from which a financial claim may derive for one party and a financial liability or participation in equity for another.

Financial instrument can exist only between two institutional units. Where financial instruments are compounded, i.e. represent a set of several instruments, for compilation of statistics there will be a need to distinguish them into separate instruments so that each of them includes only a single pair of institutional units.

Financial assets are contracts that do not contain contingency, i.e., irrespective of any conditions, generate financial claims having demonstrable value over which ownership rights are enforced, individually or collectively, and from which economic benefits can be derived by using or holding them. The concept of financial instrument is wider than the concept of financial asset as defined in the System of National Accounts, 1993.

3.2 OBJECTIVES

After studying this lesson, you shall be able to understand:

- the concept of financial instruments;
- characteristics of financial instruments; and
- various innovative financial instruments.

3.3 CONCEPT OF FINANCIAL INSTRUMENTS

Financial instruments refer to those documents which represent financial claims on assets. Financial asset refers to a claim to the repayment of a certain sum of money at the end of a specified period together with interest or dividend. Examples are Bill of exchange, Promissory Note, Treasury Bill, Government Bond, Deposit Receipt, Share, Debenture, etc. Financial instruments can also be called financial securities. Financial securities can be classified into:

(i) **Primary or direct securities:** These are securities directly issued by the ultimate investors to the ultimate savers, e.g. shares and debentures issued directly to the public.

(ii) **Secondary or indirect securities:** These are securities issued by some intermediaries called financial intermediaries to the ultimate savers, e.g. Unit Trust of India and mutual funds issue securities in the form of units to the public and the money pooled is invested in companies.

Again these securities may be classified on the basis of duration as follows:

(i) **Short-term securities:** These securities are those which mature within a period of one year. For example, Bill of Exchange, Treasury Bill, etc.

(ii) **Medium-term securities:** These securities are those which have a maturity period ranging between one and five years like Debentures maturing within a period of 5 years.

(iii) **Long-term securities:** These securities are those which have a maturity period of more than five years. For example, Government Bonds generally mature after 10 years.

3.4 CHARACTERISTICS OF FINANCIAL INSTRUMENTS

Generally speaking, financial instruments possess the following characteristic or features :

1. Most of the instruments can be easily transferred from one hand to another without many cumbersome formalities.
2. They have a ready market i.e., they can be bought and sold frequently and thus trading in these securities is made possible.
3. They possess liquidity, i.e., some instruments can be converted into cash readily. For instance, a bill of exchange can be converted into cash readily by means of discounting and rediscounting.
4. Most of the securities possess security value, i.e., they can be given as security for the purpose of raising loans.
5. Some securities enjoy tax status, i.e., investment in these securities are exempted from Income Tax, Wealth Tax, etc., subject to certain limits.
6. They carry risk in the sense that there is uncertainty with regard to payment of principal or interest or dividend as the case may be.
7. These instruments facilitate future trading so as to cover risks due to price fluctuations, interest rate fluctuations etc.
8. These instruments involve less handling costs since expenses involved in buying and selling these securities are generally much less.
9. The return on these instruments is directly in proportion to the risk undertaken.

10. These instruments may be short-term or medium term or long-term depending upon the maturity period of these instruments.

3.5 INNOVATIVE FINANCIAL INSTRUMENTS

In recent years, innovation has been the key word behind the phenomenal success of many of the financial service companies and it forms an integral part of all planning and policy decisions. This has helped them to keep in tune with the changing times and changing customer needs. Accordingly, many innovative financial instruments have come into the financial market in recent times. Some of them have been discussed hereunder:

1. **Commercial Paper:** A paper is a short-term negotiable money market instrument. It has the character of an unsecured promissory note with a fixed maturity of 3 to 6 months. Banking and non-banking companies can issue this for raising their short term debt. It also carries an attractive rate of interest. Commercial papers are sold at a discount from their face value and redeemed at their face value. Since its denomination is very high, it is suitable only to institutional investors and companies.

2. **Treasury Bill:** A treasury bill is also a money market instrument issued by the Central Government. It is also issued at a discount and redeemed at par. Recently, the Government has come out with short term treasury bills of 182-days bills and 364-days bills.

3. **Certificate of Deposit:** The scheduled commercial banks have been permitted to issue certificate of deposit without any regulation on interest rates. This is also a money market instrument and unlike a fixed deposit receipt, it is a negotiable instrument and hence it offers maximum liquidity. As such, it has a secondary market too. Since the denomination is very high, it is suitable to mainly institutional investors and companies.

4. **Inter-bank Participations (IBPs):** The scheme of inter-bank participation is confined to scheduled banks only for a period ranging between 91 days and 180 days. This may be "with risk" participation or "without risk" participation. However, only a few banks have so far issued IBPs carrying an interest rate ranging between 14 and 17 per cent per annum. This is also a money market instrument.

5. **Zero Interest Convertible Debenture/Bonds:** As the very name suggests, these instruments carry no interest till the time of conversion. These instruments are converted into equity shares after a period of time.

6. **Deep Discount Bonds:** There will be no interest payments in the case of deep discount bonds also. Hence, they are sold at a large discount to their nominal value. For example, the Industrial Development Bank of India issued in February 1996 deep discount bonds. Each bond having a face value of Rs. 2,00,000 was issued at a deep discounted price of Rs.5300 with a maturity period of 25 years. Of course, provisions are there for early withdrawal or redemption in which case the deemed face value of the bond would be reduced proportionately. This bond could be gifted to any person.

7. **Index-Linked Guilt Bonds:** These are instruments having a fixed maturity. Their maturity value is linked to the index prevailing as on the date of maturity. Hence, they are inflation-free instruments.

8. **Option Bonds:** These bonds may be cumulative or non-cumulative as per the option of the holder of the bonds. In the case of cumulative bonds, interest is accumulated and is payable only on maturity. But, in the case of non-cumulative bond, the interest is paid periodically. This option has to be exercised by the prospective investor at the time of investment.

9. **Secured Premium Notes:** These are instruments which carry no interest of three years. In other words, their interest will be paid only after 3 years, and hence, companies with high capital intensive investments can resort to this type of financing.

10. **Medium Term Debentures:** Generally, debentures are repayable only after a long period. But, these debentures have a medium term maturity. Since they are secured and negotiable, they are highly liquid. These types of debt instruments are very popular in Germany.

11. **Variable Rate Debentures:** Variable rate debentures are debt instruments. They carry a compound rate of interest, but this rate of interest is not a fixed one. It varies from time to time in accordance with some pre-determined formula as we adopt in the case of Dearness Allowance calculations.

12. **Non-Convertible Debentures with Equity Warrants:** Generally debentures are redeemed on the date of maturity but these debentures are redeemed in full at a premium in installments as in the case of anticipated insurance policies. The installments may be paid at the end of 5th, 6th, 7th and 8th year from the date of allotment.

13. **Equity with 100% Safety Net:** Some companies make "100% safety net" offer to the public. It means that they give a guarantee to the issue price. Suppose, the issue price is Rs.40/- per share (nominal value of Rs.10/- per share), the company is ready to get it back at Rs.40/- at any time, irrespective of the market price. That is, even if the market price comes down to Rs.30/- there is 100% safety net and hence the company will get it back at Rs.40/-.

14. **Cumulative convertible Preference Shares:** These instruments along with capital and accumulated dividend must be compulsorily converted into equity shares in a period of 3 to 5 years from the date of their issue, according to the discretion of the issuing company. The main object of introducing it is to offer the investor an assured minimum return together with the prospect of equity appreciation. This instrument is not popular in India.

15. **Convertible Bonds:** A convertible bond is one which can be converted into equity shares at a per-determined timing neither fully nor partially. There are compulsory convertible bonds which provide for conversion within 18 months of their issue. There are optionally convertible bonds which provide for conversion within 36 months. There are also bonds which provide for conversion after 36 months and they carry 'call' and 'put' features.

16. **Debentures with 'Call' and 'Put' Feature:** Sometimes debentures may be issued with "Call" and "Put" feature. In the case of debentures with "Call feature", the issuing company has the option to redeem the debentures at a certain price before the maturity date. In the case of debentures with "Put features", the company gives the holder the right to seek redemption at specified times at predetermined prices.

17. **Easy Exit Bond:** As the name indicates, this bond enables the small investors to encash the bond at any time after 18 months of its issue and thereby paving a way for an easy exit. It has a maturity period of 10 years with a call option any time after 5 years. Recently the IDBI has issued this type of bond with a face value of Rs.5000 per bond.

18. **Retirement Bond:** This type of bond enables an investor to get an assured monthly income for a fixed period after the expiry of the "wait period" chosen by him. No payment will be made during the "wait period". The

longer the wait period, the higher will be the monthly income. Besides these, the investor will also get a lump sum amount on maturity. For example, the IDBI has issued Retirement Bond 96 assuring a fixed monthly income for 10 years after the expiry of the wait period. This bond can be gifted to any person.

19. **Regular Income Bond:** This bond offers an attractive rate of interest payable half yearly with the facility of early redemption. The investor is assured of regular and fixed income. For example, the IDBI has issued Regular Income Bond 96 carrying 16% interest p.a. It is redeemable at the end of every year from the expiry of 3 years from the date of allotment.

20. **Infrastructure Bond:** It is a kind of debt instrument issued with a view to giving tax shelter to investors. The resources raised through this bond will be used for promoting investment in the field of certain infrastructure industries. Tax concessions are available under Sec. 88, Sec. 54 EA and Sec. 54EB of the Income Tax Act. HUDCO has issued for the first time such bonds. Its face value is Rs. 1000 each carrying an interest rate of 15% per annum payable semi annually. This bond will also be listed in important stock exchanges.

21. **Carrot and Stick bonds:** Carrot bonds have a low conversion premium to encourage early conversion, and sticks allow the issuer to call the bond at a specified premium if the common stock is trading at a specified percentage above the strike price.

22. **Convertible Bonds with a Premium put:** These are bonds issued at face value with a put, which means that the bond holder can redeem the bonds for more than their face value.

23. **Debt with Equity Warrant:** Sometimes bonds are issued with warrants for the purchase of shares. These warrants are separately tradable.

24. **Dual Currency Bonds:** Bonds that are denominated and pay interest in one currency and are redeemable in another currency come under this category. They facilitate interest rate arbitrage between two markets.

25. **ECU Bonds (European Currency Unit Bonds):** These bonds are denominated in a basket of currencies of the 10 countries that constitute the European community. They pay principal and interest in ECUs or in any of the 10 currencies at the option of the holder.

26. **Yankee Bonds:** If bonds are raised in U.S.A., they are called Yankee bonds and if they are raised in Japan, they are called Samurai Bonds.

27. **Flip-Flop Notes:** It is a kind of debt instrument which permits investors to switch between two types of securities e.g. to switch over from a long term bond to a short term fixed-rate note.

28. **Floating Rate Notes (FRNs):** These are debt instruments which facilitate periodic interest rate adjustments.

29. **Loyalty Coupons:** These are entitlements to the holder of debt for two to three years to exchange into equity shares at discount prices. To get this facility, the original subscriber must hold the debt instruments for the said period.

30. **Global Depository Receipt (GDR):** A global depository receipt is a dollar denominated instrument traded on a stock exchange in Europe or the U.S.A. or both. It represents a certain number of underlying equity shares. Though the GDR is quoted and traded in dollar terms, the underlying equity shares are denominated in rupees. The shares are issued by the company to an intermediary called depository in whose name the shares are registered. It is the depository which subsequently issues the GDRs.

3.6 SUMMARY

Financial instruments are monetary contracts between parties. They can be created, traded, modified and settled. They can be cash (currency), evidence of an ownership interest in an entity (share), or a contractual right to receive or deliver cash (bond). Financial instruments are financial contracts between interested parties. They can be created, traded, modified and settled. There are different types of financial instruments, viz, currency, share and bond. They are intangible assets, which are expected to provide future benefits in the form of a claim to future cash. It is a tradable asset representing a legal agreement or a contractual right to evidence monetary value / ownership interest of an entity. Innovative financial instruments support economic growth. Innovative financial instruments can attract funding from other public or private investors in areas of EU strong interest but which are perceived as risky by investors. Examples include sectors with high economic growth or innovative business activities. Innovative financial instruments can attract funding from other public or private investors in areas of EU strong interest but which are perceived as risky by investors.

3.7 GLOSSARY

- **Charge card advances:** The cash advance fee can be charged as a percentage of the **cash advance** or a flat rate.
- **Commercial bank:** A commercial bank is a type of financial institution that accepts deposits; offers checking account services; makes business, personal and mortgage loans; and offers basic financial products like certificates of deposit (CDs) and savings accounts to individuals and small businesses.
- **Credit card:** a small plastic card issued by a bank, building society, etc., allowing the holder to purchase goods or services on credit.

- **Debit card:** a card allowing the holder to transfer money electronically from their bank account when making a purchase.
- **ECU:** European Currency Unit
- **EU:** The European Union (EU) is a political and economic union of 28 member states that are located primarily in Europe.
- **GDRs:** GDRs represent ownership of an underlying number of shares of a foreign company and are commonly used to invest in companies from developing or emerging markets by investors in developed markets.
- **Hedge Funds:** An offshore investment fund typically formed as a private limited partnership, that engages in speculation using credit or borrowed capital.
- **HUDCO:** Housing and Urban Development Corporation.
- **Mortgage Loans:** A mortgage is a loan in which property or real estate is used as collateral. The borrower enters into an agreement with the lender (usually a bank) wherein the borrower receives cash upfront then makes payments over a set time span until he pays back the lender in full.
- **Overdraft:** An overdraft occurs when money is withdrawn from a bank account and the available balance goes below zero. In this situation the account is said to be "overdrawn".

3.8 SELF ASSESSMENT QUESTIONS

Q1. What you mean by commercial paper ?

Q2. What is treasury bill ?

Q3. What is certificate of deposit?

Q4. What is inter-bank participations?

Q5. What is zero interest convertible debenture?

Q6. What is a deep discount bond?

Q7. What is an index-linked guilt bond?

Q8. What are option bonds?

Q9. What is secured premium notes?

Q10. What are medium term debentures?

Q11. What are variable rate debentures ?

Q12. What are non-convertible debentures with equity warrants?

Q13. What is equity with 100% safety net?

Q14. What is cumulative convertible preference shares?

Q15. What are convertible bonds?

Q16. What are debentures with 'call' and 'put' feature?

Q17. What is easy exit bond?

Q18. What is retirement bond?

Q19. What is regular income bond?

Q20. What is infrastructure bond?

Q21. What are carrot and stick bonds ?

Q22. What are convertible bonds with a premium put?

Q23. What is debt with equity warrant?

Q24. What are dual currency bonds?

Q25. What is ECU Bonds?

Q26. What are yankee bonds?

Q27. What are flip-flop notes?

Q28. What is floating rate notes?

Q29. What are loyalty coupons?

Q30. What is GDR ?

3.9 LESSON END EXERCISE

Q1. Explain the concept of financial instruments?

Q2. What are the various characteristics of financial instruments?

Q3. Explain various innovative financial instruments?

3.10 SUGGESTED READINGS

1. Balance of Payments Manual, fifth edition, IMF, Washington D. C., 1993.

2. Bansal, L.K., Merchant Banking and Financial Services, Unistar Books Pvt. Ltd., Chandigarh.

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UNIT-I **LESSON NO. 4**

INTRODUCTION TO FINANCIAL SERVICES

FINANCIAL SERVICES SECTOR

STRUCTURE

4.1 Introduction

4.2 Objectives

4.3 Challenges Facing the Financial Services Sector

4.4 Present Scenario of Financial Services in India

4.5 Development of Financial System in India

4.6 Summary

4.7 Glossary

4.8 Self Assessment Questions

4.9 Lesson End Exercise

4.10 Suggested Readings

4.1 INTRODUCTION

A "financial system" is a system that allows the exchange of funds between lenders, investors, and borrowers. Financial systems operate at national and global levels. They consist of complex, closely related services, markets, and institutions intended to provide an efficient and regular linkage between investors and depositors.

Money, credit, and finance are used as medium of exchange in financial systems. They serve as a medium of known value for which goods and services can be exchanged as an alternative to bartering. A modern financial system may include banks (public sector or private sector), financial markets, financial instruments, and financial services. Financial systems allow funds to be allocated, invested, or moved between economic sectors. They enable individuals and companies to share the associated risks.

There has been an upsurge in the financial services provided by various banks and financial institutions since 1990. Efficiency of emerging financial system depends upon the quality and variety of financial services provided by the banking and non-banking financial companies. Financial services, through the network of elements such as financial institutions, financial markets and financial instruments, serve the needs of individuals, institutions and corporates. It is through these elements that the functioning of the financial system is facilitated. In fact, an orderly functioning of the financial system depends, to a great extent, on the range and the quality of financial services extended by a host of providers.

India's services sector has always served the Indian economy well, accounting for nearly 57 per cent of the gross domestic product (GDP). Here, the financial services segment has been a significant contributor. The financial services sector in India is dominated by commercial banks which have more than 60 per cent share of the total assets; other segments include mutual funds, insurance firms,

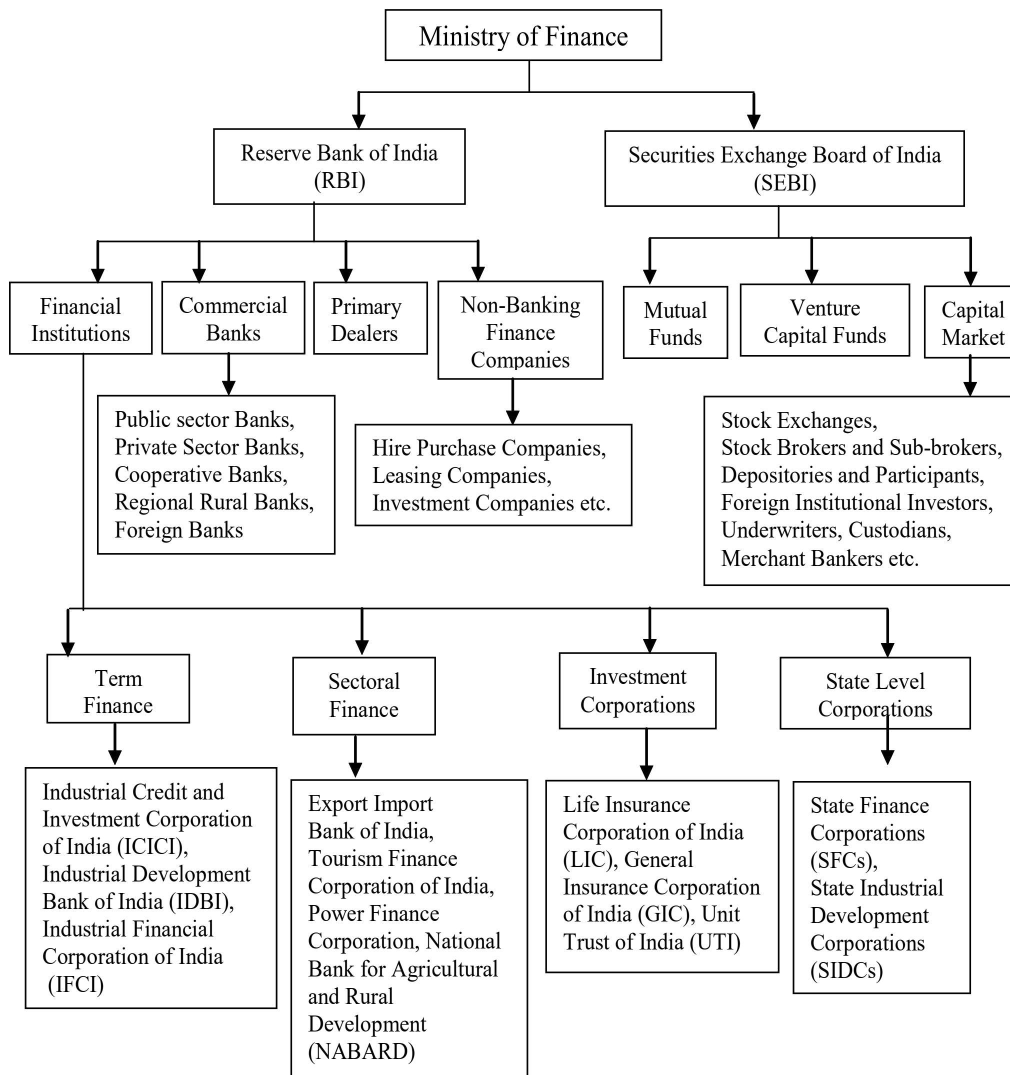
non-banking institutions, cooperatives and pension funds. The Government of India has introduced reforms to liberalize, regulate and enhance the country's financial services industry. Presently, the country can claim to be one of the world's most vibrant capital markets. In spite of the challenges that are still there, the sector's future looks good. The present situation of Indian financial service sector could be broadly represented as follows :

- RBI, at the Apex
- Commercial banks which includes public sector and private sector Banks,
- Development financial institutions which could be divided into all India institutions and state level institutions,
- Insurance companies, which can be classified as, Life Insurance Corporation of India, General Insurance Corporation of India, and private sector insurance companies,
- Other public sector financial institutions like Post Office Savings bank, National housing bank, Export Import bank of India etc.
- Mutual funds
- Non Banking Finance Corporations
- Asset reconstruction companies
- Capital market intermediaries,
- Credit information companies.

The Structure of Indian Financial System is displayed in the following chart 4.1

CHART 4.1 The structure of Indian Financial System

(Source: The Indian Banker)



4.2 OBJECTIVES

After studying this lesson, you shall be able to understand:

- various challenges facing the financial services sector;
- present scenario of financial service sector in India;
- development of financial system in India.

4.3 CHALLENGES FACING THE FINANCIAL SERVICES SECTOR

However, the financial service sector has to face many challenges in its attempt to fulfill the ever growing financial demands of the economy. Some of the important challenges are reported hereunder:

1. **Lack of qualified personnel:** The financial services sector is fully geared to the task of "financial creativity". However, this sector has to face many challenges. In fact, the dearth of qualified and trained personnel is an important impediment in its growth. Hence, it is very vital that a proper and comprehensive training must be given to the various financial intermediaries.

2. **Lack of investor awareness:** The introduction of new financial products and instruments will be of no use unless the investor is aware of the advantages and uses of the new and innovative products and instruments. Hence, the financial intermediaries should educate the prospective investors / users of the advantages of the innovative instruments through literature, seminars, workshops, advertisements and even through audio-visual aids.

3. **Lack of transparency:** The whole financial system is undergoing a phenomenal change in accordance with the requirements of the national and global environments. It is high time that this sector gave up their orthodox attitude of keeping accounts in a highly secret manner. Hence,

this sector should opt for better levels of transparency. In other words, the disclosure requirements and the accounting practices have to be in line with the international standards.

4. **Lack of specialization:** In the Indian scene, each financial intermediary seems to deal in different financial service lines without specializing in one or two areas. In other words, each intermediary is acting as a financial super market delivering so many financial products and dealing in different varieties of instruments. In other countries, financial intermediaries like Newtons, Solomon Brothers etc. specialize in one or two areas only. This helps them to achieve high levels of efficiency and excellence. Hence, in India also financial intermediaries can go for specialization.

5. **Lack of recent data:** Most of the intermediaries do not spend more on research. It is very vital that one should build up a proper data base on the basis of which one could embark upon "financial creativity". Moreover, a proper data base would keep oneself abreast of the recent developments in other parts of the whole world and above all, it would enable the fund managers to take sound financial decisions.

6. **Lack of efficient risk management system:** With the opening of the economy to multinationals and the exposure of Indian companies to international competition, much importance is given to foreign portfolio flows. It involves the utilization of multi currency transactions which exposes the client to exchange rate risk, interest rate risk and economic and political risk. Unless a proper risk management system is developed by the financial intermediaries as in the West, they would not be in a position to fulfill the growing requirements of their customers. Hence, it is absolutely essential that they should introduce Futures, Options, Swaps and other derivative products which are necessary for an efficient risk management system.

The above challenges are likely to increase in number with the growing requirements of the customers. The financial services sector should rise up to the occasion to meet these challenges by adopting new instruments and innovative means of financing so that it could play a very dynamic role in the economy.

4.4 PRESENT SCENARIO OF FINANCIAL SERVICES IN INDIA

The present scenario of financial service sector is:

1. **Conservatism to dynamism:** At present, the financial system in India is in a process of rapid transformation, particularly after the introduction of reforms in the financial sector. The main objective of the financial sector reforms is to promote an efficient, competitive and diversified financial system in the country. This is very essential to raise the allocative efficiency of available savings, increase the return on investment and thus to promote the accelerated growth of the economy as a whole. As a result, we have recently witnessed phenomenal changes in the money market, securities market, capital market, debt market and the foreign exchange market. In this changed context, the role of financial services has assumed greater significance in our county. At present, numerous new financial intermediaries have started functioning with a view to extending multifarious services to the investing public in the area of financial services. The emergence of various financial institutions and regulatory bodies has transformed the financial services sector from being a conservative industry to a very dynamic one.

2. **Emergence of Primary Equity Market:** Now, we are also witnessing the emergence of many private sector financial services. The capital markets which were very sluggish, have become a popular source of raising finance. The number of stock exchanges in the country has gone up from 9 in 1980

to 24 in 2004. The aggregate funds raised by the industries in the primary markets have gone from up. The numbers of companies listed on the stock exchange have also gone up from 2265 in 1980 to over 10000 in 2004. Thus, the primary equity market has emerged as an important vehicle to channelise the savings of the individuals and corporates for productive purposes and thus to promote the industrial and economic growth of our nation.

3. **Concept of Credit Rating:** There is every possibility of introducing equity grading. Hitherto, the investment decisions of the investors have been based on factors like name recognition of the company, operations of the group, market sentiments, reputation of the promoters etc. Now, grading from an independent agency would help the investor in his portfolio management and thus, equity grading is going to play a significant role in investment decision-making. From the company point of view, equity grading would help to broaden the market for their public offer, to replace the name recognition by objective opinion and to have a wider investor base. Thus, grading would give further fillip to the primary market. Moreover, the concept of credit rating would play a significant role in identifying the risk level of the corporate entity in which the investor wants to take part.

   Now it is mandatory for the non-banking financial companies to get credit rating for their debt instruments. The four major credit rating agencies functioning in India are :

   (i) Credit Rating Information Services of India Ltd. (CRISIL): Credit Rating Information Services of India Ltd. (CRISIL) is a global analytical company providing ratings, research and risk and policy advisory services.

(ii) **Credit Analysis and Research ltd. (CARE):** Credit Analysis and Research ltd. (CARE) provides various credit ratings that help corporates to raise capital for their various requirements and assist the investors to form informed investments decision based on the credit risk and their own risk-return expectations.

(iii) **Investment Information and Credit Rating Agency (ICRA):** Investment Information and Credit Rating Agency (ICRA) or ICRA Limited is an Indian independent and professional investment information and credit rating agency.

(iv) **Duff Phelps Credit Rating Pvt. Ltd. (DCR India):** DCR India or Duff & Phelps Credit Rating India Private Ltd is one of the top credit rating agencies in India. Their activities have been mainly confined to debt instruments only.

4. **Process of Globalisation:** Again, the process of globalisation has paved the way for the entry of innovative and sophisticated financial products into our country. Since the Government is very keen in removing all obstacles that stand in the way of inflow of foreign capital, the potentiabilities for the introduction of innovative international financial products in India are very great. Moreover, India is likely to enter the full convertibility era soon. Hence, there is every possibility of introduction of more and more innovative and sophisticated financial services in our country.

5. **Process of Liberalisation:** Realizing all these factors, the Government of India has initiated many steps to reform the financial services industry. The Government has already switched over to free pricing of issues from pricing issues. The interest rates have been deregulated. The private sector has been permitted to participate in banking and mutual funds and the public sector undertakings are being privatized. The Securities Exchange Board

of India has liberalized many stringent conditions so as to boost the capital and money markets. In this changed context, the financial service industry in India has to play a very positive and dynamic role in the years to come by offering many innovative products to suit to the varied requirements of the millions of prospective investors spread throughout the country.

4.5 DEVELOPMENT OF FINANCIAL SYSTEM IN INDIA

Some serious attention was paid to the development of a sound financial system in India only after the launching of the planning era in the country. At the time of Independence in 1947, there was no strong financial institutional mechanism in the country. There was absence of issuing institutions and non participation of intermediary financial institutions. The industrial sector also had no access to the savings of the community. The capital market was very primitive and shy. The private as well as the unorganised sector played a key role in the provision of "liquidity". On the whole, chaotic conditions prevailed in the system. With the adoption of the theory of mixed economy, the development of the financial system took a different turn so as to fulfill the socio-economic and political objectives. The Government started creating new financial institutions to supply finance both for agricultural and industrial development and it also progressively started nationalising some important financial institutions so that the flow of finance might be in the right direction.

1. **Nationalisation of Financial Institutions:** As stated earlier, the RBI is the leader of the financial system. But, it was established as a private institution in 1935. It was nationalised in 1948. It was followed by the nationalisation of the Imperial Bank of India in 1956 by renaming it as State Bank of India. In the same year, 245 Life Insurance Companies were brought under Government control by merging all of them into a single corporation called Life Insurance Corporation of India (LIC). Another

significant development in our financial system was the nationalisation of 14 major commercial banks in 1969. Again, six banks were nationalised in 1980. This process was then extended to General Insurance Companies (GIC) which were reorganised under the name of General Insurance Corporation of India. Thus, the important financial institutions were brought under public control.

2. **Starting of Unit Trust of India (UTI):** Another landmark in the history of development of our financial system is the establishment of new financial institutions to strengthen our system and to supply institutional credit to industries. The Unit Trust of India was established in 1964 as a public sector institution to collect the savings of the people and make them available for productive ventures. It is the oldest and largest mutual fund in India. It is governed by its own statutes and regulations. However, since 1994, the schemes of UTI have to be approved by the SEBI. It has introduced a number of open-ended and close-ended schemes. It also provides repurchase facility of units of the various income schemes after a minimum lock-in period of one year. Some of the unit schemes of UTI are linked with stock exchanges. Its investment is confined to both corporate and non-corporate sectors. In recent years, it has established the following subsidiaries:

   (i) The UTI Bank Ltd., in April 1994.

   (ii) The UTI Investor Service Ltd., to act as UTI's own Registrar and Transfer agency.

   (iii) The UTI Security Exchange Ltd.

3. **Establishment of Development Banks:** Many development banks were started not only to extend credit facilities to financial institutions but also to

render advisory services. These banks are multipurpose institutions which provide medium and long-term credit to industrial undertakings, discover investment projects, undertake the preparation of project reports, provide technical advice and managerial services and assist in the management of industrial units. These institutions are intended to develop backward regions as well as small and new entrepreneurs. The Industrial Finance Corporation of India (IFCI) was set-up in 1948 with the object of making medium and long-term credits more readily available to industrial concerns in India, particularly under circumstances where normal banking accommodation is inappropriate or recourse to capital issue method is impracticable. At the regional level, State Financial Corporations were established under the State Financial Corporation Act, 1951 with a view of providing medium and long-term finance to medium and small industries. It was followed by the establishment of the Industrial Credit and Investment Corporation of India (ICICI) in 1955 to develop large and medium industries in private sector, on the initiative of the World Bank. It adopted a more dynamic and modern approach in industrial financing.

Subsequently, the Government of India set-up the Refinance Corporation of India (RCI) in 1958 with a view of providing refinance facilities to banks against term loans granted by them to medium and small units. Later on it was merged with the Industrial Development Bank of India. The Industrial Development Bank of India (IDBI) was established on July 1, 1964 as a wholly-owned subsidiary of the RBI. The ownership of IDBI was then transferred to the Central Government with effect from February 16, 1976. The IDBI was the apex institution in the area of development banking and as such it had to coordinate the activities of all the other financial institutions. However, it has been converted into a commercial bank and so it has lost the status of a development bank now. At the State level, the State Industrial

Development Corporations (SIDCO)/ State Industrial Investment Corporations (SIIC) were created to meet the financial requirements of the States and to promote regional development. In 1971, the IDBI and LIC jointly set up the Industrial Reconstruction Corporation of India (IRCI) with the main objective of reconstruction and rehabilitation of sick industrial undertakings. The IRCI was converted into a statutory corporation in March 1985 and renamed as the Industrial Reconstruction Bank of India (IRBI). In 1997, the IRBI has to be completely restructured since it itself has become sick due to financing of sick industries. Now, it is converted into a limited company with a new name of Industrial Investment Bank of India (IIBI). Its objective is to finance only expansion, diversification, modernisation, etc., of industries and thus it has become a development bank. The Small Industries Development Bank of India (SIDBI) was set-up as a wholly-owned subsidiary of IDBI. It commenced operations on April 2, 1990. The SIDBI has taken over the responsibility of administrating the Small Industries Development Fund and the National Equity Fund.

4. **Institution for Financing Agriculture:** In 1963, the RBI set-up the Agricultural Refinance and Development Corporation (ARDC) to provide refinance support to banks to finance major development projects such as minor irrigation, farm mechanisation, land development, horticulture, dairy development, etc. However, in July 1982, the National Bank for Agriculture and Rural Development (NABARD) was established and the ARDC was merged with it. The whole sphere of agricultural finance has been handed over to NABARD. The functions of the Agricultural Credit Department and Rural Planning and Credit Cell of the RBI have been taken over by NABARD.

5. **Institution for Foreign Trade:** The Export and Import Bank of India (EXIM Bank) was set-up on January 1, 1982 to take over the operations

of International Finance wing of the IDBI. Its main objective is to provide financial assistance to exporters and importers. It functions as the principal financial institution for coordinating the working of other institutions engaged in financing of foreign trade. It also provides refinance facilities to other financial institutions against their export-import financing activities.

6. **Institution for Housing Finance:** The National Housing Bank (NHB) has been set-up on July 9, 1988 as an apex institution to mobilise resources for the housing sector and to promote housing finance institutions both at regional and local levels. It provides refinance facilities to housing finance institutions and scheduled banks. It also provides guarantee and underwriting facilities to housing finance institutions. Again, it coordinates the working of all agencies connected with housing.

7. **Stock Holding Corporation of India Ltd. (SHCIL):** In 1987 another institution, *viz.,* Stock Holding Corporation of India Ltd. was set up to tone up the stock and capital markets in India. Its main objective is to provide quick share transfer facilities, clearing services, depository services, support services, management information services and development services to investors both individuals and corporates. The SHCIL was set-up by seven All India financial institutions, *viz.,* IDBI, IFCI, ICICI, LIC, GIC, UTI and IRBI.

8. **Mutual Funds Industry:** Mutual funds refer to the funds raised by financial service companies by pooling the savings of the public and investing them in a diversified portfolio. They provide investment avenues for small investors who cannot participate in the equities of big companies. Mutual funds have been floated by some public sector banks, LIC, GIC and recently by private sector also.

9. **Venture Capital Institutions:** Venture capital is another method of financing in the form of equity participation. A venture capitalist finances a project based on the potentialities of a new innovative project. Much thrust is given to new ideas or technological innovations. Indeed, it is a long-term risk capital to finance high technology projects. The IDBI venture capital fund was set-up in 1986. The IFCI has started a subsidiary to finance venture capital, *viz.,* The Risk Capital and Technology Finance Corporation (RCTC). Likewise, the ICICI and the UTI have jointly set-up the Technology Development and Information Company of India Limited (TDICI) in 1988 to provide venture capital. Similarly, many State Financial Corporations and commercial banks have started subsidiaries to provide venture capital. The Indus Venture Capital Fund and the Credit Capital Venture Fund Limited come under the private sector.

10. **Credit Rating Agencies:** Of late, many credit rating agencies have been established to help investors to make a decision of their investment in various instruments and to protect them from risky ventures. At the same time, it has the effect of improving the competitiveness of the companies so that one can excel the other. Credit rating is now mandatory for all debt instruments. Similarly, for accepting deposits, non-banking companies have to compulsorily go for credit rating. Some of the important credit rating agencies established are:

    (i) Credit Rating and Information Services of India Ltd. (CRISIL).

    (ii) Investment Information and Credit Rating Agency of India Ltd. (ICRA).

    (iii) Credit Analysis and Research Ltd. (CARE).

The rating is confined to fixed deposits, debentures, preference shares and short-term instruments like commercial paper. The rating of equity shares will come into effect soon. The establishment of various credit rating agencies will go a long way in stabilising the financial system in India by supplying vital credit information about corporate customers.

11. **Multiplicity of Financial Instruments:** The expansion in size and number of financial institutions has consequently led to a considerable increase in the financial instruments also. New instruments have been introduced in the form of innovative schemes of LIC, UTI, Banks, Post Office Savings Bank Accounts, Shares and debentures of different varieties, Public Sector Bonds, National Savings Scheme, National Savings Certificates, Provident Funds, Relief Bonds, Indira Vikas Patra, etc. Thus, different types of instruments are available in the financial system so as to meet the diversified requirements of varied investors and thereby making the system more healthy and vibrant.

12. **Legislative Support:** The Indian financial system has been well supported by suitable legislative measures taken by the Government then and there for its proper growth and smooth functioning. Though there are many enactments, some of them are very important. The Indian Companies Act was passed in 1956 with a view of regulating the functioning of companies from birth to death. It mainly aims at giving more protection to investors since there is a diversity of ownership and management in companies. It was a follow-up to the Capital Issues Control Act passed in 1947. Again, in 1956, the Securities Contracts (Regulation) Act was passed to prevent undesirable transactions in securities. It mainly regulates the business of trading in the stock exchanges. This act permitted only recognised stock exchanges to function. To ensure the proper functioning of the economic system and to prevent concentration of economic power in the hands of a

few, the Monopolies and Restrictive Trade Practices Act was passed in 1970. In 1973, the Foreign Exchange Regulations Act was enacted to regulate the foreign exchange dealings and to control Indian investments abroad and *vice versa*. The Capital Issues Control Act was replaced by setting up of the Securities Exchange Board of India. Its main objective is to protect the interest of investors by suitably regulating the dealings in the stock market and money market so as to achieve efficient and fair trading in these markets. When the Government adopted the New Economic Policy, many of these acts were amended so as to remove many unwanted controls. Banks and financial institutions have been permitted to become members of the stock market in India. They have been permitted to float mutual funds, undertake leasing business, carry-out factoring services, etc.

Besides the above, the Indian Contract Act, The Negotiable Instruments Act, The Law of Limitation Act, The Banking Regulations Act, The Stamp Act, etc., deserve a special mention. When the financial system grows, the necessity of regulating it also grows side-by-side by means of bringing suitable legislations. These legislative measures have reorganised the Indian financing system to a greater extent and have restored confidence in the minds of the investing public as well.

However, to avoid overlap in certain key areas between SEBl and other bodies such as Company Law Board, RBI, etc., it is necessary to classify the respective jurisdictions. At present, the jurisdiction is divided between the RBI (money, market, repos, debt market) and SEBI. It would be advisable to consolidate the securities law into comprehensive legislation on the lines of the British Financial Services and Market Act, 2000.

13. **Financial Sector Legislative Reforms Commission (FSLRC):** The Central Government has very recently constituted the Financial Sector

Legislative Reforms Commission (FSLRC) under the chairmanship of former Justice B.N. Srikrishna to rewrite and harmonise the various financial sector legislations, rules and regulations. There are over 60 acts and multiple rules and regulations and many of them have become archaic. Moreover, large number of amendments made in these acts over time has increased the ambiguity and complexity of the system.

4.6 SUMMARY

Financial services constitute an important component of the financial system. Financial services serve the needs of individuals, institutions and corporate through a network of elements. Prior to economic liberalization, the Indian financial service sector was charaterised by so many factors which retarded its growth. Financial services cover a wide range of activities and they can be broadly classified into traditional activities and modern activities. In the changed economic scenario, many financial intermediaries have started expanding their activities in the financial services sector by offering a variety of new products. The financial service sector has thus emerged as the fastest growing sunrise industry. After the introduction of planning, rapid industrialisation has taken place. It has in turn led to the growth of the corporate sector and the Government sector. In order to meet the growing requirements of the Government and the industries, many innovative financial instruments have been introduced. Besides, there has been a rapid growth of financial intermediaries to meet the ever-growing financial requirements of different types of customers. Hence, the Indian financial system is more developed and integrated today than what it was 50 years ago.

4.7 GLOSSARY

- **ARC:** An Asset Reconstruction Company (ARC) is a specialized financial institution that buys the NPAs or bad assets from banks and financial

institutions so that the latter can clean up their balance sheets. Or in other words, ARCs are in the business of buying bad loans from banks.

- **IRBI:** The Industrial Reconstruction Corporation of India Ltd., set up in 1971 for rehabilitation of sick industrial companies, was reconstituted as Industrial Reconstruction Bank of India in 1985 under the IRBI Act, 1984.
- **UTI Bank:** The Bank was promoted in 1993 jointly by the Administrator of the Unit Trust of India (UTI-I), Life Insurance Corporation of India (LIC), General Insurance Corporation, National Insurance Company, The New India Assurance Company, The Oriental Insurance Corporation and United India Insurance Company.

4.8 SELF ASSESSMENT QUESTIONS

Q1. What you mean by conservatism to dynamism in financial service sector?

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Q2. What is globalisation?

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Q3. What is liberalization?

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Q4. What is CRISIL?

Q5. What is CARE?

Q6. What is ICRA?

Q7. What is DCR India?

Q8. Explain the establishment of development banks in India?

Q9. What do you mean by mutual fund industry?

Q10. What is venture capital?

Q11. Explain FSLRC?

4.9 LESSON END EXERCISE

Q1. What are the challenges faced by financial service sector?

Q2. Explain the present scenario of financial services in India?

Q3. Explain various credit rating agencies in India?

Q4. Explain the development of financial system in India?

4.10 SUGGESTED READINGS

1. Bhatia, B.S., and Batra, G.S., Financial Services, Deep & Deep Publishers, New Delhi.

2. Bansal, L.K., Merchant Banking and Financial Services, Unistar Books Pvt. Ltd., Chandigarh.

3. Bhole, L.M., Financial Institutions and Markets, Tata McGraw Hill, New Delhi.

4. Chandra, P., Financial Management, Tata McGraw Hill, New Delhi.

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6. Kothari, C.R., Investment Banking and Customer Service, Arihand Publishers, Jaipur.

INTRODUCTION TO FINANCIAL SERVICES

MANAGEMENT OF RISK IN FINANCIAL SERVICES

STRUCTURE

5.1 Introduction

5.2 Objectives

5.3 Concept of Risk

5.4 Types of Risk

5.4.1 Credit risk

5.4.2 Legal risk

5.4.3 Liquidity risk

5.4.4 Market risk

5.4.5 Operational risk

5.4.6 Model risk

5.5 Risk Management

5.5.1 Culture

5.5.2 Policies and procedures

5.5.3 Technology

5.5.4 Independence

5.6 Summary

5.7 Glossary

5.8 Self Assessment Questions

5.9 Lesson End Exercise

5.10 Suggested Readings

5.1 INTRODUCTION

Risk has two components namely uncertainty and exposure. If both are not present, there is no risk. If a man jumps out of an airplane with a parachute on his back, he may be uncertain as to whether or not the chute will open. He is taking risk because he is exposed to that uncertainty. If the chute fails to open, he will suffer personally. In this example, a typical spectator on the ground would not be taking risk. They may be equally uncertain as to whether the chute will open, but they have no personal exposure to that uncertainty. Exceptions might include: A spectator who is owed money by the man jumping from the plane. A spectator who is a member of the man's family, such spectators do face risk because they may suffer financially and/or emotionally should the man's chute fail to open. They are exposed and uncertain.

5.2 OBJECTIVES

After reading this lesson you should be able to understand:

- concept of risk;
- types of risk; and
- how to manage risk

5.3 CONCEPT OF RISK

A synonym for uncertainty is ignorance. We face risk because we are ignorant about the future. After all, if we were omniscient, there would be no risk. Because ignorance is a personal experience, risk is necessarily subjective. Consider another example: A person is heading to the airport to catch a flight. The weather is threatening and it is possible the flight has been cancelled. The individual is uncertain as to the status of the flight and faces exposure to that uncertainty. His travel plans will be disrupted if the flight is cancelled. Accordingly, he faces risk.

Suppose another person is also heading to the airport to catch the same flight. This person has called ahead and confirmed that the flight is not cancelled. Accordingly, he has less uncertainty and faces lower risk. In this example, there are two individuals exposed to the same event. Because they have different levels of uncertainty, they face different levels of risk. Risk is subjective. Institutions can reduce some risks simply by researching them. A bank can reduce its credit risk by getting to know its borrowers. A brokerage firm can reduce market risk by being knowledgeable about the markets it operates in. Risk is a personal experience, not only because it is subjective, but because it is individuals who suffer the consequences of risk. Although we may speak of companies taking risk, in actuality, companies are merely conduits for risk. Ultimately, all risks which flow through an organization accrue to individuals stock holders, creditors, employees, customers, board members, etc.

5.4 TYPES OF RISK

Following are the types of risk:

5.4.1 Credit risk

Credit risk is risk due to uncertainty in a counterparty's (also called an obligor or credit's) ability to meet its obligations. Because there are many types of counterparties from individuals to sovereign governments and many different types of obligations from auto loans to derivatives transactions, credit risk takes many forms. Institutions manage it in different ways. In assessing credit risk from a single counterparty, an institution must consider three issues:

(a) **Default probability:** What is the likelihood that the counterparty will default on its obligation either over the life of the obligation or over some specified horizon, such as a year? Calculated for a one-year horizon, this may be called the expected default frequency.

(b) **Credit exposure:** In the event of a default, how large will the outstanding obligation be when the default occurs?

(c) **Recovery rate:** In the event of default, what fraction of the exposure may be recovered through bankruptcy proceedings or some other form of settlement?

When we speak of the credit quality of an obligation, this refers generally to the counterparty's ability to perform on that obligation. This encompasses both the obligation's default probability and anticipated recovery rate. To place credit exposure and credit quality in perspective, recall that every risk comprises two elements: exposure and uncertainty. For credit risk, credit exposure represents the former, and credit quality represents the latter.

For loans to individuals or small businesses, credit quality is typically assessed through a process of credit scoring. Prior to extending credit, a bank or other lender will obtain information about the party requesting a loan. In the case of a bank issuing credits cards, this might include the party's annual income, existing debts, whether they rent or own a home, etc. A standard formula is applied to the information to produce a number, which is called a credit score. Based upon the credit score, the lending institution will decide whether or not to extend credit. The process is formulaic and highly standardized.

Many forms of credit risk, especially those associated with larger institutional counterparties are complicated, unique or are of such a nature that it is worth assessing them in a less formulaic manner. The term credit analysis is used to describe any process for assessing the credit quality of counterparty. While the term can encompass credit scoring, it is more commonly used to refer to processes that entail human judgment. One or more people, called credit analysts, will review information about the counterparty. This might include its balance sheet, income statement, recent trends in its industry, the current economic environment, etc.

They may also assess the exact nature of an obligation. For example, secured debt generally has higher credit quality than subordinated debt of the same issuer. Based upon their analysis, they assign the counterparty (or the specific obligation) a credit rating, which can be used for making credit decisions.

Many banks, investment managers and insurance companies hire their own credit analysts who prepare credit ratings for internal use. Other firms including Standard and Poor's, Moody's and Fitch are in the business of developing credit ratings for use by investors or other third parties. Institutions that have publicly traded debt hire one or more of them to prepare credit ratings for their debt. Those credit ratings are then distributed for little or no charge to investors. Some regulators also develop credit ratings. In the United States, the National Association of Insurance Commissioners publishes credit ratings that are used for calculating capital charges for bond portfolios held by insurance companies.

The manner in which credit exposure is assessed is highly dependent on the nature of the obligation. If a bank has loaned money to a firm, the bank might calculate its credit exposure as the outstanding balance on the loan. Suppose instead that the bank has extended a line of credit to a firm, but none of the line has yet been drawn down. The immediate credit exposure is zero, but this doesn't reflect the fact that the firm has the right to draw on the line of credit. Indeed, if the firm gets into financial distress, it can be expected to draw down on the credit line prior to any bankruptcy. A simple solution is for the bank to consider its credit exposure to be equal to the total line of credit. However, this may overstate the credit exposure. Another approach would be to calculate the credit exposure as being some fraction of the total line of credit, with the fraction determined based upon an analysis of prior experience with similar credits.

Derivative instruments represent contingent obligations, so they entail credit risk. While it is possible to measure the mark-to-market credit exposure of

derivatives based upon their current market values, this metric provides an incomplete picture. For example, many derivatives, such as forwards or swaps, have a market value of zero when they are first entered into. Mark-to-market exposure which is based only on current market values does not capture the potential for market values to increase over time. For that purposes some probabilistic metric of potential credit exposure must be used.

There are many ways that credit risk can be managed or mitigated. The first line of defense is the use of credit scoring or credit analysis to avoid extending credit to parties that entail excessive credit risk. Credit risk limits are widely used. These generally specify the maximum exposure a firm is willing to take to counterparty. Industry limits or country limits may also be established to limit the sum credit exposure a firm is willing to take to counterparties in a particular industry or country. Calculation of exposure under such limits requires some form of credit risk modelling. Transactions may be structured to include collateralization or various credit enhancements. Credit risks can be hedged with credit derivatives. Finally, firms can hold capital against outstanding credit exposures.

5.4.2 Legal risk

Legal risk is risk from uncertainty due to legal actions or uncertainty in the applicability or interpretation of contracts, laws or regulations. Depending on an institution's circumstances, legal risk may entail such issues as:

(a) **Contract formation:** What constitutes a legitimate contract? Is an oral agreement sufficient, or must there be a legal document?

(b) **Capacity:** Does counterparty have the capacity to enter into a transaction? For example, in 1992, the United Kingdom's House of Lords determined that the London Borough of Hammersmith and Fulham lacked capacity to transact in derivatives linked to interest rates. Not only were contracts

dating back to the mid-1980s with the borough declared void, but contracts with over 130 other councils were effectively invalidated. A number of derivatives dealers suffered losses.

(c) **Legality of derivatives transactions:** In some jurisdictions there are issues relating to whether certain derivatives could be deemed gambling contracts and thus made unenforceable. This was a significant concern during the early days of OTC (Over The Counter) derivatives markets.

(d) **Perfection of an interest in collateral:** A claim is perfected if it is senior to any existing or future third-party claims in the event of bankruptcy. A perfected interest represents a lien on collateral. Requirements to perfect a claim can be complex and vary by both jurisdiction and the nature of the collateral.

(e) **Netting agreements:** Under what circumstances will a closeout netting agreement be enforceable?

(f) **Contract frustration:** Might unforeseen circumstances in validate a contract? For example, if a contract is linked to an index or currency that ceases to exist, will the contract become invalid ?

Legal risk can be a particular problem for institutions who transact business across borders. Not only are they exposed to uncertainty relating to the laws of multiple jurisdictions, but they also face uncertainty as to which jurisdiction will have authority over any particular legal issue.

5.4.3 Liquidity risk

Liquidity risk is a financial risk due to uncertain liquidity. An institution might lose liquidity if its credit rating falls, it experiences sudden, unexpected cash outflows, or some other event causes counterparties to avoid trading with or lending

to the institution. A firm is also exposed to liquidity risk if markets on which it depends are subject to loss of liquidity.

Liquidity risk tends to compound other risks. If a trading organization has position in an illiquid asset, its limited ability to liquidate that position at short notice will compound its market risk. Suppose a firm has offsetting cash flows with two different counterparties on a given day. If the counterparty that owes it a payment defaults the firm will have to raise cash from other sources to make its payment. Should it be unable to do so, it too is default. Here, liquidity risk is compounding credit risk.

Obviously, a position can be hedged against market risk but still entail liquidity risk. This is true in the above credit risk example the two payments are offsetting, so they entail credit risk but not market risk. Another example is the 1993 Metallgesellschaft Debacle. Futures were used to hedge an OTC obligation. It is debatable whether the hedge was effective from a market risk standpoint, but it was the liquidity crisis caused by staggering margin calls on the futures that forced Metallgescellschaft to unwind the positions.

Accordingly, liquidity risk has to be managed in addition to market, credit and other risks. Because of its tendency to compound other risks, it is difficult or impossible to isolate liquidity risk. In all but the most simple of circumstances, comprehensive metrics of liquidity risk don't exist. Certain techniques of asset-liability management can be applied to assessing liquidity risk. A simple test for liquidity risk is to look at future net cash flows on a day-by-day basis. Any day that has a sizeable negative net cash flow is of concern. Such an analysis can be supplemented with stress testing. Look at net cash flows on a day-to-day basis assuming that an important counterparty defaults.

Obviously, such analyses cannot take into account contingent cash flows, such as cash flows from derivatives or mortgage-backed securities. If an

organization's cash flows are largely contingent, liquidity risk may be assessed using some form of scenario analysis. Construct multiple scenarios for market movements and defaults over a given period of time. Assess day-to-day cash flows under each scenario. Because balance sheets differed so significantly from one organization to the next, there is little standardization in how such analyses are implemented. Regulators are primarily concerned about systemic implications of liquidity risk.

5.4.4 Market risk

Business activities entail a variety of risk. For convenience, we distinguish between different categories of risk: market risk, credit risk, liquidity risk, etc. Although such categorization is convenient, it is only informal. Usage and definitions vary. Boundaries between categories are blurred. A loss due to widening credit spreads may reasonably be called a market loss or a credit loss, so market risk and credit risk overlap. Liquidity risk compounds other risks, such as market risk and credit risk. It cannot be divorced from the risks it compounds.

An important but somewhat ambiguous distinguish is that between market risk and business risk. Market risk is exposure to the uncertain market value of a portfolio. A trader holds a portfolio of commodity forwards. She knows what its market value is today, but she is uncertain as to its market value a week from today. She faces market risk. Business risk is exposure to uncertainty in economic value that cannot be market risk. Business risk is exposure to uncertainty in economic value that cannot be market-to-market. The distinction between market risk and business risk parallels the distinction between market-value accounting and book-value accounting. Suppose a New England electricity wholesaler is long a forward contract for on-peak electricity delivered over the next 3 months. There is an active forward market for such electricity, so the contract can be marked to market daily. Daily profits and losses on the contract reflect market risk. Suppose

the firm also owns a power plant with an expected useful life of 30 years. Power plants change hands infrequently, and electricity forward curves don't exist out to 30 years. The plant cannot be marked to market on a regular basis. In the absence of market values, market risk is not a meaningful notion. Uncertainty in the economic value of the power plant represents business risk.

The distinction between market risk and business risk is ambiguous because there is a vast "gray zone" between the two. There are many instruments for which markets exist, but the markets are illiquid. Mark-to-market values are not usually available, but mark-to-model values provide a more-or-less accurate reflection of fair value. Do these instruments pose business risk or market risk? The decision is important because firms employ fundamentally different techniques for managing the two risks.

Business risk is managed with a long-term focus. Techniques include the careful development of business plans and appropriate management oversight. Book-value accounting is generally used, so the issue of day-to-day performance is not material. The focus is on achieving a good return on investment over an extended horizon.

Market risk is managed with a short-term focus. Long-term losses are avoided by avoiding losses from one day to the next. On a tactical level, traders and portfolio managers employ a variety of risk metrics duration and convexity, the Greeks, beta etc. to assess their exposures. These allow them to identify and reduce any exposures they might consider excessive. On a more strategic level, organizations manage market risk by applying risk limits to traders' or portfolio managers' activities. Increasingly, value-at-risk is being used to define and monitor these limits. Some organizations also apply stress testing to their portfolios.

5.4.5 Operational risk

During the 1990s, financial firms and other corporations focused increasing attention on the emerging field of financial risk management. This was motivated by concerns about the risks posed by the rapidly growing OTC derivatives markets; a spat of publicized financial losses, including those of Barings Bank, Orange Country and Metallgesellschaft; regulatory initiatives, especially the Basle Accord.

During the early part of the decade, much of the focus was on techniques for measuring and managing market risk. As the decade progressed, this shifted to techniques of measuring and managing portfolio credit risk. By the end of the decade, firms and regulators were increasingly focusing on risks "other than market and credit risk." These came to be collectively called operational risks. This catch-all category of risks was understood to include, employee errors, systems failures, fire, floods or other losses to physical assets, fraud or other criminal activity. Firms had always managed these risks in various ways. The new goal was to do so in a more systematic manner. The approach would parallel and be integrated with those that were proving effective with market risk and credit risk.

The task appeared daunting. Financial institutions and regulators had to dedicate considerable resources to managing market risk and credit risk, and those were well-known, narrowly-defined risks. Operational risk was anything but well defined. People disagreed about the specific contingencies that should be considered operational risks should legal risks, tax risks, management incompetence or reputational risks be included? The debate was more than academic. It would shape the scope of initiatives to manage operational risk.

Another problem was that operational contingencies don't always fall into near categories. Losses can result from a complex confluence of events, which makes it difficult to predict or model contingencies. In 1996, the Credit Lyonnais trading floor was destroyed by fire. This might be categorized as a loss due to fire.

It might also be categorized as a loss due to fraud investigators suspect employees deliberately set the fire in order to destroy evidence of fraud.

There was considerable debate about the extent to which opertional risks should be assessed with qualitative or quantitative means. Market risks are generally assessed quantitatively with tools such as value-at-risk. Credit risk is assessed with a combination of quantitative and qualitative means. Quantitative models are employed for such things as projecting potential credit exposure, assessing portfolio credit risk or assigning credit scores. Still, the process of assessing corporate credit quality retains qualitative elements. For operational risk, certain contingencies are particularly amenable to quantitative techniques. For example, settlement errors in a trading operation's back office happen with sufficient regularity that they can be modelled statistically. Other contingencies affect financial institutions infrequently and are of a non-uniform nature which makes modelling difficult. Examples include acts of terrorism, natural disasters and trader fraud.

Working to define the Basle II accord, regulators made considerable progress in designing a framework for managing operational risk. This was reported in a consultative document (2001). Researchers and financial institutions pursued initiatives. Techniques were borrowed from fields such as actuarial science and engineering reliability analysis. By 2002, a general framework for assessing and managing operational risk was emerging. Much work remains to be done, and operational risk management will never be standardized to the extent to which market risk and credit risk management are only because of the differences between financial institutions. However, general conclusions can be drawn.

The Basle Committee defines operational risk as the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition has been widely adopted in the literature, either precisely or with slightly different wording. Each institution must interpret

the definition in light of its own business lines, procedures and systems. Each institution must identify the specific operational contingencies it is exposed to.

Most operational risks are best managed within the departments in which they arise. Information technology professionals are best suited for addressing systems-related risks. Back office staffs are best suited to address settlement risks, etc. However, overall planning, coordination, and monitoring should be provided by a centralized operational risk management department. This should closely coordinate with market risk and credit risk management departments within an overall enterprise risk management framework. Contingencies broadly fall into two categories: (a) those that occur frequently and entail modest losses; and (b) those that occur infrequently but may entail substantial losses. Both can and should be assessed using qualitative techniques such as management oversight, employee questionnaires, exit interviews, management self-assessment, and internal audit. Both can also be assessed using quantitative techniques. Contingencies of an infrequent but potentially catastrophic nature can, to some extent, be modelled using techniques developed for property and casualty insurance. However, contingencies that arise more frequently are more amendable to statistical analysis.

Statistical modelling requires data. For operational contingencies, two forms of data are useful: data on historical loss events, and data on risk indicators. Loss events run the gamut— settlement errors, systems failures, petty fraud, customer lawsuits, etc. Losses may be direct (as in the case of theft) or indirect (as in the case of damage to the institution's reputation). There are three ways data on loss events can be categorized: cause, event and consequence. For example, an event might be a mis-entered trade. The cause might be inadequate training, a systems problem or employee fatigue. Consequences might include a market loss, fees paid to counterparty, a lawsuit or damage to the firm's reputation. Any event may have multiple causes or consequences. Tracking all three dimensions of loss events facilitates the construction of event matrices, identifying the frequency with which

certain causes are associated with specific events and consequences. Even with no further analysis, such matrices can identify for management areas for improvement in procedures, training, staffing, etc.

Risk indicators differ from loss events. They are not associated with specific losses, but indicate the general level of operational risk. Examples of risk indicators a firm might tract are: amount of overtime being performed by back-office staff, staffing levels, daily transaction volumes, employee turnover rates, and systems downtime. From a modelling standpoint, the goal is to find relationships between specific risk indicators and corresponding rates of loss events. If such relationships can be identified, then risk indicators can be used to identify periods of elevated operational risk.

Once operational risks have been qualitatively or quantitatively assessed, the next steps to somehow manage them. Solutions may attempt to avoid certain risks, accept others, but attempt to mitigate their consequences, or simply accept some risks. Specific techniques might include: employee training, close managements oversight, segregation of duties, purchase of insurance, employee background checks, exiting certain businesses, etc. Choice of techniques will depend upon a cost-benefit analysis.

Inevitably, some risks are unavoidable or, from a cost-benefit standpoint, are worth taking. These should be capitalized, so another step in operational risk management is the calculation of reasonable capital charges. Many financial institutions are incorporating operational risk capital charges into their capital allocation systems.

5.4.6 Model risk

Because institutions rely heavily on models for pricing financial transactions or monitoring risks, they are exposed to model risk. This is the risk that models are

applied to tasks for which they are inappropriate or are otherwise implemented incorrectly. Examples of model risk include: A bank uses a value at risk (VAR) to monitor market risk. When the VAR measure was implemented, the bank's traders took little spread risk. It was coded with a fixed spread assumption. Since that time, the traders have started taking significant spread risk but do not realize that the model is failing to capture it. Option pricing models incorporate a risk-neutral assumption. Such models may produce erroneous results if used to measure risk or other quantities that depend upon investor risk preferences. A brokerage firm is expanding its derivatives operation into South America. They fail to modify their pricing models to reflect the lack of liquidity in certain markets. Consequently, they underestimate the cost of hedging their positions. Model risks generally categorized as a form of operational risk.

5.5 RISK MANAGEMENT

Risk management, as it is understood today, largely emerged during the early 1990s, but the term 'risk management' was used long before this. Since the 1960s, it has frequently used to describe techniques for addressing insurable risks. This form of 'risk management' encompasses: risk reduction through safety, quality control and hazard education, alternative risk financing, including self-insurance and captive insurance, and the purchase of traditional insurance products, as suitable.

More recently, derivative dealers have promoted "risk management" as the use of derivatives to hedge or customize market-risk exposures. For this reason, derivative instruments are sometimes called 'risk management products'. The new "risk management" that evolved during the 1990s is different from either of the earlier forms. It views derivatives as a problem as much as a solution. It focuses on reporting, oversight and segregation of duties within organizations.

Risk management or financial risk management, should want to distinguish it from other uses of the word**. It can be defined as practices by which a firm optimizes the manner in which it takes financial risk.** It includes monitoring of risk taking activities, upholding relevant policies and procedures, and distributing risk-related reports.

Note that risk management is not about optimizing risk in some sense. That is the province of the board of directors and senior management, perhaps working with more tactical risk takers such as traders or portfolio managers. No, risk management is about optimizing the manner in which risk is taken. Accordingly risk management is not about managing anything. It is really about facilitating.

A related concept is enterprise risk management, which is the extension of financial risk management, in some sense, to non-financial contingencies. It is somewhat elusive concept that means different things to different people. Firms have experimented with the concept, combining financial risk management, insurance purchasing, and contingency planning into a single business unit. A challenge has been the culture clash between the worlds of finance and insurance. Few professionals are expert in both.

Organizationally, financial risk management is implemented in different ways. There may be, within the board of directors, a risk committee. Usually, there is some sort of risk oversight committee, comprising senior managers. In practice, various names are given to these two committees. A senior manager called the head of risk management or chief risk officer (CRO), reports to the risk oversight committee. This head of risk management may oversee a single department called the risk management department. Professionals working within that department, called risk managers, are responsible for facilitating the taking of applicable financial risks (market risks, credit risks and operational risks) by other departments within the firm. In larger organizations, there may be more specialization. The head of

risk management might oversee three professionals: a head of market risk management, a head of credit risk management and a head or operational risk management.

Each would oversee a respective department. Other arrangements are also possible. **Functionally, there are four aspects of financial risk management.** Success depends upon a positive corporate culture, actively observed policies and procedures, effective use of technology, independence of risk management professionals. These are discussed below:

5.5.1 Culture

It is a fact that an organization will only manage risk if its members want to manage risk. Regulators struggle with this every day. They can force a bank to implement a multi-million dollar value-at-risk system. They can require an insurance company to implement hundreds of pages of procedures. But they cannot force an institution to effectively manage risk.

It is individuals who decide whether or not they are going to manage organizational risk. Unfortunately, there is a big incentive for them to choose not to. The very sorts of behaviour which reduce organizational risk entail significant personal risk. For example: A clerk who blows the whistle on a trader may get the problem resolved, or he may end up without a job. A board member who wishes to expand the use of risk management must stick her neck out. At the risk of appearing alarmist, she must suggest that potentially significant problems are not currently being addressed. A trader whose compensation depends primarily upon his reputation in the organization, can only manage risk if he first acknowledges that he is capable of making mistakes. An executive who wishes to address the risk of employee fraud may risk alienating his own colleagues.

Risk management is about rocking the boat, asking questions and challenging the establishment. No one can manage risk if they are not prepared to take risk. While individual initiative is critical, it is corporate culture that facilitates the process. Corporate culture defines what behaviour the members of an organization will condone and what behaviour they will shun. Corporate culture plays a critical role in risk management because it defines the risks which an individual must personally take if they are going to help managing organizational risks. A positive risk culture is one which promotes individual responsibility and is supportive of risk taking.

Characteristics of Positive Risk Management include :

(i) Individuals making decisions: Group decision making can be ineffective if no one is personally accountable. When a single person makes a decision possibly with the help or approval of others that individual is accountable. His reputation is on the line, so he will carefully analyze the issues before proposing a course of action.

(ii) Questioning: In a positive risk culture, people question everything. Not only does this identify better ways to do things. It also ensures that people understand and appreciate procedures.

(iii) Admissions of ignorance: Mark Twain once said, "I was gratified to be able to answer promptly. I said I don't know." Admitting that we don't know entails significant personal risk. A positive risk culture supports such honesty at every level of an organization. No risk culture is perfect. Fortunately, few are beyond repair. The challenge of risk management is to honestly assess an organization's culture, and then work to improve it.

5.5.2 Policies and procedures

When you mention policies and procedures, people are likely to roll their eyes, as thoughts of red tape and bureaucracy flood their thoughts. This is

unfortunate. Used correctly, procedures are a powerful tool of risk management. The purpose of policies and procedures is to empower people. They specify how people can accomplish what needs to be done. It is only when policies and procedures are neglected or abused that they become an impediment.

The success of policies and procedures depends critically upon a positive risk culture. Hundreds of pages of procedures, neatly printed and sitting on a shelf, are useless if no one uses them. However, even a simple set of procedures can make an enormous difference for an organization if people believe in them and take personal responsibility for upholding them. Procedures systematize the process of risk management. Consider market risk limits. These are a form of procedure which systematize oversight of market risk. They make explicit how much risk is too much risk for any given segment of a portfolio.

Without risk limits, someone would have to track the risks being taken by individual traders and apply their own subjective judgement as to how much is too much. Should they decide to act on their subjective judgement that a trader is taking too much risk, the affected trader may reasonably feel that the decision is arbitrary or unfair. He might ask: "what about the market opportunity I was pursuing or the client whose needs I was trying to meet?"

Whenever procedures do not exist, there is increased potential for disagreement, misunderstanding and conflict. A lack of procedures increases the personal risk that individuals must take if they are going to manage organizational risk. Accordingly, a lack of procedures tends to promote inaction. Effective procedures, on the other hand, empower people. They lay out specifically what people should do and what they should not do in a given situation.

Examples of procedures include :

(i) **Board procedures:** Every board of directors or governing body should operate under a set of procedures which address conflicts of interest, clarify

personal responsibility and facilitate the discussion and resolution of difficult or contentious issues.

(ii) **Lines of reporting:** Everyone in an organization should report to a single person. The line of reporting should be explicit. A worthwhile illustration for this is the Bank of England's report on the Barings collapse. That report identifies four different people who may have had oversight responsibility for Nick Leeson.

(iii) **Trading authority:** Whenever an organization engages in a new form of market activity such as the use of a new form of transaction, a new hedging strategy or proprietary trading, there should first be a formal review and approval process. A streamlined procedure should apply for granting new responsibility to any trader.

(iv) **Risk limits:** Market and credit risk limits represent procedures for managing risk. There should also be procedures for establishing and reviewing such limits in order to assure that the system of limits remains effective.

An organization should have formal procedures for changing policies or procedures. Experienced risk managers know that proposals for an informal or hasty change to procedures sometimes indicate an effort to cover up something that existing procedures would otherwise highlight. Also, because procedures become outdated over time, it is easy for organizations to change how they operate without formally recognizing that the change is taking place. Informal practices evolve out of habit, instead of by a deliberate process. Because they may be adopted out of necessity or convenience without considering how they impact organizational risk. They, too, are a source of risk.

Often, periods of change are a time of increased risk for an organization. Procedures for changing policies or procedures are an excellent mechanism that

encourages people to recognize changes as they are taking place and formally address the risks that they pose.

5.5.3 Technology

The primary role technology plays in risk management is risk assessment and communication. Technology is employed to quantify or otherwise summarize risks as they are being taken. It then communicates this information to decision-makers, as appropriate. Technology might include a VAR system or portfolio credit risk system. It can include financial engineering technology for independently marking to market positions. It may include an interactive risk report that is electronically circulated to managers every day. For many institutions, such as banks or securities firms, technology is a critical component of risk management. For other organizations, including some non-financial corporations or pension plans, technology plays a lesser role.

For institutions, which rely heavily on technology, there is always a risk of the cart being placed before the horse, with technology becoming the focus of risk management. If an organization launches a risk management initiatives by first allocating money to the project and then issuing a request for proposal, that can be a warning sign. A more staged approach starts off by recognizing that risk management is primarily about people, how they think and how they interact with one another. Technology is just a tool. In the wrong hands, it is worse than useless, but applied appropriately, it can transform an organization.

A good approach for implementing an enterprise risk management is to allocate minimal funding for the initiative, but ensure that board members or senior management or other supervisors are involved in the process. Start by planning a risk management strategy that involves no technology at all. This can be an empowering exercise. It focuses participants on the procedural and cultural issues of risk management. Ultimately, it is these which determine the success of an

initiative. Once you have decided on a strategy for managing risk, and then determine where technology needs to be incorporated or where it can enhance the strategy.

5.5.4 Independence

For risk management to succeed, risk managers must be independent of risk taking functions within the organization. Holton (2004) defines independence as comprising the following four criteria: Risk managers have reporting lines that are independent from those of risk taking functions. Except at the highest levels, risk takers have no input on the performance reviews, compensation or promotion of risk managers, and conversely. Employees cannot switch from one role to the other. Those hired into risk management stay in risk management; those hired as risk takers stay as risk takers. Risk managers do not take risk on the firm's behalf. They do not advise on which risks to take. They express no opinions about the desirability of any particular risks.

The first three items are straightforward. The fourth is more subtle or perhaps, controversial. It speaks to the very heart of what constitutes risk management. Let's briefly address the first three items and then proceed to the question: what is the role of risk management, anyway? Enron's experience with risk management is instructive. The firm maintained a risk management function staffed with capable employees. Lines of reporting were reasonably independent in theory, but less so in practice. The group's mark-to-market valuations were subject to adjustment by management. The group had few career risk managers. Enron maintained a fluid workforce. Employees were constantly on the lookout for their next internal transfer. Those who rotated through risk management were no different. A trader or structure whose deal a risk manager scrutinized one day might be in a position to offer that risk manager a new position the next. Astute risk managers were careful to not burn bridges. Even worse, risk managers were subject to Enron's "rank and yank" system of performance review. Under that system,

anyone could contribute feedback on anyone, and the consequences of a bad review were draconian. Of the above four criteria for independence, Enron was weak on the first but utterly failed to satisfy the second two. Despite the sophistication of individual employees, risk management at Enron was hollow.

Proceeding now to the fourth criteria for independence, we want to distinguish between risk taking and risk management. Within firms, there are strategic and tactical risk takers. The CEO and other senior managers are strategic risk takers. They formulate a strategy for the firm that entails taking certain risks. They communicate the strategy to tactical risk takers including traders, structures, and asset managers whose job it is to implement that strategy. This is how business has operated for hundreds of years, so where do risk managers fit in? While not typically acknowledged, there are two competing models.

According to one model, strategic and tactical risk takers need help taking risk. Under this theory, super risk takers and risk managers are required to intervene. They identify risks that should be avoided and, in doing so, risks that should be taken. In this manner, risk managers help the less qualified strategic and tactical risk takers do their jobs.

There is much wrong with this model. First, it is redundant. If strategic or tactical risk takers are not capable of doing their jobs, the answer is not to hire a super risk taker to do it for them. Rather, it is to replace them with strategic and tactical risk takers who are up to the task. Second, it undermines accountability. If a trade turns sour, is the trader at fault, or is the risk manager who failed to block the deal? Third, it leads to conflict. While strategic risk takers will never feel threatened that a super risk taker might usurp their prerogatives, tactical risk takers often do. At some firms, the result has been a cold war between the front and middle offices. Finally, risk managers are positioned to be used as scapegoats. With corporate scandals fresh in memory, one can understand why some senior

executives may be all too happy ascribing full responsibility for risk taking to a chief risk officer. With this model, risk management can become a device for executives to manage career risk as opposed to a device for managing corporate risk.

The alternative model is that risk managers are facilitators. Strategic and tactical risk takers are responsible for deciding what risks to take. Risk managers facilitate the process by ensuring effective communication between the two groups. They help strategic risk takers communicate through policies, procedures and risk limits. They help tactical risk takers communicate by preparing risk reports that describe the risks they are taking. To avoid the pitfalls of the risk-managers as super-risk-takers model, risk managers must have no authority to take risk on the firm's behalf. They do not advise on risk taking issues because, if their advice is routinely followed, they will become de facto risk takers. To avoid the semblance of giving advice, they express no opinions about the desirability of taking any particular risks. It is one thing for a risk manager to measure risk. It is entirely another for the risk manager to express an opinion that the risk is too large or otherwise not worth taking. With risk managers not expressing opinions, tactical risk takers don't feel threatened. So there is no cold war. With risk managers not responsible for taking risks, there is little possibility of shifting lame to them when things go wrong.

5.6 SUMMARY

Risk has two components namely uncertainty and exposure. If both are not present, there is no risk. There are six types of risk. Credit risk is the risk due to uncertainty in counterparty's ability to meet its obligations. Credit analysis is used to describe any process for assessing the credit quality of counterparty. Legal risk can be a particular problem for institutions who transact business across borders. A firm is exposed to liquidity risk if markets on which it depends are subject to loss

of liquidity. Market risk is exposure to the uncertain market value of a portfolio. Most operational risks are managed within the departments in which they arise. Four aspects of financial risk management are positive corporate culture, actively observed policies and procedures, efficient use of technology and independence of risk management professionals.

5.7 GLOSSARY

- **Credit risk:** It is the risk due to uncertainty in a creditor's ability to meet its obligations.
- **Legal risk:** It is the risk from uncertainty due to legal actions or uncertainty in the applicability or interpretation of contracts, laws or regulations.
- **Liquidity risk:** Liquidity risk is the financial risk due to uncertain liquidity.
- **Market risk:** Market risk is exposure to the uncertain marked value of a portfolio.
- **Operational risk:** Operational risk is the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events.
- **Risk management:** It includes monitoring of risk taking activities, upholding relevant policies and procedures, and distributing risk-related reports.

5.8 SELF ASSESSMENT QUESTIONS

Q1. What is risk ?

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Q2. What is credit risk ?

Q3. What is legal risk?

Q4. What is liquidity risk?

Q5. What is market risk?

Q6. What is operational risk?

Q7. What is model risk?

Q8. What is positive risk management?

5.9 LESSON END EXERCISE

Q1. Explain various types of risk.

Q2. In assessing the credit risk, what factors should be kept in mind? Discuss.

Q3. Explain risk management?

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Q4. Explain the policies and procedures of risk management?

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Q5. Explain the different aspects of financial risk management.

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5.10 SUGGESTED READINGS

1. Bhatia, B.S., and Batra, G.S., Financial Services, Deep & Deep Publishers, New Delhi.

2. Bansal, L.K., Merchant Banking and Financial Services, Unistar Books Pvt. Ltd., Chandigarh.

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5. Kothari, C.R., Investment Banking and Customer Service, Arihand Publishers, Jaipur.

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UNIT-II **LESSON NO. 6**

BANKING AND INSURANCE

INTRODUCTION TO BANKING

STRUCTURE

6.1 Introduction

6.2 Objectives

6.3 Meaning and Definition of a Bank

6.4 Types of Banks

- 6.4.1 On the basis of Reserve Bank Schedule
  - 6.4.1.1 Schedules Banks and
  - 6.4.1.2 Non-scheduled Banks
- 6.4.2 On the basis of ownership
  - 6.4.2.1 Public Sector Banks;
  - 6.4.2.2 Private Sector Banks;
  - 6.4.2.3 Cooperative Banks
- 6.4.3 On the basis of domicile

6.4.3.1 Domestic Banks

6.4.3.2 Foreign Banks

6.4.4 On the basis of functions

6.4.4.1 Commercial Banks

6.4.4.2 Industrial Banks

6.4.4.3 Agricultural Banks

6.4.4.4 Exchange Banks

6.4.4.5 Central Bank

6.5 Functions of Commercial Banks

6.5.1 Basic Functions

6.5.1.1 Accepting Deposits,

6.5.1.2 Advancing of Loans and

6.5.1.3 Credit Creation

6.5.2 Agency Functions

6.5.3 General Utility Functions

6.6 Summary

6.7 Glossary

6.8 Self Assessment Questions

6.9 Lesson End Exercise

6.10 Suggested Readings

6.1 INTRODUCTION

As for the origin of the present banking system in the world is concerned, the first bank called the "Bank of Venice" is believed to be established in Italy in the year 1157. The first bank in India was started in the year 1770 by the Alexander & Co., an English Agency as "Bank of Hindustan" which failed in 1782 due to the closure of the Agency House in India. The first bank in the modern sense was established in the Bengal Presidency as "Bank of Bengal" in the year 1806.

According to G. Crowther the modern banking has three ancestors in the history of banking in this world :

(i) The Merchants

(ii) The Goldsmiths

(iii) The Money Lenders

(i) The Merchants: It were the merchants who first evolved the system of banking as the trading activities required remittances of money from one place to another place which is one of the important functions of a bank even now. Because of the possibility of theft of money during physical transportation of money, the traders began to issue the documents which were taken as titles of money. This system gave rise to the institution of "Hundi" which means a letter of transfer whereby a merchant directs another merchant to pay the bearer of Hundi the specified amount of money in the Hundi and debit this amount against the drawer of Hundi.

(ii) The Goldsmiths: The second stage in the growth of banking was the role of goldsmiths. The business of goldsmiths was such that he had to secure safe to protect the gold against theft and take special precautions. In a period when paper was not in circulation and the money consisted of gold

and silver, the people started leaving their precious bullion and coins in the custody of goldsmiths. As this practice spread, the goldsmiths started charging something for taking care of the gold and silver. As the evidence of receiving valuables, he stared to issue a receipt. Since the gold and silver coins had no mark of the owners, the goldsmiths started lending them. The goldsmiths were prepared to issue an equal amount of gold or silver money to the receipt holder, the goldsmith receipts became like cheques as a medium of exchange and a means of payment by one merchant to the other merchant.

(iii) **The money lenders:** The third stage in the growth of banking system is the changing of the character of goldsmiths into that of the money lenders. With the passing of time and on the basis of experience the goldsmiths found that the withdrawals of coins were much less than the deposits with them and it was not necessary to hold the whole of the coins with them. After keeping the contingency reserve, the goldsmiths started advancing the coins on loan by charging interest. In this way the goldsmith money lender became a banker who started performing two important functions of the modern banking system that of accepting deposits and advancing loans. The only difference is that now it is the paper money and then it was gold or silver coins.

6.2 OBJECTIVES

After reading this lesson, you should be able to understand:

- the meaning and definition of bank;
- types of banks; and
- functions of commercial banks.

6.3 MEANING AND DEFINITION OF A BANK

It is very difficult to giver a precise definition of a bank due to the fact that a modern bank performs a variety of functions. Ordinarily a 'Bank' is an institution which deals with the money and credit in such a manner that it accepts deposits from the public and makes the surplus funds available to those who need them, and helps in remitting money from one place to another safely. Different economists have given different definition of a bank. Some of the important definitions are as under:

"A bank collects money from those who have it to spare or who are saving it out of their incomes, and it lends this money to those who require it." **G.Crother**

"Banking means the accepting for the purpose of Indian companies lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft or otherwise."

The Banking Companies (Regulation) Act, 1949.

An ideal definition of a bank can be given as under:

"A bank is a commercial establishment which deals in debts and aims at earning profits by accepting deposits from general public at large, which is repayable on demand or otherwise through cheques or bank drafts and otherwise which are used for lending to the borrowers or invested in Government securities."

6.4 TYPES OF BANKS

Banks are of various types and can be classified:

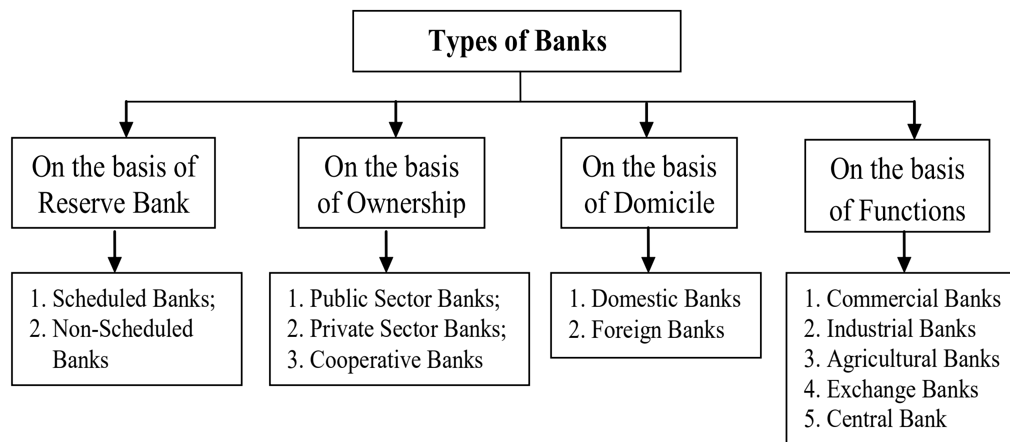
1. On the basis of Reserve Bank Schedule.

2. On the basis of ownership.

3. On the basis of domicile.

4. On the basis of functions.

Chart 6.1 Types of Banks



6.4.1 On the basis of Reserve Bank Schedule

Bank can be of the following two types on the basis of Second Schedule of the Reserve Bank of India Act, 1934:

(i) Schedules Banks and

(ii) Non-scheduled Banks

6.4.1.1 Scheduled Banks: All those banks which are included in the list of Schedule Second of the Reserve Bank of India are called the Scheduled Bank. Only those banks are included in the list of scheduled banks which satisfy the following conditions :

(a) That it must have a paid up capital and reserves of Rs. 5 lakhs.

(b) That it must ensure the Reserve Bank that its operations are not detrimental to the interest of the depositors.

(c) That it must be a corporation or a cooperative society and not a single owner firm or a partnership firm.

6.4.1.2 Non-scheduled Banks: The banks which are not included in the second schedule of the Reserve Bank of India Act, 1934 are called non-scheduled banks. They are not included in the second schedule because they do not fulfill the three pre-conditions laid down in the act to qualify for the induction in the second schedule.

6.4.2 On the basis of Ownership

Banks can be classified on the basis of ownership in the following categories:

(i) Public Sector Banks

(ii) Private Sector Banks

(iii) Cooperative Banks

6.4.2.1 Public Sector Banks: The banks which are owned or controlled by the Government are called "Public Sector Banks". In 1955 the first public sector commercial bank was established by passing a special Act of Parliament which is known as State Bank of India. Subsequently the Government took over the majority of shares of other State Banks which were operating at the state levels namely State Bank of Patiala, State Bank of Bikaner & Jaipur, State bank of Travancore, State Bank of Mysore, State Bank of Indore, State Bank of Saurashtra and State Bank of Hyderabad presently working as subsidiaries of State Bank of India.

In the field of banking, the expansion of public sector was marked with the nationalization of 14 major commercial banks by Mrs. Indira Gandhi on July 19, 1969 through an ordinance. Again on April 15, 1980 another group of 6 commercial

banks were nationalized with the deposits Rs. 200 crores each, resulting in the total of 20 such banks. But due to the merger of New Bank of India with the Punjab National Bank in 1993-94, the number of nationalized bank has been reduced to 19. The State Bank of India and its seven subsidiaries had already been nationalized. The progressive nationalization of bank has increased the role of public sector banking in the country. In 1996 these nationalized commercial banks had 31,055 branches all over India whereas State Bank of India and its subsidiaries alone had 12,903 branches.

Under the new liberalization policy of the Government, The Oriental Bank of Commerce, State Bank of India, Corporation Bank, Bank of India and Bank of Baroda have offered their share to the general public and financial institutions and therefore these banks are no longer 100% owned by Government of India. Although majority of the shares is still with the Government, therefore these are still public sector banks.

6.4.2.2 Private Sector Banks: On the contrary Private Sector Banks are those banks which are owned and controlled by the private sector i.e. private individuals and corporations. The private sector played a strategic role in the growth of joint stock banks in India. In 1951 there were in all 566 private sector banks of which 92 banks were scheduled banks and the remaining 474 were non-scheduled banks. At the time there was not even a single public sector bank. With the nationalization of banks in 1969 and 1980 their role in commercial banking had declined considerably. Since then the number of private sector banks is decreasing and the number of public sector banks is increasing.

6.4.2.3 Co-operative Banks: The word "cooperative" stands for working together. Therefore cooperative banking means an institution which is established on the principle of cooperation dealing in ordinary banking business. Cooperative banks are special type of banks doing ordinary banking business in which the

members cooperate with each other for the promotion of their common economic interests.

Features of Cooperative Banking

(i) Membership of Cooperative Banks is voluntary.

(ii) Functions of a Cooperative Bank are common banking functions.

(iii) Organization and management of a Cooperative Bank is based on democratic principles.

(iv) Main objectives of a Cooperative bank are to promote economic, social and moral development of its members.

(v) Basic principle of Cooperative Bank is equality.

Therefore, we can conclude and define a cooperative bank as under:

"Cooperative Bank is an institution established on cooperative basis which deals in ordinary banking business for the promotion of economic, social and moral development of its members on the principle of equality."

The short term agriculture credit institutions cater to the short term financial needs of the agriculturists which have the following three tier federal structure in cooperative:

(a) At the Village level: Primary Agricultural Credit Societies

(b) At the District level: Central Cooperative Banks

(c) At the State level: State Cooperative Banks

6.4.3 On the basis of domicile

The banks can be classified into the following two categories on the basis of domicile :

(i) Domestic Banks

(ii) Foreign Banks

6.4.3.1 Domestic Banks: Those banks which are incorporated and registered in the India are called domestic banks.

6.4.3.2 Foreign Banks: Foreign Banks are those banks which are set up in a foreign country with their control and management in the hands of head office in their country of origin but having business branches in India. Foreign Banks are also known as Foreign Exchange Banks or Exchange Banks. Traditionally these banks were set up for financing the foreign trade in India and discounting the foreign exchange bills. But now these banks are also accepting deposits and making advances like other commercial banks in India

6.4.4 On the basis of functions

The banks can be classified on the basis of functions in the following categories :

(i) Commercial Banks

(ii) Industrial Banks

(iii) Agricultural Banks

(iv) Exchange Banks

(v) Central Bank

6.4.4.1 Commercial Banks: Commercial Banks are those banks which perform all kinds of banking business and functions like accepting deposits, advancing loans, credit creation, and agency functions for their customers. Since their major portion of the deposits are for the short period, they advance only short term and medium

term loans for business, trade and commerce. Majority of the commercial banks are in the public sector. Of late they have started giving long term loans also to compete in the commercial money market. These commercial banks are also called joint stock banks because they are constituted and organized in the same manner as the joint stock companies are constituted.

6.4.4.2 Industrial Banks: The Industrial banks are those banks which provide medium term and long term finance to the industries for the purchase of land and building, plant and machinery and other industrial equipment. They also underwrite the shares and debentures of the industries and also subscribe to them. The main functions of an Industrial Banks are as follows:

(i) They provide long term finance to the industries to purchase land and buildings, plantand machinery and construction of factory buildings.

(ii) They also accept long term deposits.

(iii) They underwrite the shares and debentures of the industry and sometimes subscribe to them.

In India there are number of financial institutions which perform the function of an Industrial Bank. Major financial institutions are as under:

(a) Industrial Development Bank of India (IDBI)

(b) Industrial Finance Corporation of India (IFCI)

(c) Industrial Credit and Investment Corporation of India (ICICI) and

(d) State Industrial Development Corporation such as Haryana State Industrial Development Corporation (HSIDC)

6.4.4.3 Agriculture Banks: The needs of agricultural credit are different from that of industry, business, trade and commerce. Commercial banks and industrial

banks do not deal with agriculture credit financing. An agriculturist has both types of needs :

(i) He requires short term credit to purchase seeds, fertilizers and other inputs and

(ii) He also requires long term credit to purchase land, to make permanent improvement on land, to purchase agricultural machinery and equipment such as tractors etc.

Agricultural credit is generally provided in India by the Cooperative institutions. The Cooperative Agricultural Credit Institutions are divided into two categories:

(a) Short term agricultural credit institutions and

(b) Long term agricultural credit institutions

(a) Short term agricultural credit institutions: The short term agricultural credit institutions cater to the short term financial needs of the agriculturists which have the following three tier federal structure:

- At the Village level: Primary Agricultural Credit Societies
- At the District level: Central Cooperative Banks
- At the State level: State Cooperative Banks

(b) Long term agricultural credit institutions: The long term agricultural credit is provided by the Land Development Banks which were earlier known as Land Mortgage Banks. The land development banks provide long term to agriculturists for a period ranging from 5 years to 25 years.

6.4.4.4 Exchange Banks: The exchange banks are those banks which deal in foreign exchange and specialised in financing the foreign trade. Therefore, they are

also called foreign exchange banks. Foreign Exchange Banks are those banks which are set up in a foreign country with their control and management in the hands of head office in their country of origin but having business branches in India.

6.4.4.5 Central Bank: The Central Bank is the apex bank of a country which controls, regulates and supervises the banking, monetary and credit system of the country. The Central Bank is owned and controlled by the Government of the country. The Reserve Bank of India is the Central Bank in India. The important functions of central bank are as follows:

(i) It acts as banker to the Government of the country.

(ii) It also acts as agent and financial advisor to the Government of the country.

(iii) It has the monopoly to issue currency of the country.

(iv) It serves as the lender of the last resort.

(v) It acts as the clearing house and keeps cash reserves of commercial banks.

6.5 FUNCTIONS OF COMMERCIAL BANKS

The Commercial Banks perform a variety of functions which can be divided in the following three categories:

1. Basic Functions
2. Agency Functions
3. General Utility Functions

6.5.1 Basic Functions

The basic functions of bank are those functions without performing which an institution cannot be called a banking institution at all. That is why these functions

are also called primary or acid test function of a bank. The basic/primary/acid test functions of a bank are:

(i) Accepting Deposits,

(ii) Advancing of Loans and

(iii) Credit Creation

6.5.1.1 Accepting Deposits: The first and the most important function of a bank is to accept deposits from those people who can save and spare for the safe custody with the bankers. It serves two purposes for the customers. On one hand their money is safe with the bank without any fear of theft and on the other hand they also earn interest as per the kind of saving they have made. For this purpose the banks have different kinds of deposit accounts to attract the people which are as under:

(a) Saving Deposit Account

(b) Fixed Deposit Account

(c) Current Deposit Account

(d) Recurring Deposit Account

(e) Home Loan Account

(a) Saving Deposit Account: The Saving Bank Account is the most common bank account being utilized by the general public. The basic purpose of this account is to mobilise the small savings of the general public. Certain restrictions are imposed on the depositors regarding the number of withdrawals and amount to be withdrawn in a given period of time. Generally the rate of interest paid by the bank on these deposits is low as compared to recurring or fixed deposit account.

Cheque facility is also provided to the depositors with certain extra restrictions on the depositors. One of the conditions is that the depositor shall have to maintain a minimum balance in the account say Rs.500 which is otherwise very low in the case of account without the facility of the cheque book, say Rs.20 only. Some service charges are also imposed if the depositor uses the cheque facility at large levels.

(b) **Fixed Deposit Account:** This is an account where money can be deposited for a fixed period of time say one year or two years or three years of five years and so on. Once the money is deposited for a fixed period of time, the depositor is prohibited from withdrawal of money from the bank before the expiry of the stipulated period of time. The basic advantage to be customer is that he is offered interest at the higher rate of interest and the banker is free to utilize the money for that fixed period.

But where a customer is in need of money in any contingency or emergency, the bank also has the facility to provide loan against the fixed deposit receipt at liberal terms and conditions. Even if a customer insist on the withdrawal of his money the fixed deposit receipt can also be encashed before the expiry of the stipulated period of time with the condition that the customer shall not be entitled to higher rate of interest, but the customer is allowed that rate of interest which is applicable on the saving deposit account as if the amount was deposited in the savings account.

(c) **Current Deposit Account:** In the savings bank account there are restrictions on the number of withdrawals that can be made in a day or a week or a month. Therefore it does not suit to the needs of traders and businessmen who has to make several payments daily and deposits money in a similar manner. Therefore, there is a facility for them in the shape of another account called Current Deposit Account. These accounts are

generally maintained by the traders and businessmen who have to make a number of payments every day. Money from this account can be withdrawn by the account holder as many times as desired by the customer. Normally bank does not pay any interest on these current accounts, rather some incidental charges are charged by the banker as service charges. These accounts are also called demand deposits or demand liabilities.

The facility of Over Drafts (O/D) is provided to the traders through these current accounts for which the banks charge interest on the outstanding balance of the customers. A limit is fixed by the bankers for withdrawal of over drafts and the customer is not allowed to withdraw more than that limit from his O/D current account. Say if a trader has an O/D limit of Rs. 1,00,000 with a bank, he can withdraw money upto Rs.1,00,000 from the bank without depositing any money with the bank. But he cannot withdraw more than Rs.1,00,000. He shall have to pay interest on such withdrawals.

(d) **Recurring Deposit Account:** To encourage regular savings by the general public, another account is opened in the banks called Recurring Deposit Account. This account is preferred by the fixed income group, because a particular amount fixed at the time of opening the account has to be deposited in the account every month for a stipulated period of time. Say Rs.500 per month for a period of three years. In this case the customer is bound to deposit Rs.500 per month regularly for a period of three years. Generally the bank pays rate of interest higher than that of a saving account and just equal to the fixed deposit account on such recurring deposit accounts.

The withdrawal of money is allowed only after the stipulated period of time along with the interest. Rather the account stands closed at the end of the stipulated period of time. In this case also the bank provides a facility to withdraw the money before the stipulated period of time in the case of any

emergency. The bank shall allow rate of interest which is applicable on saving bank account in case the customer want to close the account before then stipulated period of time.

(e) Home Loan Account: Home loan account facility has been introduced in some scheduled commercial banks to encourage savings for the purchasing of or construction of a house to live. In this account the customer is required to deposit a particular amount per month or half yearly or even yearly for a period of five years. After the stipulated period bank provide three to five times of the deposited amount a loan to the subscribers to purchase or construct a house. Rate of interest is also very attractive on this account nearly equal to that of the fixed deposit account. Even the rebate of Income Tax is also available on the amount contributed in this account under Section 88 of the Income Tax Act, 1961. Facility to close the account after the stipulated period of time is also allowed.

6.5.1.2 Advancing of Loans: Advancing of loans is the second acid test function of the commercial banks. After keeping certain cash reserves, the banks lend their deposits to the needy borrowers. It is one of the primary functions without which an institution can not be called a bank. The bank lends a certain percentage of the cash lying in the deposits on a higher rate of interest than it pays on such deposits. The longer the period for which the loan is required the higher is the rate of interest. Similarly higher the amount of loan, the higher shall be the rate of interest. Before advancing the loans the bank satisfy themselves about the credit worthiness of the borrowers. This is how a bank earns profits and carries on its banking business. There are various types of loans which are provided by the banks to the borrowers. Some of the important ways of advancing loans are as under:

(a) Call Money Advances

(b) Cash Credits

(c) Overdrafts

(d) Discounting Bills of Exchange

(e) Term Loans

(a) Call Money Advances: The Call Money Market which is also known as inter-bank call money market deals with very short period loans called call loans. The Call Money Market is a very important constituent of the organized money market which functions as an immediate source of very short term loans. The major suppliers of the funds in the call money market are All Commercial Banks, State Bank of India (SBI), Life Insurance Corporation of India (LIC), General Insurance Corporation (GIC), Unit Trust of India (UTI) and Industrial Development Bank of India (IDBI) and the major borrowers are the scheduled Commercial Banks. No collateral securities are required against these call money market loans.

As the participants are mostly banks, it is also called inter-bank call money market. The Scheduled Commercial Banks use their surplus funds to lend for very short period to the bill brokers. The bill brokers and dealers in the stock exchanges generally borrow money at call from the commercial banks. The bill brokers in turn use them to discount or purchase the bills. Such funds are borrowed at the call rate which varies with the volume of funds lent by the commercial banks. When the brokers are asked to pay off the loans immediately, then they borrow from SBI, LIC, GIC, and UTI etc. These loans are granted by the commercial banks for a very short period, not exceeding seven days in any case. The borrowers have to repay the loan immediately whenever the lender bank calls them back.

(b) Cash Credits: This is a type of loan which is provided to thy businessmen against their current assets such as shares, stocks, bonds etc. These loans

are not based on credit worthiness or personal security of the customers. The bank provides this loan through opening an account in the name of the customer and allows them to withdraw borrowed amount of loan from time to time upto the limit fixed by the bank which is determined by the value of security provided by the borrowers. Interest is charge only on the amount of money actually withdrawn from the banks and not on the amount of the sanctioned amount of loan.

In some other cases certain banks follow a different procedure for cash credits. The whole amount of loan is credited to the current account of the borrower. In case of new customer a separate account is opened and amount of loan is transferred to it. The borrower is free to withdraw the money through cheques as and when required by the borrower. But in this case the borrower has to pay the interest on the whole amount credited in their accounts.

(c) **Overdrafts:** The facility of Over Drafts is provided to the traders and businessmen through current accounts for which the banks charge interest on the outstanding balance of the customers. A limit is fixed by the bankers for withdrawal of over drafts and the customer is not allowed to withdraw more than that limit from his Over Draft Current Account. This facility is required by the traders and businessmen because they issue several cheques in a day and similarly deposits so many cheques daily in their current accounts. They may not be knowing at a particular day that whether there is a balance in the account or not and their issued cheques are not dishonored so they are provided with the facility of overdrafts. Say it a trader has an Over Draft limit of Rs.2,00,000 with a bank, he can withdraw money upto Rs.2,00,000 from the bank without depositing any money with the bank. But he cannot withdraw more than Rs.2,00,000. He shall have to pay interest on such withdrawals.

(d) **Discounting Bills of Exchange:** This is another popular type of lending by the commercial banks. A holder of a bill of exchange can get it discounted with a commercial bank. Bills of Exchange are also called the Commercial Bills and the market dealing with these bills is also called commercial bill market. Bills of exchange are those bills which are issued by the businessmen or firms in exchange of goods sold or purchased. The bill of exchange is a written unconditional order signed by the drawer (seller) requiring the drawee (buyer) to pay on demand or at a fixed future date, (usually three months after date written on the bill of exchange), a definite sum of money. After the bill has been drawn by the drawer (seller), it is accepted by the drawee (buyer) by countersigning the bill. Once the buyer puts his acceptance on the bill by signing it, it becomes a legal document. They are like post dated cheques issued by the buyers of goods for the goods received. The bill holder can get this bill discounted in the bill market if he wants the amount of the bill before its actual maturity. These bills of exchange are discounted and re-discounted by the commercial banks for lending credit to the bill brokers or for borrowing from the central bank. The bill of exchange market is not properly developed in India. The Reserve Bank of India introduced the bill market scheme in 1952. Its main aim was to provide finance against bills of exchange for 90 days. The scheduled commercial banks were allowed to convert a part of their advances into promissory notes for 90 days for lodging as collateral security for advances from Reserve Bank of India.

(e) **Term Loan:** Earlier the commercial banks were advancing only short term loans. The commercial banks have also started advancing medium term and long term loans. Now the maturity period of term loans is more than one year. The amount of the loan sanctioned is either paid to the borrower or it is credited to the account of the borrower in the bank. The interest is

charged on the whole amount of loan sanctioned irrespective of the amount withdrawn by the borrower from his account. Repayment of the loan is accepted in lump sum or in the installments.

6.5.1.3 Credit Creation: Credit Creation is one of the basic functions of a commercial bank. A bank differs from the other financial institutions because it can create credit. Like other financial institutions the commercial banks also aim at earning profits. For this purpose they accept deposits and advance loans by keeping small cash in reserve for day-to-day transactions. In the layman's language when a bank advances a loan, the bank creates credit or deposit. Every bank loan creates an equivalent deposit in the bank. Therefore the credit creation means multiple expansions of bank deposits. The word creation refers to the ability of the bank to expand deposits as a multiple of its reserves.

The credit creation refers to the unique power of the banks to multiply loans and advances, the hence deposits. With a little cash in hand, the banks can create additional purchasing power to a considerable extent. It is because of this multiple credit creation power that the commercial banks have been named the "factories of creating credit" or manufacturers of money.

6.5.2 Agency Functions

The commercial banks also perform certain agency functions for and on behalf of their customers. The bank acts as the agent of the customer while performing these functions. Such services of the banks are called agency services. Some of the important agency services are as under:

(i) **Remittance of funds:** Commercial banks provide a safe remittance of funds of their customers from one place to another through cheques, bank drafts, telephone transfers etc.

(ii) **Collection and Payment of Credit Instruments:** The commercial banks used to collect and pay various negotiable instruments like cheques, bills of exchange, promissory notes, hundis, etc.

(iii) **Execution of Standing Orders:** The commercial banks also execute the standing orders and instruments of their customers for making various periodic payments like subscriptions, rents, insurance premiums and fees on behalf of the customers out of the accounts of their customers.

(iv) **Purchase and Sale of Securities:** The commercial banks also undertake the sale and purchase of securities like shares, stocks, bonds, debentures etc., on behalf of their customers performing the function as a broker agent.

(v) **Collection of dividends on shares and interest on debentures:** Commercial banks also make collection of dividends announces by the companies of which the customer of the bank is a shareholder, and also collects the interest on the debentures which becomes due on particular dates generally half yearly or annually.

(vi) **Trustees and Executors of wills:** The commercial banks preserves the wills of their customers as their trustees and execute the wills after the death of the customer as per the will as the executors.

(vii) **Representation and Correspondence:** The commercial banks also act as the representative and correspondents of their customers and get passports, traveler's tickets, book vehicles and plots for their customers on the directions of the customers.

6.5.3 General Utility Functions

In addition to basic functions and agency functions the commercial banks also provide general utility services for their customers which are needed in the

various walks of life and the commercial banks provide a helping hand in solving the general problems of the customers, like safety from loss or theft and so many other facilities some them are as under:

(i) **Locker Facility:** The commercial banks provide locker facility to its customers at very reasonable charges which is not possible at the premises of the customers. The customers can avail the facility of lockers in different sizes according to the needs of the customers. The locker charges also vary with the size of the lockers. The customers can keep their valuables in the important documents in these lockers for safety. Lockers can be operated in the usual business hour of the bank on all working days.

(ii) **Traveler's Cheque Facility:** Where customers want to visit long distant places and also need money, they need not carry the money with them which is not safe during long distant journeys and there is always a fear of loss or theft during the journey. The commercial banks provide a unique facility through traveler's cheque. The customers can get traveler's cheques from the banks and travel without the fear of theft or loss of money. Wherever they need money they can approach the branch of the bank in that city and encash the traveler's cheque according to the need.

(iii) **Gift Cheque Facility:** Some commercial banks also provide the facility of issuing gift cheques in the denomination of different amounts according to the needs of the customers, say Rs.11, 21, 51, 101, 501 and so on. This facility is provided for the special occasions for the customers and normally the banks do not charge anything for issuing these gift cheques.

(iv) **Letter of Credit:** The commercial banks also help their customers by providing another unique service by providing the letter of credit in which the bank certifies the credit worthiness of the customers. These letters of credit are used in the long distant trade and especially in foreign trade

where the parties do not know each other and it is bank which provides the safety to them regarding their credit worthiness by issuing letter of credit.

(v) **Underwriting Contract:** The commercial banks underwrite the securities issued by the public or private companies and Government securities. It is the reputation of the bank which matters in the underwriting contracts. Where the bank is a very reputed one, the investors shall not have any hesitation in investing the money in which their banker is the underwriter. In case the public do not purchase the securities, it is the underwriting bank which has to purchase the securities upto the amount of which the bank has underwritten.

(vi) **Provides Statistical Data:** The commercial banks also help their customers by providing them important information through statistical data. Commercial banks collect statistical data in which important information relating to industry, trade, commerce, money and banking is collected and published in their journals and bulletins containing research articles on the economic and financial matters. Such statistical data may be useful for the customers in dealing with their own business, trade or commerce.

(vii) **Foreign Exchange Facilities:** The commercial banks also deal in the business of foreign currencies. These banks provide foreign exchange and also discount the foreign bills of exchange. Some commercial banks have also opened special branches for the foreign exchange services to the non-resident Indians settled abroad.

(viii) **Merchant Banking Services:** The commercial banks have also started providing merchant banking facilities. The Banking Commission Report, 1972 emphasised the need of creating specialised institutions to cater financial requirements of different sectors exclusively and examined the need of setting up merchant banking institutions. Commission recommended

the setting up of merchant banking institution. Consequently in 1972 itself State Bank of India started its merchant banking division. Since then a number of other commercial banks and financial institutions started their merchant banking divisions. Now the merchant banking firms in private sector have started gearing up to meet the challenge posed by commercial banks and financial institutions in the field of merchant banking in India.

(ix) Acting as Referee: The commercial banks are the best source of seeking information about the creditworthiness of the customers. Banks may be referred for seeking information regarding credit worthiness, financial position, business reputation and respectability of their customers.

6.6 SUMMARY

A bank is an institution which deals with the money and credit in such a manner that it accepts deposits from the public and makes the surplus funds available to those who need them, and helps in remitting money from one place to another safely. The banks can be classified on the basis of Reserve Bank Schedule, ownership, domicile and functions. The commercial banks perform basic functions, agency functions and general utility functions.

6.7 GLOSSARY

- **Bank:** A bank collects money from those who have it to spare or who are saving it out of their incomes, and it lends this money to those who acquire it.
- **Cash Credit:** It is a type of loan which is provided to the businessman against their current assets.
- **Commercial Bank:** Commercial bank is that bank which performs all kinds of banking business and functions like accepting deposits, advancing loans, credit creation and agency functions for their customers.

- **Public Sector Bank:** The bank which is owned or controlled by the Government is known as public sector bank.
- **Scheduled Bank:** All those banks which are included in the list of Schedule Second of the Reserve Bank of India are called Scheduled Bank.

6.8 SELF ASSESSMENT QUESTIONS

Q1. Define bank ?

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Q2. Explain various banks on the basis of reserve bank schedule?

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Q3. Differentiate between public and private sector banks?

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Q4. Explain cooperative banking functions?

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Q5. Explain various types of domicile banks?

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Q6. What are commercial banks?

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Q7. What are industrial banks?

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Q8. Explain agricultural banks?

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Q9. Explain exchange banks?

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Q10. Explain central banks?

Q11. What are the features of cooperative banking?

6.9 LESSON END EXERCISE

Q1. Explain various types of Banks?

Q2. Explain various banks on the basis of ownership?

Q3. Classify various banks on the basis of functions?

Q4. Explain basic functions of commercial banks?

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Q5. Explain various agency functions of commercial banks?

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Q6. Explain various general utility functions of commercial banks?

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6.10 SUGGESTED READINGS

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BANKING AND INSURANCE

INTRODUCTION TO MERCHANT BANKING

STRUCTURE

7.1 Introduction

7.2 Objectives

7.3 Concept and Nature of Merchant Banking

7.4 Functions of Merchant Banker

7.4.1 Service Based Functions

7.4.1.1 Project Counselling

7.4.1.2 Credit Syndication

7.4.1.3 Issue Management

7.4.1.4 Corporate Counselling

7.4.1.5 Portfolio Management

7.4.1.6 Stock Broking and Dealership

7.4.1.7 Joint Venture Abroad

7.4.1.8 Debenture Trusteeship

7.4.2 Fund Based Functions

7.4.2.1 Bill Discounting

7.4.2.2 Venture Capital

7.4.2.3 Bought Out Deals

7.4.2.4 Lease Financing and Hire Purchase

7.4.2.5 Factoring

7.4.2.6 Underwriting

7.5 Summary

7.6 Glossary

7.7 Self Assessment Questions

7.8 Lesson End Exercise

7.9 Suggested Readings

7.1 INTRODUCTION

Financial Service is rendered through numerous intermediaries who are known by different names. One of the prominent intermediaries is known as merchant banker. Their scope of operation differs from country to country. Merchant banking as it is known in present days had its origin in U.K and U.S.A in early fifties. But the roots of this service rendering industry can be traced as back as in late eighteenth century and early nineteenth century. There were merchants, who traded overseas, built reputation and later shared their goodwill with newer traders to facilitate their merchant activities especially by providing guarantees for payments. Subsequently they entered any field which added to their business depending on the demand of time. Thus, as time changed their role changed, consequently it has never been possible to pinpoint their role. As Sir Edward Reid of Baring Brothers & Co. commented, it is (merchant banking) sometimes applied to banks which are not merchants, merchants who are not banks and sometimes to houses who are neither merchants nor banks.” Report of the Committee on the Working of Monetary System (1961) observed that origin of merchant bankers is associated with a variety of financial services including accepting. This is why merchant bankers are popular as ‘issue houses’ or ‘accepting houses’ in U.K. In U.S.A investment bankers have been performing the task being performed by merchant bankers elsewhere. Whether these are called accepting house or investment banker or merchant bankers, their common object is to facilitate trade and industry. Meeting their diverse and dynamic needs with the change in time and complexities in business has always been a challenge for merchant banking.

A merchant bank is a financial institution providing capital to companies in the form of share ownership instead of loans. A merchant bank also provides advisory on corporate matters to the firms in which they invest.

The role of merchant bankers is described as under :

1. **Raising finance:** Merchant Bankers help their clients in raising finance by way of issue of a debenture, shares, bank loans, etc. They tap both the domestic as well as the international markets. Finance raised by this method may be used for commencing a new project or business or it may even be used for expansion and modernization of an existing business.

2. **Promotional activities:** In India, merchant bankers play the role of promoter of industrial enterprises. They help entrepreneurs in conceiving ideas, identifying projects, preparation of feasibility reports, getting Government approvals as well as incentives, etc. Merchant bankers may, at times, also provide assistance in financial and technical collaborations and joint ventures.

3. **Brokers in stock exchanges:** Merchant bankers buy and sell shares in the stock exchange on behalf of the clients. They additionally conduct researches on equity shares, advise the clients on the share to be purchased, the time of purchase, quantity of such purchase and the time for selling these shares. Mutual funds offer merchant banking services, large brokers, investment banks, and venture capitals.

4. **Project management:** Merchant bankers offer help to clients in several ways in the process of project management. They offer advice regarding the location of the project, preparation of project report, in carrying out feasibility studies, planning out the financing of the project, tapping sources of such finance, information regarding incentives and concessions from the government.

5. **Advise on modernization and expansion:** Merchant bankers advise on amalgamations, mergers, acquisitions, takeovers, foreign collaborations,

diversification of business, technology up-gradation, joint-ventures, etc.

6. **Managing public issue:** They provide the following services in the above-mentioned process:

- the timing of the public issue
- the size of the issue
- the price of the issue
- acting in the capacity of manager to the issue
- assisting in receiving applications as well as allotment of securities
- appointment of brokers as well as underwriters of the issue
- listing of shares on the relevant stock exchange.

Initially, merchant bankers mostly performed the function of managing new public issues of corporate securities of either newly formed companies or existing companies and foreign companies in the process of dilution of equity provided under the FERA. Here, they acted as sponsors of issues. They get the permission of the Controller of Capital Issues (which is now the SEBI). They also provide several other services to guarantee success in the process of marketing of securities. These services include, preparation of the prospectus, making underwriting arrangements, appointing registrars, bankers, brokers to the issue, arranging for advertising and publicity as well as compliance with the listing requirements of the relevant stock exchanges, etc. A merchant banker acts as experts on the terms, type and timing of the issues of the corporate securities and makes them suitable for investors and provides freedom and flexibility to issuing companies.

7. **Credit syndication:** A merchant banker provides specialized services in the stages of preparation of a project, the loan applications required for the raising of short-term and long- term credit from various banks and financial institutions, etc. They help in managing Euro-issues and raising funds abroad.

8. **Handling government consent for industrial projects:** A merchant banker completes all formalities for his or her client, about government permission to expand and modernize business (necessary for companies) and commencing new businesses (necessary for business people).

9. **Special assistance to entrepreneurs and small companies:** Merchant banker advises entrepreneurs and small companies on availability and existence of business opportunities, concessions, incentives and government policies and helps them to take advantage of this option available to them, to the best of their capabilities.

10. **Services to PSU's:** Merchant banker offers numerous services to public sector undertakings and units and their public utilities. They assist in raising capital (long-term), in the marketing of securities, in foreign collaborations as well as in arranging for long-term finances from lending institutions.

11. **Revival of sick units:** A merchant bank helps in reviving sick industrial units. They negotiate with various agencies such as banks, long-term lending institutions, and the Board for Industrial and Financial Reconstruction (BIFR). They also plan and execute full revival packages.

12. **Portfolio management of sick units:** Merchant bankers offer revival services to companies that issue the securities as well as investors.

    These bankers advise clients, which are usually institutional investors, on investment decisions. They undertake purchase and sale of securities to

provide them with portfolio management services. Some of these bankers are operating mutual funds as well as offshore funds.

13. **Corporate restructuring:** These services of merchant bankers include mergers, acquisitions (about existing units), the sale of units and disinvestment. These procedures demand proper negotiations, thorough preparation of numerous documents and completion of lengthy legal formalities. Merchant bankers fulfill all these formalities on behalf of the clients.

14. **Money market operations:** A merchant bank deals with as well as underwrites short-term instruments like:

- government bonds;
- certificate of deposit issued by banks and financial institutions;
- commercial paper issued by large corporate firms;
- treasury bills issued by the government (in India by the Reserve Bank of India).

15. **Leasing and finance services:** Merchant banks also assist leasing and financing services. A lease refers to a contract that exists between a lessor and a lessee, by which the lessor permits the use of a specific asset that belongs to him or her (like equipment, land) by the lessee for a specified period. There is a fee charged by the lessor which is referred to as the rentals. Several merchant bankers offer leasing and financing facilities to the customers. Some banks also keep venture capital funds to assist entrepreneurs. These banks also help the companies to raise finance through public deposits.

16. **Servicing issues:** Merchant bankers now also act as the paying agents for service of the debt- securities and act as the registrars as well as the transfer agents. In this way, they maintain the registers of the shareholders and the debenture holders and also arrange the payment of dividend and or the interest that is due to them.

17. **Management of dividend and interest:** Merchant banks help the clients in the management of the interest on the debentures or loans, as well as the dividend on the shares. In addition to this, they advise the client with respect to the timings (whether interim or annual) of the dividend as well as the rate of the dividend.

18. **Other services:** Along with all the services mentioned above, the merchant bankers also offer certain other specialized services such as advisory services on matters such as mergers, amalgamations, tax related matters, on the matter of recruitment of executives, the cost of audit as well as its management among several others. The scope of functions, activities and the services provided by the merchant bankers are ever increasing and growing with the constant development in the money market.

7.2 OBJECTIVES

After reading this lesson, you should be able to understand:

- the concept and nature of merchant banking;
- service based functions of merchant bankers; and
- fund based functions of merchant bankers.

7.3 CONCEPT AND NATURE OF MERCHANT BANKING

Despite the fact that merchant banking is emerging as one of the prominent segment of financial service sector, it is difficult to define what merchant banking

is. The reason is very obvious as its limits have never been adequately and strictly defined and it caters to wide variety of financial activities. Dictionary of Banking and Finance explains merchant bank as an organisation that underwrites securities for corporations, advises such clients on mergers and is involved in the ownership of commercial ventures. Securities and Exchange Board of India (Merchant Bankers) Rules 1992 defines merchant bankers as "any person who is engaged in the business of issue management either by making arrangement regarding selling, buying or subscribing to securities or acting as manager, consultant, adviser or rendering corporate advisory services in relation to such issue management. The Guidelines for Merchant Bankers (issued by Ministry of Finance, Department of Economic Affairs, Stock Exchange Division on 9-4-1990) instead of defining merchant banking stated that these guidelines shall apply to those presently engaged in merchant banking activity including as managers to issue and undertakes authorised activities. These activities interalia include underwriting, portfolio management etc. Thus to defines merchant bankers a definite better approach is to include those agencies as merchant bankers which do what a merchant banker does.

To understand nature of merchant banking well, a contrast may be involved, between commercial banking and merchant banking. Although the terms 'Merchant' and 'Commercial' have similar connotations yet commercial banking and merchant banking are different. Commercial bankers are basically a financing agency where as merchant banks provide basically financial (not financing) services. Commercial bankers are comparatively retail banking activity where as merchant banking is a whole sale banking (even if it provides financing services also). A merchant banking firm does not undertake commercial banking where as its, reverse is possible. Commercial banking involves collections of savings and putting it, to optimum use as per plans and guidelines where as merchant banking refers to just an agency facilitating transfer capital from those who own to those who can use it without handling the amount of its own. Merchant bankers are more of an intermediary. In

the same context a merchant bank can be distinguished from a development bank since the latter is more involved in fund raising and lending. Like commercial banks, development banks may also have separate merchant banking division.

7.4 FUNCTIONS OF MERCHANT BANKER

Setting up of new industrial units, expansion, diversification and modernisation of existing units have been the central plank of the rapid industrialisation in any economy. This process besides adequate financial resources requires sound technical and managerial inputs. Though, a number of financial agencies are instituted to cater to the needs of rapid industrialisation, the task of financing has become more complicated, thus requiring a fresh look. In view of increasing specialisation in every sphere the process of industrialisation from the primary planning stages of setting up a new unit to that of research and development including expansion, diversification or modernisation requires the services of specialists or professionals. Thus, the need for having expert advice, guidance of specialists or professionals in the field has become an absolute necessity with rapid economic growth and spectacular industrial development in India. It has also been necessitated by the plethora of regulations for industry, capital, issues, foreign investment and collaboration, amalgamations, Companies Act, SEBI, Government policy regarding backward area development, export promotion and import substitution etc. A few agencies are able to provide expert advice in the diversified areas mentioned above. But it is inconvenient to entrepreneurs and industrialists to knock at the doors of several agencies in getting the guidance of specialists and professionals. Hence, it is highly essential to provide expert advice in diversified areas under a single roof to provide a comfortable cushion to entrepreneurs to accelerate industrial development. This is where merchant bankers come to picture. Although is it is very difficult to spellout all the areas where merchant bankers can interact, yet, some important areas where merchant bankers have decisive role are discussed here. These roles can broadly be divided into two parts:

1. Service based Functions

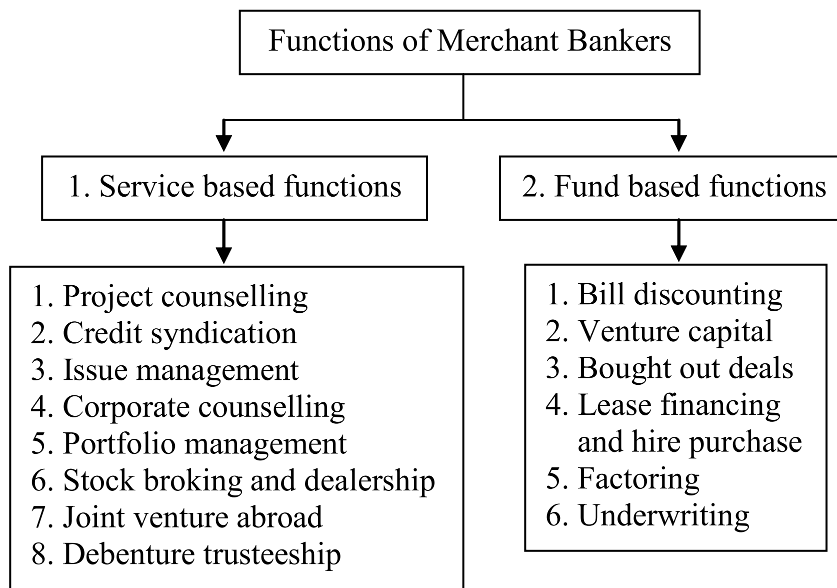
2. Fund based Functions

7.4.1 Service based Functions

7.4.1.1 Project Counselling: The first step to launch a business unit is selection of a viable project. Merchant bankers undertake this assignment on a very large scale since they have experts with them in diverse fields. Project counselling covers a variety of sub assignments. Illustrative list of services which can be rendered under this category is:

(i) Guidance in relation to project viability i.e. project identification and counselling. It may be for setting up new units, expansion or improvement of existing facilities.

Chart 7.1: Functions of Merchant Bankers



(ii) Selection of consultants for preparation of project reports / market surveys etc. Sometimes merchant bankers also engage in preparation of project reports or market surveys.

(iii) Advice on various procedural steps including obtaining of governmental approvals clearance etc. for e.g. foreign collaboration.

(iv) Proposing a suitable capital structure laying broad as well as specific features.

(v) Techno- economic soundness of the project and marketing aspects.

(vi) Financial engineering i.e. selection of right mix of financing pattern specifically for short term requirements.

(vii) Organisation and management set up for a strong base and efficient working of the project.

7.4.1.2 Credit Syndication: Normally every project has to raise debt funds for different sources as per need. Substantial debt raising may be required for a new and capital intensive project. For such project merchant bankers may undertake credit syndication. Credit syndication is credit procurement service. As per the requirements, such syndication can be from national as well as international sources. Some of the important credit syndication services offered are:

(i) Preparing applications for financial assistance to be submitted to financial institutions and banks.

(ii) Monitoring the sanction of funds while acting as a specialised liaison agency.

(iii) Negotiating the term of assistance on behalf of client.

(iv) Post sanction formalities with these institutions and banks.

(v) Assistance in drawl of term loans and or bridging loans.

(vi) Assessing working capital requirements and arranging it.

Need of syndication arises due to the fact that especially in big projects one institution may hesitate to meet the whole debt requirement of the project. They want to spread the risk. Further shortage of funds availability with one lender also requires credit syndication. The merchant banker by rendering credit syndication services saves the time of the borrower.

The modus operandi of syndication is really quite simple. The borrower approaches several banks which might be willing to syndicate a loan, specifying the amount and the tenor for which loan is to be syndicated. On receiving a query, the syndicator scouts for banks who may be willing to participate in the syndicate. Based on an informal survey, it communicates its desire to syndicate the loan at an indicative price to the corporate borrower, all in a matter of days. After reviewing the bids from various banks, the borrower awards the mandate to the bank that offers him the best terms.

The syndicator, on his part, can underscore his willingness to syndicate the loan on a firm commitment basis or on a best-efforts basis. The former is a kin to underwriting and will attract capital adequacy requirements. That may reduce the bank's flexibility. "In India, given the fact that banks may not be willing to maintain capital in the interim period, most syndicates the likely to be done on a best-efforts basis."

Best-efforts, as the name suggests, limits the obligation of the syndicator, as he is not compelled to provide the loan on his own, in case he fails to arrange the loan.

However, more often than not, the syndicator would try to fulfill his commitments for the inability to do so would tarnish his reputation. Once the

syndicator has been awarded a mandate, the borrower has to sign a "clear market clause" which stops him from seeking a syndicated loan from any other bank, till such time as the documentation for the syndication is drawn up by the syndicate manager. This may take about three-four weeks.

In the interim period, the syndicate manager gets the banks to agree to syndicate the loan. It can do this on a broadcast basis, by sending taxes to the concerned banks inviting participation. If the company is well known, the loan uncomplicated and the market liquid, such a method would work well. However, if the corporate tends to keep a low profile and the loan structure is complicated; the syndicate manager would have to woo the participant banks with offer documents or an information memorandum on the company. The document is similar to a prospect but less detailed. Nevertheless drawing up such a document does call for a lot of homework. The syndicate manager has to be very careful because he can be held responsible for any inaccuracy or omission of material facts.

The participants, after reviewing the prospects, decide whether or not to join the syndicate. However, given the fact that most of the participants may be smaller Indian banks, they may take weeks to give the final nod. Once the bank decides to become a member of the syndicate, it indicates the amount and the price that it is likely to charge on the loan. Based on information received from all participants, the syndicate manager prepares a common document to be signed by all the members of the syndicate and the borrowing company. The document usually lists out details of the agreement with regard to tenor, interest prepayment clause, security, covenants, warranties and agency clause.

7.4.1.3 Issue management: Traditionally this is one of the main functions of merchant banker. Whenever an issue is made whether it is public issue or private placement and further whether it is for equity shares, preference shares or debentures, the merchant banker has a crucial role to play. Raising of funds from

public has many dimensions and formalities which are not possible for the concerned companies to comply with, where merchant banker comes to their rescue. Marketing effort to convince the prospective investor needs special attention. Here again merchant bankers are specialists. The specific important activities related to issue management performed by merchant banks are mentioned here:

(i) Advise the company about the quantum and terms of raising funds.

(ii) Advise as to what type of security may be acceptable in the market as well as to the concerned lending institutions at the time of issue.

(iii) Advise as to whether a fresh issue to be made or right issue to be made or if both, then in what proportion, obtaining the desired consents, if any, from government or other authorities.

(iv) Advice on the appointment of bankers, brokers to the issue.

(v) Advice on the selection of issue house or Registrar to the issue, printer advertising agency etc.

(vi) Fixing the terms of the agencies engaged to facilitate making a public issue.

(vii) Preparation of a complete action plan and budget for total expenses of the issue.

(viii) Drafting of documents like prospectus, letter of offer and getting approval from concerned agencies.

(ix) Assisting in advertisement campaigns, holding the press, brokers' and investors' conferences etc. for grooming the issue.

(x) Advise the company for the issue period and days of opening and closing the issue.

(xi) Monitoring the collection of funds in public issue.

(xii) Coordination with underwriters, brokers and bankers to the issue and stock exchange etc.

(xiii) Strict compliance of post issue activities.

7.4.1.4 Corporate counselling: Although the functions discussed uptill now are also covered under corporate counselling but here other dimensions will be deliberated. Corporate counselling is to rejuvenate the corporate units which are otherwise having signals to low productivity, low efficiency and low profitability. The merchant bankers can play a substantial role in reviving the sick units. They make mergers and acquisition exercise smooth. They can advise on improvement in the systems operating in managing the show of a corporate unit. Some of the specific assignments for the merchant banker are:

(i) Rejuvenating old line and ailing / sick unit or appraising their technology and process, assessing their requirements and restructuring their capital base.

(ii) Evolving rehabilitation programmes / packages which can be acceptable to the financial institutions and banks.

(iii) Assisting in obtaining approvals from Board for Industrial and Financial Reconstruction (BIFR) and other authorities under the Sick Industrial Companies (special provisions) Act1985 (SICA).

(iv) Monitoring implementation of schemes of rehabilitation.

(v) Advice on financial restructuring involving redeployment of corporate assets to refocus companies' line of business.

(vi) Advice on rearranging the portfolio of business assets through acquisition etc.

(vii) Assisting in valuing the assets and liabilities.

(viii) Identifying potential buyers for disposal of assets if required. Identify the candidates for takeover.

(ix) Advice on tactics in approaching potential acquisition.

(x) Assisting in deciding the mode of acquisition whether friendly or unfriendly or hostile.

(xi) Designing the transaction to reap the maximum tax advantages. Acting as an agent for leveraged buyout (LBO) involving heavy use of borrowed funds to purchase a company or division of a company.

(xii) Facilitating Management Buy outs (MBO) i.e selling a part of business to their own managers by a company.

(xiii) Clearly spelling out organisation goals.

(xiv) Evolving corporate strategies to achieve the laid down goals.

(xv) Designing or restructuring the organisational pattern and size.

(xvi) Evolving Management Information System.

Corporate advisory services should offer real value to the client. Highly specialised in nature, these services should be clearly distinguished from the gamut of other financial services offered by NBFCs such as underwriting or fund-based activities of leasing and hire purchase. In India corporate advisory has a good potential. The Indian industry is going through an unprecedented churning, bracing itself for global competition. The Indian corporate sector has been on a restructuring spree. Groups have been shedding companies. Companies in turn, have been dropping divisions as they struggle to become fit to survive in the new milieu. Free pricing of issues and the opportunity to tap the international market through the

Euro-issue route has greatly enhanced the need for expert advisory services. In areas of restructuring, strategic alliances and corporate planning is now advising foreign companies in their plans for development of infrastructure in India. Merchant bankers have a great role to play.

Strategic product consolidation is another recent phenomenon. Units in which the company does not plan to become a market leader are spun off to others. A good corporate advisor is always on the alert to seize such opportunities. The process of acquisition cannot be done overnight. It requires a patient search for the right company which can be acquired, the proper evaluation of the financial impact of the acquisition, a sound strategy in blending the business acquired within the fold of the group, followed by negotiation and execution of the agreement. Occasionally, advisory services are required in cases of splits within the family group. In such cases, there is a need to split the company into different units amongst the disputing family members. At the same time, the shareholders interest is to be kept in mind by the corporate advisor.

7.4.1.5 Portfolio management: Merchant bankers as a body of professionally qualified persons also undertake assignments of managing an individual investor's portfolio. Portfolio management is being practised as an investment management counselling in which the investor is advised to seek financial assets like government securities, commercial papers, debentures, shares, warrants etc. that would grow in value and provide income. The investors whether local or foreigner with substantial amount for investment in securities seeks portfolio management services of authorised merchant bankers. The functioning of portfolio manager can be regulated or unregulated. Portfolio manager may use totally his discretion or may act only after getting signal from investor for each transaction of sale or purchase. A diverse range of services which may be rendered by merchant banker include:

(i) Advising what and when to sell and buy.

(ii) Arranging sale or purchase of securities.

(iii) Communicating changes in investment market to the client investor.

(iv) Compliance of regulations of different regulating bodies for sale of purchase of portfolio.

(v) Collection of returns and reinvest as per directions of clients.

(vi) Evaluating the portfolio at regular intervals or at direction of investors.

(vii) Advising on tax matters pertaining to income from and investment in portfolio.

(viii) Safe custody of securities.

7.4.1.6 Stock broking and dealership: The merchant bankers who have requisite professional knowledge and experience may also act as share broker on a stock exchange and even as dealer for OTC (Over The Counter trading). To venture into this area it is normally desired that the merchant banker has reasonable network. Their actions and activities are regulated by rules and regulations of the concerned stock exchange. They are at liberty to appoint sub brokers and sub dealers to ensure wider net work of their operations. They can be broker for inland as well as foreign stock exchanges. In India the merchant bankers who desire to act as brokers are regulated by SEBI (Stock Broker and Sub-brokers) Rules 1992.

7.4.1.7 Joint venture abroad: Depending on economic and political considerations many countries may permit joint ventures by local businessmen abroad. Here again merchant bankers can play a decisive role. They facilitate meeting of foreign partner, get sanctions under various provisions, make techno economic surveys, legal documentations under local as well as foreign legal provisions etc.

7.4.1.8 Debenture trusteeship: The merchant bankers can get themselves registered to act as trustee. These trustees are to protect the interests of debenture holders as per the terms laid down in trust deed. They are, as trustees, to undertake redressal of grievances of debenture holders. They are to ensure that refund monies are paid and debenture certificates are dispatched in accordance with the Companies Act. Debenture trustees are expected to observe high standards of integrity and fairness in discharging their functions. They can call for periodical reports from the body corporate. They charge fee for such services.

7.4.2 Fund based Functions

7.4.2.1 Bill discounting: Bill discounting is a service against which merchant banker has to arrange funds against the bills which have been discounted. This service is undertaken by merchant bankers generally if bill market is big as well as mature. Otherwise bill discounting is undertaken by banks only. Depending on their credibility they may also undertake the assignment of bill acceptance. These bills accepted and or discounted can be foreign and merchant bankers can specify what types of bills they entertain. They charge commission for these services.

7.4.2.2 Venture capital: Venture capital is the organized financing of relatively new enterprises to achieve substantial capital gains. Such new companies are chosen because of their potential for considerable growth due to advance technology, new products or services or other valuable innovations. A high risk is implied in the term and is implicit in this type of investment. Since certain ingredients necessary for success of such projects are missing in the begging but are added later on. Merchant bankers undertake to arrange and if necessary, to provide such venture capital since traditional sources of finance like banks, financial institutions or public issue etc. may not be available. Since expected returns on projects involving venture capital is high, these are normally provided on soft terms. Such scheme is also popular as seed capital or risk capital scheme. Merchant bankers deeply study

such proposals before releasing the money. At opportune time such investment can be disinvested to keep the cycle of venture capital more on.

7.4.2.3 Bought out deals: When a promoter envisages that if public issue made to raise capital will not clinch, he may approach merchant bankers (bought out dealer or sponsor) and places the shares of company initially with him which are offered to public at a later stage, this route is known as bought out deal. Many a time a syndicate of merchant bankers jointly sponsor a bought out deal to spread the risk involved. In contract to venture capital, there is no role to be played by nontraditional technology. Such bought shares by sponsor can be disposed off at an opportune time on "over the counter" or other stock exchanges.

7.4.2.4 Lease financing and hire purchase: Depending on the funds available, merchant bankers can also enter the field of lease or hire purchase financing. Lease is an agreement whereby the lessor (merchant banker in our case) conveys to the lessee (the user), in return for rent, the right to use an asset for an agreed period of time. On the other hand in hire purchase the user at the end of the agreed period has an option to purchase the asset which he has used till date. The merchant bankers can advise the client to go in for leasing or hire purchase system of financing an asset. A comparative study may be communicated to the prospective client showing benefits of these alternatives. The client can also depend on merchant banker for acquiring the needed asset and complying with all formalities.

7.4.2.5 Factoring: Factoring is a novel financing innovation. It is a mixed service having financial as well as non financial aspects. On one hand it involves management and collection of book debts which arise in process of credit sale. The merchant bankers can take up this assignment and are required to perform activities like sales ledger administration, credit collection, credit protection, evolving credit policy, arranging letter of credit etc. On the other hand there is involvement of finance. Against factored debts the merchant banker may provide advance with a certain

margin. The released funds can be used by client to manage its liquidity and working capital. Merchant bankers are entitled to service charges for factoring services. The merchant banker's role is thus to:

(i) Maintain the books of accounts pertaining to credit sales

(ii) Make a systematic analysis of relevant information for credit monitoring and control.

(iii) Provide full or partial protection against bad debts and accepting the risk of non realization.

(iv) Provide financial assistance to the client.

(v) Provide information about prospective buyers.

(vi) Provide financial counseling and assisting managing the liquidity.

7.4.2.6 Underwriting: It refers to a contract by means of which merchant banker gives an assurance to the issuing company that the former would subscribe to the securities offered in the event of non-subscription by the persons to whom it was offered. The liability of merchant banker arises if the issue is not fully subscribed and this liability is restricted to the commitment extended by him. The merchant bankers undertaking underwriting make efforts on their own to induce the prospective investors to subscribe to the concerned issue. Such assignment is accepted after evaluating viz:

(i) Company's standing and its past record.

(ii) Competence of the management.

(iii) Purpose of the issue.

(iv) Potentials of the project being financed.

(v) Offer price and terms of the issue.

(vi) Business environment.

The financial involvement of merchant banker in underwriting arises in case of development. To get their blocked funds released, the merchant bankers have stock exchange as exit route. They get underwriting commission.

These are some of the prominent activities being undertaken by merchant bankers world over. The practices may differ from country to country depending on maturity of financial sector of their economy. The multifarious activities of the corporate sector and spectacular growth of industry gives new dimensions to merchant banking activities. In the phase of globalisation of economies merchant bankers are facing new challenges. The changing international financing environment has rather pushed merchant bankers to operate at international level creating more opportunities to serve the world business community in diverse ways.

7.5 SUMMARY

A merchant bank is a company that conducts underwriting, loan services, financial advising, and fundraising services for large corporations and high net worth individuals. Unlike retail or commercial banks, merchant banks do not provide services to the general public. They do not provide regular banking services like checking accounts and do not take deposits.

These banks are experts in international trade, which makes them specialists in dealing with multinational corporations. Some of the largest merchant banks in the world include J.P. Morgan, Goldman Sachs, and Citigroup.

In India, merchant bankers play the role of promoter of industrial enterprises. They help entrepreneurs in conceiving ideas, identifying projects, preparation of feasibility reports, getting Government approvals as well as incentives, etc.

Merchant Banking is a combination of Banking and consultancy services. It provides consultancy to its clients for financial, marketing, managerial and legal matters. Consultancy means to provide advice, guidance and service for a fee. Merchant banking was first started in India in 1967 by Grindlays Bank. Merchant Banking helps its clients to raise finance through issue of shares, debentures, bank loans, etc.

7.6 GLOSSARY

- **SBICAP:** SBI Capital Markets Limited is India's leading investment bank and project advisor, assisting domestic companies in fund mobilisation efforts.
- **SEBI:** The Securities and Exchange Board of India (**SEBI**) is the regulator for the securities market in India. It was established in 1988 and given statutory powers on 30 January 1992 through the **SEBI** Act, 1992.
- **Self Regulatory Organization:** A self regulatory organization (SRO) is an organization that exercises some degree of regulatory authority over an industry or profession. The regulatory authority could exist in place of government regulation, or applied in addition to government regulation.

7.7 SELF ASSESSMENT QUESTIONS

Q1. Define merchant banking?

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Q2. What is project counselling?

Q3. What do you mean by credit syndication?

Q4. Explain issue management?

Q5. Explain corporate counselling?

Q6. Explain portfolio management?

Q7. What is stock broking?

Q8. What you mean by lease financing and hire purchase?

Q9. What are debenture trustees?

Q10. What you mean by bill discounting?

Q11. What is venture capital?

Q12. Explain stock broking and dealership?

Q13. What are bought out deals?

Q14. What is factoring?

Q15. What is underwriting?

Q16. What is the role of merchant bankers in factoring?

7.8 LESSON END EXERCISE

Q1. Explain the concept and nature of merchant banking?

Q2. What is the role of merchant bankers?

Q3. Explain service based functions of merchant banking?

Q4. Explain fund based functions of merchant banking?

7.9 SUGGESTED READINGS

1. Bhatia, B.S., and Batra, G.S., Financial Services, Deep & Deep Publishers, New Delhi.

2. Bansal, L.K., Merchant Banking and Financial Services, Unistar Books Pvt. Ltd., Chandigarh.

3. Bhole, L.M., Financial Institutions and Markets, Tata McGraw Hill, New Delhi.

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MERCHANT BANKING REGULATIONS, PARAMETERS AND FEATURES

STRUCTURE

8.1 Introduction

8.2 Objectives

8.3 Merchant Banking Regulations

8.3.1 Categories of Merchant Bankers

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8.3.1.2 Category II

8.3.1.3 Category III

8.3.1.4 Category IV

8.3.2 Registration

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8.3.3 Code of Conduct

8.3.4 Lead Manager

8.3.5 Duties of Merchant Banker/Lead Manager

8.3.6 Liabilities of Merchant Bankers

8.3.6.1 Suspension of registration

8.3.6.2 Cancellation of registration

8.4 Parameters of Evaluating a Merchant Banker

8.4.1 Qualitative

8.4.2 Quantitative

8.4.3 Merchant Banker’s Environment

8.5 Features of Merchant Banking in India

8.5.1 Types

8.5.2 Registration

8.5.3 Quality of Service

8.5.4 Lead managers made more responsible

8.5.5 Business Potentials

8.5.6 Association

8.5.7 Inspection

8.5.8 Challenges

8.5.8 Collaboration

8.6 Summary

8.7 Glossary

8.8 Self Assessment Questions

8.9 Lesson End Exercise

8.10 Suggested Readings

8.1 INRODUCTION

A merchant bank is historically a bank dealing in commercial loans and investment. In modern British usage it is the same as an investment bank. Merchant banks were the first modern banks and evolved from medieval merchants who traded in commodities, particularly cloth merchants. Historically, merchant banks' purpose was to facilitate and/or finance production and trade of commodities, hence the name "merchant". Few banks today restrict their activities to such a narrow scope.

In modern usage in the United States, the term additionally has taken on a more narrow meaning, and refers to a financial institution providing capital to companies in the form of share ownership instead of loans. A merchant bank also provides advisory on corporate matters to the firms in which they invest.

8.2 OBJECTIVES

After reading this lesson, you should be able to understand:

- the merchant banking regulations;
- parameters of evaluating merchant bankers; and
- features of merchant banking in India

8.3 MERCHANT BANKING REGULATIONS

SEBI (Merchant Bankers) Regulations 1992 define merchant banker as "any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities or acting as manager, consultant, adviser or rendering corporate advisory service in relation to such issue management." Thus regulations are applicable only to limited activities undertaken by merchant banker. On the basis of regulations, merchant banking

activities can be categorised as 'authorised' and 'not authorised' activities. The merchant bankers are required to get themselves registered under regulations only for authorized activities. The authorized activities are undertaking issue management assignment, as manager, consultant, adviser, underwriter port folio manager.

(i) Merchant Banking Activities not requiring SEBI's registration are:

- Project Counselling
- Corporate Counselling
- Factoring
- Credit Rating
- Bill acceptance and discounting
- Loan syndication
- Merger and amalgamation

(ii) Merchant Banking Activities requiring SEBI's registration under different regulations but not under Merchant Banking regulations:

- Venture Capital
- Mutual Funds
- Depository
- Portfolio Management
- Trusteeship of debentures
- Share Broking
- Custodian Service

- Foreign Institution of Investor
- Share Transfer

Another angle from which authorized activities can be identified is the activities specified for each categories of merchant banker.

8.3.1 Categories of Merchant Bankers

The merchant banking regulations require that any body seeking registration as merchant banker has to apply in one of the following four categories:

8.3.1.1 Category I: These merchant bankers can carry on any activity of the issue management, which will *inter-alia* consist of preparation of prospectus and other information relating to the issue, determining financial structure, tie up of financiers and final allotment and refund of subscription. They can also act as adviser, consultant, manager, underwriter, portfolio manager.

8.3.1.2 Category II: Such merchant bankers can act as adviser, consultant, co-manager, underwriter and portfolio manager. This means they can not undertake issue management of their own.

8.3.1.3 Category III: These merchant bankers can neither undertake issue management nor act as co-manager. They cannot conduct business of portfolio management. Thus the area of their operation restricts to act as underwriter, adviser and consultant to the issue.

8.3.1.4 Category IV: Such merchant bankers do not undertake any activities requiring funds. They can act only as adviser or consultant to an issue.

8.3.2 Registration

Any agency to operate as merchant banker has to register itself under SEBI Regulations. Application is to be submitted in the prescribed format. To get

registration and certificate to operate as merchant banker, the agency has to fulfill two sets of criteria:

(i) Operational capabilities

(ii) Capital adequacy

8.3.2.1 Operational capabilities: As mentioned earlier, the regulations desire the merchant banker to be professional, fair and competent to serve investors. In this context SEBI before granting 'certificate to operate as merchant banker' makes sure that concerned agency is competent on these parameters. To be more specific these are:

(a) It is necessary that to serve the clients and investors the merchant banker should have sufficient physical infrastructure. It is desired that the applicant has the necessary infrastructure like adequate office space, equipments and manpower to effectively discharge his activities.

(b) To ensure that services rendered are the best, SEBI desires the applicant to have at least two persons who have the experience to conduct the business of the merchant banker.

(c) In order to avoid excessive registration SEBI makes sure that a person directly or indirectly connected with the applicant has not been already granted registration. Such persons include an associate, subsidiary, interconnected or group company of the applicant.

(d) The applicant or his partner or director should be man of integrity. SEBI requires that applicant or its main officials should not be involved in any litigation connected with the securities market which has an adverse bearing on the business of the applicant.

- They should not at any time be convicted for any offence involving moral turpitude or has been found guilty of any economic offence.
- The applicant is to have professional qualification from any recognized institution.
- SEBI is to make sure that such registration should be in the interest of investors.

Only those applicants who qualify on all these points are granted registration.

8.3.2.2 Capital adequacy: In the categories where in fund based activities are involved, SEBI desires them to have sufficient capital. The concept of adequate capital is expressed in terms of "net worth". "Net worth" means the value of capital contributed to the business plus free reserves. At the time of registration as well as subsequently following pattern of "net worth" should be at least maintained:

Table 8.1: Pattern of Net worth at the time of registration

Category of Merchant Bankers	Minimum Net worth
Category I	Rs. 5,00,00,000
Category II	Rs. 50,00,000
Category III	Rs. 20,00,000
Category IV	NIL

Those applicants who qualify on both fronts are granted registration. The registered applicants are granted certificate of registration in 'Form B' in which SEBI specifies for which category registration has been granted. If the applicant is granted a category lower than applied for, the applicant is free to approach SEBI for higher category but within one year from date of such registration. When certificate is finally granted the registered merchant bankers are to submit required

fees. Registration is granted for three years at one time. To keep the registration operative, merchant bankers have to pay registration fee. The registration fee pattern is as under:

Table 8.2: Registration fee pattern for first three years

Category	Fee for first two years	Third year
Category I	Rs. 2.5 lakh per year	Rs. 1 lakh
Category II	Rs. 1.5 lakh per year	Rs. 50,000
Category III	Rs. 1 lakh per year	Rs. 25,000
Category IV	Rs. 5,000 per year	Rs. 1,000

Once registration granted is about to expire, merchant bankers are to get this registration renewed. Application for such renewal is again to be made. To ensure that there is no break in registration, such application has to be made within 3 months before the expiry of the certificate. Although it is termed as renewal, but application is processed as for new registration that is why application is again made in "Form A". Once registration is renewed due fee is to be paid which is as under:

Table 8.3: Registration fee at the time of renewal

Category	Fee for first two years	Third year
Category I	Rs. 1 lakh per year	Rs. 20,000
Category II	Rs. 75000 per year	Rs. 10,000
Category III	Rs. 50,000 per year	Rs. 5,000
Category IV	Rs. 5000 per year	Rs. 2000

8.3.3 Code of Conduct

Once merchant bankers are registered to ensure that they maintain high standard of services, regulations require them to adhere to a code of conduct specified in the Schedule III of the Regulations while acting as merchant bankers. Some important provisions of code are as under:

- Maintain high standard of service.
- Exercise due diligence, ensure proper care and exercise independent professional judgement.
- Disclose to the clients, possible sources of conflicts of duties and interest while providing unbaised services.
- Conduct business observing high standard of integrity and fairness in all his dealings with clients and other merchant bankers.
- Maintain secrecy about client.
- Do not engage in unfair competition.
- Not to make misrepresentation.
- Provide true and adequate information to investors.
- Not to create false market or engage in price rigging.

8.3.4 Lead Manager

It is required under regulations that every issue should be managed by at least one merchant banker acting as 'lead manager'. Such lead manager is not required if:

- the issue is right issue.

- the size of issue is not exceeding rupees 50 lakh.

The merchant banker acting as lead manager must enter into an agreement with the concerned company. This agreement must state their mutual rights, liabilities and obligations relating to such issue. Agreement terms pertaining to particulars to disclosures, allotment and refund should be clearly defined, allocated and determined.

In bigger issues more than one lead manager can be appointed but their number is subject to norms laid down by SEBI.

Table 8.4: Number of lead mangers as per size of issue

Size of issue	Maximum number of lead manager
Less than Rs. 50 Crore	Two
Rs. 50 crore but less than Rs.100 crore	Three
Rs.100 crore but less than Rs.200 crore	Four
Rs.200 crore but less than Rs.400 crore	Five
Rs.400 crore and above	Five or more as agreed by SEBI

8.3.5 Duties of Merchant Banker / Lead Manager

(i) In case more than one merchant bankers are engaged as lead manager, they have to clearly demark their duties and responsibilities. A statement of such division of job and responsibilities is to be furnished to SEBI at least one month before opening of the issue. Where the circumstances warrant joint and several responsibility of lead manager for a particular activity, a coordinator designated from among the lead managers shall furnish to SEBI with report, comments etc. on the matters relating to the joint responsibility. The activities where division is normally sought is on "pre-issue activities" and "post issue activities", SEBI requires that "post issue activities" should

be the responsibility of one lead manager. It involves essential follow up steps like finalisation on the basis of allotment, weeding out multiple applications, listing of instrument, dispatch of certificates and refunds etc.

(ii) A merchant banker cannot be a lead manager to an issue made by anybody corporate which is an associate of the lead merchant banker.

(iii) A lead manager is not to associate with an issue if any merchant banker associated with the issue is not holder of certificate of registration.

(iv) A lead manager who is category I merchant banker has to accept a minimum underwriting obligation of 5 per cent of the total underwriting commitment or Rs. 25 lakh whichever is less. This is to ensure his financial involvement in the issue.

(v) It is his duty to submit SEBI a due diligence certificate in "Form C". This is to ensure that the contents of the prospectus or letter of an offer are verified and are reasonable. This certificate is to reach at least two weeks prior to opening of an issue.

(vi) SEBI requires lead manager to submit specified documents like particulars to the issue, draft letter of offer or prospectus.

(vii) Lead manager to incorporate changes in prospectus etc. if desired by SEBI.

(viii) Lead manager has to continue as lead manager with the issue till the subscribers have received the certificates or refunds of excess money.

(ix) Merchant bankers are prohibited from entering into any transaction, directly or indirectly in securities on the basis of unpublished price sensitive information obtained by them during the course of any professional assignment. It is referring to insider trading.

(x) SEBI is to be informed, by merchant banker about the acquisition of securities of the boy corporate whose issue is being managed by the merchant banker, within 15 days from the date of entering into such transaction.

(xi) A merchant banker has to disclose to SEBI the following information:

- his responsibilities with regard to the management of the issue.
- any change in the information or particulars previously furnished which have a bearing on the certificate granted to it.
- the name of body corporate whose issues he has managed or has been associated with.
- any default in capital adequacy requirements.
- his activities as a manager, underwriter, consultant or adviser to an issue as the case may be.

(xii) Every merchant banker shall keep and maintain the required books of accounts, records and documents like balance sheet, income statement, auditor's report, a statement of financial statement. Such records are to be maintained for 5 years. They are to submit half yearly unaudited financial results when required by SEBI with a view to monitor the capital adequacy of the merchant banker.

(xiii) When SEBI initiates inspection of the said records, the merchant banker has to cooperate. SEBI shall give notice before inspection.

8.3.6 Liabilities of Merchant Bankers

Many provisions are incorporated in the MB Regulations to regulate the activities of merchant bankers. To make them more responsible and accountable

SEBI has provisions to impose penalty in case of defaults by them. The merchant bankers are subject to penalty if they

- fail to comply the conditions subject to which certificate has been granted
- fail to comply with the provisions of the concerned rules and regulations

Two types of penalties can be imposed by SEBI on defaulting merchant bankers. One is suspension of registration and second is cancellation of registration.

8.3.6.1 Suspension of registration: Under the following circumstances the registration of a merchant is banker stands suspended when a merchant banker:

(i) violates the provisions of the Act, rules and regulations and terms of registration

(ii) fails to furnish required information to SEBI or provides false information

(iii) fails to satisfy the investors and SEBI about the complaints of investors

(iv) manipulates or rigs the price of securities

(v) misconducts or adopts unprofessional practices

(vi) fails to maintain required capital adequacy or pay the required fees

8.3.6.2 Cancellation of registration: In cases where there are grave misconducts or defaults, the registration of a merchant banker can even be cancelled. Some of such situations are where a merchant banker:

(i) indulges in deliberate manipulation or price rigging or other activities against the interest of investors.

(ii) fails to maintain satisfactory financial status which may lead to dilution in services to investors.

(iii) involves in fraud or is convicted of a criminal offence

(iv) indulges repeatedly in defaults resulting in suspension of registration.

In these regulations SEBI has deviated from the earlier penalty point system announced by SEBI in guidelines for merchant bankers in 1991. Defaults were categorized in four types, general default (Type I), minor defaults (Type II), major defaults (Type III) and serious defaults (Type IV). Penalty points are assigned to each type of defaults these being one, two, three and four respectively. The defaults in each type was specified specifically e.g.

(i) General default (Type I),

- non receipt of draft prospectus,
- inter-se allocation of responsibilities,
- due diligence certificate etc.

(ii) Minor defaults (Type II)

- exaggerated information
- non compliance of advertisement code.
- delay in refunds
- allotment of securities etc. constituted minor default,

(iii) Major defaults (Type III)

- failure to take mandatory underwriting,
- engaging more lead manager than warranted under guidelines

- association with unauthorized merchant banker etc. were termed as major defaults and
- unethical practices

(iv) Serious defaults (Type IV)

- violation of code of conduct
- non cooperation with SEBI constituted serious defaults.

8.4 PARAMETERS OF EVALUATING A MERCHANT BANKER

Merchant bankers can be evaluated by their clients (issuers or companies and investors) on two broad parameters discussed here:

8.4.1 Qualitative

It refers to those factors which hint at quality of service rendered by merchant banker. The most important feature here is quality of the staff with the merchant banker. The employed officials should be professionally qualified having expertise specially in finance, project evaluation, marketing, operation research. It is not sufficient to recruit professionals. Their knowledge should be up dated regularly so that they are near to international practices. To evaluate qualitative aspects, the merchant bankers can be judged on their ability to advise the clients on matters like capital structure, innovative instrument, ability to get clearances for client from different agencies, his association and rapport with other intermediaries like registration to the issue, bankers to the issue, underwriter etc. Even the investor evaluate the merchant banker because they will like to subscribe to the issues of only reliable merchant banker and this is more important in view of SEBI's move not to vet prospectus for any issue. Features like what is the ability to evaluate promoters, techno-economic feasibility of projects and assessing the investor friendliness of the promoter matter for investors. Issuers also consider the ability

of merchant banker to be perfect market timer. Pricing strategy is an aspect which investor as well as issuer both should evaluate before having business with a merchant banker. To high price is a loss to investor and low prices are not appreciated by the issuers. Despite the specified disclosure requirements, investors depend more on merchant banker who has a practice of more and more and dependable disclosures. Concern of merchant banker for after issue services and investors protection is another parameter used by investors to evaluate merchant bankers.

8.4.2 Quantitative

The main parameter here is his statistics of activities undertaken like the number of issues handled, the amount of funds managed, the organizations which have been his client, the size of the issue handled etc. The statistics as to the issues being quoted at discount or at premium after handling the issues is very significant parameter. How many underwritings have been done and the amount involved in the process also indicate quality of merchant banker. A merchant banker with high net worth is generally considered to be efficient. How many professionals and other qualified staff members are associated also matters.

8.4.3 Merchant Banker's Environment

Merchant bankers rendering financing services are influenced by a number of factors. These factors also assist us assessing the quality of services rendered by them. These environmental components may continue to be the same but their impact is always likely to be dynamic. Investor's expectations increase as they become more aware and educated. Regulatory agencies go on amending their rules and regulations to discipline the merchant bankers. Such changes in regulations etc. may be more frequent till the time there is professional maturity. The fast development on technology front certainly improves the quality of services if

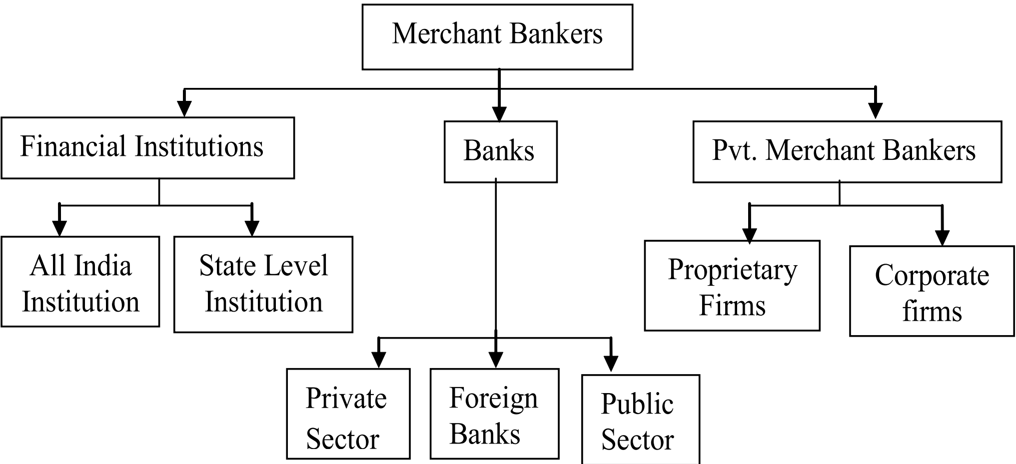
adopted. Any one not changing as per technology is sure to lag behind. Innovations always pay in profession.

8.5 FEATURES OF MERCHANT BANKING IN INDIA

8.5.1 Types

Merchant banking in India has been given a specific direction by SEBI (Merchant Bankers) Regulation. Their role in public issue is exhaustive and their responsibilities absolute, professional expertise is needed. Thus after SEBI, merchant bankers emerged from all segments of the economy. It was no longer a monopoly of institutional and banker merchant bankers. This is shown in Chart 8.1.

Chart 8.1: Types of Merchant Bankers



In simple terms the merchant banking activity can be divided amongst four segments:

(i) Institutions like IDBI, ICICI, IFCI floated merchant banking subsidiaries or divisions.

(ii) Foreign banks like Grindlays, Standard Chartered, Honkong Bank, City Bank launched merchant banking divisions.

(iii) Nationalised banks promoted subsidiaries to carry out merchant banking activities like SBI Caps, PNB Caps, Canfina.

(iv) Private sector merchant bankers like JM, Kotak Mahindra, DSP, Master Trust who were either brokers or underwriters or portfolio managers.

8.5.2 Registration

In a period of two years since SEBI took over merchant bankers, the primary market was in boom so there was a line of professionals to get them registered as merchant bankers. It was generally felt that the merchant banking profession being regulated, only competent and well equipped organizations should be granted such recognition to act as merchant bankers. However, it was strongly felt by a large number of professionals in merchant banking that SEBI's liberal grant of recognition might not augur well for long term growth of this specialised business. SEBI, on the contrary expressed a view that the large number of new players brought in a sense of competition to the profession and ultimately their success was dependent on how well they served their clientele. While SEBI had a strong rationale to support its viewpoint, many feel that this resulted in a general dilution in the quality of services. SEBI contemplated enhancing the minimum net worth requirement from Rs.10 million to Rs.25 million. In a nascent liberalized capital market environment, SEBI's task of regulating the intermediaries was certainly not very easy. Whatever critics might pointed out, the fact remained that SEBI instilled a lot of discipline into the market place.

As a result of unrestricted entry, over 350 Category I Merchant bankers got registered with SEBI till 1995. Assuming that each outfit had at least two other branch offices in India (most of them have over six branches), in effect there are

1,050 outfits. Even assuming that each outfit independently churned out three issues in a year (which is the bare minimum if one has to meet the expenses of running the office), there should have been over 3000 issues hitting the markets in a year or on an average 250 issues every month.

8.5.3 Quality of Service

Such keen competition for business led to a large number of merchant bankers compromising on quality and turning a blind eye to pretty obvious misrepresentations, and reducing the importance of the due diligence certificate to a mere formality, which was totally devoid of any kind of moral responsibility. SEBI guidelines were flouted on a regular basis by taking advantage of any loophole which could be found. They treated the SEBI Acknowledgement Card as a clean-chit given by SEBI which absolves them form all responsibilities. Matters came to such a state that there was no single person responsible for any sort of discrepancies, wrongful disclosures, inadequate or misleading information etc., intentionally or otherwise, in the offer documents. Merchant Bankers, SEBI and the issuing company seemed to be engrossed in a game of passing the parcel with each one shifting the blame and responsibility on the others. Pushed against the wall, the investors reacted by going on a prolonged holiday which forced the market and all its intermediaries to take a second look.

The merchant banking community realized the importance of specialization and also the need to bring international standards of services to the profession. Foreign collaborations were sought like ICICI tied up with JP Morgan to promote a joint venture ICICI Securities and Finance Co. Ltd.

The increase in the number of registered merchant bankers created unhealthy competition in the market. Besides, there was a significant increase in the number of new promoters coming out with new projects. Merchant bankers are solely responsible for appraising the projects of their economic and financial viability. But

appraising a project calls for experience and professional knowledge of the highest order market and specially investors experienced the ill effects of free pricing concept after abolition of CCI and by handling of issues by immature and unethical merchant bankers. In 1994 when SEBI made proportionate allotment compulsory and raised minimum subscription from Rs.1000 to Rs.5000, the market was put on institutionalization of the market. Accordingly merchant bankers had to mend their strategy. They evolved their marketing strategies which were oriented towards large investors, or the wholesale investors. Further, since they were to deal with institutional investors who are informed buyers, the merchant bankers became more conscious while selecting the issuer. To some extent weak merchant bankers were out of the business. This compelled many merchant bankers to move to other related and permitted activities. Many merchant bankers used their network to mobilise only fixed deposits.

In an attempt to prune down the number of Category I Merchant Bankers, SEBI increased the minimum net worth required of them from Rs.1 crore to Rs.5 crore. The reintroduction of imposing penalty points on erring merchant bankers was welcome step. SEBI passed on to the lead managers the power of vetting offer documents for issues.

SEBI's decision in early 1995 to make underwriting optional for new issues lead to slump in the business of merchant bankers who are engaged in underwriting. Underwritten amount reduced from 88 per cent (of the issue amount of Rs.6060.8 crore) being Rs.5360 crore in 1992-93 to mere 28 per cent (of the issue amount of Rs.10981.7 crore) being Rs.3060 crore in 1995-96. The number of issue underwritten also came down from 98 per cent of (of the issues made i.e. 528) being 518 to 31 per cent (of the issue made i.e. 1428) being 440.

In post CCI period free pricing was a boon for promoters since merchant bankers used to give them a green signal to go ahead with high premium. It was

observed that those merchant bankers, who aggressively priced issues so that the company can charge a higher premium, were preferred. But in all this the lead manager's responsibility towards the investor was all but forgotten. It was supposed to appraise the project and price it according to its true worth. But this was seldom done. On the other hand the promoters with the backing of a few brokers massively rigged the price of their share on the secondary market prior to the public issue and then the lead managers very smugly referred to the prevailing market price in the offer document to justify the high price. It was seen that promoters were using the proceeds of the loan to buy their own stock from the market to jack up their price. Promoter of the infamous MS Shoes was charged of using this route to prop up his stock on the BSE. The capacity of merchant banker to evaluate projects was doubted. Certainly MS Shoes episode made merchant banker conscious of their reputation. They attempted coming odds with the promoters. To cite an example, in April 1995 Apple Industries Ltd., which was to lead manager to an issue by Continental Engineers, withdrew citing lapses on the promoters part to disclose information. Apple Industries claimed that the promoters had not informed them that a joint venture with Shannon Development Authority, Ireland had expired. Apple withdrew its "due diligence" certificate granted to Continental and surrendered the acknowledgement card received from SEBI. Apple claimed that as responsible lead managers and to protect the interests of investors it was withdrawing from the issue. This episode was a pointer to the fact that merchant bankers are slowly cleaning up their act and avoiding issues with questionable credentials.

8.5.4 Lead managers made more responsible

The primary motive for any investor, be it an individual or a corporate entity, in subscribing to public offerings is to get adequate returns on their investment in the form of dividend, interest income and capital appreciation. The lead manager has to carry the multiple responsibilities of serving his client and also ensuring the overall quality of the issue to protect the interests of the investors and smooth

working and growth of the capital market. The critical parameters in this connection are the promoter group, the project(s) undertaken and the offer price of the securities. The viability and profitability of the project(s) undertaken and the strength of the promoter group in terms of their track record, project management capabilities and synergy of their present interest with proposed activities are undoubtedly key parameters in determining the strength of an issue.

The recent past has witnessed inherently strong offerings from even established houses receiving a poor response from the investing community due to aggressive pricing. There have been a few cases where the offer price has even been higher than the market price of the shares at the time of the issue. Apart from the often touted reason of a transition phase for the fee pricing regime, the situations has been aggravated by some of the lead managers trying to get assignments by promising a higher premium.

The post-issue scenario was an area where investors have suffered over the year, as some companies have been known to be lax in dispatching certificates and refund orders and in ensuring listing on all the Stock Exchanges as mentioned in the offer document. Lead managers had to ensure proper compliance with the existing guidelines and time schedules and also redress investor complaints within a reasonable period of time after the completion of the issue formalities.

The importance of due diligence in ensuring proper disclosure in order to enable investors to take informed investment decisions can hardly be understated. While the regulatory bodies are responsible for setting the disclosure norms, the lead managers had to ensure adequate disclosure of all important information relevant to an issue instead of interpreting the nuances of existing guidelines.

8.5.5 Business Potentials

For merchant banking business the year 1995-96 proved to be fatal since half of about 1000 merchant bankers did not have any issue to handle. As per a

survey by 'Prime Database' only 472 merchant bankers out of 1000 strong merchant banking community handled any issue at all either in lead manager, co-manager, or advisory capacity in the said period. Out of 472 only 261 were engaged as lead managers, 52 merchant bankers handled only one issue and 33 handled two issues each in the whole year.

During 1995-96 since the assignments with merchant bankers were few, a move started where in merchant bankers category IV objected to advisory role in merchant banker category I. Advisory role in open to all categories, whereas only a category I merchant banker can lead manage an issue. According to category IV merchant bankers, there is a conflict of interests when category I merchant bankers are also allowed to be advisors to an issue. Category IV merchant bankers are, in fact asked for segregation between the functions of investment banking and advisor role for the corporate finance team. The principal complaint was that a category I banker can use his financial muscle to get the advisory role whereas others in category III and IV were perfectly capable of performing. Interestingly, much of the business is generated by category III and IV merchant bankers. Naturally, after they have done a considerable amount of initial advisory work in terms of the project, its financial structuring and in many cases even recommending the issue price, it hurts to see that the title of advisor goes to a category I banker.

8.5.6 Association

SEBI contemplated the merchant bankers as Self Regulatory Organization (SRO). In this process merchant bankers promoted Association of Merchant Bankers of India (AMBI). At different times it has acted as spokesman of merchant bankers. It prepared a due diligence report defining the role and responsibilities of merchant bankers and also suggested measures for evolving standard norms for exercising 'due diligence' in capital issue. It prescribed a 'due diligence' checklist which enlists the areas to be covered during such exercise. The seven areas identified are:

(i) General background about the company

(ii) Management and Control,

(iii) Industry and Competitors

(iv) Human resources,

(v) Operations

(vi) Financial considerations and

(vii) Legal

A SEBI-AMBI interface committee was proposed with proposals to pass on some important powers to AMBI from SEBI. In this emerging SRO, difference of opinion was highlighted amongst private sector and public sector merchant banks. Consequently another association known as Federation of Merchant Bankers and Finance Companies (FMBFC) emerged. Besides providing a feedback channel for regulatory bodies, it proposes inter allia to safeguard the professionals interests of its members and educate investors on an ongoing basis.

8.5.7 Inspection

On the other hand to keep the merchant bankers disciplined SEBI started inspecting the merchant bankers of all the four categories. It is to scrutinize the quality of services provided by merchant bankers as well as to ensure that they follow the regulations and guidelines issued from time to time. SEBI claims that such inspection will be initiated generally as a follow up measure to investor complaints. Through inspection SEBI wants merchant bankers to be greater accountable and responsible. SBI Capital Market (SBI Caps) was debarred from operating for six months in December 1995 when many irregularities were detected during inspection by SEBI.

SEBI officials have been pulling up merchant bankers for not honouring their commitments and generally not maintaining discipline in pursuit of commercial interests. The Executive Director of SEBI (primary market) at annual meeting of AMBI in December 1996 had gone to an extent to observe that "those merchant bankers who did not honour their commitments do not deserve to be in business". Merchant bankers have been blamed for bringing poor quality issue in primary market and driving away the retail investors from the market. Finance Minister P. Chidambaram also made a statement that "the markets were ruined by poor quality issues brought by poor quality merchant bankers". He planned the black sheep in the merchant banking community for current state of gloom in the capital market. These facts can be substantiated by quoting finding of a study of price performance of 40 equity issues that hit the market between April 1995 and September 1996. Of the companies covered by study (41 in all) only three scrips were quoting above the offer price on the bourses in November end 1996. Two are quoted at offer price while the rest 36 scrips are quoted below the offer price.

SEBI to discipline the merchant banker took a firm stand by debarring 64 merchant bankers including leading members from public as well as private sector for not complying with the direction of SEBI to furnish information about their employees to SEBI in June 1997. Since SEBI proposed to disclose the investors about the track record of lead managers to a public / right issue, in March 1997 it sought information like names, educational qualifications, income tax details, bank account, details of any other business done in the name of self, spouse, child or parent passport number, ration card number and history of employment of the professionals working in merchant banking firms. Further, SEBI proposed to conduct test for capital market players in 1997. At least 20 per cent of personnel in such firms will be required to pass this test. The given certificate will be valid for 3 years. Such certification system is based on experience of developed and developing markets like U.S., U.K., Zambia, Sri Lanka.

8.5.8 Challenges

One general point which needs attention is that 'merchant banking is not only about issue management and underwriting as has been defined by SEBI in India. On this small and medium size operators entered into pure issue management and underwriting. Easy norms made for easy entry into merchant banking. Even after raising minimum net worth criterion new entrants entered but in absence of primary market activity they are sitting idle. In 1996-97 out of 1162 merchant bankers 720 did not have any assignment to handle. It will take time appreciate the concept of merchant banking as "servicing every financial need of the client". This concept will compel those who jumped into the business without a clear plan to exit. As market matures only a few large companies should survive.

8.5.8 Collaboration

Foreign collaboration appears to be imperative specially for merchant bankers who want to turn to external commercial borrowings and innovative fields like mergers and acquisitions. The foreign collaboration supported by sound financial position will enable merchant bankers to establish themselves in long run. Such collaborations enable sharing skill and knowledge of experienced partners. SEBI proposes to conduct test for merchant banks also besides other intermediaries. This is so because SEBI has made quality of manpower one criteria for renewal of merchant banking license. Thus, merchant bankers are to pure skill upgradation. This is also necessary since Indian market is no longer a seller's market and competition is forcing marketing skills to emerge. Merchant banking in India is still at a very primitive stage. As it matures only a few large companies will survive. Merchant bankers with innovative ideas will flourish.

8.6 SUMMARY

Merchant banking is a type of financial service that involves issues management and other related activities. Merchant bankers are the institutions engaged in the providing merchant banking services to corporate entities. There are several kinds of service rendered by merchant bankers. These include project counselling, credit syndication, corporate counselling, portfolio management, stock broking, venture capital, bill discounting, leasing, factoring, underwriting etc. SEBI has issued SEBI (Merchant Banking) Regulation on merchant banking. The regulations are applicable only to limited activities undertaken by merchant banker. Besides this, operational guidelines are required to be followed by merchant bankers in the discharge of their duties. They have pre-issue and post-issue obligations, which are a part of issue management.

8.7 GLOSSARY

- **Corporate Counselling:** Services providing towards ensuring efficient running of a corporate enterprise are called corporate counselling.
- **Credit Syndication:** It is concerned with extending finance in both Indian rupees and Foreign currency, on a consortium basis.
- **Merchant Bank:** It is an organisation that underwrites corporate securities and advises clients on various issues involved in the ownership of commercial ventures.
- **Underwriter:** An investment and banking firm, which enters a contract with the issuer of new securities to distribute them to the investing public.

8.8 SELF ASSESSMENT QUESTIONS

Q1. Mention merchant banking activities which do not require SEBI's registration ?

Q2. Mention various merchant banking activities which require SEBI's registration?

Q3. Who is lead manager?

Q4. Explain merchant bankers' categories for seeking registration under merchant banking regulations?

Q5. Explain merchant Banker's Environment?

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Q6. Under what circumstances the registration of merchant bankers stands suspended?

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8.9 LESSON END EXERCISE

Q1. Explain the role of SEBI in regulating the merchant banking operations in India?

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Q2. Explain the operational capabilities required to get registration and certificate to operate as merchant banker?

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Q3. Explain the capital adequacy required for registration as merchant bankers?

Q4. Discuss the code of conduct laid down for merchant bankers by SEBI?

Q5. Explain the duties and liabilities of lead manager?

Q6. Explain various parameters of evaluating a merchant banker?

Q7 What are the various types of merchant bankers?

Q8. Under what circumstances the registration of merchant bankers can be cancelled?

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Q9. Discuss in detail the features of merchant banking in India?

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8.10 SUGGESTED READINGS

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BANKING AND INSURANCE

INTRODUCTION TO INSURANCE

STRUCTURE

9.1 Introduction

9.2 Objectives

9.3 Meaning of Insurance

9.4 Brief History of Insurance

9.5 Characteristics of Insurance

9.6 Functions of Insurance

9.6.1 Primary Functions

9.6.2 Secondary Functions

9.6.3 Other Functions

9.7 Pre-Requisites for the Success of Insurance

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9.11 Self Assessment Questions

9.12 Lesson End Exercise

9.13 Suggested Readings

9.1 INRODUCTION

It is a commonly acknowledged phenomenon that there are countless risks in every sphere of life. For property, there are fire risks; for shipment of goods, there are perils of sea; for human life, there are risks of death or disability; and so on. The chances of occurrences of the events causing losses are quite uncertain because these may or may not take place. In other words, our life and property are not safe and there is always a risk of losing it. A simple way to cover this risk of loss money-wise is to get life and property insured. In this business, people facing common risks come together and make their small contributions to the common fund. While it may not be possible to tell in advance, which person will suffer the losses, it is possible to work out how many persons on an average out of the group may suffer the losses. When risk occurs, the loss is made good out of the common fund. In this way, each and every one shares the risk. In fact, insurance companies bear risk in return for a payment of premium, which is calculated on the likelihood of loss.

Insurance may be described as a social device to reduce or eliminate risks of loss to life and property. It is a provision which a prudent man makes against inevitable contingencies, loss or misfortune.

Once Frank H. Knight said, "Risk is uncertainty and uncertainty is one of the fundamental facts of life." Insurance is the modern method by which men make the uncertain, certain and the unequal, equal. It is the means by which success to the support of the weak and weak secure, not by favour sent by right duly purchased and paid for, the support of the strong.

Under the plan of insurance, a large number of people associate themselves by sharing risks attached to individuals. As in private life, in business also there are dangers and risks of different kinds. The aim of all types of insurance is to make provision against such dangers. The risks which can be insured against include fire, the perils of sea (marine insurance), death (life insurance) and, accidents and burglary. Any risk

contingent upon these, may be insured against at a premium a commensurate with the risk involved. Thus, collective bearing of risks is insurance.

9.2 OBJECTIVES

After reading this lesson, you should be able to explain:

- the meaning of insurance;
- brief history of insurance;
- characteristics of insurance;
- functions of insurance;
- pre-requisites for the success of insurance; and
- limitations of insurance.

9.3 MEANING OF INSURANCE

Insurance is a tool by which fatalities of a small number are compensated out of funds collected from the insured. Insurance companies pay back for financial losses arising out of occurrence of insured events, e.g. in personal accident policy the insured event is death due to accident. In fire policy the insured events are fire and other natural calamities. Hence, insurance is a safeguard against uncertainties. It provides financial recompense for losses suffered due to incident of unanticipated events, insured within the policy of insurance. Insurance, essentially, is an arrangement where the losses experimented by a few are extended over several who are exposed to similar risks. Insurance is a protection against financial loss arising on the happening of an unexpected event.

An individual who wants to cover risk pays a small amount of money to an organization called on Insurance Company and gets insured. An insurance company

insures different people by collecting a small amount of money from each one of them and collectively this money is enough to compensate or cover the loss that some members may suffer.

The fixed amount of money paid by the insured to the insurance company regularly is called premium. Insurance company collects premium to provide security for the purpose.

Insurance is an agreement or a contract between the insured and the Insurance Company (Insurer).

The term "insurance" has been defined by different experts on the subject as follows:

In the words of John Magee, "Insurance is a plan by which large number of people associate themselves and transfer to the shoulders of all, risks that attach to individuals."

In the words of Allen Z. Mayerson, "Insurance is a device for the transfer to an insurer of certain risks of economic loss that would otherwise come by the insured."

In the words of Justice Channel, "Insurance is a contract whereby one person, called the insurer, undertakes in return for the agreed consideration called premium, to pay to another person called the insured, a sum of money or its equivalent on specified event."

Example 9.1: In a village, there are 1000 houses. Each house is valued at Rs.30,000 on an average. If 10 houses get burnt every year, calculate the total loss per year. Calculate how much money each house owner should contribute per year to compensate total loss caused by fire.

Solution: Total loss per year = Rs.30,000 × 10 = Rs.3,00,000

Required contribution from each house owner = $\frac{3,00,000}{1,000}$ = Rs. 300

Therefore all the 1,000 house owners should agree to contribute a sum of Rs. 300 each at the beginning of the year and create a fund. This will be enough to pay a compensation of Rs. 30,000 to each of the 10 house owners whose house are burnt by fire. This way the risk of loss of 10 house owners is spread over a group of 1000 house owners.

Example 9.2 In a town, there are 10,000 persons who are all aged 50 years and are enjoying normal health. It is expected that 20 persons may die during the year. If the economic value of the loss suffered by the family of each dying person were taken to be Rs. 50,000, calculate the total loss. How much money each person should contribute to compensate the total loss?

Solution: Total loss workout to be = Rs. 50,000× 20 = Rs. 10,00,000

Required contribution from each person/year would be = Rs. $\frac{10,00,000}{10,000}$ = Rs. 100

This amount is enough to pay Rs. 50,000 to the family of each of the 20 dying persons. Thus, the risk of 20 persons is shared by 10,000 persons.

9.4 BRIEF HISTORY OF INSURANCE

Marine insurance is the oldest form of insurance followed by life insurance and fire insurance. The history of insurance can be traced back to the early civilization. As civilization progressed, the incidence of losses started increasing giving rise to the concept of loss sharing. The Aryans through their village co-operatives practiced loss of profit insurance. The code of Manu indicates that there was a practice of marine insurance carried out by the traders in India with those of Sri Lanka, Egypt and Greece.

The earliest transaction of insurance as practiced today can be traced back to the 14th century A.D. in Italy when ships were only being covered. This practice of

Marine Insurance, gradually spread to London during 16th century. The history of Marine Insurance is closely linked with the origin and rise of the Lloyd's shipowners. Marine traders, who used to gather at Lloyd's coffee house in London, agree to share losses to goods during transportation by ship.

Marine related losses included:

- Loss of ship by sinking due to bad weather
- Goods in transit by ship robbed by sea pirates
- Loss or damage to the goods in transit by ship due to bad weather in high sea.

The Lloyd's Act was framed to set up the Lloyd's by whom they were empowered to transact other classes of Insurance. Today, Lloyd's is regarded as the largest insurance underwriter in the world. The first insurance policy was issued in England in 1583.

9.5 CHARACTERISTICS OF INSURANCE

The following are the characteristics of insurance :

1. **Sharing of risks:** Insurance is a cooperative device to share the burden of risk which may fall on happening of some unforeseen events, such as the death of head of the family, or on happening or marine perils or loss of by fire.
2. **Cooperative device:** Insurance is a cooperative form of distributing a certain risk over a group of persons who are exposed to it. A large number of persons share the losses arising from a particular risk.
3. **Evaluation of risk:** For the purpose of ascertaining the insurance premium, the volume of risk is evaluated, which forms the basis of insurance contract.

4. **Payment on happening of specified event:** On happening of specified event, the insurance company is bound to make payment to the insured. Happening of the specified event is certain in life insurance; but in the case of fire, marine or accidental insurance, it is not necessary. In such cases, the insurer is not liable for payment of indemnity.

5. **Amount of Payment:** The amount of payment in indemnity insurance depends on the nature of losses occurred, subject to a maximum of the sum insured. In life insurance, however, a fixed amount is paid on the happening of some uncertain event or on the maturity of the policy.

6. **Large number of insured person:** The success of insurance business depends on the large number of persons insured against similar risk. This will enable the insurer to spread the losses of risk among large number of persons, thus keeping the premium rate at the minimum.

7. **Insurance is not a gambling:** Insurance is not a gambling. Gambling is illegal which gives gain to one party and loss to the other. Insurance is a valid contract to indemnity against losses. Moreover, insurable interest is present in insurance contracts and it has the element of investment also.

8. **Insurance is not charity:** Charity pays without consideration but in the case of insurance, premium is paid by the insured to the insurer in consideration of future payment.

9. **Protection against risks:** Insurance provides protection against risks involved in life, materials and property. It is a device to avoid or reduce risks.

10. **Spreading of risks:** Insurance is a plan which spreads the risks and losses of few people among a large number of people. John Magee writes, “Insurance is a plan by which a large number of people associate themselves and transfer to the shoulders of all, risks attached to individuals”.

11. **Transfer of risk:** Insurance is a plan in which the insured transfers his risk on the insurer. This may be the reason that Mayerson observes, that insurance is a device ot transfer some economic losses to the insurer, otherwise such losses would have been borne by the insured themselves.

12. **Ascertaining of losses:** By taking a life insurance policy, one can ascertain his future losses in terms of money. This is done by the insurer to determining the rate of premium; which is calculated on the basis of maximum risks.

13. **A contract:** Insurance is a legal contract between the insurer and insured under which the insurer promises to compensate the insured financially within the scope of insurance policy, and the insured promises to pay a fixed rate of premium to the insurer.

14. **Based upon certain principle:** Insurance is a contract based upon certain fundamental principles of insurance which includes utmost good faith, insurable interest, contribution, indemnity, causa proxima, subrogation, etc. which are the basis for successful operation of insurance plan.

15. **Institutional set up:** After nationalization, the insurance business in the country is operating under statutory organizational set up. In India, the Life Insurance Corporation, the General Insurance Corporation and its subsidiary companies, and private players are operating in the various fields of insurance.

16. **Insurance for pure risks only:** Pure risks give only losses to the insured, and no profits. Examples of pure risks are: accident, misfortune, death, fire, injury etc. which are all one-sided risks and the ultimate result in loss. Insurance companies issue policies against pure risks only, not against speculative risks. Speculative risks have chances of profits of losses.

17. **Social device:** Insurance is a plan of social welfare and protection of interests of the people and Miller observe, “Insurance is of social nature.”

18. **Based on mutual good-faith:** Insurance is a contract based on good faith between the parties. Therefore, both the parties are bound to disclose the important facts affecting to the contract before each other. Utmost good faith is one of the important principles of insurance.

19. **Regulation under the law:** The government of every country enacts the law governing insurance business so as to regulate and control its activities for the interest of the people. In India the Life Insurance Act 1956 and General Insurance (Nationalisation) Act 1972 and Insurance Regulatory and Development Authority Act 1999 are the major enactments in this direction.

20. **Wider scope:** The scope of insurance is much wider and extensive. Various types of policies have been developed in the country against risks on life, fire, marine, accident, theft, burglary etc.

To conclude, insurance is a device for the transfer of risk from the insured to insurer, who agree to it for a consideration (known as premium), and promises that the specified extent of loss suffered by the insured shall be compensated. It is a legal contract of a technical nature.

9.6 FUNCTIONS OF INSURANCE

The functions of insurance may be categorized as below:

1. Primary Functions
2. Secondary Functions
3. Other Functions

9.6.1 Primary Functions

The primary functions of insurance include the following:

1. **Provide protection:** The primary purpose of insurance is to provide protection against future risk, accidents, and uncertainty. Insurance cannot check the happening of the risk, but can certainly provide for the losses of risk. Professor Hopkins observes, "Insurance is a protection against economic loss by sharing the risk with others." He further adds "Insurance is the protection against economic loss."

2. **Collective bearing of risk:** Insurance is a device to share the financial loss of few among many others. Dinsdale opines, insurance is a mean by which few losses are shares among larger people. Similarly, William Bevridge observes, "The collective bearing of risks is insurance." All the insureds contribute the premiums towards a fund and out of which the persons exposed to a particular risk is paid. Similarly, Rigel and Miller observe, "Insurance is a device whereby the uncertain risk may be made more certain."

3. **Evaluation of risk:** Insurance determines the probable volume of risk by evaluating various factors that give rise to risk. Risk is the basis for determining the premium rate also.

4. **Provide certainty against risk:** Insurance is a device which helps to change from uncertainty to certainty. This may the reason that John Magee writes that the function of insurance is to provide certainty. Similarly, Riegel and Miller observe, "The function of insurance is primarily to decrease the uncertainty of events."

5. **Spreading risks:** Professor Thomas has correctly written that "Insurance is the device for spreading or distributing risks."

9.6.2 Secondary Functions

1. **Prevention of losses:** Insurance cautions individuals and businessmen to adopt suitable device to prevent unfortunate consequences of risk by observing safety

instructions; installation of automatic sparkler or alarm systems, etc. Prevention of losses cause lesser payment to the assured by the insurer and this will encourage for more savings by way of premium. Reduced rate of premiums stimulate for more business and better protection to the insureds. The Loss Prevention Association of India formed by the insurers, alerts the people about future risks and uncertainties through publicity measures.

2. **Small capital to cover larger risks:** Dinsdale observes, insurance relives the businessmen and others from security investments, by paying small amount of premium against larger risk and uncertainty. There is no need for them to invest separately for security purpose and this money can be invested in other activities.

3. **Contributes towards the development of larger enterprises:** Insurance provides development opportunity to those larger enterprises having more risks in their setting up. Even the financial institutions may be prepared to give credit to sick industrial units which have insured their assets including plant and machinery.

9.6.3 Other Functions

There are indirect functions of insurance which benefit the economy indirectly. Some of such functions are:

1. **Means of savings and investment:** Insurance serves as savings and investment. Insurance is a compulsory way of savings and it restricts the unnecessary expenses by the insured. For the purpose of availing income-tax exemptions also, people invest in insurance. In the words of Magee, insurance is a plan by which large number of people associates themselves and transfer, to the shoulders of all, risks attached to individuals".

2. **Source of earning foreign exchange:** Insurance is an international business. The country can earn foreign exchange by way of issue of marine insurance policies.

3. **Promotes exports:** Insurance makes the foreign trade risk free through different types of policies issued under marine insurance cover. In case of loss of cargo and others due to marine perils the insurance company makes good the loss.

4. **Provides social security:** Through various social protection plans, the insurance provides social security to people. It not only provides security at the time of death but also provides assistance to the insured at the time of sickness, old age, maternity etc.

9.7 PRE-REQUISITES FOR THE SUCCESS OF INSURANCE

For the successful operations of insurance, certain important factors or requisites are very essential. These are:

1. Presence of a large number of risks.
2. More risks in the life or property of a person so that he may feel necessary to be insured.
3. Probability of real loss on account of risk.
4. Presence of a large number of people exposed with the same nature and kind of risks.
5. Involvement of loss from the risk must be large enough.
6. The loss from the expected risk should be determinable in advance.
7. The happening of loss / event must be beyond the control of the insured.

8. The loss to all the insured should not take place at a time. Otherwise, the insurer may face problem in discharging all the claims at a time.

9. The cost of insurance should be feasible. In other words, the premium rates should be reasonable so that large number of people can opt for insurance as a device against risk.

10. The risk insurable should be such to become easier to calculate the actual loss.

9.8 LIMITATIONS OF INSURANCE

In spite of number of advantages of insurance, it has certain limitations. On account of such limitations, the benefits of insurance could not be availed in full. These limitations are:

1. **All the risk cannot be insured:** All the risk cannot be insured; only pure risks can be insured, speculative risks are not insurable.

2. **Insurable interest (financial interest) on the subject matter:** Insurance is possible only when the insured has insurable interest in the subject matter of insurance either at the time of insurance or at the time of loss, or at both the times; in the absence of which the contract of insurance becomes void.

3. **Impossibility of measurement of real loss:** In case the loss arisen from the happening of the event cannot be valued in terms of money, such risks are not insurable.

4. **Not possible to insure the risk covered by a single individual or a small group:** Insurance against the risk of a single individual or a small group of persons are not advisable since it is not practicable due to higher cost involved.

5. **Higher premium rates:** Another important limitation is that the premium rates are higher in our country and as such, certain category of people cannot avail

the advantage of insurance. The main reason for the higher rate of premiums is the higher operating cost.

6. **Moral hazards:** It becomes difficult to control moral hazards in insurance. There are certain people who misutilize the insurance plans for their self-interest by claiming false claims from insurance companies.

7. **Certain rights cannot be insured by private insurers:** The private insurers are not permitted to insure certain specified types of risks like unemployment insurance, bankruptcy of banks insurance, etc.

8. **Unattractive investment:** Insurance is not a profitable investment. Its main object is to provide security against risks. Insurance business cannot be a source to acquire profits.

9. **In certain cases cooperation of government is necessary:** Certain specified risks can be insured with cooperation of the government only; such as unemployment insurance, insolvency of banks, food insurance, etc.

10. **All the pure risks are not insured:** All the pure risks are not insured by the insurer. Even if does with higher rate of premium only. For example, insurer does not take any interest to accept a proposal of a person whose heart surgery has gone through.

9.9 SUMMARY

Insurance is on arrangement under which people facing common risks come to gather and make their small contributions to the common fund. While it may not be possible to say in advance which person will suffer the losses, it is possible to work out how many persons or an average out of the group, may suffer losses. When risk occurs the loss is made good out of the common fund.

Insurance is a means of protection from financial loss. It is a form of risk management, primarily used to hedge against the risk of a contingent or uncertain loss

An entity which provides insurance is known as an insurer, insurance company, insurance carrier or underwriter. A person or entity who buys insurance is known as an insured or as a policyholder. The insurance transaction involves the insured assuming a guaranteed and known relatively small loss in the form of payment to the insurer in exchange for the insurer's promise to compensate the insured in the event of a covered loss. The loss may or may not be financial, but it must be reducible to financial terms, and usually involves something in which the insured has an insurable interest established by ownership, possession, or pre-existing relationship.

The insured receives a contract, called the insurance policy, which details the conditions and circumstances under which the insurer will compensate the insured. The amount of money charged by the insurer to the Policyholder for the coverage set forth in the insurance policy is called the premium. If the insured experiences a loss which is potentially covered by the insurance policy, the insured submits a claim to the insurer for processing by a claims adjuster. The insurer may hedge its own risk by taking out reinsurance, whereby another insurance company agrees to carry some of the risk, especially if the primary insurer deems the risk too large for it to carry.

9.10 GLOSSARY

- **Contract: A** written or spoken agreement, especially one concerning employment, sales, or tenancy that is intended to be enforceable by law.
- **Hedge:** A way of protecting oneself against financial loss or other adverse circumstances.
- **Insurance:** A contract whereby one party undertakes to compensate the other party for any loss or damage suffered by the latter, in

consideration of payment of premium for a certain period of time is known as insurance.

- **Insured:** A person or organization covered by insurance.
- **Insurer:** A person or company that underwrites an insurance risk; the party in an insurance contract undertaking to pay compensation.
- **Marine:** Relating to or found in the sea.
- **Risk:** A situation involving exposure to danger. Or expose (someone or something valued) to danger, harm, or loss.

9.11 SELF ASSESSMENT QUESTIONS

Q1. Define insurance ?

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Q2. Give brief history of insurance?

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Q3. Explain primary functions of insurance?

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Q4. Explain secondary functions of insurance?

Q5. Explain other functions of insurance?

Q6. Discuss the pre-requisite for the success of insurance?

9.12 LESSON END EXERCISE

Q1. Explain insurance and describe various characteristics of insurance?

Q2. Explain various functions of insurance?

Q3. What are various limitations of insurance?

Q4. In a village, there are 2,000 houses. Each house is valued at Rs.40,000 on an average. If 20 houses get burnt every year, calculate the total loss per year. Calculate how much money each house owner should contribute per year to compensate total loss caused by fire.

Q5. In a town, there are 20,000 persons who are all aged 50 years and are enjoying normal health. It is expected that 30 persons may die during the year. If the economic value of the loss suffered by the family of each dying person were taken to be Rs. 60,000, calculate the total loss. How much money each person should contribute to compensate the total loss?

9.13 SUGGESTED READINGS

1. Ganguly, Anand, Insurance Management, New Age Publishers, New Delhi.

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BANKING AND INSURANCE

SCOPT, CLASSIFICATION AND PRINCIPLES OF INSURANCE

STRUCTURE

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10.8 Lesson End Exercise

10.9 Suggested Readings

10.1 INRODUCTION

Insurance is of primary importance both in the national economy and international trade. Insurance premium cash-flows generate funds for investment in the economy. The development of the insurance sector depends on the general level of economic development and prospects for the immediate future. Generally, there is a positive correlation between the economic development of a country and the amount the people spend on insurance. Hence, this chapter deals with the history and origin of insurance in India; definition of insurance as a contractual, financial and legal aspects of insurance.

Being a multi-dimensional subject, it is difficult to point out the origin of insurance. In the beginning, the thinker Hardy Ivamy started understanding insurance as a contractual relation between insurer and the assured through which the former undertakes to indemnify the loss caused to the latter due to an uncertain risk involved or to pay a certain sum of money in the event of an incident happening or not happening, against a consideration called as premium.

Everything in this universe is subject to accident, destruction and perishment. A businessman used this idea of risk as the substance of his business. He undertakes the burden of risk against a consideration by a probability study and affixation of an adequate consideration. He therefore earns profit on the trade of risk whereas the insured is entitled to receive the indemnification or a fixed sum on the happening of the uncertain event causing loss. Hence, the contract of insurance then is described as a mechanism of risk distribution and sharing.

10.2 OBJECTIVES

After reading this lesson, you should be able to understand:

- the scope or classification of insurance; and
- principles of Insurance

10.3 SCOPE OR CLASSIFICATION OF INSURANCE

Broadly, insurance may be classified into the following categories:

I. Classification on the basis of nature of business

II. Classification from business point of view.

III. Classification from risk point of view

10.3.1 On the basis of nature of business

On the basis of nature of business, insurance may be of the following types:

1. Life Insurance
2. Fire Insurance
3. Marine Insurance
4. Social Insurance, and
5. Miscellaneous Insurance

10.3.1.1 Life Insurance: Life insurance may be defined as a contract in which the insurer, in consideration of a certain premium, either in a lump sum or by other periodical payments, agrees to pay the assured, or to the person for whose benefit the policy is taken, the assured sum of money, on the happening of a specified event contingent on the human life.

A contract of life insurance, as in other forms of insurance, requires that the assured must have at the time of the contract an insurable interest in his life upon which the insurance is affected. In a contract of life insurance, unlike other insurance, interest has only to be proved at the date of the contract, and not necessarily present at the time when the policy falls due.

A person can assure in his own life and every part of it, and can insure for any sum whatsoever, as he likes. Similarly, a wife has an insurable interest in her husband and vice-versa. However, mere natural love and affection is not sufficient to constitute an insurable interest. It must be shown that the person affecting an assurance on the life of another is so related to that other person as to have a claim for support. For example, a sister has an insurable interest in the life of a brother who supports her.

A person not related to the other can have insurable interest on that other person. For example, a creditor has insurable interest in the life of his debtor to the extent of the debt. A creditor can insure the life of his debtor upto the amount of the debt, at the time of issue of the policy.

An employee has an insurable interest in the life of the employer arising out of contractual obligation to employ him for a stipulated period at fixed salary. Similarly, from an employer to the employee who is bound by the contract to serve for a certain period of time.

10.3.1.2 Fire Insurance: Fire insurance is a contract to indemnity the insured for distribution of or damage to property caused by fire. The insurer undertakes to pay the amount of the insured loss subject to the maximum amount stated in the policy. Fire insurance is essentially a contract of indemnity, not against accident, but against loss caused by accident. It is becoming very common in fire insurance policies to insert a condition, called the average clause, by which the insured is called upon to bear a portion of the loss himself. The main object of this clause is to check under-insurance and to encourage for full insurance. It impress upon the property-owner for the need of having his property accurately valued before insurance.

Regarding insurable interest, the insured must have insurable interest in the subject matter both at the time of affecting the policy and at the time of loss. The

risk in fire insurance policy commences from the moment of cover note, or the deposit receipt, or the interim protection is issued, and continues for the term covered by the contract of insurance. It may even date back; if the parties so intend. The rate of premium varies to the degree of hazard or risk involved.

10.3.1.3 Marine Insurance: A contract of marine insurance is an agreement whereby the insurer undertakes to indemnity the assured in a manner and to the extent thereby agreed, against marine losses, that is, the losses incidental to marine adventure. There is a marine adventure when any insurable property is exposed to marine perils. Marine perils also known as perils of the seas, means the perils consequent on, or incidental to, the navigation of the sea or the perils of the seas, such as fire, war perils, pirates, robbers, thieves; captures, jettisons, barratry and any other perils which are either of the like kind or may be designed by the policy.

There are different types of marine policies known by different names according to the manner of their execution or the risk they cover. They are voyage policy, time policy, valued policy, unvalued policy, floating policy, wager or honour policy.

10.3.1.4 Social Insurance: Social insurance has been developed to provide economic security to weaker sections of the society who are unable to pay the premium for adequate insurance. The following types of insurance can be included in social insurance:

(i) **Sickness Insurance:** In this type of insurance medical benefits, medicines and reimbursement of pay during the sickness period, etc. are given to the insured person who fell sick.

(ii) **Death Insurance:** Economic assistance is provided to dependants of the assured in case of death during employment. The employer can transfer his such liability by getting insurance policy against employees.

(iii) **Disability Insurance:** There is provision for compensation in case of total or partial disability suffered by factory employees due to accident while working in factories. According to Employees Compensation Act, the responsibility to pay compensation is vest with the employer. But the employer transfers his liability on the insurer by taking group insurance policy.

(iv) **Unemployment Insurance:** In case insured person becomes unemployed due certain specific reasons, he is given economic support till he gets employment.

(v) **Old-age Insurance:** In this category of insurance, the insured or his dependents is paid, after certain age and economic assistance.

For the last few years, the Indian Government has extended the scope of Social Insurance. Under the concept of social justice, this scheme now extended to Daily-wages earners, Rickshaw pullers, Landless labourers, Sweepers, Craftsmen, etc. through different insurance plans.

10.3.1.5 Miscellaneous Insurance: The process of fast development in the society gave rise to a number of risk or hazards. To provide security against such hazards, many other types of insurance also have been developed. The important among them are:

(i) Vehicle insurance on buses, cars, trucks, motorcycles, etc. and made compulsory so that the losses due to accidents can be claimed from the insurance company.

(ii) Personal accident insurance by paying an annual premium Rs.12 on policy worth Rs.12,000. In case of accidental death or total / partial disability, a fixed amount as per conditions of insurance, is paid to the insured.

(iii) Burglary insurance (against theft, dacoity etc.)

(iv) Legal liability insurance (insurance whereby the assured is liable to pay the damages to property or to compensate the loss of personal injury or death. This is in the form of fidelity guarantee insurance, automobiles insurance and machines etc.)

(v) Crop insurance (crops are insured against losses due to heavy rains and floods, cyclone, draughts, crop diseases, etc.)

(vi) Cattle insurance (Insurance for indemnity against the loss of cattle from various kinds of diseases).

In addition to the above, insurance plans are available against crime, medical insurance, bullock cart, jewellery, cycle rickshaw, radio, T.Vs., etc.

10.3.2 Classification from business point of view

From business point of view, insurance can be classified into two broad categories:

1. Life Insurance; and
2. General Insurance

10.3.2.1 Life Insurance: According to Life Insurance Act, 1938, life insurance refers to the contract of insurance on human life, under which if any individual's death, other than accident, or happening of any event concerning to human life, a certain amount is guaranteed to be paid to assured or his / her legal representative. According to the terms of contract the assured should pay premium, the rate of which may differ according to the human life. The act also provides for:

(a) Payment of double or triple rate of accidental benefits, as per terms of contract.

(b) Annuity on human life, and

(c) Superannuation allowance and annuity from the funds created for granting assistance to such persons.

10.3.2.2 General Insurance: According to Sec.3(g) of the General Insurance Business (Nationalisation) Act, 1972, General insurance business refers to fire, marine, and miscellaneous insurance business whether carried on singly or in combination with one or more of them, but does not include capital redemption business and annuity certain business.

10.3.3 Classification from Risk Point of View

From risk point of view, insurance can be classified into four categories

1. Personal Insurance
2. Property Insurance
3. Liability Insurance
4. Fidelity Guarantee Insurance

A brief description of each is given below:

10.3.3.1 Personal Insurance: Personal insurance refers to the loss of life by accident, or sickness to individual which is covered by the policy. The insurer undertakes to pay the sum insured on the happening of certain event or on maturity of the period of insurance. This insurable sum is determined at the time of affecting the policy and includes life insurance, accident insurance, and sickness insurance. Life insurance contains the element of investment and protection, while the accidental, sickness or health insurance contains the element of indemnity only.

10.3.3.2 Property Insurance: Contract of property insurance is a contract of indemnity. Proof by the assured of loss is an essential element of property insurance.

The policies of insurance against burglary, home-breaking or theft etc. fall under this category. The assured is required to protect the insured property. After the loss has taken place, the assured usually required to notify the police as to losses.

10.3.3.3 Liability Insurance: Liability insurance is the major field of general insurance whereby the insurer promises to pay the damage of property or to compensate the losses to a third party. The amount of compensation is paid directly to third party. The fields of liability insurance include workmen compensation insurance, third party motor insurance, professional indemnity insurance and third party liability insurance etc. In liability insurance, there may be various reasons for the arising of liability; viz. accident to a worker at the workplace, defective goods, explosion in the factory during the process of production, formation of poisonous gas within the factory, due to the uses of chemicals and other such substances in the manufacturing process.

10.3.3.4 Fidelity Guarantee Insurance: In this type of insurance, the insurer undertakes to indemnify the assured (employer) in consideration of certain premium, for losses arising out of fraud, or embezzlement on the part of the employees. This kind of insurance is frequently adopted as a precautionary measure in cases where new and untrained employees are given positions of trust and confidence.

10.4 PRINCIPLES OF INSURANCE

A contract of insurance like any other contract must possess all the essential elements of a contract, e.g. existence of an agreement, free consent of parties, competence of parties to enter into an agreement, lawful consideration, etc. In addition to these, the following requirements (principles) are most essential for a contract of insurance to be valid:

10.4.1 Good Faith

The legal maxim caveat emptor (let the buyer beware) prevails in ordinary business contracts. However, the insurance contracts are an exception to the said principle of caveat emptor.

A contract of insurance is a contract uberimae fidei (i.e. based on absolute good faith). It means that the insured must disclose all material facts concerning the subject matter of the insurance. If a material fact is not disclosed or if there is misrepresentation or fraud, it shall render the contract voidable at the option of the insurer. What is a material fact depends on the circumstances of each individual case. Hence it is a question of fact and not a question of law. It is for the law court to decide whether there has or has not been a failure to disclose material facts. Generally speaking, a material fact is one which the insurer shall take into account while considering whether to accept the risk or not to accept the risk. Further the fact is also material if it has a bearing on the amount of premium which the insurer will charge. It is important to remember that the onus of proof of concealment lies on the insurer. Further, the doctrine of good faith is not one-sided. Like the insured, the insurer is duty bound to disclose such material facts as are within his knowledge or that of his agents. For example, he must draw attention to any restrictions in his policy.

10.4.2 Indemnity

Life insurance is a contingent contract, i.e. the money becomes payable on the happening of an agreed event, e.g. in endowment policy the agreed sum becomes payable after a certain specified period of time or death whichever is earlier. Hence, the agreed sum becomes payable sooner or later.

Other forms of insurance (e.g. fire or marine) are not contingent contracts. They are contracts of indemnity. The insurer in these cases promises to indemnify

the insured person for what he actually losses on account of some mischance or misfortune. "The contract of insurance contained in a marine or fire policy is a contract of indemnity and of indemnity only, and that this contract means that the assured, in case of a loss against which the policy has been made, shall be fully indemnified but shall never be more than fully indemnified".

The considerations of public interest also dictate that the insured must not get anything more than the actual loss since otherwise the assured may be under constant temptation to destroy his property and commit a certain social act. Even in case of over-insurance (i.e. where policy is taken for a sum more than the real value of the property), the assured is entitled to only actual loss.

10.4.3 Subrogation

According to the principle of subrogation, the insurer becomes entitled to all the rights of the ensured as regards the subject matter of insurance. The principle has been expressed in an American case in the following words:

"Subrogation is the substitution of one person in place of another, whether as a creditor or as the possessor of any other rightful claim, so that he who is substituted succeeds to the rights of the other in relation to the claim, its rights remedies, or securities".

The insured may have the rights against the third party on account of negligence of the third party or on account of some mischief of the third party or on account of an agreement between the insured or third party etc.

The following essential characteristics of the doctrine of subrogation deserve consideration:

(i) Contracts of Life and Personal Accident Insurance: The doctrine of subrogation applies only to contracts of indemnity (i.e. contracts of fire

and marine insurance) since the principle is in itself a mere corollary of the 'doctrine of indemnity'. It does not apply to contracts of life and personal accident insurance. Hence, the legal representative can get the insured sum from the insurance as well as the damages, if any, from the third party.

(ii) **Payment of the whole loss:** The "doctrine of subrogation" applies only upon payment of the whole loss by the insurer to the insured. In case of partial loss, the principle does not apply. However, the express provision may entitle the insurer to exercise his right of subrogation even before the payment has been made to the insured.

(iii) **The insured to surrender all his rights claims and remedies in favour of insurers:** Upon payment of the whole loss by insurers to the insured, the insurers shall step into the shoes of the insured and shall avail themselves of all the rights-claims and remedies which the insured had against the third party/parties. If the insured himself receives compensation for the loss from the third party after he has been indemnified by his insurer, he holds that further compensation as a trustee for his insurer, to the extent that the latter is entitled to.

(iv) **Insurer entitled to benefit only to the extent of his payment:** The insurer is, by virtue of subrogation, entitled to rights, claims and remedies only to the extent of his payment. It has been made quite clear in a U.S. case according to which if the insurer, upon payment of the claim to the insured, recovers from the defaulting third party more than the amount paid under the policy, he has to pay this excess to the insured, though he may charge the insured his share of reasonable expenses incurred in collecting the money.

(v) **The insured to provide facility to the insurer:** Any action taken by the insurer against the third party is usually in the name of the assured. However,

the cost of any action taken is borne by the insurer. The insured is duty bound to give to the insurer all such reasonable facilities as the latter may require in enforcing his rights against the third parties.

(vi) **The insurer entitled to only such rights as are available to the insured:** The insurer shall be entitled to only such rights as are available to the insured. He cannot acquire better rights against the parties at fault than what the insurer himself would have had.

10.4.4 Insurable Interest

The assured must possess an "insurable interest" in the subject matter of insurance. For an insurance contract to be valid, 'Insurable Interest' is the legal right to insure. The legal right to insure is measured in terms of money and vests in a person to whom the law recognizes as a person who is interested in the preservation of a thing or the continuance of a life. Mere mutual love and affection is not considered in law as sufficient to an insurable interest for purposes of obtaining an insurance cover. A contract of insurance without an insurable interest is a wagering agreement and is void. 'Insurable interest' in different types of insurances is discussed below.

Some of the instances where a person has an insurable interest in the life of another are as follows:

(i) A son may insure his father's life on whom he is dependent. Similarly, the father can take an insurance policy on his son's life when he is dependent on him. The sum recoverable under a life policy is limited to the amount or value of the insured's insurable interest in the life insured at the date of the policy.

(ii) A creditor can take insurance on the life of his debtor only upto the amount of his debt plus some additional charges on account of premiums and interest.

(iii) A partner can insure the life of another partner to the extent of the latter's capital only. It is because in the event of his death, it is only his share in the business that needs to be paid out for running the business smoothly as far as money is concerned even after his death.

(iv) An employer has also an insurable interest in the life of his contractor, a corporation has an insurable interest in the life of a senior officer during the course of his employment in the company whose death might adversely affect the profits of the business.

(v) A trustee has an insurable interest with regard to interest of which he is a trustee.

(vi) An insurer has an insurable interest in the subject matter of a policy, therefore, he can get re-insurable cover.

(vii) Surety in the life of his principal debtors to the extent of his guarantee only.

10.4.5 Cause Proxima

Causa proxima is a Latin phrase which means proximate cause (i.e. nearest cause). It means that when the loss arises on account of more than one cause, then the nearest cause is considered responsible for the loss. It is that cause which, in a natural and unbroken series of events, is responsible for loss or damage. It is the cause closest to the result in order of effect, though not necessarily in time. Thus such a cause is proximate in efficiency. The principle of causa proxima states that to ascertain whether the insurer is liable for the loss or not, the proximate and not the remote cause must be looked to.

If there is only one cause of damage or loss, there is no difficulty in fixing the liability of the insurer. However, usually the loss or damage arises on account of a series of causes. In such a case, the principle of causa proxima is applied. But

too much stress must not be laid on the word "proximate" in the sense as to lose sight or destroy altogether the idea of the cause itself. The true and over-ruling principle is to look at the contract as a whole and to ascertain what the parties to it really want, what was that which brought about the loss, the event the accident, and this is not in an artificial sense, but in the real sense which the parties to a contract have in mind, when they speak of cause at all.

10.4.6 Doctrine of Contribution

It is another corollary of the Doctrine of Indemnity. The insured can realize his loss from the insurance companies, in case he is having more than one policy on the same subject matter which has been destroyed, in any order he likes. Of course, he is not permitted to recover more than the actual loss. The recovery of loss by the insured according to his discretion usually creates inequities among different insurers. The doctrine of contribution ensures equitable distribution of loss as between insurers. The doctrine of contribution states that insurer / insurers who has / have paid more than his / their proportionate share to the insured shall have the right to recover the proportionate contribution from other insurer / insurers. For example, a person insures his house under two policies with A for Rs.20,000 and with B for Rs.8,000. Now suppose the loss if for Rs.18,000, the contribution shall be as follows :

A shall pay:

$$\frac{20,000}{28,000} \text{X } 18,000 = \text{Rs. } 12,857.00$$

B shall pay:

$$\frac{8,000}{28,000} \text{X } 18,000 = \text{Rs. } 5,143.00$$

The above discussion reveals the following characteristics of the doctrine of contribution:

(1) The subject-matter of insurance must be same to all the policies;

(2) The peril which is insured against must be the same in all the policies;

(3) The same insured must be there in all the policies; and

(4) All the policies must be in force when the loss occurs.

It may, however, be stated that the contribution clause is usually there in the policy. This clause limits liability of the insurance company to its retable proportion of the loss due to insured peril if there is any other insurance affected by or on behalf of the insured covering any of the property destroyed or damaged. This clause discourages multiple or over-insurance and thereby prevents unfair methods of competition. The doctrine of contribution like the principles of subrogation and indemnity is applicable to fire and marine policies only.

10.5 SUMMARY

A contract of compensation for the loss or damage suffered on the occurrence of certain specified events by the insured is called insurance. Premium is payable for the period of insurance. An insurance contract is built on certain principles, such as good faith, insurable interest, compensation, subrogation, contribution etc. A life insurance contract serves the purpose of protection as well as an investment contract. It is a protection contract since it gives protection to the assured in the event of death by making a payment of the entire amount of sum assured. It is an investment contract too, as it gives the assured the advantage of returning the money with interest and bonus at the end of the policy. A contract of general insurance serves only as a protection contract and not as an investment contract, where the money paid as premium will come back to the insured, by way of claims, only on the occurrence of some specified events.

10.6 GLOSSARY

- **Fire Insurance:** Under fire insurance, the insurance company undertakes to indemnify the loss sustained by the insured party on account of fire accident.

- **General Insurance:** A contract whereby upon periodic payment of a sum of money called premium the insurer undertakes to compensate the insured in the event of any specified loss or loss suffered by the latter, is known as general insurance.

- **Liability Insurance:** Liability insurance (also called third-party insurance) is a part of the general insurance system of risk financing to protect the purchaser (the "insured") from the risks of liabilities imposed by lawsuits and similar claims.

- **Life Insurance:** A contract in which the insurer undertakes to pay a certain sum of money to the insured, either on the expiry of a specified period, or on the death of the insured, in consideration of payment of premium for a certain period of time is known as life insurance.

- **Marine Insurance:** An insurance contract which covers the risks of loss arising from the incidental to marine adventure is known as marine insurance.

- **Personal Insurance:** Personal Insurance is a type of cover that provides financial security to you and your family for events such as a serious injury or illness, loss of ability to earn, total and permanent disablement or even death.

- **Property Insurance:** Property insurance is a broad term for a series of policies that provide either property protection coverage or liability coverage.

- **Social Insurance: A** system of compulsory contribution to enable the provision of state assistance in sickness, unemployment, etc.

10.7 SELF ASSESSMENT QUESTIONS

Q1. What is life insurance?

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Q2. What is fire insurance?

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Q3. What is marine insurance?

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Q4. What is social insurance?

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Q5. What is general insurance?

Q6. What is miscellaneous insurance?

Q7. What is personal insurance?

Q8. What is property insurance?

Q9. What is liability insurance?

Q10. What is fidelity insurance?

Q11. Explain the principle of good faith?

Q12. What is principle of indemnity?

10.8 LESSON END EXERCISE

Q1. Explain various kinds of insurance on the basis of nature?

Q2. Explain various kinds of insurance on the basis of business?

Q3. Explain various kinds of insurance on the basis of risk?

Q4. Explain principle of subrogation?

Q5. Explain principle of insured interest?

Q6. Explain principle of cause proxima?

Q7. Explain principle of doctrine of contribution?

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10.9 SUGGESTED READINGS

1. Ganguly, Anand, Insurance Management, New Age Publishers, New Delhi.
2. Gupta, P.K., Insurance and Risk Management, Himalaya Publishing House, New Delhi.
3. Mathew, M.J., Insurance, RBSA Publishers, Jaipur.
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LEASE FINANCING

INTRODUCTION TO LEASE FINANCING

STRUCTURE

11.1 Introduction

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11.10 Suggested Readings

11.1 INRODUCTION

Traditionally firms acquire productive assets and use them as owners. The sources of finance to a firm for procuring assets may be internal or external. Over the years there has been a declining trend in the internally generated resources due to low profitability. The financial institutions experience paucity of funds at their disposal to meet the increasing needs of borrowers. Further, modern business environment is becoming more and more complex. To succeed in the situation, the firms aim at growth with stability. To accomplish this objective, firms are required to go for massive expansion, diversification and modernisation. Essentially such projects involve a huge amount of investment. High rate of inflation, severe cost escalation, heavy taxation and meagre internal resources forced many companies to look for alternative means of financing the projects. Leasing has emerged as a new source of financing capital assets.

11.2 OBJECTIVES

After reading this lesson, you should be able to understand:

- the concept of leasing;
- essentials of leasing; and
- types of leasing.

11.3 CONCEPT OF LEASING

Leasing, as a financing concept, is an arrangement between two parties, the leasing company or lessor and the user or lessee, whereby the former arranges to buy capital equipment for the use of the latter for an agreed period of time in return for the payment of rent. The rentals are predetermined and payable at fixed intervals of time, according to the mutual convenience of both the parties. However, the lessor remains the owner of the equipment over the primary period.

By resorting to leasing, the lessee company is able to exploit the economic value of the equipment by using it as if he owned it without having to pay for its capital cost. Lease rentals can be conveniently paid over the lease period out of profits earned from the use of the equipment and the rent is cent percent tax deductible.

Conceptually, a lease may be defined as a contractual arrangement/ transaction in which a party owning an asset/equipment (lessor) provides the asset for use to transfers the right to use the equipment to the user (lessee), over a certain agreed period of time for consideration in the form of return or periodic payment (rentals) with or without a further payment (premium). At the end of the period of contract (lease period), the asset/ equipment reverts back to the lessor unless there is a provision for the renewal of the contract. Leasing essentially involves the divorce of ownership from the economic use of an asset/equipment. It is a device of financing the cost of an asset. It is a contract in which a specific equipment required by the lessee is purchased by the lessor (financier) from a manufacturer/ vendor selected by the lessee. The lessee has possession and use of the asset on payment of the specified rentals over a predetermined period of time. Lease financing is thus a device of financing/money lending. The real function or a lessor is not renting of asset but lending of funds/finance/credit and lease financing is in effect a contract of lending money. The lessor (financier) is the nominal owner of the asset as the possession and economic use to the equipment vests in the lessee. The lessee is free to choose the asset according to his requirements and the lessor dose not take recourse to the equipment as long as the rentals are regularly paid to him.

Lease financing is one of the popular and common methods of assets based finance, which is the alternative to the loan finance. Lease is a contract. A contract under which one party, the lessor (owner) of an asset agrees to grant the use of that asset to lessee, in exchange for periodic rental payments.

Lease is contractual agreement between the owner of the assets and user of the assets for a specific period by a periodical rent.

Lease may be defined as a contractual arrangement in which a party owning an asset provides the asset for use to another, the right to use the assets to the user over a certain period of time, for consideration in form of periodic payment, with or without a further payment.

According to the equipment leasing association of UK definition, leasing is a contract between the lessor and the lessee for hire of a specific asset selected from a manufacturers or vendor of such assets by the lessee. The lessor retains the ownership of the asset. The lessee passes possession and uses the asset on payment for the specified period.

11.4 ESSENTIALS OF LEASING

The essential elements of leasing are the following:

1. **Parties to the Contract:** There are essentially two parties to a contract of lease financing, viz, the owner and the user, respectively called the lessor and the lessee. Lessors as well as lessees may be individuals, partnerships, joint stock companies, corporations or financial Institution. Sometimes, there may be joint lessors or joint lessees, particularly where the properties or the amount of finance involved is enormous. Besides, there may be a lease-broker who acts as an intermediary in arranging lease deals. Merchant banking divisions of certain foreign banks in India, subsidiaries of some Indian banks and even some private merchant bankers are acting as lease brokers. They charge certain percentage of fees for their services, ranging between 0.50 to 1 per cent. Besides, a lease contract may involve a 'lease financier', who refinances the lessor, either by providing term loans or by subscribing to equity or under a specific refinance scheme.

2. **Asset:** The asset, property or equipment to be leased is the subject matter of a contract of lease financing. The asset may be an automobile, plant and machinery, equipment, land and building, factory, a running business, aircraft, etc. The asset must, however, be of the lessee's choice suitable for his business needs.

3. **Ownership Separated from user:** The essence of a lease financing contract is that during the lease tenure, ownership of the asset vests with the lessor and its use is allowed to the lessee. On the expiry of the lease tenure, the asset reverts to the lessor.

4. **Term of Lease:** The term of lease is the period for which the agreement of lease remains in operation. Every lease should have a definite period, otherwise it will be legally inoperative. The lease period may sometimes stretch over the entire economic life of the asset (i.e., financial lease) or a period shorter than the useful life of the asset (i.e, operating lease). The lease may be perpetual, i.e., with an option at the end of the lease period to renew the lease for a further specific period.

5. **Lease Rentals:** The consideration which the lessee pays to the lessor for the lease transaction is the lease rental. The lease rentals are so structured as to compensate the lessor for the investment made in the asset (in the form of depreciation), the interest on the investment, repairs, etc. if any borne by the 1essor and servicing charges over the lease period.

6. **Modes of Terminating Lease:** At the end of the lease period, the lease is terminated and various courses are possible, viz.,

   (a) The lease is renewed on a perpetual basis or for a definite period,

   (b) The asset reverts to the lessor,

(c) The asset reverts to the lessor and the lessor sells it to a third party,

(d) The lessor sells the asset to the lessee.

The parties may mutually agree to and choose any of the aforesaid alternatives at the beginning of the lease nature.

11.5 CLASSIFICATION OF LEASING

An equipment lease transaction can differ on the basis of (i) the extent to which the risks and rewards of ownership are transferred, (ii) number of parties to the transaction, (iii) domiciles of the equipment manufacturer, the lessor and the lessee, etc. Risk with reference to leasing refers to the possibility of loss arising on account of under-utilization or technological obsolescence of the equipment while reward means the incremental net cash flows that are generated from the usage of the equipment over its economic life and the realization of the anticipated residual value on expiry of the economic life. On the basis of these variations, leasing can be classified into the following types:

1. On the basis of Term of lease
   - Finance Lease
   - Operating Lease
2. On the basis of Method of lease
   - Sale and Lease back
   - Direct Lease

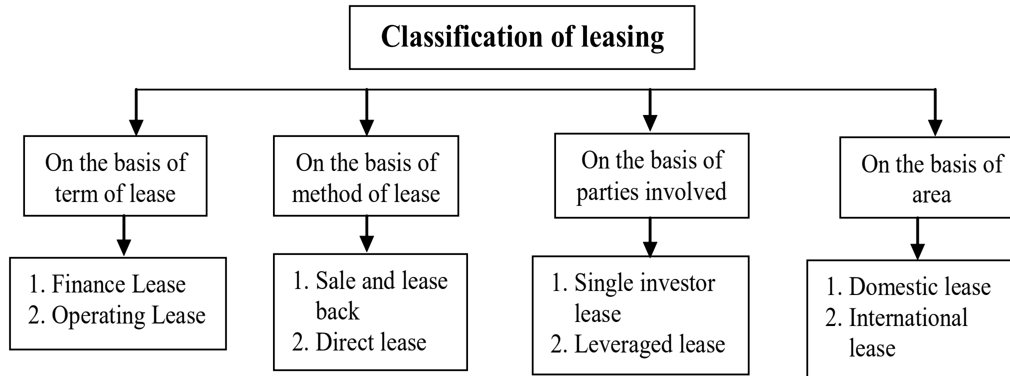
3 On the basis of Parties involved

- Single Investor Lease
- Leveraged Lease

4. On the basis of Area

- Domestic Lease
- International Lease

Chart 11.1: Classification of leasing



11.5.1 On the basis of Term of lease

11.5.1.1 Finance Lease: According to the International Accounting Standards (IAS-17), in a finance lease, the lessor transfers to the lessee, substantially all the risks and rewards incidental to the ownership of the asset whether or not the title is eventually transferred. It involves payment of rentals over an obligatory non-cancelable lease period, sufficient in total to amortize the capital outlay of the lessor and leave some profit. In such leases, the lessor is only a financier and is usually not interested in the assets. It is for this reason such leases are also usually not interested in the assests. Such leases are also called full payout leases as they enable a lessor to recover his investment in the lease and device a profit types of assets. Included under such lease are ships, aircraft, railway wagons, lands, building heavy machinery, diesel generating sets and so on.

The IAS-17 stipulates that a substantial part of the ownership related risks and rewards in leasing are transferred when:

(i) The ownership of the equipment is transferred to the lease by the end of the lease term,

(ii) The lease has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair market value at the date of the option becomes exercisable and at the stipulation of the lease.

(iii) The lease term is for a major part of the useful life of the asset. The title may not eventually be transferred. The useful life of an asset refers to the minimum of it's:

 (a) physical life in terms of the period for which it can perform its function,

 (b) technological life in the sense of the period in which it does not become obsolete.

 (c) product market life deemed as the period during which its product enjoys satisfactory market.

 The criterion / cut-off point is that if the lease term exceeds 75 per cent of the useful life of the equipment, it is a finance lease.

(iv) The present value of the minimum lease payment is greater than or substantially equal to the fair market value of the asset at the inception of the lease (cost or equipment). The title may or may not be eventually transferred. The cut-off point is that the present value exceeds 90 per cent of the fair market value of the equipment. The present value should be computed using a discount rate equal to the rate implicit in the lease in the

case of lessor and, in the case of the lessee, upon the incremental borrowing rate.

In India, however, a lease is a finance lease, if one of the last two conditions, is satisfied. A lease agreement with any of the first two conditions is treated as hire-purchase agreement.

A finance lease is structured to include the following features :

(i) The lessee (the intending buyer) selects the equipment according to his requirement from its manufacturer or distributor.

(ii) The lessee negotiates and settles with the manufacturer or distributor, the price, the delivery schedule, installation, terms of warranties, maintenance and payment, etc.

(iii) The lessor purchases the equipment either directly from the manufacturer or distributor (under straight-forward leasing) or from the lessee after the equipment is delivered (under sale and lease back).

(iv) The lessor then leases out the equipment to the lessee. The lessor retains the ownership while lessee is allowed to use the equipment.

(v) A finance lease may provide a right or option, to the lessee, to purchase the equipment at a future date. However, this practice is rarely found in India.

(vi) The lease period spreads over the expected economic life of the asset. The lease is originally for a non-cancelable period called the primary lease period during which the lessor seeks to recover his investment along with some profit. During this period cancellation of lease is possible only at a very heavy cost. Thereafter, the lease is subject to renewal for the secondary lease period, during which the rentals are substantially low.

(vii) The lessee is entitled to exclusive and peaceful use of the equipment during the entire lease period provided he pays the rentals and complies with the terms of the lease.

(viii) As the equipment is chosen by the lessee, the responsibility of its suitability, the risk of obsolescence and the liability for repair, maintenance and insurance or the equipment rest with the lessee.

11.5.1.2 Operating Lease: According to the IAS-17, an operating lease is one which is not a finance lease. In an operating lease, the lessor does not transfer all the risks and rewards incidental to the ownership of the asset and the cost of the asset is not fully amortized during the primary lease period. The lessor provides services (other than the financing of the purchase price) attached to the leased asset, such as maintenance, repair and technical advice. For this reason, operating lease includes a cost for the services provided, and the lessor does not depend on a single lessee for recovery of his cost. Operating lease is generally used for computers, office equipments, automobiles, trucks, telephones, etc.

An operating lease is structured with the following features :

(i) An operating lease is generally for a period significantly shorter than the economic life of the leased asset. In some cases it may be even on hourly, daily, weekly or monthly basis. The lease is cancelable by either party during the lease period.

(ii) Since the lease periods are shorter than the expected life of the asset, the lease rentals are not sufficient to totally amortize the cost of the assets.

(iii) The lessor does not rely on the single lessee for recovery of his investment. He has the ultimate interest in the residual value of the asset. The lessor bears the risk of obsolescence, since the lessee is free to cancel the lease at any time.

(iv) Operating lease normally include maintenance clause requiring the lessor to maintain the leased asset and provide services such as insurance, support stair, fuel, etc.

Examples of Operating leases are:

(a) Providing mobile cranes with operators,

(b) Chartering of aircraft and ships, including the provision of crew, fuel and support services.

(c) Hiring of computers with operators,

(d) Hiring of taxi for a particular travel, which includes service of driver, provision for maintenance, fuel immediate repairs, etc.

11.5.2 On the basis of Method of lease

11.5.2.1 Sale and Lease back: In a way, it is an indirect form of leasing. The owner of an equipment / asset sells it to a leasing company (Lessor) which leases it back to the owner (lessee). A classic example of this type of leasing is the sale and lease back of safe deposits values by banks under which banks sell them in their custody to a leasing company at a market price substantially higher than the book value. The leasing company in turn offers these lockers on a long-term basis to the bank. The bank subleases the lockers to its customers. The lease back arrangement in sale and lease back type of leasing can be in the form of finance lease or operating lease.

11.5.2.2 Direct Lease: A direct lease can be of two types: Bipartite and Tripartite Lease.

Bipartite Lease: There are two parties in the lease transaction, namely,

(i) Equipment supplier-cum-lessor

(ii) Lessee

Such a type of lease is typically structured as an operating lease with inbuilt facilities, like upgradation of the equipment (Upgrade Lease), addition to the original equipment configuration and so on. The lessor maintains the asset and, if necessary, replaces it with similar equipment in working conditions (Swap Lease).

Tripartite Lease: Such type of lease involves three different parties in the lease agreement: equipment supplier, lessor and lessee. An innovative variant of tripartite lease is the sales-aid lease under which the equipment supplier arranges for lease finance in various companies;

- Providing reference about the customer to the leasing company,
- Negotiating the terms of the lease with the customer and completing all the formalities on behalf of the leasing company,
- Writing the lease on account and discounting the lease receivables with the designated leasing company. The effect is that the leasing company owns the equipment and obtains an assignment of lease rental.

The sales-aid lease is usually with recourse to the supplier in the event of default by the lessee either in the form of offer from the supplier to buy back the equipment from the lessor or a guarantee on behalf of the lessee.

11.5.3 On the basis of Parties involved

11.5.3.1 Single Investor Lease: There are only two parties to the lease transaction, the lessor and the lessee. The leasing company (lessor) funds the entire investment by an appropriate mix of debt and equity funds. The debts raised by the leasing company to finance the asset are without recourse to the lessee, i.e. in the case of default in servicing the debt by the leasing company, the lender is not entitled to payment from the lessee.

11.5.3.2 Leveraged Lease: There are three parties to the transaction: (i) lessor (equity investor), (ii) lender and (iii) lessee. In such type of lease, the leasing company (equity investor) buys the asset through substantial borrowing. The lender (loan participant) obtains an assignment of the lease and a first mortgaged asset on the leased asset. The transaction is routed through a trustee who looks after the interest of the lender and lessor. On receipt of the rentals from the lessee, the trustee remits the debt service component of the rental to the loan participant and the balance to the lessor.

Like other lease transactions, leveraged lease entitles the lessor to claim tax shields on depreciation and other capital allowances on the entire investment cost including the non-recourse debt. The return on equity (profit after tax divided by net worth) is, therefore, high. From the lessee's point of view, the effective rate of interest implicit in the lease arrangement is less than on a straight loan as the lessor passes on the portion of the tax benefits to the lessee in the form of lower rental payments. Leveraged lease packages are generally structured for leasing investment-intensive assets like aircrafts, ships, etc,

11.5.4 On the basis of Area

11.5.4.1 Domestic Lease: A lease transaction is classified as domestic if all parties to the agreement, namely, equipment supplier, lessor and the lessee, are domiciled in the same country.

11.5.4.2 International Lease: If the parties to the lease transaction arc domiciled in different countries, it is known as international lease. This type of lease is further sub-classified into (i) Import Lease and (ii) Cross-border lease.

Import Lease: In an import lease, the lessor and the lessee are domiciled in the same country, but the equipment supplier is located in a different country. The lessor imports the asset and leases it to the lessee.

Cross-border Lease: When the lessor and the lessee are domiciled in different countries, the lease is classified as cross-border lease. The domicile of the supplier is immaterial.

Operationally, domestic and international leases are differentiated on the basis of risk. The latter type of lease transaction is effected by two additional risk factors, i,e, country risk and currency risk. The country risk arises from the need to structure the lease transaction in the light of an understanding of the political and economic climate and knowledge of the tax and regulatory environment governing them in the foreign countries concerned. As the payment to the supplier and the lease rentals are denominated in different currencies, any variation in the exchange rate will involve currency risk.

11.6 SUMMARY

A lease is a contract between two parties: the lessee and the lessor. The lessee is liable for periodic payments in exchange for the right to use the asset. The lessor, who is the owner of the asset, is entitled to the lease payments in exchange for lending the asset.

Many types of lease transactions are possible depending on the relationship between the lessee and the lessor. In a sales-type lease, the lessor is the manufacturer or primary dealer of the asset. In a direct lease, the lessor is an independent company that specializes in purchasing assets and leasing them to customers. If a firm already owns an asset it would prefer to lease, it can arrange a sale and leaseback transaction.

In a perfect market, the cost of leasing is equivalent to the cost of purchasing and reselling the asset. Also, the cost of leasing and then purchasing the asset is equivalent to the cost of borrowing to purchase the asset. In many cases, the lease provides options for the lessee to obtain ownership of the asset at the end of the

lease. Some examples include fair market value leases, $1.00 out leases, and fixed price or fair market value cap leases. The FASB recognizes two types of leases based on the lease terms: operating leases and capital leases. Operating leases are viewed as rentals for accounting purposes. Capital leases are viewed as purchases. The IRS separates leases into two broad categories: true tax leases and non-tax leases. With a true tax lease, the lessee deducts lease payments as an operating expense. A non-tax lease is treated as a loan.

11.7 GLOSSARY

- **Direct lease:** When the lease belongs to the owner of the assets and users of the assets with direct relationship it is called as direct lease. Direct lease may be Dipartite lease (two parties in the lease) or Tripartite lease. (Three parties in the lease)

- **Domestic lease:** In the lease transaction, if both the parties belong to the domicile of the same country it is called as domestic leasing.

- **Financing lease:** Financing lease is also called as full payout lease. It is one of the long-term leases and cannot be cancelable before the expiry of the agreement. It means a lease for terms that approach the economic life of the asset, the total payments over the term of the lease are greater than the leasers initial cost of the leased asset. For example: Hiring a factory, or building for a long period. It includes all expenditures related to maintenance.

- **International lease:** If the lease transaction and the leasing parties belong to the domicile of different countries, it is called as international leasing.

- **Leveraged lease:** This type of lease is used to acquire the high level capital cost of assets and equipments. Under this lease, there are three parties involved; the lessor, the lender and the lessee. Under the leverage lease,

the lessor acts as equity participant supplying a fraction of the total cost of the assets while the lender supplies the major part.

- **Operating lease:** Operating lease is also called as service lease. Operating lease is one of the short-term and cancelable leases. It means a lease for a time shorter than the economic life of the assets; generally the payments over the term of the lease are less than the leaser's initial cost of the leased asset. For example: Hiring a car for a particular travel. It includes all expenses such as driver salary, maintenance, fuels, repairs etc.

- **Sale and lease back:** Sale and lease back is a lease under which the leasee sells an asset for cash to a prospective leaser and then leases back the same asset, making fixed periodic payments for its use. It may be in the firm of operating leasing or financial leasing. It is one of the convenient methods of leasing which facilitates the financial liquidity of the company.

- **Single investor lease:** When the lease belongs to only two parties namely leaser and it is called as single investor lease. It consists of only one investor (owner). Normally all types of leasing such as operating, financially, sale and lease back and direct lease are coming under this category.

11.8 SELF ASSESSMENT QUESTIONS

Q1. What is leasing?

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Q2. What are the various essentials elements of leasing?

Q3. What is finance lease?

Q4. What is operating lease?

Q5. What is sale and lease back?

Q6. What is direct lease?

Q7. What is bipartite lease?

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Q8. What is tripartite lease?

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Q9. What is single investor lease?

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Q10. What is leveraged lease?

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Q11. What is domestic lease?

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Q12. What is international lease?

Q13. What is import lease?

Q14. What is cross-border lease?

11.9 LESSON END EXERCISE

Q1. Classify leasing on the basis of term of lease?

Q2. Classify leasing on the basis of method of lease?

Q3. Classify leasing on the basis of parties involved in lease?

Q4. Classify leasing on the basis of area of lease?

11.10 SUGGESTED READINGS

1. Meir, Kohn, Financial Institutions and Markets, Tata McGraw Hill, New Delhi.
2. Paramasivan, C. and Subramanian, T., Financial Management, New Age International Publishers, New Delhi.
3. Sundharam, K.P.M., and Varshney, P.N., Banking and Financial System, Sultan Chand and Sons, New Delhi.
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UNIT-III LESSON NO. 12

LEASE FINANCING

STEPS LEASING TRANSACTION

STRUCTURE

12.1 Introduction

12.2 Objective

12.3 Steps involved in Leasing Transaction

12.4 Advantages of Leasing

12.5 Limitation of Leasing

12.6 Summary

12.7 Glossary

12.8 Self Assessment Questions

12.9 Lesson End Exercise

12.10 Suggested Readings

12.1 INRODUCTION

Lessor is the owner of the asset and lessee is the person who takes the asset on lease. The lessee pays lease rentals periodically to the lessor. The lessor allows the lessee to utilize the asset over the agreed period of time. The terms and conditions of the lease contract are based on the agreement between the lessor and the lessee. The lease contract contains the period of lease. At the end of lease period, either the agreement may be renewed or the lessee may return the asset to the lesser. Sometimes, the asset may also be transferred by the lessor to the lessee. There are various terminologies related to leasing namely Lessee, Lease Rentals, Lease Property, Lease Term, Leasing Contract etc. Lessee is a person who acquires the asset on lease and also pays lease rentals. Lease Rentals is a periodic payment paid by the lessee to the lessor. It is based on depreciation, interest on investment, service charges, maintenance charges, repairs, installation charges, etc. Lease property is the property which is let out for lease by the lessor to the lessee. It also contains details regarding lessor, lessee, about lease rentals nature, etc. Lease term is the duration for which the property is let out for lease. Leasing contract covers name of the lessor, lessee, date of lease agreement, duration, nature of leasing, lease rentals and who has to pay, and types of lease equipment.

12.2 OBJECTIVE

After reading this lesson, you should be able to understand:

- the steps in leasing transaction;
- advantages of leasing; and
- limitations of leasing.

12.3 STEPS INVOLVED IN LEASING TRANSACTION

Figure 12.1: Steps involved in leasing transaction

The steps involved in a leasing transaction are summarised as follows:

1. **Lease Selection:** First, the lessee has to decide the asset required and select the suppler. He has to decide about the design specifications, the price, warranties, terms of delivery, servicing etc.

2. **Lease Agreement:** The lessee then enters into a lease agreement with the lessor. The lease agreement contains the terms and conditions of the lease such as:

   (a) The basic lease period during which the lease is irrecoverable.

   (b) The timing and amount of periodical rental payments during the lease period.

   (c) Details of any option to renew the lease or to purchase the asset at the end of the period.

   (d) Details regarding payment of cost of maintenance and repairs, taxes, insurance and other expenses.

3. **Asset Delivery and Payments:** After the lease agreement is signed the lessor contacts the manufacturer and requests him to supply the asset to

the lessee. The lessor makes payment to the manufacturer after the asset has been delivered and accepted by the lessee.

12.4 ADVANTAGES OF LEASING

12.4.1 To the Lessee

Lease financing has the following advantages to the lessee:

1. **Financing of Capital goods:** Lease financing enables the lessee to have finance for huge investments in land, building, plant, machinery, heavy equipments, etc., up to 100 per cent, without requiring any immediate down payment. Thus, the lessee is able to commence his business virtually without making any initial investment (of course, he may have to invest the minimal sum of working capital needs).

2. **Additional Source of Finance:** Leasing facilitates the acquisition of equipment, plant and machinery, without the necessary capital outlay, and, thus, has a competitive advantage of mobilizing the scarce financial resources of the business enterprise. It enhances the working capital position and makes available the internal accruals for business operations.

3. **Less Costly:** Leasing as a method of financing is less costly than other alternatives available.

4. **Off-Balance Sheet Financing:** Neither the leased asset nor the lease liability is depicted on the balance sheet except the fact of lease arrangement which is mentioned by way of a footnote. Lease financing, therefore, does not affect the debt raising capacity of the enterprise, the lessor's security being also confirmed to the leased asset.

   However, the advantage is by, and large, more apparent than real. Development banks and other lending agencies do not base their decision

to lend solely on the apparent strength of the balance sheet of the borrower. They certainly call for information regarding the off-balance sheet liabilities to assess the real borrowing capacity.

But the off-balance sheet financing can be misleading to lenders who rely on the financial statements. In brief, the non-disclosure of outstanding lease obligations and the value of the leased assets in the balance sheet would result in (i) understatement of debt -equity ratio and (ii) Over statement of asset turnover ratio as well as return on investment. They under-estimate the real risk and over-estimate the value of the firm as they are affected by these variables. In recognition of the distortions implicit in the non-disclosures of finance lease in the financial statements of the lessee, the IAS-17 has recommended capitalization of finance leases in the books of the lessee.

5. **Ownership Preserved:** Leasing provides finance without diluting the ownership or control of the promoters. Against it, other modes of long-term finance, viz, equity or debentures, normally dilute the ownership of the promoters.

6. **Avoid Conditionalities:** Lease finance is considered preferable to institutional finance, as in the former case, there are no conditionalities. Lease financing is beneficial since it is free from restrictive covenants and conditionalities, such as, representations on the board, conversion of debt into equity, payment of dividend, etc, which usually accompany institutional finance and term loans from banks.

7. **Flexibility in Structuring of Rentals:** The lease rentals can be structured to accommodate the cash flow situation of the lessee, making the payment of rentals convenient to him. The lease rentals are so tailor-made that the lessee is able to pay the rentals from the funds generated from operations.

The lease period is also chosen so as to suit the lessee's capacity to pay rentals and considering the operating life-span of the asset.

8. **Simplicity:** A lease finance arrangement is simple to negotiate and free from cumbersome procedures with faster and simple documentation. As against it, institutional finance and term loans require compliance of covenants and formalities and bulk of documentation, causing procedural delays.

9. **Tax Benefits:** By suitable structuring of lease rentals, a lot of tax advantages can be derived. If the lessee is in a tax paying position, the rental may be increased to lower his taxable income. The cost of asset is thus amortized more rapidly than in a case where the asset is owned by the lessee, since depreciation is allowable at the prescribed rates. If the lessor is in tax paying position, the rentals may be lowered to pass on a part of the tax benefit to the lessee. Thus, the rentals can be adjusted suitably for postponement of taxes.

10. **Obsolescence Risk is Averted:** In a lease arrangement the lessor being the owner bears the risk of obsolescence and the lessee is always free to replace the asset with the latest technology.

12.4.2 To the Lessor

A lessor has the following advantages:

1. **Full Security:** The lessor's interest is fully secured since he is always the owner of the leased asset and can take repossession of the asset if the lessee defaults. As against it, realising an asset secured against a loan is more difficult and cumbersome.

2. **Tax Benefit:** The greatest advantage for the lessor is the tax relief by way of depreciation. If the lessor is in high tax bracket, he can lease out assets with high depreciation rates, and thus, reduce his tax liability substantially. Besides, the rentals can be suitably structured to pass on some tax benefit to the lessees.

3. **High Profitability:** The leasing business is highly profitable since the rate of return is more than what the lessor pays on his borrowings. Also, the rate of return is more than in case of lending finance directly.

4. **Trading on Equity:** Lessors usually carry out their operations with greater financial leverage, That is, they have a very low equity capital and use a substantial amount of borrowed funds and deposits. Thus, the ultimate return on equity is very high.

5. **High Growth Potential:** The leasing industry has a high growth potential. Leasing financing enables the lessees to acquire equipment and machinery even during a period of depression, since they do not have to invest any capital. Leasing, thus, maintains the economic growth even during recessionary period.

12.5 LIMITATIONS OF LEASING

Lease financing suffers from certain limitations which are discussed as under:

1. **Restrictions on Use of Equipment:** A lease arrangement may impose certain restrictions on use of the equipment, or require compulsory insurance, etc. Besides, the lessee is not free to make additions or alterations to the leased asset to suit his requirements.

2. **Limitations of Financial Lease:** A financial lease may entail higher payout obligations, if the equipment is found not useful and the lessee opts for

premature termination of the lease agreement. Besides, the lessee is not entitled to the protection of express or implied warranties since he is not the owner of the asset.

3. **Loss of Residual Value:** The lessee never becomes the owner of the leased asset. Thus, he is deprived of the residual value of the asset and is not even entitled to any improvements done by the lessor or caused by inflation or otherwise, such as appreciation in value of leasehold land.

4. **Consequences of Default:** If the lessee defaults in complying with any terms and conditions of the lease contract, the lessor may terminate the lease and take over the possession of the leased asset. In case of finance lease, the lessee may be required to pay for damages and accelerated rental payments.

5. **Understatement of Lessee's Asset:** Since the leased assets do not form part of lessee's assets, there is an effective understatement of his assets, which may sometimes lead to gross under-estimation of the lessee. However, there is now an accounting practice to disclose the leased assets by way or footnote to the balance sheet.

6. **Double Sales Tax:** With the amendment of sale-tax law in various states, a lease financing transaction may be charged to sales tax twice-once when the lessor purchases the equipment and again when it is leased to the lessee.

12.6 SUMMARY

Leasing transactions involves three steps. Firstly lessee identifies the equipment and the supplier or lessor of the asset. Secondly, lessee enters into agreement with lessor and lastly, lessor delivers the asset to the lessee.

There are various advantages of leasing. Lessee can enjoy the asset without acquiring or owing the asset. The lessee need not pay down payment in leasing. It helps to avoid outflow of cash. Hence, less amount of working capital can be retained in the business. A leasing contract can be modified according to the needs of any business or the lessee. Leasing does not require any significant down payment. It provides 100 percent financing option. Leasing provides tax benefits. Lease payments can be deducted as an operating expense, rather than depreciating asset over a longer period of time. Small scale industries can benefit through leasing. They can go for modernization and increase production by leasing plant and machinery. Financial institutions will not be willing to grant long term loans of higher value for a newly started business, Hence new entrepreneurs can enjoy the asset without owning them through leasing. They need not borrow loans for buying the asset. A business has to borrow money to buy equipment. But through leasing equipment need not be purchased. Hence it provides better debt equity ratio. Lease payments and rates are fixed, hence it is very easy to forecast and prepare financial budgets accurately. Leasing is not treated as loan and it will not appear in the liability side of the balance sheet. So, the debt equity ratio of the concern is not affected due to leasing. Hence, the company can enjoy a better image in the market. New loans can also be borrowed from the financial institutions because of holding a better image in the market. Lessee can decide the type of leasing, asset or property and the supplier according to the requirement. Lessee can utilize the asset for longer period of time. Lessee can either renew the contract or terminate the contract according to the requirement. Tax benefits are available both to the lessee and the lessor. All the leasing charges paid will be treated as revenue expenditure. Leasing helps in reduction of payment of tax. Lessee enjoys the utilization of asset without spending money on capital expenditure. Leasing is the cheapest or fastest mode of getting higher value of assets. It is very beneficial to the small scale industrialist who requires assts immediately for production as it is difficult for the small scale industries to avail loan from financial institution. A lessee can opt for operating

leasing when the asset acquired is subject to the technological changes. Lessee can enjoy the asset without acquiring it. Technocrats can enjoy more benefits through leasing as the promoters will not able to contribute sufficient margin money.

12.7 GLOSSARY

- **Balance-Sheet:** It is a statement of the assets, liabilities, and capital of a business or other organization at a particular point in time, detailing the balance of income and expenditure over the preceding period.
- **Capital Goods:** Goods that are used in producing other goods, rather than being bought by consumers.
- **Debentures: A** long-term security yielding a fixed rate of interest, issued by a company and secured against assets.
- **Equity shares:** Equity shares are the vital source for raising long-term capital. Equity shares represent the ownership of a company and capital raised by the issue of such **shares** is known as ownership capital or owner's funds.
- **IAS-17:** IAS 17 prescribes the accounting policies and disclosures applicable to leases, both for lessees and lessors.
- **Off-Balance-Sheet:** Off balance sheet refers to items that are effectively assets or liabilities of a company but do not appear on the company's balance sheet.

12.8 SELF ASSESSMENT QUESTIONS

Q1. What you mean by lease transaction?

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Q2. What is leasing selection?

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Q3. What is lease agreement?

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Q4. When lease transaction comes to an end?

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Q5. How leasing helps in tax benefits?

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12.9 LESSON END EXERCISE

Q1. Explain steps in leasing transaction?

Q2. What are the various advantages of leasing to the lessee?

Q3. What are the various advantages of leasing to the lessor?

Q4. What are the limitations of leasing?

12.10 SUGGESTED READINGS

1. Meir, Kohn, Financial Institutions and Markets, Tata McGraw Hill, New Delhi.

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LEASE FINANCING

LEGAL ASPECTS OF LEASING

STRUCTURE

13.1 Introduction

13.2 Objectives

13.3 Legal Aspects of Leasing

13.4 Contents of a Lease Agreement

13.5 Income Tax Provisions Relating to Leasing

13.6 Sales Tax Provisions Pertaining to Leasing

13.7 Summary

13.8 Glossary

13.9 Self Assessment Questions

13.10 Lesson End Exercise

13.11 Suggested Readings

13.1 INRODUCTION

In the over 100 countries that govern accounting using International Financial Reporting Standards, the controlling standard is IAS 17, "Leases". However, it is currently being phased out and to be replaced with IFRS 16 for reporting periods from 2019. While IAS 17 is similar in many respects to FAS 13 in the U.S., IAS 17 avoids the "bright line" tests (specifying an exact percentage as a limit) on the lease term and present value of the rents. Instead, IAS 17 has the following five tests. If any of these tests are met, the lease is considered a finance lease:

- ownership of the asset is transferred to the lessee at the end of the lease term;
- the lease contains a bargain purchase option to buy the equipment at less than fair market value;
- the lease term is for the major part of the economic life of the asset even if title is not transferred;
- at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset.
- the leased assets are of a specialised nature such that only the lessee can use them without major modifications being made.

IAS 17 is now transitioning to IFRS 16, as a joint project with the U.S. lease accounting standard. The standard was published in 2016, with companies required to have implemented it by 2019 or earlier. The criteria for being classified as a finance lease are similar to the above, but judgment is required. Simply meeting one requirement may not be enough.

In India, finance lease is one in which risk and rewards incidental to the ownership of the leased asset are transferred to lessee but not the actual ownership. Thus, in case of finance lease notional ownership is passed to the lessee.

Features of finance lease:

- it's not cancel-able.
- the lessor may or may not bear the cost of insurance, repair, maintenance etc. Usually the lessee has to bear all cost.
- the lessor may transfer ownership of the asset to the lessee by the end of the lease term.
- the lessee has an option to purchase the asset at a price which is expected to be sufficiently lower than the value at the end of the lease period.

13.2 OBJECTIVES

After reading this lesson, you should be able to understand:

- the legal aspects of leasing;
- contents of a lease agreement;
- income tax provisions relating to leasing; and
- sales tax provisions relating to leasing.

13.3 LEGAL ASPECTS OF LEASING

There is no separate statute for equipment leasing in India. The provisions relating to bailment in the Indian Contract Act govern equipment leasing agreements as well Section 148 of the Indian Contract Act defines bailment as:

The delivery of goods by one person to another, for some purpose, upon a contract that they shall, when the purpose is accomplished, be returned or otherwise disposed off according to the directions of the person delivering them. The person delivering the goods is called the "bailor" and the person to whom they are delivered is called the "bailee".

Since an equipment lease transaction is regarded as a contract of bailment, the obligations of the lessor and the lessee are similar to those of the bailor and the bailee (other than those expressly specified in the least contract) as defined by the provisions of sections 150 and 168 of the Indian Contract Act. Essentially these provisions have the following implications for the lessor and the lessee.

(i) The lessor has the duty to deliver the asset to the lessee, to legally authorise the lessee to use the asset, and to leave the asset in peaceful possession of the lessee during the currency of the agreement.

(ii) The lessee has the obligation to pay the lease rentals as specified in the lease agreement, to protect the lessor's title to take reasonable care of the asset, and to return the leased asset on the expiry of the lease period.

13.4 CONTENTS OF A LEASE AGREEMENT

The lease agreement specifies the legal rights and obligations of the lessor and the lessee. It typically contains terms relating to the following:

1. Description of the lessor, the lessee, and the equipment.

2. Amount, time, and place of rental payments.

3. Time and place of equipment delivery.

4. Lessee's responsibility for taking delivery and possession of the leased equipment.

5. Lessee's responsibility for maintenance, repairs, registration, etc and the lessor's right in case of default by the lessee.

6. Lessee's right to enjoy the benefits of the warranties provided by the equipment manufacturer / supplier.

7. Insurance to be taken by the lessee on behalf of the lessor.

8. Variation in lease rentals if there is a change in certain external factors like bank interest rates, depreciation rates, and fiscal incentives.

9. Option of lease renewal for the lessee.

10. Return of equipment on expiry of the lease period.

11. Arbitration procedure in the event of dispute.

13.5 INCOME TAX PROVISIONS RELATING TO LEASING

The principal income tax provisions relating to leasing are as follows:

(i) The lessee can claim lease rentals as tax-deductible expenses.

(ii) The lease rentals received by the lessor are taxable under the head of "Profits and Gains of Business or Profession".

(iii) The lessor can claim depreciation on the investment made in leased assets.

The Lease Transaction

The lease Transaction involves obligatory (absolute and unconditional) rental payments by the lessee to the lessor, sufficient to cover the leasing company's initial outlay, interest and other costs and provide some profit.

It is interesting to mention, that the experience of the Western countries reveal wide variations in the "annual payment plans" as a percentage of original cost. It varied between 40 to 60 percent on a declining basis as the period of lease increased. Similarly, total repayment seems to vary from 115 to 136 percent of the original cost. People also believe that leasing transactions provide tax-shelter and tax concessions for the lessor, although revision in tax-laws that permits a firm to take large depreciation allowances may lessen the advantages of leasing to a tenant.

Tax Benefits in Leasing

Different countries have adopted their own approaches in this context, in U. K. and U.S.A. investment incentives tend to have been extended so as to provide tax shelter for lessors. Germany and Scandinavian countries provide for it to lesser degree. While in France there is practically no such provision.

The tax benefits accruing to long-term investment in fixed capital have given rise to different viewpoints. The question posed in this context is whether the tax shelter arising out of investment incentives should accrue to the lessor. For, it is also viewed that leasing is used as an instrument for avoiding or deferring tax liability. Where the incidence of tax is heavy, a leasing company may have access to taxable capital and shelter it by purchasing assets for use by lessee. The lessor may offer a lower rate to the lessee and share a part of tax benefits with the lessee. One may argue that the leasing companies are able to spread the incentives to different industrial enterprises irrespective of whether such enterprises are paying tax or not. In other words, an enterprise not making sufficient current profit to take advantage of tax incentives for new investment may find it worthwhile to derive lower rental benefit which a leasing company availing of the tax benefit may allow. Thus, incentives may be spread among industrial companies which are profitable as well as those which are not so profitable. From this, one may contend that the weaker enterprises which do not deserve to be encouraged may also be sustained to continue.

As per the Income Act, 1961

Under the Income Tax Act 1961, the benefits of depreciation and investment allowance accrue to the owner of the asset who uses it for the purpose of the business carried on by him. Hence, the benefit of depreciation can be availed only by the “lessor” though the lessee would be entitled to charge the entire amount of lease rentals against profits.

The matter relating to allowability of investment allowance even to the "lessor" is subject to doubts. There is some controversy over the entitlement of investment allowance.

The Madras Bench of the Income Tax Appellate Tribunal held, in First Leasing Co. Ltd. Vs I.T.O. (1982), that the leasing company (i.e., the owner) would be entitled to investment allowance on the plant and machinery leased by it provided the other conditions specified in Section 32 A of the Act are fulfilled.

With effect front 1st April, 1987, the provisions of a new section 32AB, entitled "Investment Deposit Account" will become applicable, according to which, where any person purchases any new ship, new aircraft or new machinery or plant, shall be entitled to a deduction of:

(i) the amount or amounts so utilised for the purchase of the asset, or

(ii) 20% of the profits of "eligible business or profession" whichever is less.

By implication, the benefit of this section will not be available even to the lessor unless and until the asset is leased out to a small-scale industrial undertaking which is not engaged in the business of construction, manufacture or production of any article or thing specified in the Eleventh Schedule.

13.6 SALES TAX PROVISIONS PERTAINING TO LEASING

The major sales tax provisions relevant for leasing are as follows:

(i) The lessor is not entitled for the confessional rate of central sales tax because the asset purchased for leasing is meant neither for resale nor for use in manufacture. (It may be noted that if a firm buys an asset for resale or for use in manufacture it is entitled for the confessional rate of sales tax).

(ii) The 46th Amendment Act has brought lease transitions under the purview of 'sale' and has empowered the central and state government to levy sales tax

on lease transactions. While the Central Sales Tax Act has yet to be amended in this respect, several state governments have amended their sales tax laws to impose sales tax on lease transactions.

Leasing companies are required to pay sales-tax at higher rates as leasing companies are not allowed to use "C" Form. This makes leasing correspondingly more expensive as the cost of the asset acquired under lease finance becomes inflated to the extent of the sales tax paid by leasing companies. The following example clarifies this point.

In this context, "eligible business or profession" expressly excludes :

(i) the business of construction, manufacture or production of any article or thing, specified in the list in the Eleventh Schedule, carried on by an industrial undertaking as defined in Section 80 HHS;

(ii) the business of leasing or hiring of machinery or plant to an industrial undertaking other than a small-scale industrial undertaking engaged in the business of construction, manufacture or production of any article or thing specified in the list in the Eleventh Schedule.

The cost of the asset under lease transaction is about 5.5% to 6% higher than the asset acquired under loan option. Hence, the lessee is required to pay more for the same asset under lease finance assistance as compared to loan option. Of course, the ultimate sufferer is the lessee. However, lease business as a whole gets indirectly affected on this account.

In states like Maharashtra and Gujarat, lease rentals are taxed as per sales tax laws in force. This also makes leasing more expensive, because lessee is required to pay sales tax on the rentals paid to lessor. In addition to paying the higher amount of rentals due to increased cost of asset on account of the reasons mentioned above.

Tax Deferment

It is commonly misunderstood (now perhaps understood) that Leasing save taxes. There is not even a saving of a signal rupee of tax. Unlike in the purchase where only interest part of the installments becomes income, in lease the whole installments (technically called lease rent) becomes income. But the lessor gets depreciation benefit also. Over a number of years the sum total of capital recovered inbuilt into lease rentals is exactly equal. So there is no question of tax saving. But leasing result into tax deferment.

The benefit of tax deferral is due to the following :

(a) Depreciation is front loaded expense (from income tax angle since the Income Tax Act allows, only WDV method of charging depreciation) whereas capital recovery is back loaded.

Depreciation benefit in first year exceeds capital recovery, so lessor is able to postpone the tax liability. The relationship between depreciation and capital recovery gets reversed which means depreciation is more income for taxation. The postponement of tax liability is a function of lessors ability to write enough lease to keep himself out of tax net. But that is possible only in initial years of organisation and once the growth rate stabilizes (means the firm is in equilibrium), the firm has to pay tax. This is called Structural Difference.

(b) Another major feature of depreciation and capital recovery' (these should be corresponding figures in profit and loss account) is the Time Horizon Difference, whereas for writing off asset (say having 40 per cent depreciation rate) it will require approximately 12 years, it takes a less number of years to recover entire capital (say 5 years equal to lease tenure).

The net tax gain or even loss can be calculated mathematically as under:

Tax Gain = [present value of depreciation-present value of Capital Recovery]* tax rate

Tax Loss = [present value of capital recovery-present value of depreciation]* tax rate

Interpretation of Tax Loss

Through the absolute values of capital recovery and deprecation benefit will always be equal but the discounted value of the both will be invariably different on account of "time horizon difference" and "structural difference". In the example, it is evident that the lessor is offering even capital receipt, i.e., his own investment for taxation. Thus besides paying tax on finance charges he is paying tax on his investment.

So as is evident from the above Tables the lessor should be careful in writing off the lease transaction. It was noted that some leasing companies were structuring their transactions in such a way that more than 50 per cent of the lease rent is received in the first year completely unaware of the fact that it reduced their total profitability by an amount equal to tax loss. At macro level, the revenue remains totally unaffected. Tax Gain of lessor means Tax Loss of lessee and vice-versa. Consider a user of the asset instead of acquiring the asset by raising debt acquires through lease. Then at macro level, the following debits and credits will be appearing from tax point of view.

Taxation with Regard to Sale and Leaseback

In this arrangement, an equipment user who is also legal owner of the equipment sells to leasing company the equipment. The equipment has a reasonable remaining economic life. The leasing company then leases back this equipment to the seller who then becomes lessee. The whole transaction is done only on paper and there is no actual physical movement of the equipment even though the ownership changes. The user company normally prefers to do so because of number of reasons including:

(i) it is facing liquidity crunch and it expects that the sale proceeds will help it in coming out of the crunch,

(ii) financing working capital requirements,

(iii) if the sale price is more than the book value of the asset, the selling of such an asset results into book profit. The book profit might not be taxable due to block of assets concept of depreciation in Income Tax.

In this kind of arrangement the leasing company should prefer an independent valuation of the asset and then go for the transaction. If the lessor agrees to purchase it at higher price, he will be doing so at a great risk because in case of lessee's default in payment of dues followed by repossession of the asset, he may not be able to sell the asset for an amount which is at least equal to his outstanding exposure.

The malpractices and the 1997 Income Tax Amendment

While this arrangement seems to be quite genuine, some companies misused it. There were reports of sale and leaseback of non-existent assets or at an exorbitant price with a view to enhanced depreciation benefit to the leasing company. Some loss making companies having huge plant and machineries used to sell their plant at a very high price so that the brought forward losses, mainly unabsorbed depreciation, under Income Tax Act, could do set -off against the income under any head. This was coupled with the fact that the leasing company then adds the acquisition cost of the asset, which was much higher than the fair market value, to its relevant block of assets. So in a nutshell, the dead loss was being set-off against the income which otherwise would have been taxable.

The 1997 tax amendment, the consequence was inevitable. There was loss to the revenue, necessitating an amendment in the Income-tax Act. To check this malpractice Expl.4A to section 43(1) was inserted in the Income Tax Act w.e.f. assessment year 1997-98 which in simple words mean in the case of sale and lease back transaction the actual cost for the purposes of adding it to the relevant block shall be same as the written down value of the said asset at the time of transfer in the hands

of seller. So it is irrelevant for how much the leasing company acquires the asset. What is relevant is the WDV in the hands of selling company at the time of transfer. Also the unabsorbed depreciation can now be only set-off against the profits of business or profession. So the loophole of "Loss Transfer" has now been plugged.

Devising a lease transaction

The following points must be kept in mind while devising a lease transaction

(i) As far as possible, the company should prefer to write leases towards the close of half-years relevant for income-tax purposes. The last date of the first half-year is 2nd October and for the second half-year, it is 1st March.

(ii) Have a secondary' lease period to prolong depreciation benefit.

(iii) In case of lease of commercial vehicles especially heavy' vehicles normally the transporter (lessee) incurs expenditure on body building increase the security deposit in order to keep its exposure exactly same in the lease. By doing so, the impact of depreciation benefit in initial years will be sharper.

(iv) Lease tenure should be at least 3 to 5 years depending upon depreciation rate.

(v) The percentage of security deposit to the cost of asset should not be less than the percentage of written down value to the cost of the asset at the end of the lease tenure. This will ensure that the transaction does not result into tax loss.

Transfer of lease asset at the end of lease tenure.

The following precautions must be taken at the time of transfer of lease asset at the end of the Lease tenure :

(i) It should not appear that the asset never restored back to lessor. In lease, at the end of lease tenure, asset reverts back to lessor. It should be evidenced

somehow that the lessor took back the delivery of equipment and then sold it to the person (lessee in most of the cases).

(ii) Do not transfer the asset at a price which exactly or is almost equal to the residual value as mentioned in the schedule to lease agreement. If it is done so, it would appear that price was initially settled which means the authorities can deem this transaction as a deferred sale as a consequence the depreciation benefit could be jeopardised.

13.7 SUMMARY

Leasing offers to a lessor several advantages over ownership of an asset. Under existing tax laws, lease rental incurred are considered operating expenses and hence deductible from taxable income.

Moreover, the lessor has the leased asset as a form of security and should there be financial problems, the lessor can legally repossess the asset. The lessee, too, benefits in obtaining full deductions (with exceptions) of lease rental if the leased asset is used exclusively for the production of income.

13.8 GLOSSARY

- **FAS:** Financial Accounting Standards
- **IFRS:** International Financial Reporting Standards (IFRS) is a set of accounting standards developed by an independent, not-for-profit organization called the International Accounting Standards Board (IASB).
- **Tax Deferment:** Tax deferral refers to instances where a taxpayer can delay paying taxes to some future period. In theory, the net taxes paid should be the same. Taxes can sometimes be deferred

indefinitely, or may be taxed at a lower rate in the future, particularly for deferral of income taxes.

- **WDV method of Depreciation:** Written down value is a method of depreciation in which a fixed rate of depreciation is charged on the book value of the asset, over its useful life. In straight-line method, depreciation is calculated on the original cost.

13.9 SELF ASSESSMENT QUESTIONS

Q1. What are the contents of lease agreement?

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Q2. What are the various tax benefits in leasing?

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Q3. What you mean by tax deferment?

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Q4. Explain the taxation with regard to sale and leaseback?

Q5. What are the various benefits of tax deferral?

13.10 LESSON END EXERCISE

Q1. Explain legal aspects of leasing?

Q2. What are the various provisions relating to leasing?

Q3. What are the points kept in mind while devising a lease transaction?

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13.11 SUGGESTED READINGS

1. Meir, Kohn, Financial Institutions and Markets, Tata McGraw Hill, New Delhi.

2. Paramasivan, C., and Subramanian, T., Finanacial Management, New Age International Limited Publishers, New Delhi.

3. Sundharam, K.P.M., and Varshney, P.N., Banking and Financial System, Sultan Chand and Sons, New Delhi.

4. Varshney, P.N., and Mittal D.K., Indian Financial System, Sultan Chand & Sons, New Delhi.

5. Vinod Kothari, Lease Financing and Hire Purchase (Including Merchant Banking and Mutual Funds), Wadhwa and Co.(P). Ltd. Nagpur.

LEASE FINANCING

ACCOUNTING TREATMENT OF LEASE

STRUCTURE

14.1 Introduction

14.2 Objectives

14.3 Accounting Treatment of Lease

14.4 Summary

14.5 Glossary

14.6 Self Assessment Questions

14.7 Lesson End Exercise

14.8 Suggested Readings

14.1 INRODUCTION

Presently the accounting treatment of lease transactions in India is as follows:

1. The leased asset is shown on the balance sheet of the lessor.
2. Depreciation and other tax shields associated with the leased asset are claimed by the lessor.
3. The entire lease rental is treated as income in the books of the lessor and as expense in the books of the lessee.

In nutshell, from the point of view of the lessee, a lease transaction represents an off-the balance-sheet transaction and this appears to be an important advantage associated with leasing. It may be noted that in countries like the United States and the United Kingdom, where leasing is very popular, leases which meet certain criteria are capitalised in the books of the lessee. This essentially implies that:

(a) The leased asset and the corresponding liability (reckoned at the present value of the stream of rental payments) are shown on the balance sheet of the lessee.

(b) Depreciation charges are claimed by the lessee,

(c) The lease rental is split into two parts, the interest component (which is charged to the profit and loss statement) and the principal repayment component.

14.2 OBJECTIVES

After reading this lesson, you should be able to understand the accounting aspects of leasing transactions in which would able to explain:

- the accounting recommendations of IASC;

- the case for capitalisation;
- the practice of lease accounting;
- reasons for following this treatment;
- shortcomings of this treatment;
- introduction of guidance note;
- salient features of the guidance note;
- international accounting standard on lease accounting;
- accounting for leases in financial statements of lessees;
- accounting for leases in the financial statements of lessor;
- accounting for sale and lease back transactions;
- journal entries in the books of lessor; and
- present practices of lease accounting.

14.3 ACCOUNTING TREATMENT OF LEASE

It was the accounting treatment of lease transaction which generated all the debate in every country where this industry flourished. Almost all the controversies which cover around leasing have their roots in accounting. The accounting of lease transaction is quite complex and typical, varied treatment of accounting further compound the problem.

An attempt was made to analyse how lease transaction are accounted for by the lessees and the lessors, and comment on the resultant controversies in lease accounting.

Till recently lease accounting was not subject to any specific regulatory code in India, though accounting standards have been put forth by International bodies. In the absence of any specific guidelines to this effect, both lessors and lessees have taken maximum business advantage of the situation.

The lessees pay an annual lease rental in return for the use of an asset. The lessors pay for the asset. And almost all lease transactions in the country are financial leases.

It is true that financial leases are in their economic substance identical to loan transactions. The lessor not aiming for specialisation in a range of assets, is merely providing a loan under a different name, and as such irrespective of whether the lease contract contains a purchase option or not, it is almost always, never the lessor's intention to take back a leased asset. This being the case, though it is difficult to justify the prevalence of the present accounting practices, they nevertheless exist.

In practice, lessees treat the payment of the lease rental as revenue expenditure. In other words the entire rental paid during the accounting period (say one year), is deducted from the income generated for that year. Thus if the lease rental paid is Rs. 1,00,000 p.a. for 5 years, the Profit and Loss account in its relevant entries would look as follows :

For the First Year:

Profit and Loss A/c

Debit		Credit
Lease Rental	1,00,000	

For the First Year:

Profit and Loss A/c

Debit		Credit
Lease Rental	1,00,000	

The same could be repeated for the remaining three years.

There would be no other entry in the books of account to show the nature of the transaction. The asset finds no place in the balance sheet of the lessee. Further future liabilities with regard to lease rentals also do not appear. As the lessor is the legal owner of the asset, the charge of depreciation, cost of debt, if any and investment allowance, if applicable, are not entered in the books of the lessees.

The lessor, being the legal owner of the asset, is therefore, in a legal position to claim all such deductions that are due to owners of assets, who do not necessarily use the assets in direct manufacturing activity but loan them to another party for such use. The entire lease rental received by the lessor is treated by him as his revenue income. Thus, in this illustration of an annual lease rental of Rs. 1,00,000 p.a. for 5 years, the revenue income of the lessor is Rs. l,00,000 p.a. for 5 years. The lessor's profit and loss account on the business of this single hypothetical asset, would in its relevant parts read as follows:

Profit and Loss A/c

Debit			Credit
Lease Rental (if paid)	1.00,000	Lease Rental Received	1,00,000
Depreciation			
Investment Allowance			
If available			

This example could be repeated for all five years.

Such an accounting practice on the part of the lessees and the lessors, substantiates it. It has been proved that the fundamental source of the leasing business exists in the imperfections in the capital market, and due to the accounting practice as described above, business advantage can be taken.

Should lessee have taken a loan instead of entering a lease agreement, the tax deductible expenditure would have been restricted to (i) interest, (ii) depreciation, and (iii) investment allowance, if available. These three specific tax advantages are under a lease agreement, passed on to the lessor, and the accruing benefit is shared between the lessor and the lessee, in the form of a reduced rental.

In so far as the lease-rental is concerned, it becomes entirely an allowable revenue expenditure for the lessee and is treated as a revenue income for the lessor. The lessee therefore is at a much higher tax gain than what would have otherwise been available, while the lessor has a higher income shelter to write off tax credits and show higher profits (which can be bargained for higher levels of funds from the market).

This method of accounting for lease is neither prudent nor is it advisable. Firstly, on the part of the lessees, no provision is made for future liabilities during the tenure of the lease. Secondly, the economic substance of the transaction is one of a loan, with an inherent desire to recover the capital invested by the lessor, at the earliest, and to write off the asset subsequently. Thirdly, the financial statements of the lessors and the lessees, do not disclose all items or factors, the knowledge of which might influence the decisions of the user of financial statements.

In the light of such arguments, that have time and again surfaced in accounting circles, that the need to examine the process of lease accounting has arisen. Of the accounting standards in practice outside India, One is the FASB-13, a document running into more than hundred pages, which deals in great detail on how lessors and lessees

should account for leases in their books. The other is IAS-17 issued by the International Accounting Standards Committee, which may be adopted by its member bodies.

Following are the arguments for the suggested accounting practice that are putforth by the IASC, and show by illustration its impact on the financial statements of the lessees and the lessors.

1. The Accounting Recommendations of IASC

In respect of the lessees, the IAS-17, pointed out that a financial lease creates both an asset as well as a liability. An asset because, the minimum financial lease period covers the major part of an asset's useful life; and a liability because a financial lease imposes upon the lessee future obligations to pay, which amounts can be reasonably predicted and which is irrevocable. The lessor, on the other hand, does not possess property. The lessor's asset is the sums recoverable from a lessee over the period of the lease, and not the property leased.

The IAS-17, prescribes the following accounting treatment in the books of the lessees:

- The financial lease must be reflected as an asset and as a liability too.
- The value of the lease so reflected must be higher of the fair value of the leased property (net of grants and tax credits) or, the present value of the minimum lease payments.
- In calculating the present value of the minimum lease payments, the discount factor applicable would be the implicit interest rate (see Annexure-IV). If the implicit interest rate is not practicable to determine, the lessee's incremental borrowing rate is used.

- The lease payments, or rental must be apportioned between a revenue charge and a capital charge.

- The revenue charge (or finance charge) is the "interest" portion of the rental/ installment and this must be allocated to various periods on the basis of a constant periodic rate of interest.

- The installment minus the interest portion is the sum that constitutes a reduction of the liability every year.

- The asset recorded is subject to the normal depreciation policy of the lessee. If there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term, the asset should be fully depreciated over the shorter of the lease-term or its useful life.

With respect to the accounting of lease transactions in the books of the lessor, the IAS- 17 prescribes the following:

- An asset held as a financial lease must be recorded in the balance sheet as a receivable and not as property or plant and equipment.

- The value of asset so recorded must be at a value equal to the net investment in the lease.

- The recognition of revenue income should be based on a pattern reflecting a constant periodic rate of return.

- The constant periodic rate of return must be based either on the lessor's net investment outstanding or the net cash investment outstanding in respect of the financial lease.

- The method used should be applied consistently to leases of a similar financial character.

Let us assume for purposes of simplicity the following:

(i) The lessor's choice of method in calculating the interest portion of the lease rental follows a line similar to that of the lessee.

(ii) The implicit interest rate is the same for the lessor and the lessee.

(iii) The fair value of the lease is equal to the lessor's net investment in the lease.

Thus the "Payment on Principal A/C" becomes the "Receipts on Capital A/C", while the "Payment on Interest A/C" becomes the "Receipts on Revenue A/C" in the books of the lessor.

Let us take an example to illustrate these guidelines. Suppose a lessee "receives" an asset whose fair value is Rs. 3,35,300/-. The lease is for a period of 5 years and the lease rentals to be paid are given as Rs. 1,00,000/- every year at the end of each year. The implicit interest rate is 15% and the present value of minimum lease payment discounted at 15% is also Rs. 3,35,300/- Suppose the lease period begins on 1st Jan, 1992, the lease term would end on 31st Dec. 1996.

The lessee's apportionment of the lease rental between the interest portion and the reduction of liability is shown in Table 14.1.

Table 14.1

Apportionment of the Lease Rentals

Year Ending	Present Value	Annual Rentals Factor	Payment on Principal A/C	Payment on Interest a/c
1	2	3	(2)*(3)=4	(3)-(4)=5
31.12.1992	0.497	1,00,000	49,700	50,300
31.12.1993	0.572	1,00,000	57,200	42,800
31.12.1994	0.658	1,00,000	65,800	34,200
31.12.1995	0.756	1,00,000	75,600	24,400
31.12.1996	0.870	1,00,000	87,000	13,000
		5,00,000	**3,35,300**	**1,64,700**

This can be shown in the respective books of the lessees and the lessors as follows:

In the Books of the Lessee

For the year ending 31.12.1992, the relevant portion of the final accounts would read as follows:

Profit and Loss A/c

Debit			Credit
Interest	50,300	Lease Rental	1,00,000
Depreciation	67,060		

Balance Sheet

Liabilities			Assets		
Principal	3,35,300		Property	3,35,300	
Less: Repayment	49,700		Less: Depreciation		
		2,85,600	20%	67,060	2,68,240

For the year ending 31.12.1993, the relevant portion of the final accounts would read as follows:

Profit and Loss A/c

Debit		Credit	
Interest	42,800	Lease Rental	1,00,000
Depreciation	53,648		

Balance Sheet

Liabilities			Assets		
Principal	2,85,600		Property	2,68,240	
Less: Repayment	57,200		Less: Depreciation		
		2,28,400	20%	53,648	2,12,592

Similarly the final accounts can be presented for the remaining period of the lease term i.e. for the years-ending 31.12.1994, 31.12.1995 and 31.12.1996.

In the Books of the Lessor:

For the year ending 31.12.1992, the relevant portion of the final accounts would read as:

Profit and Loss A/c

Debit		Credit
	Interest	50,300

Balance Sheet

Liabilities	Assets		
	Receivable	3,35,300	
	Less: Receipts	49,700	
			2,85,600

For the year-ending 31.12.1993, the relevant portion of the final accounts can be show as:

Profit and Loss A/c

Debit		Credit
	Interest	42,800

Balance Sheet

Liabilities	Assets		
	Receivable	2,85,600	
	Less: Receipts	57,200	
			2,28,400

This could be extended for the years ending 31.12.1994, 31.12.1995, 31.12.1996

One of the fundamental flaws in the IAS-17, is a contradiction with a basic economic identity. Every economic transaction is undertaken at a price; the amount paid by the buyer is exactly equal to the amount received by the seller. In the case of

financial transactions, this price is termed as interest. The money value of interest is the same to both the parties. Thus what a bank receives as interest income, is the same as what the loanee pays as interest expense. The IASC, by permitting different interest rates and by permitting different methods of computing interest, seems to have contravened this implicit provision in economic transactions. It seems to suggest that both the lessors and the lessees do not have the same money value for the same transaction.

In this case the suggestions for appropriate lease accounting is the basic distinction between capital and revenue must be maintained and that the lessor should be required to declare the rate of interest on every transaction. The amortisation of the lease and separation into capital and revenue transactions would be determined by this rate of interest.

2. The Case for Capitalisation

Capitalisation of leases in the recording of lease transactions in account books, is one of the biggest sources of controversies. It has been argued that a lease transaction creates a financial obligation to pay, on the part of the lessee, in consideration of which the lessee procures a right to use the asset. The financial obligation imposes a liability as future cash outflows can be ascertained with reasonable certainty. The right procured by the lessee creates an asset, and this right is of an enduring nature; enduring to the extent of the period of the lease. In the case of finance leases, the primary period of the lease is generally long enough to recover the cost of acquisition of the asset and the period also covers the major useful life of the asset. Finance leases are in nature very similar to lending contracts, and hence it would not be presumptuous to point out that in finance leases, the enduring benefit that a lessee acquires is very similar to the enduring benefit acquired by outright purchase or by borrowing. Hence, it is argued that in the case of finance lease, the enduring benefit must be reflected as a fixed asset in the balance sheet.

Just as the lessees have an obligation to pay, the lessors have a legal right to receive, as per the provision of the lease contract, a periodic rental. This legal right of the lessors is their asset. That is to say, the lessors have a lien on the lessees to claim the sum of moneys due to them under the lease contract, in such amounts and at such intervals as are specified in the contract. It is argued that though lessors possess a legal title to the asset, the intention to own for purposes of leasing, does not normally exist. What exists is an intention to hire an asset, whose legal title would pass on to the lessee at the end of the lease period, and/or dispose off the asset by other methods. In most finance leases, especially in equipment leasing, the intention to re-hire does not exist, which is one of the main distinguishing points when compared to operating leases. Lessors do not specialise in any particular family of equipment, nor do they maintain and service the assets. As such, the task of the lessors is confined to providing finance.

With regard to this controversy, our stand is unilaterally with the arguments which support the capitalisation of leases. In the first place a distinction must be made between legal practice and accounting practice. A legal practice follows from the requirements of law, whose objectives cover a very broad spectrum and whose purpose is at a higher level of moral and ethical standards. Accounting practice on the other hand reflects or seeks to reflect a true and fair view of the financial affairs of the company and nothing more. Ideally speaking, even an activity debarred by law, if undertaken, must be reflected in the books of accounts. It cannot be ignored simply because it is illegal. Thus, arguments based on points of law, are simply not arguments at all.

Secondly, accountants have recognised and accepted the principle of economic substance over legal form. Every transaction, in its location in the books of accounts and the final accounts, must reflect, the nature of the transaction, Accounting information must communicate the true profits, and a fair view of future liabilities and assets.

Finally, the argument that leases are different from loans also does not hold much water. This is because, lessors for the most part do not provide any “real” service.

That is, the lessors simply provide finance. They are not specialists in the assets they are dealing in, they do not maintain the assets in use, and in many cases have no intention of taking back a leased asset. This would be universally true in the case of equipment leases. Thus, a potential lessee gets precisely the same services as a bank would have given.

3. The Practice of Lease Accounting (The Earlier Practice)

The normal lease accounting practice followed in India, till the introduction of Guidance Note on lease accounting issued by ICAI was as under:

(i) The lessor capitalises the leased asset in its balance sheet. The security deposit taken, if any, is shown as liability in the balance sheet.

(ii) The lessor credits the entire lease rent accrued as per lease agreement to the profit and loss account.

(iii) The lessor charges depreciation on lease asset in the books of account usually on straight line basis at the rates specified in Schedule XIV of the companies Act, 1956.

(iv) At the end of the lease tenure, the asset is normally disposed off to the lessee at a mutually agreed price.

(v) The security deposit taken if any, is adjusted against the consideration for the asset transferred.

(vi) The loss on the sale of asset being the difference between the book value of the lease asset and the consideration received is charged to the profit and loss account. The vice-versa of it was rare phenomena.

4. Reasons for Following Lease Treatment

(i) Varied treatment of lease accounting often resulted in overstatement of profits because the companies were charging a lower rate of depreciation.

(ii) Since the borrowing capacity is a function of NOF the companies were able to source borrowing more than what it would have been had it not charged lower depreciation.

(iii) The practice of charging lower depreciation enabled the weaker companies to pay higher dividend than it would pay genuinely, thus eroding their capital base.

(iv) The companies were able to defeat the purpose of the section 205, read with sections 349 and 350 of the companies Act, *1956,* which provide, inter alia, that companies cannot declare dividend without charging depreciation.

(v) The financial statements were not depicting true and fair view of the state of the affairs and the operational results of the company.

(vi) It enabled the companies to access the capital market because the dividend payment resulted in maintaining track record.

5. Shortcomings of Lease Treatment

(i) The inadequate provision of depreciation and almost nil provision for income tax resulted in financial statements not presenting true and fair view.

(ii) The treatment was not in consonance with the fundamental accounting principle of "matching concept." This concept requires that should be a corresponding charge to each revenue item of the profit and loss account.

(iii) There was a danger of eating out its own capital by paying higher dividend.

(iv) The Debt Equity Ratio and Return on Assets employed of lessee becomes unnecessarily impressive, leasing being off-balance sheet finance.

6. Introduction of Guidance Note

The ICAJ issued Guidance Note on lease accounting in 1988 which was to become operative w.e.f 1-4-1989.But the Madras High Court stayed its implementation on a writ petition filed by the Association of leasing and financial Services Companies (ALFS).The ALFS contended in its petition that the implement action of the Guidance Note is not in the interests of the leasing industry and would serve no purpose. However, the ALFS withdrew the petition in July 1995. The ICAI issued the guidance Note in Sept. 1995. The RBI has made the guidance note compulsory for NBFCs w. e. f. 2-1-1998. Para 5 of the Non-Banking Financial Companies Prudential Norms (Reserve Bank) Directions, 1998 require NBFCs to compulsorily follow the guidance note.

7. Salient Features of the Guidance Note (GN)

(i) The main thrust of the Guidance Note is on the "Matching Concept" i.e., there should be logical compatibility between the revenue recognised and the corresponding expense in profit and loss account. The Guidance Note seeks to the provision of lease equilisation begin the difference between the capital recovered inbuilt into lease rentals and the statutory depreciation under Companies Act to determine true net profit which otherwise gets exaggerated due to inadequate provision for depreciation.

It is worthwhile to note the depreciation rates mentioned in Schedule XIV of companies Act were primarily meant for manufacturing concerns having productive capacity of approximately, fifteen years. So the depreciation rates mentioned in the schedule can be justified on assets given on lease since the tenure of the most of the finance leases is around five years whereas in the case of motor vehicles, even three years tenure is not uncommon. Moreover there was no special mention for provision of the assets given on lease in the Schedule. So the provision for depreciation is given on lease in the Schedule. So the

provision for depreciation in respect of assets given on lease needed some correction.

(ii) The GN provides for a net credit in respect of asset given on lease in the profit and loss account called finance charges which is equal to the return on the outstanding investment. The return is nothing but IRR.

So finance charges = Net Outstanding Investment * IRR

(iii) Para 7 of the GN requires determination of the residual value. The amount of residual value is crucial for the determination of IRR.

Since the expected residual value of the asset is taken as a cash inflow at the end of the lease tenure, its value has a definite bearing on IRR. And it is the IRR which determines the year wise profitability of the transaction. So, the residual value should be determined after taking into account all aspects like technology obsolescence, the economic life of the asset etc. An inflated residual value would lead to determination of higher IRR which would in turn inflate the profits during the entire lease tenure, except the last year when all the exaggerations in the profits will be equally matched by extremely lower profitability due to loss on sale of lease asset.

After the satisfactory completion of finance lease contract the leasing company has no interest in the asset since it has recovered its entire investment together with desired rate of return. But technically, the ownership still remains with it. Seeing from lessee's point of view he has paid the entire cost of asset together with interest over the lease tenure. But he still does not have ownership. So what the leasing company does is, it transfers the lease asset to lessee for a consideration which is equal to security deposit to make all the concerned accounts nil. However, there it is treated as deferred sale, then the depreciation benefit allowed may be withdrawn.

(iv) Para 8 of the GN states that if the ultimate collection of lease rentals with reasonable certainty is lacking, its revenue recognition is to be postponed to the extent of uncertainty involved and it may be appropriate to recognise revenue only when it is reasonably certain that the ultimate collection will be made. This issued has a linkage with Income Tax, the RBI directions on prudential norms.

(v) The GN also requires lessee to disclose by way of note to account the future obligations of the lessee as per the agreement. This is a boost to the leasing industry since it puts a check on the unscrupulous lessees pretending to be the owners of the assets acquired on lease.

(vi) The problem of non-provision of Income Tax or almost nil provision has not been dealt with. In India, deferred tax accounting is not mandatory. As a consequence, the deferred taxes become part of the reserves which can be used for accessing more borrowings.

(vii) The lessee is not required to capitalise the asset acquired by way of finance lease. So, if the significant portion of a company's fixed assets has been acquired by way of finance lease, certain ratios like debt equity, return on assets will be exaggerated. This problem has also not been dealt with. The earlier Guidance Note issued in 1988 however did require capitalisation of finance lease in the books of lessee. The present Guidance Note only requires lessee to disclose by way of a foot note the future obligations in respect of assets acquired on lease.

In some countries, like U.S.A., Canada, the lessee is required to capitalise the finance lease in its books of account, though the tax and depreciation benefit rests with the lessor.

(viii) In case of sale and leaseback, the difference between the book value and the fair value is immediately adjusted with profit or loss. The difference between

the fair value and the sale value is amortised during the remaining economic life of the asset.

(ix) In the case of leasing by manufacturer, the difference between the normal selling price and the cost of the asset is to be recognised as income / loss immediately. The difference between the total lease rentals and the normal selling price is to be booked as income during the lease tenure applying the capital recovery method. It is important to note that the manufacturer will debit the asset given on lease with corresponding credit to the sales account for an amount equal to the normal selling price.

8. International Accounting Standard on Lease Accounting (IAS-17)

The International Accounting Standard Committee issued Accounting Standard on accounting for lease transactions which became effective from 1-1-1984. The Accounting Standard seeks to capitalisation of finance leases in the books of lessee since the substantial risks and rewards rest with the lessee in the case of finance lease.

9. Accounting for Leases in Financial Statements of Lessees

(i) Finance Leases

(a) A finance lease should be reflected in the balance sheet of the lessee by capitalising the asset with the fair market price net of grants and tax credits receivable by the lessor of the asset or at the present value of the minimum lease payments. The corresponding credit is to be given to lessor's account and shown as liability in the balance sheet.

(b) Periodical lease payment should be bifurcated into finance charges by applying implicit rate of return and payment towards lessor's account. The finance charges should be debited to the profit and loss account while the lessor's account will be debited by the principal repayment.

(c) The depreciation on lease asset should be charged on the same lines as that of depreciation on other assets owned.

(ii) Operating leases

The lease rent should be debited in the profit and loss account of the relevant accounting period in accordance with the agreement.

10. Accounting for Leases in the Financial Statements of Lessor

(i) Finance Lease

(a) The asset given on lease should be recorded as receivable.

(b) The recognition of income should be determined by applying the implicit rate of return on net outstanding investment relevant to the accounting period. While doing so, the recovery of the amount due from the lessee must be considered (concept of prudence).

(c) In the case of manufacturer or dealer lessor, the selling profit should be immediately recognised. However, if lower rate of interest is quoted, then the selling profit should be recognised keeping in view the normal selling profit the transaction would have fetched.

(ii) Operating lease

(a) The amount invested in leased asset should be shown as fixed assets just like other fixed assets.

(b) The lease rent should be recognised equally during the lease tenure.

(c) The depreciation should be provided just like other fixed assets.

11. Accounting for Sale and Lease Back Transactions

(i) If a sale and lease back transaction is of the nature of finance lease, any excess of sale proceeds over the carrying cost should be differed and recognised as income over the lease tenure from the standpoint of lessee.

(ii) If a sale and lease back transaction is in the nature of operation lease, and the transaction is established at fair value any profit should be recognised immediately. However, if the sale price is below the fair value and the loss is compensated by lower lease rentals, the loss should be deferred and amortised in proportion to the lease rent over the period for which the asset is expected to be used. If the sale price is above the fair value, the excess over the fair value should be deferred and amortised over the lease period for which the asset is expected to be used.

(iii) If the fair value at the time of sale and leaseback transaction is less than the carrying cost, a loss equal to the difference between the carrying amount and the fair value should be recognised immediately.

12. Journal entries in the books of lessor:

The details of journal entries to be made are as follows:

Table 14.2 Journal entries in the books of Lessor

S.No.	Particulars	Entry	Frequency
1	For taking security Deposit	Dr. Bank A/C Cr. Security Deposit	one-time entry
2	For buying the equipment and giving it on Lease	Dr. Asset given on lease Cr. Supplier	one-time entry
3	For making payment to supplier	Dr. Supplier Cr. Bank	one-time entry
4	For making lease rent due	Dr. Lease rent receivable Cr. Lease rent	monthly entry as and when received
5	For receiving lease rent	Dr. Bank Cr. Lease rent receivable	monthly entry as and when received
6	For charging depreciation	Dr. Depreciation Cr. Accumulated depreciation	yearly entry
7	For providing lease equalization		
(a)	if capital recovery exceeds statutory depreciation	Dr. Lease Equalisation Cr. Lease Adjustment	yearly entry
(b)	if capital recovery is less than the statutory depreciation	Dr. Lease Adjustment Cr.Lease Equalisation	yearly entry
8	For closing lease adjustment account		
(a)	if lease adjustment has debit balance	Dr. Lease Asset Cr. Adjustment	one-time entry
(b)	if lease adjustment has credit balance	Dr. Lease Adjustment Cr. Lease Asset	one-time entry

9	For refunding security deposit	Dr Security Deposit Cr. Bank	one-time entry
10	For making balance in accumulated depreciation nil	Dr. Accumulated Depreciation Cr. Lease Asset	one-time entry
11	For transferring the asset at the end of lease tenure		
(a)	if sale consideration exceeds the book value of the asset	Dr. Bank Cr. Lease Asset Cr. Profit on sale of Lease Asset	one-time entry
(b)	if sale consideration is less than the book value of the asset	Dr. Bank Dr. Loss on sale of Lease Asset Cr. Lease Asset	one-time entry

The frequency of this entry could be even quarterly or yearly or any time interval depending upon the terms of lease agreement.

13. Present Practices of Lease Accounting

(i) Accounting for Leases in the Lessor's Books

1. The leased asset is recorded as a fixed asset and shown separately as "Assets given on Lease" and owned assets are separately shown. The leased assets are also sub-classified as plant and machinery, vehicles, furniture etc.

2. Lease rentals receivable during the accounting period are taken as income in the profit and loss account.

3. Depreciation is provided on the bases prescribed in the Companies Act (normally at straight line rates). Since leases are normally for a 5 years term, this means that the asset is not fully depreciated during the lease term. In case

the lease term is extended for 3 years. The asset would still not be fully depreciated.

Arising from the above, the following points emerge for discussion: It is apparent that the above accounting practices have been adopted by the industry, in view of the prevalent income tax laws. As per the tax laws, the legal owner of the asset is entitled to depreciation, and lease rentals paid (or payable), for the period are allowable as expense.

Hence, in order to claim depreciation, the practice has been to record leased assets as "Fixed Assets" in the lessor's books. Thus the lessors do not make a distinction between a finance lease and operating lease. Essentially an operating lease is for a short term and the same asset may be leased by the lessor to various lessees one after another.

Although it is accepted that the legal ownership rests with the lessor, the question arises as to the substance and financial reality in the case of a finance tease. In the case of a finance lease, the lessor transfers to the lessee, substantially, the entire risks and rewards incident to ownership, and in reality it is an investment (receivable) on which he earns his finance income. Accordingly, it would be appropriate to classify the lease as a "receivable".

Another aspect of lease accounting is the amount of depreciation being provided by the lessors. In practice, depreciation is provided according to the rates, as explained above, without considering the fact that in a finance lease the lease period may be of a term say 5 years, and consequently the cost of asset is not depreciated in the 5 year period. In effect, this would mean that there is under provision of depreciation (and the concept of matching income with expenditure is not followed). This is done mainly with the objective of increasing the bottom line in the profit and loss account.

Similarly, lease rentals are fully recorded as income without segregating of structured or tailored leases, the lease rentals may be worked out in a way to gain

maximum tax advantage, or to suit the cash flow requirements of lessor / lessee. But here again, the question of appropriate accrual of finance income is not taken into account.

At present, generally very few disclosures are made on the significant accounting policies followed.

(ii) Accounting for Leases in the Books of Lessee

1. The assets taken on lease are not accounted for in the books. No disclosure is made in the Notes to Accounts also.

2. The lease rental paid/payable (for the period) are charged to the profit and loss account as expenses. Here again, no disclosures are made regarding lease obligations.

14.4 SUMMARY

IAS-17 Leases prescribes the accounting policies and disclosures applicable to leases, both for lessees and lessors. Leases are required to be classified as either finance leases (which transfer substantially all the risks and rewards of ownership, and give rise to asset and liability recognition by the lessee and a receivable by the lessor) and operating leases (which result in expense recognition by the lessee, with the asset remaining recognised by the lessor).

IAS 17 was reissued in December 2003 and applies to annual periods beginning on or after 1st January 2005. IAS 17 will be superseded by IFRS 16 Leases as of 1st January 2019.

Objective of IAS 17

The objective of IAS 17 (1997) is to prescribe, for lessees and lessors, the appropriate accounting policies and disclosures to apply in relation to finance and operating leases.

Scope

IAS 17 applies to all leases other than lease agreements for minerals, oil, natural gas, and similar regenerative resources and licensing agreements for films, videos, plays, manuscripts, patents, copyrights, and similar items.

However, IAS 17 does not apply as the basis of measurement for the following leased assets:

- property held by lessees that is accounted for as investment property for which the lessee uses the fair value model set out in IAS 40.
- investment property provided by lessors under operating leases.
- biological assets held by lessees under finance leases.
- biological assets provided by lessors under operating leases.

Accounting by lessees

The following principles should be applied in the financial statements of lessees:

- At commencement of the lease term, finance leases should be recorded as an asset and a liability at the lower of the fair value of the asset and the present value of the minimum lease payments (discounted at the interest rate implicit in the lease, if practicable, or else at the entity's incremental borrowing rate).
- Finance lease payments should be apportioned between the finance charge and the reduction of the outstanding liability (the finance charge to be allocated so as to produce a constant periodic rate of interest on the remaining balance of the liability).
- The depreciation policy for assets held under finance leases should be consistent with that for owned assets. If there is no reasonable certainty that the lessee

will obtain ownership at the end of the lease – the asset should be depreciated over the shorter of the lease term or the life of the asset.

- For operating leases, the lease payments should be recognised as an expense in the income statement over the lease term on a straight-line basis, unless another systematic basis is more representative of the time pattern of the user's benefit.

  Incentives for the agreement of a new or renewed operating lease should be recognised by the lessee as a reduction of the rental expense over the lease term, irrespective of the incentive's nature or form, or the timing of payments.

Accounting by lessors:

The following principles should be applied in the financial statements of lessors:

- At commencement of the lease term, the lessor should record a finance lease in the balance sheet as a receivable, at an amount equal to the net investment in the lease.

- The lessor should recognise finance income based on a pattern reflecting a constant periodic rate of return on the lessor's net investment outstanding in respect of the finance lease.

- Assets held for operating leases should be presented in the balance sheet of the lessor according to the nature of the asset. Lease income should be recognised over the lease term on a straight-line basis, unless another systematic basis is more representative of the time pattern in which use benefit is derived from the leased asset is diminished.

  Incentives for the agreement of a new or renewed operating lease should be recognised by the lessor as a reduction of the rental income over the lease term, irrespective of the incentive's nature or form, or the timing of payments.

Manufacturers, dealers or lessors should include selling profit or loss in the same period as they would for an outright sale. If artificially low rates of interest are charged, selling profit should be restricted to that which would apply if a commercial rate of interest were charged.

Under the 2003 revisions to IAS 17, initial direct and incremental costs incurred by lessors in negotiating leases must be recognised over the lease term. They may no longer be charged to expense when incurred. This treatment does not apply to manufacturers, dealers or lessors where such cost recognition is as an expense when the selling profit is recognised.

14.5 GLOSSARY

- **Guidance Note:** Guidance Notes issued by the ICAI on accounting/ auditing aspects are designed to provide guidance to members on matters which may arise in the course of their professional work and on which they may desire assistance in resolving issues which may pose difficulty.

- **ICAI:** The Institute of Chartered Accountants of India (ICAI) is the national professional accounting body of India.

- **IRR:** The internal rate of return (IRR) is a metric used in capital budgeting to estimate the profitability of potential investments. The internal rate of return is a discount rate that makes the net present value (NPV) of all cash flows from a particular project equal to zero.

- **NBFCs:** Non-banking financial companies (NBFCs) are financial institutions that offer various banking services but do not have a banking license. Generally, these institutions are not allowed to take traditional demand deposits, readily available funds, such as those in checking or savings accounts from the public.

14.6 SELF ASSESSMENT QUESTIONS

Q1. What are the accounting recommendations of IASC?

Q2. What is Guidance Note?

Q3. What is finance lease?

Q4. What is operating lease?

Q5. What are the objectives of IAS-17?

14.7 LESSON END EXERCISE

Q1. Explain accounting aspects of leasing transactions?

Q2. Explain the features of guidance note?

Q3. Give journal entries in the books of lessor?

14.8 SUGGESTED READINGS

1. Meir, Kohn, Financial Institutions and Markets, Tata McGraw Hill, New Delhi.

2. Paramasivan, C., and Subramanian, T., Finanacial Management, New Age International Limited Publishers, New Delhi.

3. Sundharam, K.P.M., and Varshney, P.N., Banking and Financial System, Sultan Chand and Sons, New Delhi.

4. Varshney, P.N., and Mittal D.K., Indian Financial System, Sultan Chand & Sons, New Delhi.

5. Vinod Kothari, Lease Financing and Hire Purchase (Including Merchant Banking and Mutual Funds), Wadhwa and Co. (P). Ltd. Nagpur.

LEASE FINANCING

STRUCTURE OF LEASING INDUSTRY IN INDIA

STRUCTURE

15.1 Introduction

15.2 Objectives

15.3 Structure of Leasing Industry in India

15.3.1 Private Sector Leasing and

15.3.1.1 Pure Leasing Companies

15.3.1.2 Hire Purchase and Finance Companies

15.3.1.3 Subsidiaries of Manufacturing Group Companies

15.3.2 Public Sector Leasing

15.3.2.1 Financial Institutions

15.3.2.2 Subsidiaries of Banks

15.3.2.3 Other Public Sector Organisations

15.4 Problems of Leasing

15.5 Prospects of Leasing

15.6 Summary

15.7 Glossary

15.8 Self Assessment Questions

15.9 Lesson End Exercise

15.10 Suggested Readings

15.1 INRODUCTION

The equipment leasing has significantly grown all over the world. Even in India, the growth of equipment leasing has been phenomenal. During the last five years, literally 600 leasing companies have been floated in India, of which around 100 are active. It has also been observed that a large number of industrial organisations, both in the private and public sectors are considering leasing as one of the alternatives for financing the equipment acquisition. Presently, leases have come in all modes, sizes, and varieties. A large number of companies are using or have plans to use leasing as a source of finance in one way or the other. It is interesting to note the rising share of leased assets to the total investments on assets. For instance, the share of leased assets to total investments ranged from 5 per cent to 33 per cent in 1988 in the EEC countries, and the US, respectively. These developments have touched India also. In India, today equipment from satellites and aircrafts to autos is obtained through leasing.

Leasing companies have grown from a few lessors in 1980, to more than 600 (public and private limited) by 1988. In India, the equipment leasing boom began in 1985, rapidly covering plant and machinery, furniture and fixture, vehicles, computers, and household durables. However, it is to be noted that though the number of leasing companies increased phenomenally, the size of business in terms of leased assets did not increase accordingly. However, In India, the share of the leased assets formed less than 1 per cent, in spite of over 600 companies coming into existence by 1988.

It is observed from the leasing market that leasing companies started quoting different lease rentals for the same transaction. A majority of the companies declared dividends ranging from 15 to 25 per cent from the first year of operations itself.

15.2 OBJECTIVES

After reading this lesson, you should be able;

- to understand the structure of easing companies in India
- able to know various problems and prospects of leaning.

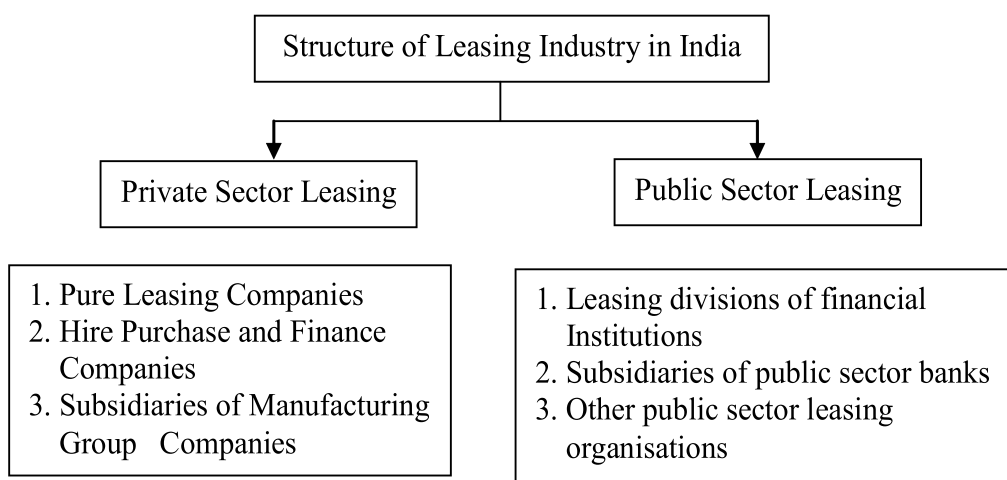
15.3 STRUCTURE OF LEASING INDUSTRY IN INDIA

Presently, leasing finance becomes popular and effective financial sources for most of the business concerns. With the importance of lease finance, banks and financial institutions provide leasing financial assistance to the industrial concern.

The present structure of leasing industry in India consists of:

1. Private Sector Leasing and
2. Public Sector Leasing.

Chart 15.1: Structure of Leasing Industry in India



15.3.1 Private Sector Leasing

Presently, Private Sector Leasing consists of about 400 leasing companies and plays a significant role in providing lease facilities to different industries, and help raise funds from various unexplored sources. The following are the important constituents of the private sector leasing industry.

(i) Pure Leasing Companies.

(ii) Hire Purchase and Finance Companies and

(iii) Subsidiaries of Manufacturing Group Companies.

15.3.1.1 Pure Leasing Companies: These companies operate independently without any link or association with any other organisation or group of organisation. The First Leasing Company of India Limited (FLGI), The Twentieth Century Finance Corporation Limited (TGFL), and the Grover Leasing Limited, fall under this category.

15.3.1.2 Hire Purchase and Finance Companies: The companies started prior to 1980 to do hire purchase and finance business especially for vehicles added leasing to their activities during 1980. Some of them do leasing as major activity and some others do leasing on a small scale as a tax planning device. A few such companies are Sundaram Finance Ltd (SFL), Mercantile Commercial and Credit Corporation ltd. (MCCL), and Motor and General Finance Ltd. (MGF).

15.3.1.3 Subsidiaries of Manufacturing Group Companies: These companies consist of two categories: Vendor leasing and In house leasing.

(a) Vendor leasing: These types of companies are formed to boost and promote the sale of its parent companies products through offering leasing facilities.

(b) In house leasing: In house leasing or capture leasing companies are set up to meet the fund requirements or to avoid the income tax liabilities of the group companies.

The objective of vendor leasing companies is to boost and promote the sales of its parent companies products through offering leasing facilities. On the other hand, the captive leasing companies are floated to meet the group companies' fund requirements. Some of the in-house leasing companies are also set up to avoid the income-tax by the group companies. Another objective of this type is to raise funds to a large extent from outside sources, by using the group's name; since leasing companies

are allowed high debt-equity ratio of 10:1 tax avoidance is suspected to be the major objective of the in-house leasing companies. For example, the needs of the loss-incurring company by extending leasing facility at a very low rentals (which even are not sufficient to recoup the cost of equipment) and by simultaneously leasing to a profit-making company within the group at an extremely high rentals (to compensate for the loss incurred in other transactions) and reduce the tax burden of a profit-making company. The leasing company earns sufficient profit to compensate for the losses in leasing transactions with loss-incurring companies within the group. The profit-making company is benefited because of the tax deductability of high lease rentals. Thus, the taxes which ought to have bolstered government revenues are channellised into loss incurring company of the group.

Because of these advantages, big industrial houses jumped into the fray by setting up in-house and vendor subsidiary companies. Perhaps, this has led to a proliferation of in-house set-ups. For example, Swadeshi Leasing Ltd was floated by the Hindustan Motors Ltd., the key Leasing Ltd. by JK Synthetics Ltd., the Classic Leasing by ITC Ltd., Nagarjuna Finance Ltd., by the Empire Industries, Eligi Equipment Finance by the Eligi Group, and DCL Finance by DCL Group. A few examples of subsidiaries of manufacturing companies are Ashok Leyland Finance Ltd. of Ashok Leyland Ltd., Krest Development and Leasing Ltd. of Best and Crompton Ltd., Bajaj Auto Finance of Bajaj Auto Ltd., and Enfield Finance of Enfield India Ltd. Besides, a few leasing companies are subsidiaries of finance and leasing companies - Cholamandlam Finance Ltd is a subsidiary of cholamandlam Investment and Finance Ltd., Response Hire Purchase and Credit Ltd. of First Leasing and Empire Credit Ltd. belongs to Empire Leasing. Further, four leasing companies were floated jointly by banks, the International Finance Corporation (IFC), and private leasing companies. Most leasing companies are engaged in the business of leasing, and hire purchase financing. In leasing, they are primarily concerned with equipment financing, ranging from machine tools to big earth moving and chemical plants. A few companies also engage in real estate

business and property development, and one or two companies are also involved in leasing of safe deposit lockers in almost all major cities in the country.

15.3.2 Public sector leasing

The public sector leasing organisations are divided into:

(i) Leasing divisions of financial institutions.

(ii) Subsidiaries of public sector banks.

(iii) Other public sector leasing organisations.

15.3.2.1 Financial Institutions: the financial institutions such as IFCI, ICICI, IRBI and NSIC have set up their leasing divisions or subsidiaries to do leasing business. The Shipping Credit and Investment Company of India offers leasing facilities in foreign currencies for ships, deep seas fishing vehicles and related equipments to its clients.

15.3.2.2 Subsidiaries of Banks: The commercial banks in India can under section 19(1) of the Banking Regulation Act, 1949, set up subsidiaries for undertaking leasing activities. The SBI was the first bank to start a subsidiary for leasing business in 1986.

Leasing in SBI is transacted through, Strategic Business Unit (SBU) of the bank. Each SBU is manned by specially trained staff and is equipped with the latest technological aids to meet the needs of top corporate clients. For the bank as a whole, leasing is considered as a high growth area. Now the bank is concentrating only on 'Big Ticket Leasing' which is generally of Rs. 5 crore and above. So far SBI has disbursed more than Rs.300 crores by way of leasing with the average size of deal being Rs. 25 crores.

15.3.2.3 Other Public Sector Organisations: A few State-level industrial development organisations, such as the State Industrial Investment Corporation of Maharashtra (SICOM), the Gujarat Industrial and Investment Corporation (GIIC),

and the UP Industrial Investment Corporation (UPIIC) have floated their own subsidiary leasing companies. A few public sector manufacturing companies, such as the Electronics Corporation of India Ltd. (ECIL), CMC Computers Ltd., the Bharat Electronics Ltd. (BEL), and the Hindustan Packaging Co Ltd. (HPCL), have also started leasing to sell their equipment through lease rather than outright sale.

15.4 PROBLEMS OF LEASING

Leasing has great potential in India. However, leasing in India faces serious handicaps which may mar its growth in future. Following are some of the problems:

1. **Unhealthy Competition:** The market for leasing has not grown with the same pace as the number of lessors. As a result, there is over supply of lessors leading to competition. With the leasing business becoming more competitive, the margin of profit for lessors has dropped from four to five per cent to the present 2.5 to 3 per cent. Bank subsidiaries and financial institutions have the competitive edge over the private sector concerns because of cheap source of finance.

2. **Lack of Qualified Personnel:** Leasing requires qualified and experienced people at the helm of its affairs. Leasing is a specialised business and persons constituting its top management should have expertise in accounting, finance, legal and decision areas. In India, the concept of leasing business is of recent one and hence it is difficult to get right man to deal with leasing business. On account of this, operations of leasing business are bound to suffer.

3. **Tax Considerations:** Most people believe that lessees prefer leasing because of the tax benefits it offers. In reality, it only transfers the benefit i.e. the lessee's tax shelter is lessor's burden. The lease becomes economically viable only when the transfer's effective tax rate is low. In addition, taxes like sales tax, wealth tax, additional tax, surcharge etc. add to the cost of leasing. Thus leasing

becomes more expensive from of financing than conventional mode of finance such as hire purchase.

4. **Stamp Duty:** The States treat a leasing transaction as a sale for the purpose of making them eligible to sales tax. On the contrary, for stamp duty, the transaction is treated as a pure lease transaction. Accordingly a heavy stamp duty is levied on lease documents. This adds to the burden of leasing industry.

5. **Delayed Payment and Bad Debts:** The problem of delayed payment of rents and bad debts add to the costs of lease. The lessor does not take into consideration this aspect while fixing the rentals at the time of lease agreement. These problems would disturb prospects of leasing business.

15.5 PROSPECTS OF LEASING

Today, leasing accounts for 6 per cent of the total capital investment in India. Leasing will play a significant role to account for at least 15 per cent of gross capital formation.

The world leasing industry grew at a rate of about 10 per cent. As the economy is opened up there will be substantial demand for a variety of leasing products such as foreign currency leases, cross border leases, leverage leases etc. Leasing companies set for substantial growth in line with international trends.

Leasing has great prospects in India. It is on the threshold of a major breakthrough in industrial development due to liberalised economic policy measures initiated by the government. Leasing as a convenient and flexible financing option can play a vital role in the process of industrial development. The leasing industry has taken the centre stage with the government and public sector undertakings are looking to industry to finance railway, telecommunication, transport, power and infrastructure sectors. The infrastructure financing is so crucial for an economic growth cannot be accelerated without leasing industry. The government has indicated that it is open to

suggestions for reviewing the existing policies. Such conduciveness and the willingness to prevent bottlenecks in the area of taxation and other areas will go a long way in speeding up the growth of the industry.

15.6 SUMMARY

Leasing is a service industry as it provides funds and also taps the capital market. It supplements the government developmental plan by supplying equipment to the industry. The Eight plan's projections, coupled with the flexible government policies towards industry, modernisation and expansion of capabilities and the emphasis on technological upgradation augurs well for the prospects of leasing. The Central Government has reacted fairly as far as monetary, fiscal, and regulatory policy issues were concerned. The manner and direction of growth will be, to some extent, affected by fiscal, monetary and economic policies, although leasing industry is not dependent upon them. Leasing will thrive whatever the fiscal and monetary system adopted, provided only that it does not treat leasing disadvantageously.

Leasing is growing industry. It is seen that leasing has grown in the latter 80s, and is still growing. It is, however, worth nothing that despite good prospects for leasing, many existing private sector leasing companies do not find a place in the market; only a few leaders from the private sector, besides the public sector, remain in the fray. This shows that the leasing industry needs the full support, co-operation, and encouragement of the government. At the same time, regulatory framework is essential to control its mushroom growth and irregularities, and to ensure a healthy growth. It is expected that a substantial number of manufacturers of many types of equipment may set up their leasing operations either as an integral part of the parent company or through a subsidiary to sell their products. As long as the leasing industry continues to be innovative, it will find a ready market for the service it has to offer.

15.7 GLOSSARY

- **EEC:** The abbreviation for the European Economic Community. An organization of nations established in 1957 to promote free trade and economic cooperation among the nations of Western Europe. Its original members were Belgium, France, Italy, Luxembourg, The Netherlands, and West Germany.

- **Financial Institutions:** The major categories of financial institutions include central banks, retail and commercial banks, internet banks, credit unions, savings and loans associations, investment banks, investment companies, brokerage firms, insurance companies and mortgage companies.

- **Hire Purchase:** A system by which one pays for a thing in regular instalments while having the use of it.

- **Private Sector Leasing:** Private Sector Leasing is where a private landlord lets their property to a third party housing provider (usually a registered provider but not essential) who in turn lets to the disabled tenant.

- **Vendor Leasing:** Vendor leasing is equipment lease financing offered by vendors through bank, captive and independent lessors to the end-user of assets in conjunction with the sale of their products, it being specifically designed to assist equipment manufacturers, dealers and retailers by supporting their sales activities.

15.8 SELF ASSESSMENT QUESTIONS

Q1. What is pure leasing?

Q2. What is hire purchase?

Q3. What is vendor leasing?

Q4. What is in-house leasing?

Q5. What are the various divisions of financial institutions?

15.9 LESSON END EXERCISE

Q1. Explain the structure of leasing industry in India?

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Q2. Explain private sector leasing?

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Q3. Explain public sector leasing?

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Q4. What are the problems in leasing?

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Q5. What are the various prospects in leasing?

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15.10 SUGGESTED READINGS

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UNIT-IV **LESSON NO. 16**

DEBT SECURITISATION AND HOUSING FINANCE

INTRODUCTION TO SECURITISATION

STRUCTURE

16.1 Introduction

16.2 Objectives

16.3 Concept of Securitisation

16.4 Securitisation vs. Factoring

16.5 Modus Operandi of Securitisation

- 16.5.1 Parties involved in the operational mechanics of Securitisation
- 16.5.2 Stages involved in the working of Securitisation
- 16.5.3 Role of Merchant Bankers
- 16.5.4 Role of Other Parties

16.6 Securitisation as a tool of Risk Management

16.7 Summary

16.8 Glossary

16.9 Self Assessment Questions

16.10 Lesson End Exercise

16.11 Suggested Readings

16.1 INTRODUCTION

The financial system all over the world is in the process of rapid transformation. As a result, the capital market, money market and the debt market are getting widened and deepened. It is interesting to note that new instruments and new products are emerging in the debt market too. In fact the development of a debt market increases the efficiency of a capital market to a greater extent. Again, along with the equity market, there is bound to be a natural growth in the debt market also. Thus, it is obvious that a debt market should also have both primary and secondary markets. In this context, debt or asset securitisation assumes a significant role and it is one of the most innovative techniques introduced in the debt market to achieve the above objective. Moreover, it is the debt market which has provided more impetus for capital formation than the equity market in the economically advanced countries.

16.2 OBJECTIVES

After reading this lesson you should be able

- to explain the concept of securitisation, differentiate between securitisation and factoring
- able to understand mode of operation of securitisation.

16.3 CONCEPT OF SECURITISATION

Securitisation of debt or asset refers to the process of liquidating the illiquid and long term assets like loans and receivables of financial institutions by issuing marketable securities against them. In other words, it is a technique by which a long term, non-negotiable and high valued financial asset like hire purchase is converted into securities of small values which can be tradable in the market just like shares.

Thus, it is nothing but a process of removing long term assets from the balance sheet of a lending financial institution and replacing them with liquid cash through the

issue of securities against them. Under securitisation, a financial institution pools its illiquid, non-negotiable and long term assets, creates securities against them, gets them rated and sells them to investors. It is an ongoing process in the sense that assets are converted into securities, securities into cash, cash into assets and assets into securities and so on.

Generally, extension of credit by banks and other financial institutions in the form of bills purchase or discounting or hire purchase financing appears as an asset on their balance sheets. Some of these assets are long term in nature and it implies that funds are locked up unnecessarily for an undue long period. So, it carry on their lending operations without much interruptions, they have to rely upon various other sources of finance which are not only costly but also not available easily. Again, they have to bear the risk of the credit outstandings. Now, securitisation is a readymade solution for them. Securitisation helps them to recycle funds at a reasonable cost and with less credit risk. In other words, securitisation helps to remove these assets from the balance sheets of financial institutions by providing liquidity through tradable financial instruments.

Again from another angle also, securitisation is a boon to financial institutions. From the risk management point of view, the lending financial institutions have to absorb the entire credit risk by holding the credit outstandings in their own portfolio. Securitisation offers a good scope for risk diversification. It is worthwhile to note that the entire transaction relating to securitisation is carried out on the asset side of the Balance Sheet. That is one asset (illiquid) is converted into another asset (cash).

As stated earlier, securitisation helps to liquidity assets mainly of medium and long term loans and receivables of financial institutions. The concept of securitisation can be defined as follows:

"A carefully structured process whereby loans and other receivables are packaged, underwritten and sold in the form of asset backed securities".

Yet another simple definition is as follows:

"Securitization is nothing but liquifying assets comprising loans and receivables of an institution through systematic issuance of financial instruments".

According to Hendersen, J. and Scott, J.P. "Securitisation is the process which takes 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 the investors who purchase a negotiable financial instrument evidencing this indebtedness without recourse, or in some cases with limited recourse, to the original lender". Thus, financial assets can be made liquid through securitisation i.e., through packaging loans and selling them in the market. It is very clear from the above definitions that securitisation is nothing but the packaging of a pool of financial assets into marketable securities. In brief, illiquid assets are converted into tradable securities.

Structured Securities Vs. Conventional Securities

Securitisation is basically a structured financial transaction. It envisages the issue of securities against illiquid assets and such securities are really structured securities. It is so because, they are backed by the value of the underlying financial asset and the credit support of a third party also. At this stage, one should not confuse such structured securities with conventional securities like bonds, debentures etc. They differ from each other in the following respects:

(i) **Source of repayment:** In the case of conventional securities, the primary source of repayment is the earning power and cash flow of the issuing company. But, under securitisation, the issuing company is completely free from this botheration since the burden of repayment is shifted to a pool of assets or to a third party.

(ii) **Structure:** Under securitisation, the securities may be structured in such a way so as to achieve a desired level of risk and a desired level of rating depending

upon the type and amount of assets pooled. Such a choice is not available in the case of conventional securities.

(iii) **Nature:** In fact, these structured securities are basically derivatives of the traditional debt instruments. Of course, the credit standing of these securities is well supported by a pool of assets or by a guarantee or by both.

16.4 SECURITISATION VS. FACTORING

At this stage, one should not confuse the term "securitisation" with that of "factoring". Since both deal with the assets viz., book debts and receivables, it is very essential that the differences between them must be clearly understood. The main differences are:

(i) Factoring is mainly associated with the assets (book debts and receivables) of manufacturing and trading companies whereas securitisation is mainly associated with the assets of financial companies.

(ii) Factoring mainly deals with trade debts and trade receivables of clients. On the other hand, securitisation deals with loans and receivables arising out of loans like hire purchase finance receivables, receivables from Government department etc.

(iii) In the case of factoring, the trade debts and receivables in questions are short term in nature whereas they are medium term or long term in nature in the case of securitisation.

(iv) The question of issuing securities against book debts does not arise at all in the case of factoring whereas it forms the very basis of securitisation.

(v) The factor himself takes up the "collection work" whereas it can be done either by the originator or by a separate servicing agency under securitisation.

(vi) Under factoring, the entire credit risk is passed on to the factor. But under securitisation, a part of the credit risk can be absorbed by the originator by transferring the assets at a discount.

16.5 MODUS OPERANDI OF SECURITISATION

Mode of operation of securitisation involves following points:

1. Parties involved in the operational mechanics of securitisation.
2. Stages involved in the working of securitisation.
3. Role of Merchant Bankers.
4. Role of Other Parties.

16.5.1 Parties involved in the operational mechanics of Securitisation are as follows:

(i) The originator: "Owner" and "generator" of the assets to be securitized. Originators may be banks and other financial institutions, corporates, government authorities. It is the entity on the books of which the reconstruction to be done. Examples of the originators are banks and other financial institutions, corporate, governments and municipalities. In case of sale, the originator transferred both legal and the beneficial interest in the asset to the Special Launch Vehicle owner and generator of the assets to be securitized. Originators may be banks and other financial institutions, corporate, Government authorities.

(ii) A Special Purpose Vehicle (SPV) or a trust: A special purpose vehicle (SPV) is created to carry out a specific business purpose or activity. SPVs are frequently used in structured finance transactions, such as in asset securitizations, joint ventures, or to isolate certain company assets or operations.

(iii) **A merchant or investment banker:** A vital role is played by the merchant or investment banker in the process of securitisation. They generally act as a Special Purpose Vehicle. There are various issues involved in securitization namely the timing of the issue of pass through certificates, pricing of these certificates for marketing and above all underwriting of these issues. While in private placement they act as agents for the issuer connecting the sellers and buyers. They can also involve in structuring the issue to see that the issue meet all legal, regulatory, accounting, tax and other requirements. In the above mentioned perspective the merchant banker plays a vital role. The securitization process has further widened the scope of the activities of the merchant bankers.

(iv) **A credit rating agency**: An independent company that evaluates the financial condition of issuers of debt instruments and then assigns a rating that reflects its assessment of the issuer's ability to make the debt payments. Potential investors, customers, employees and business partners rely upon the data and objective analysis of credit rating agencies in determining the overall strength and stability of a company.

(v) **A servicing agent:** Receiving and paying agent (RPA) or Service providers are usually the originators or affiliates of the originators of the assets, are responsible for collecting principal and interest payments on the assets when due and for pursuing the collection of delinquent accounts. They also provide the trustee and the certificate holders with monthly and annual reports about the portfolio of assets sold or used as collateral.

(vi) **The original borrowers or obligors:** An obligor is a customer of the originator who is obliged to pay on a contractual basis for goods or services provided by the originator.

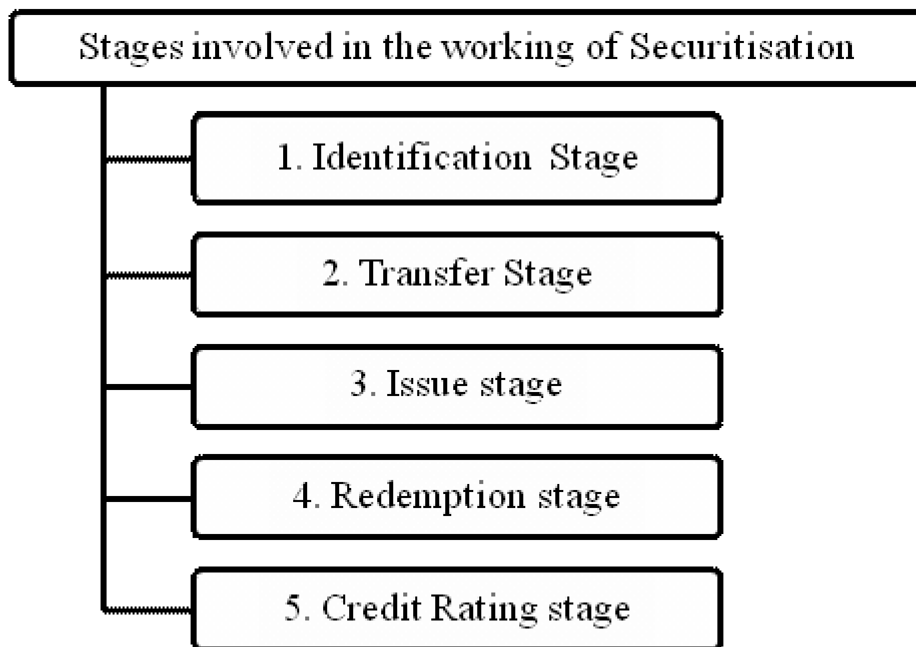
(vii) **The prospective investors i.e. the buyers of securities:** Purchasers of the asset-backed securities. Examples of investors in the securitization market are:

pension funds, banks, mutual funds, hedge funds, insurance companies, central banks, international financial institutions and corporates.

16.5.2 Stages involved in the working of Securitisation are as follows:

(i) Identification Process: The lending financial institution either a bank or any other institution for that matter which decides to go in for securitisation of its assets is called the 'originator'. The originator might have got assets comprising of a variety of receivables like commercial mortgages, lease receivables, hire purchase receivables etc. The originator has to pick up a pool of assets of homogeneous nature, considering the maturities, interest rates involved, frequency of repayments and marketability. This process of selecting a pool of loans and receivables from the asset portfolios for securitisation is called "identification process".

Figure 16.1: Stages involved in the working of Securitisation



(ii) Transfer Process: After the identification process is over, the selected pool of assets are then "passed through" to another institution which is ready to help the originator to convert those pools of assets into securities. This institution is called the special purpose vehicle (SPV) or the trust. The pass through transaction between the originator and the SPV is either by way of outright sale i.e. full transfer of assets in question for valuable consideration or by passing them for a collateralized loan. Generally, it is done on an outright sale basis. This process of passing through the selected poof of assets by the originator to a SPV is called transfer process and once this transfer process is over, the assets are removed from the balance sheet of the originator.

(iii) Issue Process: After this transfer process is over, the SPV takes up the onerous task of converting these assets of various types of different maturities. It is on this basis, the SPV issues securities to investors. The SPV actually splits the package into individual securities of smaller values and they are sold to the investing public. The SPV gets itself reimbursed out of the sale proceeds. The securities issued by the SPV are called by different names like Pay through Certificates, Pass through Certificates, Interest only Certificate and Principal only Certificates etc. The securities are structured in such a way that the maturity of these securities may synchronies with the maturities of the securitised loans or receivables.

(iv) Redemption Process: The redemption and payments of interest on these securities are facilitated by the collections received by the SPV from the securitised assets. The task of collection of dues is generally entrusted to the originator of a special servicing agent can be appointed for this purpose. This agency is paid a certain percentage of commission for the collection services rendered. The servicing agent is responsible for collecting the principal and interest payments on assets pooled when due and he must pay a special attention to delinquent accounts. Usually, the originator is appointed as the servicer.

Thus under securitisation, the role of the originator gets reduced to that of a collection agent on behalf of the SPV, in case he is appointed as a collection agent. A pass through certificate may be either "with recourse" to the originator or "without recourse". The usual practice is to make it "without recourse". Hence, the holder of a pass through certificate has to look to the SPV for payment of the principal and interest on the certificates held by him. Thus, the main task of the SPV is to structure the deal, raise proceeds by issuing pass through certificates and arrange for payment f interest and principal to the investors.

(v) **Credit Rating Process:** Since the passes through certificates have to be publicly issued, they require credit rating by a good credit rating agency so that they become more attractive and easily acceptable. Hence, these certificates are rated at least by one credit rating agency on the eve of the securitisation. The issues could also be guaranteed by external guarantor institutions like merchant bankers which would enhance the credit worthiness of the certificates and would be readily acceptable to investors. Of course, this rating guarantee provides a sense of confidence to the investor with regard to the timely payment of principal and interest by the SPV.

Pass through certificates, like debentures, directly reflect the ownership rights in the assets securitised, their repayment schedule, interest rate etc. These certificates, before maturity, are tradable in a secondary market to ensure liquidity for the investors. They are negotiable securities and hence they can be easily tradable in the market.

16.5.3 Role of Merchant Bankers

Merchant or investment bankers can play a big role in asset securitisation. They generally act as Special Purpose Vehicle. There are many issues involved in securitisation namely the timing of the issue of pass through certificates, pricing of these

certificates for marketing and above all underwriting of these issues. In private placement, they act as agents for the issuer connecting the sellers and buyers. They can also involve in structuring the issue to see that the issue meets all legal regulatory, accounting, tax and other requirements. In all these aspects, merchant bankers have a definite role to play. The mere fact that an issue has been underwritten by a popular merchant banker will add credit to that issue and it would become more attractive from the investor's point of view. Thus, securitisation enlarges the activities of the merchant bankers too.

16.5.4 Role of Other Parties

The other parties in the game of securitisation are the original borrowers and the prospective investors. The original borrowers refer to those who have availed of the loan facilities from the lending institution i.e., the originator. They are also called obligors. Infact the success of the securitisation process depends upon these original borrowers. If they fail to meet their commitments on the due dates, the securitisation process will be at danger. Infact the receipts of cash flows from the original borrowers are passed through to the investors. The prospective investors are nothing but the public at large who are willing to purchase the pass through certificates.

16.6 SECURITISATION AS A TOOL OF RISK MANAGEMENT

"Securitisation" is one way in which a company might go about financing its assets. There are generally seven reasons why companies consider securitization:

- to improve their return on capital, since securitization normally requires less capital to support it than traditional on-balance sheet funding;
- to raise finance when other forms of finance are unavailable (in a recession banks are often unwilling to lend - and during a boom, banks often cannot keep up with the demand for funds);

- to improve return on assets- securitisation can be a cheap source of funds, but the attractiveness of securitization for this reason depends primarily on the costs associated with alternative funding sources;
- to diversify the sources of funding which can be accessed, so that dependence upon banking or retail sources of funds is reduced;
- to reduce credit exposure to particular assets (for instance, if a particular class of lending becomes large in relation to the balance sheet as a whole, then securitisation can remove some of the assets from the balance sheet);
- to match certain classes of asset. Mortgage assets are technically 25 year assets, a proportion of which should be funded with long term finance; securitization normally offers the ability to raise finance with a longer maturity than is available in other funding markets;
- to achieve a regulatory advantage, since securitisation normally removes certain risks which can cause regulators some concern, there can be a beneficial result in terms of the availability of certain forms of finance (for example, in the UK building societies consider securitization as a means of managing the restriction on their wholesale funding abilities).

16.7 SUMMARY

The process of securitization primarily involves three parties namely, the originator, the special purpose vehicle (SPV) and the investor. The originator is the one who owns the financial asset and who wants to offload the same in the market. The originator could be a banking, industrial or finance company. The SPV or in other words the issuer is the one who issues mortgage-backed securities to investor in the market.

The process involved in the process of securitisation consists of the following stages:

- The process initiates when the lender (or originator) segregates loans / lease / receivables into pools which are relatively homogenous in regard to types of credit, maturity and interest rate risk.
- The pools of assets are then transferred to a Special Purpose Vehicle (SPV) usually constituted as a trust. The originator may float the SPV as a subsidiary in the form of a limited company. Another option could be for the SPV to be floated jointly by the originator / individuals / banks / institutions who are interested in the securitization deal.
- Based on these, the SPV issues asset backed securities in the form of debt, certificates of beneficial ownership and other instruments. The securities issued may be with or without recourse.
- Interest and principal payments on the loans, leases and receivables in the underlying pool of assets are collected by the servicer (who could also be the originator) and transmitted to the investors.
- Credit enhancement can add features to boost investor confidence. This could be in the form of a provision of recourse, a guarantee requiring the originator to cover losses, a letter of credit from a bank, or over collateralization.

16.8 GLOSSARY

- **Factoring:** Factoring is a financial transaction and a type of debtor finance in which a business sells its accounts receivable (i.e., invoices) to a third party (called a factor) at a discount. A business will sometimes factor its receivable assets to meet its present and immediate cash needs.

- **Merchant Bankers:** Merchant banks conduct underwriting, loan services, financial advising, and fundraising services for large corporations and high net worth individuals. They do not provide services for the general public like checking accounts.

- **Risk Management:** In business, the forecasting and evaluation of financial risks together with the identification of procedures to avoid or minimize their impact.

- **Securities:** A security is a tradable financial asset. Securities are broadly categorized into: debt securities (e.g., banknotes, bonds and debentures) equity securities (e.g., common stocks) derivatives (e.g., forwards, futures, options, and swaps).

- **SPV:** A special purpose vehicle / entity is a "bankruptcy-remote entity" that a parent company uses to isolate or securitize assets and it often holds this off-balance sheet.

16.9 SELF ASSESSMENT QUESTIONS

Q1. Define securitisation?

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Q2. Make comparison between structured securities and conventional securities?

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Q3. Make comparison between securitisation and factoring?

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Q4. What are the various parties involved in the operational mechanics of Securitisation?

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Q5. Explain the role of merchant bankers in the process of securitisation?

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Q6. Explain the role of other parties in the process of securitisation?

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16.10 LESSON END EXERCISE

Q1. Explain the concept of securitisation in detail?

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Q2. Explain the modus operandi of securitisation?

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Q3. Explain the stages involved in the working of securitisation?

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Q4. How securitisation is a tool of risk management?

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DEBT SECURITISATION AND HOUSING FINANCE

STRUCTURE FOR SECURITISATION

STRUCTURE

17.1 Introduction

17.2 Objectives

17.3 Background of Securitisation

17.4 Structure for Securitisation / Types of Securities

17.4.1 Pass Through and Pay Through Certificates

17.4.2 Preferred Stock Certificates

17.4.3 Asset Based Commercial Papers

17.4.4 Other Types

17.5 Securitisable Assets

17.6 Benefits of Securitisation

17.7 Summary

17.9 Self Assessment Questions

17.10 Lesson End Exercise

17.11 Suggested Readings

17.1 INTRODUCTION

Securitization is the procedure where an issuer designs a marketable financial instrument by merging or pooling various financial assets into one group. The issuer then sells this group of repackaged assets to investors. Securitization offers opportunities for investors and frees up capital for originators, both of which promote liquidity in the marketplace. In theory, any financial asset can be securitized that is, turned into a tradable item of monetary value. In essence, this is what all securities are. However, securitisation most often occurs with loans and other assets that generate receivables such as different types of consumer or commercial debt. It can involve the pooling of contractual debts such as auto loans and credit card debt obligations.

17.2 OBJECTIVES

After reading this lesson you should be able to understand:

- background of securitisation;
- structure for securitisation / types of securities; and
- benefits of securitisation.

17.3 BACKGROUND OF SECURITISATION

Securitisation as a technique gained popularity in the United Stated in the 1970. United Kingdom is the second largest market for securitization after the United States. Securitization started in United States in 1970 with the issue of residential mortgages by public housing finance corporations. These institutions have found that they had to pay higher interest to attract short term deposit, while rates earned on long term mortgage loans were less. This created mismatches between assets and liabilities. The solution was found in securitization.

The modern asset securitisation transactions were devised in early 1970s by the governmental agencies of the United States. Pioneered by Governmental agencies, this technique was later adopted by private companies. As volumes of asset securitization expanded and the calculations showed substantial benefits for companies involved, the businesses and legislators in other jurisdictions started searching for ways to implement asset securitization at home. Among them were the two most developed civil law countries: France and Germany.

In 1988 France was among the first European countries to provide the legal framework for asset securitization. This resulted in an immediate boost of securitizations, but later the development turned out to be less explosive than anticipated. Germany began conducting securitization in early 1990s. During this decade Germany boasted a significant part of European asset backed securities issuance.

Securitisation as a technique gained popularity in the United States in the 1970s. Favourable tax treatment, legislative enactments, establishment of Government backed institutions that extend guarantees and pragmatic regulatory environment are essential for this system to work. The Government wanted to promote secondary markets in mortgages to allow liquidity for mortgage finance companies. GNMA was the first one to buy mortgages from mortgage companies and to convert them in to pass through securities. Other US Government agencies like FNMA and Freddie Mac joined in later. The first securitization of receivables outside the mortgages happened in 1975 when Sperry Corporation securitized its computer lease receivables. The European Model: Pfanbriefe and mortgage bonds: another mortgage funding device, slightly different from the US tyre pass through, has expired in Europe for almost two centuries in the past. In Denmark, for example, mortgage bonds are more than 200 years old. Germany also has a long history of Pfanbriefes and it is stated that there have been no defaults on these instruments for all these years.

The success of securitisation has been due to the United States Federal Government. For encouraging the home ownership, Congress created government-owned and government-sponsored entities for creation of residential mortgages.

Mae and was a privately-owned government-sponsored entity. The second entity is the Government National Mortgage Association, better known as Ginnie Mae, and is a government-owned entity. Both Fannie Mae and Ginnie Mae were created to purchase and sell federally-insured mortgages.

Finally, in 1971, Congress created the Federal Home Loan Mortgage Corporation or Freddie Mac in order to improve the secondary market for conventional home mortgages. Secondly, the government broadened the authority of the Federal National Mortgage Administration ("Fannie Mae") to increase Fannie Mae's activities in the secondary mortgage market. Finally, the Government National Mortgage Association ("Gennie Mae") began to guarantee the payment of certain mortgage-backed securities.

In the 1980s there was emergence of more complex payment structures creating a wider investment market for mortgage backed securities. Beginning in 1983, Freddie Mac issued Collateralized Mortgage Obligations known as CMOs. These CMOs altered the traditional pay-through structure of mortgage-backed securities by creating tranches with different payment structures in order to meet the needs of different investors. The Tax Reform Act of 1986 allowed for pass-through tax treatment for entities issuing multiple classes or tranches of securities by creating Real Estate Mortgage Investment Conduits, or REMICs

The private sector entered the secondary mortgage market when California Federal Savings and Loan issued the first publicly rated mortgage backed security in 1975. In 1977, Bank of America issued the first publicly rated security backed by conventional mortgages. Eventually, mortgage bankers, home builders, investment banks, and insurance companies began issuing mortgage backed

securities of their own. Gaining from the experiences of the secondary mortgage market, other types of financial assets were soon being securitized. In 1975, Sperry Corporation began securitizing operating leases for computer equipment. This transaction received a higher credit rating than Sperry's own rating. The securitization of other types of leases soon ensued, including the securitization of automobile, equipment, and aircraft leases.

Also, in 1985, automobile loans were first securitized by Marine Midland Bank and Valley National Bank. Soon after, larger issuers began securitizing automobile loans, including General Motors Acceptance Corporation, Chrysler Financial Corporation, and Nissan Motors Acceptance Corp. By 1987, Bank of America and Republic Bank of Delaware offered securities backed by credit card receivables. As early as 1994, securitizations of credit card receivables were increasing while mortgage securitization began to significantly decline.

The Federal Government also remained active in the securitization of financial assets other than residential mortgages. The Federal Government has participated in the securitization of student loans through the Student Loan Marketing Association, also known as Sallie Mae, and agricultural loans through the Federal Agricultural Mortgage Corporation or Farmer Mac.

The federal Housing Administration was established with the enactment of the Housing Act 1934. The act provide for the insurance of home mortgage loans made by private lenders and for the chartering of national mortgage association. The Act led to the establishment of National Mortgage Association of Washington in 1938, whose name was later changed to Federal National Mortgage Association.

According to the amendments made to the Act in 1968, the Federal National Mortgage Association was divided into two separate entities, the Government National Mortgage Association (Ginnie Mae) and the Federal National Mortgage Association (Fannie Mae). Ginnie Mae remained as a wholly owned government

entity, while Fannie Mae became privately owned by retiring the government-held stock.

Securitization started in the early 1970s through the sale of mortgage loans by Ginnie Mae. The mission of Ginnie Mae is to support expanded affordable housing in the US by providing an efficient government-guaranteed secondary market vehicle, linking the capital markets with Federal housing markets.

Ginnie Mae does not loan money for mortgages but acts as a guarantor or a surety. Ginnie Mae does not issue, sell, buy mortgage-backed securities or purchase mortgage loans. Ginnie Mae manages a mortgage-backed securities program, where it guarantees securities backed by pools of mortgages. These securities are called Mortgage-Backed Securities (MBS). These MBS are issued by certain private institutions that are approved by Ginnie Mae. The mortgages insurances are undertaken by the Rural Housing Service (RHS) or are guaranteed by the Department of Veterans Affairs (VA).

In the 1980s, there was growth in the market with the introduction of transactions by the quasigovernmental agencies. Freddie Mac and Fannie Mae buy mortgages from commercial banks, thrift institutions, mortgage banks and other primary lenders. Then, Freddie Mae and Fannie Mae either hold these mortgages in their own portfolios or package them into mortgage-backed securities for re-sale to investors.

17.4 STRUCTURE FOR SECURITISATION/ TYPES OF SECURITIES

Securitisation is a structured transaction, whereby the originator transfers or sells some of its assets to a SPV which breaks these assets into tradable securities of smaller value which could be sold to the investing public. The appropriate structure for securitisation depends on a variety of factors like quality of assets securitised, default experience of original borrowers, amount of amortisation at maturity, financial reputation and soundness of the originator etc. The general

principle is that the securities must be structured in such a way that the maturity of these securities may coincide with the maturity of the securitised loans. However, there are three important types of securities as listed below:

1. Pass through and pay through certificates
2. Preferred stock certificates
3. Asset-based commercial papers
4. Other types

17.4.1 Pass through and pay through certificates

In the case of pass through certificates, payments to investors depend upon the cash flow from the assets backing such certificates. In other words, as and when cash (principal and interest) is received from the original borrower by the SPV, it is passed on to the holders of certificates at regular intervals and the entire principal is returned with the retirement of the assets packed in the pool. Thus, pass through certificates have a single maturity structure and the tenure of these certificates is matched with the life of the securitised assets.

On the other hand, pay through certificates has a multiple maturity structure depending upon the maturity pattern of underlying assets. Thus, two or three types of securities with different maturity patterns like short term, medium term and long term may be issued. The greatest advantage is that they can be issued depending upon the investor's demand for varying maturity patterns. This type is more attractive from the investor's point of view because the yield is often inbuilt in the price of the securities themselves i.e. they are offered at a discount to face value as in the case of deep-discount bonds.

17.4.2 Preferred stock certificates

Preferred stocks are instruments issued by a subsidiary company against the trade debts and consumer receivables of its parent company. In other words, subsidiary companies buy the trade debts and receivables of parent companies, convert them into short term securities, and help the parent companies to enjoy liquidity. Thus trade debts can also be securitised through the issue of preferred stocks. Generally, these stocks are backed by guarantees given by highly rated merchant banks and hence they are also attractive from the investor's point of view. These instruments are mostly short term in nature.

17.4.3 Asset based commercial papers

This type of structure is mostly prevalent in mortgage backed securities. Under this type, the SPV purchases portfolio of mortgages from different sources (various lending institutions) and they are combined into a single group on the basis of interest rates, maturity dates and underlying collaterals. They are then transferred to a Trust which in turn issues mortgage backed certificates to the investors. These certificates are issued against the combined principal value of the mortgages and they are also short term instruments. Each certificate holder is entitled to participate in the cash flow from underlying mortgages to the extent of his investments in the certificates.

17.4.4 Other types

Apart from the above, there are also other types of certificates namely:

(i) Interest only certificates and

(ii) Principal only certificates

In the case of **Interest only certificates,** payments are made to investors only from the interest incomes earned from the assets securitised. As the very

name suggests, payments are made to investors only from the repayment of principal by the original borrows, in the case of principal only certificates. These certificates enable speculative dealings since the speculators know well that the interest rate movements would affect the bond values immediately. For instance, **the principal only certificates** would increase in value when interest rates go down. It is so because, it becomes advantageous to repay the existing debts and resort to fresh borrowings at lower cost. This early redemption of securities would benefit the investors to a greater extent. Similarly, when the interest rates go up, interest only certificate holders stand to gain since more interest would be available from the underlying assets. One cannot exactly predict the future movements of interest, and hence, these certificates give much scope for speculators to play their game.

Thus, securitisation offers much scope for the introduction of newer and newer instruments so as to meet the varying requirements of investors. Debt securitisation offers a variety of investment instruments to the investing public at large as well as to the financial intermediaries like mutual funds, insurance companies etc.

17.5 SECURITISABLE ASSETS

As stated earlier, all assets are not suitable for securitisation. For instance, trade debts and receivables are not generally suitable for securitisation whereas they are readily acceptable to a factor. Only in rare cases, they are securitised. The following assets are generally securitised by financial institutions:

1. **Term loans to financially reputed companies:** A term loan is a loan from a bank for a specific amount that has a specified repayment schedule and either a fixed or floating interest rate. A term loan is often appropriate for an established small business with sound financial statements and the ability to make a substantial down payment to minimize payment amounts and the total cost of the loan.

2. **Receivables from Government Departments and Companies:** Receivables also referred to as accounts receivable, are debts owed to a company by its customers for goods or services that have been delivered or used but not yet paid for.

3. **Credit Card receivables:** Credit card receivables, also known as credit card factoring, is a type of financing available to businesses that are paid by customers with credit cards. Credit card factoring companies consider a business' future credit card sales as an asset.

4. **Hire purchase loans like vehicle loans:** Hire purchase is an agreement whereby a person hires goods for a period of time by paying installments, and can own the goods at the end of the agreement if all installments are paid.

5. **Lease Finance:** Lease financing is one of the important sources of medium and long term financing where the owner of an asset gives another person, the right to use that asset against periodical payments. The owner of the asset is known as lessor and the user is called lessee.

6. **Mortgage Loans etc.:** A mortgage is a loan in which property or real estate is used as collateral. The borrower enters into an agreement with the lender (usually a bank) wherein the borrower receives cash upfront then makes payments over a set time span until he pays back the lender in full.

17.6 BENEFITS OF SECURITISATION

Debt securitisation provides many benefits to all the parties, such as, the originator, investors and the regulatory authorities. Some of the important benefits are the following:

1. **Additional Source of Fund:** The originator (i.e. the lending institution) is much benefited because securitisation provides an additional source of funds by converting an otherwise illiquid asset into ready liquidity. As a result, there is an immediate improvement in the cash flow of the originator. Thus, it acts as a source of liquidity.

2. **Greater Profitability:** Securitisation helps financial institutions to get liquid cash from medium term and long term assets immediately rather than over a longer period. It leads to greater recycling of funds which in turn leads to higher business turnover and profitability. Again, the cash flow could be recycled for investment in higher yielding assets. This means greater profitability. Moreover, economies of scale can be achieved since securitisation offers scope for the fuller utilization of the existing capabilities by providing liquid cash immediately. It results in additional business turnover. Again, the originator can also act as the receiving and paying agent. If so, it gets additional income in the form of servicing fee.

3. **Enhancement of Capital Adequacy Ratio:** Securitisation enables financial institutions to enhance their capital adequacy ratio by reducing their assets volume. The process of securitisation necessitates the selection of a pool of assets by the financial institutions to be sold or transferred to another institution called SPV. Once the assets are transferred, they are removed from the balance sheet of the originator. It results in the reduction of assets volume, thereby increasing the capital adequacy ratio. Capital adequacy ratio can also be improved by replacing the loan assets with the lesser risk weighted assets. Thus, the removal of assets from the Balance Sheet under a true sale improves the capital adequacy norms.

4. **Spreading of Credit Risk:** Securitisation facilities the spreading of credit risk to different parties involved in the process of securitisation. In the

absence of securitisation, the entire credit risk associated with a particular financial transaction has to be borne by the originator himself. Now, the originator is able to diversify the risk factors among the various parties involved in securitisation. Thus, securitisation helps to achieve diversification of credit risks which are greater in the case of medium term and long term loans. Thus, it is used as tool for risk management.

5. **Lower Cost of Funding:** In view of enhancement of cash flows and diversification of risk factors, securitisation enables the originator to have an easy access to the securities market. It means that companies with low credit rating can issue asset backed securities at lower interest cost due to high credit rating on such securities. This helps it to secure funds at lower cost. Moreover, the criteria for choosing the pool of assets ensure an efficient cost of funds. In the present context of scarcity of funds and higher interest rates, securitisation provides a good scope for cheap funding.

6. **Provision of Multiple Instrument:** From the investor's point of view, securitisation provides multiple new investment instruments so as to meet the varying requirements of the investing public. It also offers varieties of instruments for other financial intermediaries like mutual funds, insurance companies, pension funds etc. giving them many choices.

7. **Higher Rate of Return:** When compared to traditional debt securities like bonds and debentures, securitised securities offer better rate of return along with better liquidity. These instruments are rated by good credit rating agencies and hence more attractive. Being structured assets based securities; they offer more protection and yield a good return. The bankruptcy/winding up of the originator does not affect the investors since the payment is guaranteed by the SPV.

8. **Prevention of Idle Capital:** In the absence of securitisation, capital would remain idle in the form of illiquid assets like mortgages, term loans etc., in many of the lending institutions. Now, securitisation helps recycling of funds by converting these assets into liquidity, liquidity into assets, assets into liquidity and so on by means of issuing tradable and transferable securities against these assets. Thus, it provides impetus for capital formation.

9. **Better than Traditional Instruments:** Certificates are issued to investors against the backing of assets securitised. The underlying assets are used not only as collateral to the certificates but also to generate the income to pay the principal and interest to the investors. It does not entail any servicing needs and hence does not require much cost. It is better than even mutual fund units because it is issued against the backing of collateral securities whereas there is no such backing for mutual fund certificates. Thus, these instruments, being structured asset backed securities, afford a greater protection to investors.

   Again, there is much transparency from the investor's point of view. They can very well see the collateral pool that a particular issue represents and this transparency reduces uncertainty as to the risk element.

10. **Other Benefits:** Securitisation, if carried out in true spirit, leads to greater economy in the use of capital with efficiency and cost effectiveness in both funding and lending. This is a great boon to the regulating authorities as well since their primary objective is to prevent the accumulation of capital where it is not needed.

In the long run, it is beneficial to the borrowers also. They will be able to get funds at cheaper rates since the originators are likely to pass on the benefit to the ultimate borrows. There is no doubt that securitisation is a low cost and innovative funding source ensuring economy in the use of capital.

17.7 SUMMARY

The process of securitization primarily involves three parties namely, the originator, the special purpose vehicle (SPV) and the investor. The originator is the one who owns the financial asset and who wants to offload the same in the market. The originator could be a banking, industrial or finance company. The SPV or in other words the issuer is the one who issues mortgage-backed securities to investor in the market.

The process involved in the process of securitisation consists of the following stages:

- The process initiates when the lender (or originator) segregates loans / lease / receivables into pools which are relatively homogenous in regard to types of credit, maturity and interest rate risk.
- The pools of assets are then transferred to a Special Purpose Vehicle (SPV) usually constituted as a trust. The originator may float the SPV as a subsidiary in the form of a limited company. Another option could be for the SPV to be floated jointly by the originator / individuals / banks / institutions who are interested in the securitization deal.
- Based on these, the SPV issues asset backed securities in the form of debt, certificates of beneficial ownership and other instruments. The securities issued may be with or without recourse.
- Interest and principal payments on the loans, leases and receivables in the underlying pool of assets are collected by the servicer (who could also be the originator) and transmitted to the investors.
- Credit enhancement can add features to boost investor confidence. This could be in the form of a provision of recourse, a guarantee requiring the

originator to cover losses, a letter of credit from a bank, or over collateralization.

17.8 GLOSSARY

- **Securitisation:** Securitisation is the process whereby an entity (originator) sells in the market illiquid and non-tradable assets in exchange for cash (the so-called "traditional securitisation" or "true sale securitisation") or sells only the credit risk associated with the assets (also called "synthetic securitisation").

- **GNIMA:** Ginnie Mae guarantees the timely payment of principal and interest payments on residential mortgage-backed security (MBS) instruments to institutional investors worldwide. These securities, or "pools" of mortgage loans, are used as collateral for the issuance of securities on Wall Street.

- **FNMA:** FNMA is the nickname for the Federal National Mortgage Association (FNMA) established in 1938; Fannie Mae's purpose is to create a secondary market for the purchase and sale of mortgages. In 1968, Fannie Mae ceased to exist as a government entity and became a quasi-governmental, federally chartered corporation in order to buy mortgages other than those insured by the Federal Housing Administration (FHA).

- **CMOs:** A collateralized mortgage obligation (CMO) is a fixed income security that uses mortgage-backed securities as collateral. Like other structured securities, CMOs are subdivided into graduated risk classes, called tranches that vary in degree based on the maturity structure of the mortgages.

- **REMICS:** A real estate mortgage investment conduit (REMIC) is a special purpose vehicle that is used to pool mortgage loans and issue mortgage-

backed securities (MBS). Real estate mortgage investment conduits hold commercial and residential mortgages in trust and issue interests in these mortgages to investors.

17.9 SELF ASSESSMENT QUESTIONS

Q1. What are pass through and pay through certificates?

Q2. What are preferred stock certificates?

Q3. What are asset based commercial papers?

Q4. What are interest only certificates?

Q5. What are principal only certificates?

17.10 LESSON END EXERCISE

Q1. Throw light on the background of securitisation?

Q2. Explain the structure of securitisation?

Q3. What are securitsable assets?

Q4. What are the benefits of securitisation?

17.11 SUGGESTED READINGS

1. Bhatia, B.S., and Batra, G.S., Financial Services, Deep & Deep Publishers, New Delhi.

2. Bansal, L.K., Merchant Banking and Financial Services, Unistar Books Pvt. Ltd., Chandigarh.

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DEBT SECURITISATION AND HOUSING FINANCE

SECURITISATION IN INDIA

STRUCTURE

18.1 Introduction

18.2 Objectives

18.3 Securitisation and Banks

18.4 Conditions for Successful Securitisation

18.5 Securitisation Abroad

18.6 Securitisation in India

18.7 Causes for the Unpopularity of Securitisation in India

18.8 Summary

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18.10 Self Assessment Questions

18.11 Lesson End Exercise

18.12 Suggested Readings

18.1 INTRODUCTION

Securitisation is the process of converting illiquid loans into marketable securities. The lender sells his or her right to receive future payments from the borrowers to a third party, and is paid for it. The lender is therefore repaid at the time of securitization. These future cash flows from the borrowers are sold to investors in the form of marketable securities.

Securitisation in India mainly takes the form of a trust structure, wherein the underlying assets are sold to a trustee company, which holds the security in trust for investors. The trustee company in this case is a special-purpose vehicle (SPV), which issues securities in the form of pass-through or pay-through certificates (PTCs). The trustee is the legal owner of the underlying assets. Investors holding the PTCs are entitled to beneficial interest in the underlying assets held by the trustee. The parties involved in the securitization process and their respective roles are stated briefly below:

(i) **Originator:** The original lender and seller of receivables. In India, this is typically a bank, an NBFC, or a housing finance company.

(ii) **Seller:** One who pools the assets to securitize them. In India, the seller and the originator are usually the same entity.

(iii) **Borrower:** The counterparty to whom the originator makes a loan. Payments (typically in the form of equated monthly installments) by borrowers fund investor payouts.

(iv) **Issuer (SPV):** The entity that issues marketable securities (to which investors subscribe) and ensures that transactions are executed on specific terms. In India, the SPV is typically set up as a trust.

(v) **Arranger:** Investment banks responsible for structuring the securities. They coordinate with other parties (such as investors, rating agencies, and legal counsel) to execute the transaction successfully.

(vi) **Investor:** The purchaser of securities. In India, investors are typically banks, insurance funds, and mutual funds.

(vii) **Rating agency:** These agencies analyze risks associated with each transaction, stipulate credit enhancements commensurate with the ratings of the PTCs, monitor the performance of the transactions until maturity, and take appropriate rating actions.

(viii) **Credit enhancement provider:** Typically the originator, as a facility that covers any shortfall in pool collections in relation to investor payouts. The enhancement can also be provided by a third party for a fee.

(ix) **Servicer:** The entity that collects periodic installments due from individual borrowers, makes payouts to investors, follows up on delinquent borrowers, and furnishes periodic information about pool performance to the rating agency. In India, the originator typically acts as the servicer.

18.2 OBJECTIVES

After reading this lesson you should be able to understand:

- the scope of banks in securitisation and banks;
- conditions for successful securitisation;
- securitisation abroad;
- securitisation in India; and
- causes for the unpopularity of securitisation in India; and

18.3 SECURITISATION AND BANKS

There is a vast scope for commercial banks to go in for securitisation due to the following factors:

1. **Innovative and low cost source of fund:** Traditionally deposit has been the only dependable source of funds for banks over the years. But, in recent times, banks have to face severe competition from other non-banking institutions in deposit mobilization. Now, securitisation offers an excellent source of funds at cheaper rates. Unlike deposits, it will not entail any servicing needs and the consequent increase in costs.

2. **Better capital adequacy norms:** Securitisation has the effect of improving the capital adequacy norms of banks. Generally, commercial firms utilize the cash flow from securitisation for repayment of their borrowings, and thus, they can achieve a good debt-equity ratio. But, in the case of banks, borrowings are limited. So they can better utilize the cash flow to create lower risk weighted assets. Hence, high risk weighted assets can be easily converted into lower risk weighted assets. Thus, it helps banks to achieve better capital adequacy norms.

3. **Creation of more credit:** In India, banks are subject to high statutory pre-emptions for which more liquid cash is essential now and then. This has necessarily impaired the capacity of banks to create credit. Infact, securitisation is not at all affected by these factors. The cash flow from securitisation could be very well used for further expansion of credit without any statutory restrictions.

4. **Increased Profitability:** The profitability of banks has been very much affected to a greater extent in these days due to many factors. In this context, securitisation has a salutary impact on the profitability of banks. It provides

for more liquidity, quicker recycling of funds and greater economy in the use of capital. This has the effect of improving the profitability of banks. Besides, they can also earn income in the form of service fee by acting as receiving and paying agent.

5. **Tool for Asset-liability Management and Risk Management:** Securitisation can be better used as a tool to avoid mismatch in the asset-liability management. It would reduce the over dependence of banks on the market for money at call and short notice as well as the refinancing agencies for recycling of funds. Again, it can be used as a risk management tool also. It completely eliminates the interest risk and thus it provides a hedge to banks against interest risk which are inherent in the free interest rate market.

18.4 CONDITIONS FOR SUCCESSFUL SECURITISATION

If securitisation of debt has to be successful, the following conditions must have been fulfilled:

1. Ultimately, the success of securitisation depends upon the ability of the original borrower to repay his loan. Therefore, selection of assets to be securitised requires utmost care. The assets should be ranked and selected on the basis of least losses and to provide for maximum protection to the investor.

2. The credit rating is an integral part of securitisation. Hence, credit rating must be done by credit rating agencies on a scientific basis and the ratings should be unquestionable. Then only the prospective investor's confidence can be built. The credit rating agencies should take into account the various types of risks such as credit risk, interest risk, liquidity risk etc. along with other usual factors.

3. The SPV should be a separate organization from that of the originator. It should be completely insulted from the parent corporate entity so that SPV could be protected from the danger of bankruptcy.

4. The pass through certificates or any other similar instruments arising out of securitisation must be listed in stock exchanges so that they may be readily acceptable to investors. It would provide instant liquidity and moreover, its price could also be easily ascertained.

5. Alternatively, it is also advisable to provide two-way quotations for facilitating the buying and selling of the pass through certificates in the market as in the case of mutual fund units.

6. There must be standardized loan documentation for similar loans so that there may be uniformity between different financial institutions. It must carry a right to assign debts to third parties, so that, it could be sold or transferred to the SPV.

7. There should be a proper accounting treatment for the various transactions involved in asset securitisation. Suitable accounting norms for the reorganisation of the trust created for securitised debt should be evolved. The accounting system should provide for the removal of the securitised assets from the balance sheet of the originator. Only then, the real benefit will go to the originator.

8. Above all, there should be proper and adequate guidelines given by the regulatory authorities dealing with the various aspects of the process of securitisation.

18.5 SECURITISATION ABROAD

The credit of introducing the concept of securitisation goes to America where the first structured asset securitised financing came into being in 1970. In

1970, the newly created Government National Mortgage Association (Ginnie Mae) began its operations by publicly trading in securities, backed by a pool of mortgage loans. It was followed by Federal National Mortgage Association and similar organizations. These organizations bought residential mortgage loans, made pools out of them and issued mortgage-backed securities against them. The payment of principal and interest of these instruments was also guaranteed. The securities issued by it were called "Mortgage pass through securities". A pool of mortgage was created by putting together assets that had similar characteristics in terms of duration, interest rate and quality. The pool was then placed with a trust which actually sold the certificates drawn against such mortgages to the investors either directly or through private placement. Thus, the concept of securitisation was confined to mortgages only. However, in March 1985, non-mortgage collaterals started getting securitised in the U.S.A. For instance, the first offering of 192 million of lease backed certificates for Sperry lease Finance Corporation was underwritten by The First Boston. Now it has become a popular mode of financing in America. It is slowly becoming a global phenomenon covering transactions relating to various modes of finance.

Securitisation is gaining popularity also in the U.K. in recent years only. Like America, this concept started with mortgage securitisation. The Bank America Finance Ltd., U.K. issued mortgage securities in January, 1985 against the residential property mortgages as underlying assets. The first mortgage securitisation issue for the international market arranged was MINI in London in 1985. Now, clearing banks and buildings societies have entered into this market under the supervision of the Bank of England. Securitisation of debt and the consequent debt instruments are now popular in countries like Italy, Australia, Canada, France, Spain, and Japan. In many of these countries, the process of securitisation has been encouraged by passing suitable legislations.

18.6 SECURITISATION IN INDIA

The concept of asset securitisation is slowly entering into the Indian soil. Financial institutions have not yet come forward to make use of this avenue for financing on a large scale. However, there is a tardy movement of the financial institutions in resorting to this mode of financing. The securitisation of the ICICI's receivables by the Citibank in February 1991 is the first attempt in this direction. A sum of Rs.15 crores was raised by means of securitisation of assets. Following this, the hire purchase portfolio of TELCO was securitised by the Citibank. Again, the Retail Residential Receivables of DLF International were also securitised by the Citibank in June 1992. The Citibank's own portfolio of "Citimobile Scheme" was subject to securitisation. Infact the Citibank has pioneered this trend in India. Now, the HDFC has taken up this route along with the Citibank. The HDFC is on the way to securities its housing loan portfolio around Rs.50 crores. Infrastructure Leasing and Financial Services has entered into this field by setting up a SPV. If securitisation has to become popular in India, the commercial banks should enter into this field in a big way. Infact, the commercial banks can remove the non-performing assets from their balance sheet by resorting to this technique. At the same time, they can recycle the funds for greater profitability. If financial institutions have to meet their ever-increasing capital requirements, securitisation would go a long way in mobilizing adequate resources.

18.7 CAUSES FOR THE UNPOPULARITY OF SECURITISATION IN INDIA

Though securitisation brings many benefits, it is not firmly rooted in Indian soil due to the following reasons:

1. **New Concept:** Securitisation itself is a new concept in debt market. There is much unawareness not only among the investors but also among the various financial intermediaries. Though securitisation brings immediate

benefits to the lending institutions, most of them neither aware of this concept nor its advantages.

2. **Heavy Stamp duty and Registration Fees:** Basically, securitisation requires the transfer of various illiquid and non-performing assets to a central agency called Special Purpose Vehicle. This transfer involves heavy stamp duty and registration fee. These costs are so exorbitant that people are automatically discouraged to go in for this innovative technique of financing.

3. **Cumbersome Transfer Procedures:** Again, the transfer of assets involves very complicated and cumbersome legal procedures which stand as a real impediment in the way of securitisation.

4. **Difficulty in Assignment of Debts:** The right to assign debts to third parties has been permitted only under certain circumstances under the Transfer of Property Act and infact, this transfer / sale of debts forms the central theme of securitisation. Hence, the Transfer of Property Act should be suitably amended so as to facilitate securitisation in India.

5. **Absence of Standardized Loan Documentation:** As it is, there is no standardized loan documentation procedure in India. There is no uniformity between different financial institutions regarding the loan documentation even for the same type of loans. In such a case, it becomes very difficult for an agency like the Special Purpose Vehicle to pool the similar assets of the various financial institutions for securitisation.

6. **Inadequate Credit Rating Facilities:** Credit rating is an integral part of securitisation. Unfortunately, credit rating in India is at its infancy level. Now only, it becomes obligatory to get credit rating for all debt instruments issued by non-banking companies. The credit rating agencies are not adequately available in India at present to take up the stupendous task of

credit rating instruments for securitisation purposes. However, a good progress has been made in this direction in recent times.

7. **Absence of Proper Accounting Procedures:** Proper accounting procedure should be evolved for securitisation. Creation of a Trust or Special Purpose Vehicle is a must for securitisation and as such there is no accounting procedure for the recognition of this trust. Again, securitisation paves way for the removal of the securitised assets from the Balance sheet of the originator. It is a challenge to the accounting professionals in the country to evolve suitable accounting procedures for securitisation.

8. **Absence of Proper guidelines:** One can find a lot of guidelines issued by the Regulatory authorities to deal with mutual funds, non-banking companies etc. But, they are conspicuously absent in the field of securitisation. There are various processes involved in securitisation right from the identification process to the redemption process. Again, various types of structures are available. Hence, proper guidelines must be issued covering all these aspects so that financial intermediaries can go for securitisation without any hesitation and thus securitisation becomes a smooth affair.

There is a bright future for securitisation in India due to the following factors:

(i) With the liberalization of the financial markets, there is bound to be more demand for capital.

(ii) There has been an explosive growth of capital market and a vast increase in the investor base in recent times.

(iii) The entry of newer financial intermediaries like mutual funds, money market, pension funds etc. has paved the way for floating debt instruments easily in the market.

(iv) Debt instruments have become popular in recent times since corporate customers are not willing to take recourse to the equity route as a major source of financing their projects.

(v) There is a proposal to establish Asset Reconstruction Fund as per the Narasimhan Committee recommendations for the purpose of securitisation of non-performing assets.

(vi) Since the financial institutions and banks have to follow the capital adequacy norms as recommended by the Narasimhan Committee, they have to necessarily go for securitisation.

The above factors clearly indicate that there is a vast scope for the introduction of the concept of securitisation of assets on a large scale as an innovative step for resource: mobilization. More than that, it is used as a tool to improve the balance sheets by bringing out changes in the critical financial ratios like debt-equity ratio, return on assets ratio, asset turnover ratio, capital adequacy ratio etc.

There is much scope for securitisation in respects of loans under (i) mortgage (ii) housing loans (iii) other term loan and (iv) credit and receivables.

In the case of non-banking financial companies also, lease receivables and vehicle loans could be readily securitised. With nearly Rs.70,000 crore outstanding corporate debts of financial institutions, at least Rs.50,000 crore could be securitised and thereby the financial institutions could raise their liquidity for greater profitability.

While most of the innovations in the financial service industry directly benefit the customers, these innovations like factoring and securitisation directly bring benefits to the financial institutions themselves first and then to the public at large. It is high time that the Government came forward with all positive help to encourage securitisation in India.

The immediate need of the hour is to amend the various relevant Act like the Transfer of Property Act, 1882, the Registration Act 1908, Stamp Laws Act 1809 etc. to make asset securitisation a smooth affair. Proper accounting procedures should be evolved besides appropriate guidelines by the regulatory authorities. Securitisation would facilitate the transfer of capital from non-performing and idle assets to more efficient assets. Creation of new debt instruments would further deepen the financial market. On the whole, the economy would be developed at a faster rate than what it is, if securitisation becomes a popular technique of financing. Since the stamp duties have been considerably reduced in any states and the National Stock Exchange has decided to list securitised assets, securitisation is expected to have a very bright future in India and the debt market is expected to become very active in the days to come.

18.8 SUMMARY

A technique whereby assets are converted into securities, which are in turn converted into cash on an ongoing basis, with a view to allow for increasing turnover of business and profit, is known as asset securitization. The technique provides for flexibility in yield, pricing pattern, issue risk and marketability of instruments, to the advantage of both borrowers and lenders. There are many features to securitization such as marketability of financial claims, wide distribution, homogeneity, etc. Securitized financial instruments are useful as they help small investors by facilitating liquidity. An entity called "Special Purpose Vehicle" acts as an intermediary between the originator of the receivables and the end-investors. It also plays an active role in reinvesting or reshaping the cash flows arising from the assets transferred to it. It helps improve the return on capital, as it normally requires less capital to support as compared to traditional on balance sheet funding. Similarly, it also helps in raising finance when other forms of finance are unavailable, besides being helpful in reducing credit exposure, etc. Securitization is beneficial in many ways. For instance, it facilitates off-balance sheet financing. In addition, it also

helps firms access the market for low-cost credit. However, the process may cause a diminution in the importance of banks in the financial intermediation process. Similarly, it may also cause heightened volatility in asset values by allowing the transformation of non-liquid loans into liquid securities. A well-developed capital market allows for the smooth growth of securitization.

18.9 GLOSSARY

- **Asset Liability Management:** Asset Liability Management (ALM) can be defined as a mechanism to address the risk faced by a bank due to a mismatch between assets and liabilities either due to liquidity or changes in interest rates. Liquidity is an institution's ability to meet its liabilities either by borrowing or converting assets.
- **Risk Management**: In business, the forecasting and evaluation of financial risks together with the identification of procedures to avoid or minimize their impact.

18.10 SELF ASSESSMENT QUESTIONS

Q1. What are the parties involved in securitisation process?

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Q2. What you mean by securitisation abroad?

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Q3. Explain securitisation in India?

Q4. Why the future of securtisation is bright in India?

18.11 LESSON END EXERCISE

Q1. What is the scope of commercial banks to go in for securitisation?

Q2. What are the various conditions for successful securitisation?

Q3. What are the various causes for the unpopularity of the securitisation in India?

18.12 SUGGESTED READINGS

1. Bhatia, B.S., and Batra, G.S., Financial Services, Deep & Deep Publishers, New Delhi.

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DEBT SECURITISATION AND HOUSING FINANCE

NATIONAL HOUSING BANK

STRUCTURE

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19.2 Objectives

19.3 Profile of the National Housing Bank

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19.1 INTRODUCTION

National Housing Bank (NHB), a Government of India owned entity, was set up on 9th July 1988 under the National Housing Bank Act, 1987. NHB is an apex financial institution for housing. NHB has been established with an objective to operate as a principal agency to promote housing finance institutions both at local and regional levels and to provide financial and other support incidental to such institutions and for matters connected therewith.

NHB registers, regulates and supervises Housing Finance Company (HFCs), keeps surveillance through On-site & Off-site Mechanisms and co-ordinates with other Regulators.

The Sub-Group on Housing Finance for the Seventh Five Year Plan (1985–90) identified the non-availability of long-term finance to individual households on any significant scale as a major lacuna impeding progress of the housing sector and recommended the setting up of a national level institution.

The Committee of Secretaries considered the recommendation and set up the High Level Group under the Chairmanship of Dr. C. Rangarajan, the then Deputy Governor, RBI to examine the proposal and recommended the setting up of National Housing Bank as an autonomous housing finance institution. The recommendations of the High Level Group were accepted by the Government of India.

The Hon'ble Prime Minister of India, while presenting the Union Budget for 1987-88 on 28th February 1987 announced the decision to establish the National Housing Bank (NHB) as an apex level institution for housing finance. Following that, the National Housing Bank Bill (53 of 1987) providing the legislative framework for the establishment of NHB was passed by Parliament in the winter session of 1987 and with the assent of the Hon'ble President of India on 23rd December 1987, became an Act of Parliament.

The National Housing Policy, 1988 envisaged the setting up of NHB as the Apex level institution for housing.

In pursuance of the above, NHB was set up on 9th July 1988 under the National Housing Bank Act, 1987. NHB is wholly owned by Govt. of India as after 24th April 2019 notification of RBI, which contributed the entire paid-up capital. The general superintendence, direction and management of the affairs and business of NHB vest, under the Act, in a Board of Directors. The Head office of NHB is at New Delhi.

NHB has been established to achieve, inter-Alia, the following objectives:

1. To promote a sound, healthy, viable and cost effective housing finance system to cater to all segments of the population and to integrate the housing finance system with the overall financial system.

2. To promote a network of dedicated housing finance institutions to adequately serve various regions and different income groups.

3. To augment resources for the sector and channelise them for housing.

4. To make housing credit more affordable.

5. To regulate the activities of housing finance companies based on regulatory and supervisory authority derived under the Act.

6. To encourage augmentation of supply of buildable land and also building materials for housing and to upgrade the housing stock in the country.

7. To encourage public agencies to emerge as facilitators and suppliers of serviced land, for housing.

19.2 OBJECTIVES

After reading this lesson you should be able to understand:

- profile of the National Housing Bank;
- objectives of the National Housing Bank; and
- functions of the National Housing Bank.

19.3 PROFILE OF THE NATIONAL HOUSING BANK

The Government of India identified that non-availability of long term finance to individual household and the housing institutions on a significant scale as a major lacuna impeding progress of housing sector in our country. Therefore a Sub-Group on Housing Finance was constituted for the Seventh Five Year Plan (1985-90) to study the aspect and submit its recommendation. This Sub-Group recommended the setting up of national level institution. The Committee of Secretaries considered the recommendations of the sub group and set up the High Level Group under the Chairmanship of Dr. C. Rangarajan, the then Deputy Governor, Reserve Bank of India to examine the proposal. The group recommended the setting up of National Housing Bank as an autonomous housing finance institution. In turn, the recommendations of the High Level Group were accepted by the Government of India.

The National Housing Policy, 1988 was framed by Government of India. This policy as well proposed the setting up of an apex level institution for housing. The Hon'ble Finance Minister of India, while presenting the Union Budget for 1987-88 on February 28, 1987 announced the decision to establish the National Housing Bank (NHB) as an apex level institution for housing finance. The National Housing Bank Bill was presented in Parliament for providing legislative framework for the establishment of National Housing Bank. It was passed by Parliament in

the winter session of 1987 and with the assent of the Hon'ble President of India on December 23, 1987, became an Act of Parliament. Thus, in pursuance of the above, National Housing Bank was set up on July 9, 1988 under the National Housing Bank Act, 1987. The Bank was set up as a wholly owned subsidiary of the Reserve Bank of India. It began its operations with a total capital of Rs. 170 crore (Rs. 100 crore as share capital, Rs.50 crore as long-term loan from the RBI, and Rs.20 crore through the sale of bonds). In September 1989, its share capital was raised to Rs.150 crore. During 1989-90, it issued its second series of bonds to which the total subscription amounted to Rs.60 crores. These bonds were guaranteed by the Central Government. The RBI had sanctioned in 1989-90, a long term loan of Rs.25 crore to it. Further, it can borrow in the U.S. capital market $50 million under the USAID Government Guarantee program. In 1995-96, the paid up and authorized capital of NHB was raised to Rs.300 crore with an additional capital contribution of Rs. 50 crore by the RBI. Thus, the resources base of the NHB has been made quite strong.

19.4 OBJECTIVES OF THE NATIONAL HOUSING BANK

National Housing Bank has been established for the obvious reason of dismal performance of the housing sector and poor institutional housing finance system in our country as at the end of 6th Plan period and for the avowed objective of facilitating fast development of Housing Finance Institutions and an accelerated development of Housing Sector.

1. The NHB has been established to promote a sound, healthy, viable and cost effective housing finance system to cater to all segments of the population and to integrate the housing finance system with the overall financial system.

2. NHB has also been assigned the responsibility of promoting a network of dedicated housing fiancé institutions to adequately serve various regions and different income groups.

3. It is also responsible to augment resources for the sector and channelize them for housing.

4. The NHB is expected to make housing credit more affordable and accessible to common man.

5. The NHB has been established with the task of regulating the activities of housing finance companies based on regulatory and supervisory authority derived under the NHB Act, 1987.

6. Yet another objective of the bank is to encourage augmentation of supply of buildable land and also building materials for housing and to upgrade the housing stock in the country. The bank has been assigned the responsibility to encourage public agencies to emerge as facilitators and suppliers of serviced land for housing.

19.5 FUNCTIONS OF THE NATIONAL HOUSING BANK

19.5.1 Promoting, establishing, supporting / aiding the house financing institutions (HFIs)

Following are some functions under this category:

1. Making of loans and advances or rendering any other form of financial assistance, whatsoever, for housing activities to HFIs, banks, state cooperative, agricultural and rural development banks or any other institution / class of institutions notified by the Government.

2. It can subscribe or purchase stocks, shares, bonds, debentures and securities of every other description floated by housing finance companies with a view to enhance the financial resources of these institutions.

3. NHB can also extend guarantee to the financial obligations of Housing Finance Institutions (HFIs) and underwrite the issue of stocks / shares / bonds / debentures / other securities of HFIs.

4. This activity is a part of its promotional effort so that the housing finance institutions do not suffer for want of funds.

5. It can draw, accept, discount / rediscount, buy / sell and deal in bills of exchange, promissory notes, bonds, debentures, hundies, coupons or other instruments of housing finance companies or instruments related to housing finance. The aim behind these activities is to develop a sound capital market for the financial instruments floated by the HFCs.

6. It can also deal in buying or selling, or otherwise dealing in loans & advances secured by mortgage / charge of immoveable property relating to banks or HFIs.

7. It can also deal in creating trust(s) and transferring loans or advances together with or without securities there from to HFIs for a consideration.

8. It can undertake setting up of mutual funds of undertaking housing finance activities. It can also participate in housing mortgage insurance.

9. NHB is responsible for undertaking research and surveys on construction techniques and other studies relating to or connected with shelter/housing and human settlement. Organizing training program / seminars / symposia on matters relating to housing is another function of NHB.

10. NHB is also responsible for formulating schemes for purpose of mobilization of resources and extension of credit for housing sector in India.

11. The Bank is also responsible for formulating schemes for the economically weaker sections of society, which may be subsidized by the Government or any other source. The Bank has a mandate to provide guidelines to HFIs to ensure their growth on sound lines.

12. Since it is an apex organization in India in the field of housing finance, it is also responsible to act as agent of the Central / State Government / the RBI or of any 'authority as may be authorized by the RBI. Further it can do any other kind of business which the Government may, on the recommendations of the RBI, authorize. It represents India at international bodies and plate forums on the matters of housing finance and housing sector.

The NHB has been authorized to borrow and accept deposits to augment its resources so that it can lend to HFCs on a large scale. It borrows from the capital market and accepts deposits from the public both for short period as well as long period.

19.5.2 Resource Mobilization

National Housing Bank mobilizes both short term and long term resources. Short term resources are mobilized through issuance of Commercial Papers (CPs) and Short Term Loans from banks. Long Term borrowings includes issuance of Zero-coupon Bonds (ZCB), Coupon Bonds, Term Loans from banks, Deposits from banks under Rural Housing Fund (RHF), Deposits from Housing Finance Companies (HFCs) and Deposits from public under Sunidhi and Suvriddhi term deposit schemes. The gross borrowing during the year 2010-11 was Rs. 35,503 crore and Rs. 34295 crore in 2009-10.

The Bonds issued by NHB are rated "AAA" by at least two of the rating agencies approved by SEBI viz. CARE ratings, CRISIL, Fitch ratings and Brickwork ratings and are listed on Bombay Stock Exchange / National Stock Exchange. Commercial Papers issued by NHB were rated "A1+" by ICRA. These ratings indicate highest degree of certainty regarding timely payment of financial obligation on the instruments. The total borrowing outstanding as on 30th June 2011 is Rs. 21,776 crore. NHB has been authorised by Ministry of Finance to issue capital gains bonds. These are issued for three years and these are the main source of resource mobilisation. NHB mobilises the funds at a very competitive rates through the capital gain bonds. At present the NHB offers six per cent rate of interest on these bonds.

19.5.3 Rural Housing Fund (RHF)

The Central Government has created a Rural Housing Fund to enhance NHB's refinance operations in the rural housing sector by tapping the resources Scheduled Commercial Banks to the extent of shortfall in their priority sector lending. The allocation for the year 2008-09 was Rs.2000 crore. In the year 2009-10 and 2010-11 a further sum of Rs. 2000 crore each was allocated to the Bank from the Fund.

19.5.4 Term Deposit Schemes

NHB launched two new term deposit schemes viz. "SUNIDHI" & "SUVRIDDHI" during the year 2008-09. "SUNIDHI" term deposit is open for individuals / HUFs / Partnerships / Societies & Trusts / Association of Persons. Minimum tenor is one year and the maximum is five years. "SUVRIDDHI" is term deposit scheme open only for individuals and HUFs and the tenor is five years. "SUVRIDDHI" is notified under section 80C of Income Tax Act, 1961.Amount outstanding as on 30.06.2011 under both the schemes is 223 crore out of which 48 crore was mobilised during the year.

19.5.5 Refinance Facility from Reserve Bank of India

Reserve bank of India is the promoter of National Housing Bank. It extends special refinance facility to NHB when the later requires the fund for short term liquidity. A facility of Rs. 4000 crore was given to NHB which was to be utilized by March 2010. NHB fully utilized this facility and has also repaid the amount to the RBI.

19.5.6 Borrowing and Acceptance of Deposits

For purposes of carrying out its functions, the NHB do following functions:

1. Issue and sell bonds and debentures with or without the guarantee of the CentralGovernment, in such manner and on such terms as may be prescribed;

2. Borrow money from the Central Government, banks, financial institutions, mutual funds and from any other authority or organization or institution approved by the Government on such terms and conditions as may be agreed upon;

3. Accepting deposits repayable after such period and on such terms as may generally or specially be approved by the RBI;

4. Borrow money from the RBI (i) by way of loans and advances and, generally, obtain financial assistance in a manner specified by the RBI; (ii) out of the National Housing Credit (long-term operations) Fund established under Section 46-D of the RBI Act;

5. Receive, for services rendered, remuneration, commission, commitment charges, consultancy charges, service charges, royalties, premium, licence fees and other considerations of any description;

6. Receive gifts, grants, donations or benefactions from the Government or any other source.

The Central Government may guarantee the bonds and debentures issued by the NHB as to the repayment of the principal and the payment of interest at rate(s) fixed by the Government.

The explicit and primary aim of the NHB is to promote housing finance institutions at local and regional levels in the private and joint sectors by providing financial and other support to such institutions. It refinances housing loans under its refinance schemes for scheduled commercial and co-operative banks, housing finance companies, apex co-operative housing finance societies, and so on. It extends financial support to SLDBs in respect of their housing loans through subscription of Special Rural Housing Debentures floated by them. One hundred per cent refinance is given by it in respect of direct loans upto Rs.1 lakh. Its objective is to limit the floor space of dwellings to a reasonable size. Its refinance is available for 15 to 20 years. There were 22 HFCs which were approved by the NHB for the purpose of receiving refinance.

The NHB has taken steps to augment real resources also for housing by extending term loans at market rates of interest for land development projects to be completed within a specified time limit, viz., two years or so. It also supports industries that augment supplies of building materials so as to lower the construction cost.

To provide loans directly to individuals for enabling them to own houses is, of course, one of its main activities. For this purpose, it has started a flexible, convenient, special loan-linked saving plan known as Home Loan Account Scheme (HLAS). The basic idea behind this scheme is that prospective house owners should save in advance of the decision to acquire a house. All India scheduled commercial banks, scheduled State Co-operative banks, and scheduled urban co-operative

banks are participating in the implementation of the scheme. The ceiling of Rs. 3 lakh on the housing loan under the scheme imposed earlier has now been removed, but loans above Rs. 2 lakh will be limited to 1.5 times the accumulated savings

19.5.7 Other Business of NHB

Subject to the provisions of the NHB Act, the NHB is authorized to transact all/any of the following kinds of business:

1. Promoting, establishing, supporting/aiding in the promotion/ establishment/ support of housing financing institutions (HFIs);

2. Making of loans and advances or rendering any other form of financial assistance, whatsoever, for housing activities to HFIs, banks, state cooperative, agricultural and rural development banks or any other institution/class of institutions notified by the Government;

3. Subscribing to / purchasing stocks, shares, bonds, debentures and securities of every other description;

4. Guaranteeing the financial obligations of HFIs and underwriting the issue of stocks / shares / bonds / debentures / other securities of HFIs;

5. Drawing, accepting, discounting / rediscounting, buying / selling and dealing in bills of exchange promissory notes, bonds / debentures, hundies, coupons / other instruments;

    (i) Buying / selling, or otherwise dealing in any loans / advances secured by mortgage / charge of immoveable property relating to banks / HFIs;

    (ii) Creating trust(s) and transferring loans/advances together with/ without securities there from to HFIs for a consideration;

(iii) Setting aside loans / advances held by the NHB and issuing / selling securities based upon them in the form of debt obligations/trust certificates of beneficial interest/other instruments, and to act as trustee for the holders of such securities;

(iv) Setting up of mutual funds of undertaking housing finance activities;

(v) Undertaking / participating in housing mortgage insurance;

6. Promoting / forming / conducting or associating in promotion / formation / conduct of companies /mortgage banks / subsidiaries / societies / trusts / other associations of persons it may deem fit for carrying out all / any of its functions under the NHB Act;

7. Undertaking research and surveys on construction techniques and other studies relating to / connected with shelter / housing and human settlement;

8. Formulating scheme(s) for purpose of mobilization of resources and extension of credit for housing;

9. Formulating scheme(s) for the economically weaker sections of society which may be subsidized by the Government or any other source.

10. Organising training programmes / seminars / symposia on matters relating to housing;

11. Providing guidelines to HFIs to ensure their growth on sound lines;

12. Providing technical/administrative assistance to HFIs;

13. Coordinating with the Life Insurance Corporation of India, the Unit Trust of India, the General Insurance Corporation of India and other financial institutions, in the discharge of its overall functions;

14. Exercising all powers and functions in the performance of duties entrusted to it under the NHB act or under any other law in force for the time being;

15. Acting as agent of the Central / State Government / the RBI or of any authority as may be authorized by the RBI;

16. Any other kind of business which the Government may, on the recommendations of the RBI, authorize;

17. Generally, doing of all such matters and things as may be incidental to or consequential upon the exercise of its powers or the discharge of its duties under the NHB act.

19.6 SUMMARY

It was set up in July 1988 as an apex level housing finance institution and as a wholly owned subsidiary of the RBI. It began its operations with a total capital of Rs.170 crore (Rs.100 crore as share capital, Rs.50 crore as long-term loan from the RBI, and Rs.20 crore through the sale of bonds). In September 1989, its share capital was raised to Rs.150 crore. During 1989-90, it issued its second series of bonds to which the total subscription amounted to Rs.60 crores. These bonds were guaranteed by the central government and had carried an interest rate of 11.5 per cent per annum. The RBI had sanctioned in 1989-90 a long term loan of Rs.25 crore to it. Further, it can borrow in the U.S. capital market $50 million under the USAID Government Guarantee programme. In 1995-96, the paid up and authorized capital of NHB was raised to Rs.300 crore with an additional capital contribution of Rs.50 crore by the RBI. Thus, the resources base of the NHB has been made quite strong.

19.7 GLOSSARY

- **HUDCO:** The Housing and Urban Development Corporation Limited (HUDCO) is a government-owned corporation in India. One of the public sector undertakings (PSU), it is wholly owned by the Union Government and is under the administrative control of the Ministry of Housing and Urban Poverty Alleviation.

- **USAID:** The United States Agency for International Development (USAID) is an independent agency of the United States federal government that is primarily responsible for administering civilian foreign aid and development assistance.

- **Commercial Papers:** Commercial paper is a money-market security issued (sold) by large corporations to obtain funds to meet short-term debt obligations (for example, payroll) and is backed only by an issuing bank or company promise to pay the face amount on the maturity date specified on the note.

- **Zero-Coupon Bonds:** A bond that is issued at a deep discount to its face value but pays no interest.

19.8 SELF ASSESSMENT QUESTIONS

Q1. Explain NHB?

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Q2. How NHB mobilize resources?

Q3. Explain rural housing fund?

Q4. Explain term deposit schemes?

Q5. Explain borrowing and acceptance of Deposit function of NHB?

19.9 LESSON END EXERCISE

Q1. Explain the profile of NHB?

Q2. What are the various functions of NHB?

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Q3. What are the various objectives of NHB?

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Q4. What are the various businesses of NHB?

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DEBT SECURITISATION AND HOUSING FINANCE

HOUSE FINANCING

STRUCTURE

20.1 Introduction

20.2 Objectives

20.3 House Financing: Introduction

20.4 Housing Finance System in India

20.4.1 Central and State Governments

20.4.2 Housing and Urban Development Corporation (HUDCO)

20.4.3 Insurance Organisations/Corporations

20.4.4 Commercial Banks

20.4.5 Cooperative Banks

20.4.6 SHFSs

20.4.7 HDFC

20.5 New Developments in House Financing

20.5.1 Commercial Banks

20.5.2 Housing Finance Subsidiaries

20.6 Summary

20.7 Glossary

20.8 Self Assessment Questions

20.9 Lesson End Exercise

20.10 Suggested Readings

20.1 INTRODUCTION

Housing is the basic need of every human being. Population of India has been growing at a phenomenal rate after independence but during the last few decades housing sector has lagged much behind. Housing scenario depicts a very dismal condition in our country. Millions and millions of people are without shelter and they are unable to afford it at their own. Own shelter is a pipe dream for many a million amongst them who are less fortunate and are at the lowest rung of the poverty ladder. A significant size of population is rotting in sub human conditions all over the country in slums where manhood is unquestionably brutalized, womanhood is dishonored and childhood is poisoned at a very nascent stage. One finds thousands of slums around Kanpur, Ahmadabad, Mumbai, Kolkata, Ghaziabad, Delhi and other industrial and metro cities of the country. There is no hope of applying the soothing balm on the wounds of crying humanity living in utmost wretchedness and extreme poverty.

The condition is hopeless and there is no plausible answer and easy solution in sight before the gubernatorial class at the Centre and States. Ever increasing population and migration of populations to the urban centers in search of livelihood have made the matter worst. In fact, the housing conditions of the labour force and industrial workers of our country are extremely worse. In times of summer these are the hottest, in times of winter the coolest and in times of rain submerged and drenched in water. The sacred hands that build the nation are deprived of their basic right to clean & safe drinking water and hygienic living environment and a shelter that can save them from the vagaries of nature.

Here not only the productivity of our nation, aspiring to be a world power and world's 4th largest economy, is at stake but also the national pride is put to shame when Westerns call India is a country of slums. India who proudly claims to be one of the most happening economies of the world and devoted to all inclusive

development programs aspiring to be a world power is put to shame when a large chunk of its population is crying for help.

Housing is one of the basic necessities of man, and the capital required per dwelling is so large that few individuals can raise it from their own savings. There is therefore a great need and scope for the development of arrangements for supplying loans or finance for the purpose of house construction. However, for some reason or other, the shelter sector of the Indian financial system remained utterly underdeveloped till the end of the 1980s. The lack of adequate institutional supply of credit for house building was stressed as an important gap in the process of financial development in India. In the recent past, the authorities have initiated certain steps to bridge this gap.

Finance for housing is provided in the form of mortgage loans, i.e., it is provided against the security of immoveable property of land and buildings. The suppliers of house mortgage loans in India are the following: the Housing and Urban Development Corporation (HUDCO), the apex Co-operative Housing finance Societies and Housing Boards in different states, central and state governments, LIC, Commercial banks, GIC, and a few private housing finance companies and *nidhis*. The governments provide direct loans mainly to their employees. The participation of commercial and urban co-operative banks in direct mortgage loan has been marginal till recently. The LIC has been a major supplier of mortgage loans in indirect and direct forms. It has been giving loans for house building to the state governments, apex Co-operative Housing Finance Societies, HUDCO, and so on. In addition, it has been providing mortgage loans directly individuals under its various mortgage schemes.

20.2 OBJECTIVES

After reading this lesson you should be able to understand:

- the introduction of house financing;
- housing finance system in India; and
- new developments in house financing.

20.3 HOUSE FINANCING: INTRODUCTION

The home is basic unit of society, but the capital required per dwelling is so large that few individuals can raise it from their own savings. So there is a great need and scope for the purpose of construction of house.

The term "Housing Finance" or "Home Loan" means finance for buying or modifying a property. The different housing loan products could be classified as:

(a) Home Loans

(b) Home Extension Loans

(c) Home Improvement Loans

(d) Land Loans

(e) NRI Loans

(f) Home Equity Loans

(g) Short Term bridging Loans

(h) Converting high interest housing loan to low interest housing loan.

Eligibility criteria of housing finance in India:

The individual, who is planning to buy a house in India, can apply for home loan, whether he is "Resident" or Non-resident individual. The individual can apply for loan even before the selection of the property which is to be purchased. Once an individual decides the maximum amount that he can put into the property, all Housing Finance Institution (HFIs) can help to plan his budget by calculating his "Affordability" which is based on his individual or clubbed income.

The loan applicant has an option of having co-applicant to his loan to enhance his loan eligibility. All HFIs lay down conditions on who can be co-applicants. All co-owners to the property need to be co-applicants to the loan necessarily. But any minor cannot be co-applicant as he is not eligible to enter into contract as per law. HFIs do not permit friends or relatives who are not blood relatives to take property jointly. Income of co-applicants as decided by HFIs can be clubbed together to get higher loan eligibility.

The following table shows some acceptable relationship of co-applicants for clubbing of income:

(a)	Husband – Wife	(Yes)
(b)	Parent – Son (if only son)	(Yes)
(c)	Parent – Daughter (if only daughter)	(Yes)
(d)	Brother – Brother (if currently staying together and intend staying together in new property)	(Yes)
(e)	Brother – Sister	(No)
(f)	Sister – Sister	(No)
(g)	Parent – Minor Child	(No)

General Terms and Conditions of a Housing Loan:

The following are the general terms and conditions applicable to the basic housing loan product only. These are likely to change with respect to different types of housing loans.

1. The loan to value ratio cannot exceed a particular percentage. This differs from product to product and from one HFI to another. The ratio is known as 'LTV'.

2. The maximum tenure of the loan is normally fixed by HFIs. However, HFIs do provide for different tenor with different terms and conditions.

3. The installment that applicant pay is normally restricted to about 40 percent of his monthly gross income. This is known as Installment to Income Ratio (IIR).

4. The total monthly outflow towards all the loans that applicant has availed of including current loan is normally restricted to 50 percent of applicants monthly gross income. This is known as the Fixed Obligation to Income Ratio (FOIR).

5. An applicant will eligible for a loan amount, which is lowest as per his eligibility. This is calculated as per the LTV norms, the IIR norms and the FOIR norms.

6. Most HFIs consider applicant's profile before they judge his capacity. The applicants are judged on the basis of age, qualification, number of dependents, employment details, employer credentials, work experience, previous track record of repayment of any loans that he has availed of, occupation, the industry to which applicant's business relates to. If applicant is self-employed, then turnover of the last 3-4 years is required.

7. Some HFIs insist on guarantees from other individuals for due repayment of applicant's loan. In such cases applicants have to arrange for the personal guarantee before the disbursement of loan takes place.

8. Most HFIs have a team of civil engineers to visit the site to get a technical report on the quality of construction and compliance with the local laws before they disburse the loan.

9. Most HFIs have a panel of lawyers who go through applicant's property documents to ensure that the documents are clear and are not mis-represented.

10. The disbursement of loan takes place as per progress of construction of property unless it is ready property in which case the disbursement of loan will take place by one single cheque. PEMI are simple interest on loan amount disburse to an applicant in case of a part disbursement is payable by an applicant on the disbursement.

11. The disbursement in most cases, favours the builder or the seller or the society or the development authority as the case may be. The disbursement does come in applicant's favours only in special circumstances.

12. An applicant can repay the loan either through deduction against salary, post dated cheques, standing instruction or by cash or demand draft (DD).

13. The principal is amortized either an annual reducing or monthly reducing basis as case may be.

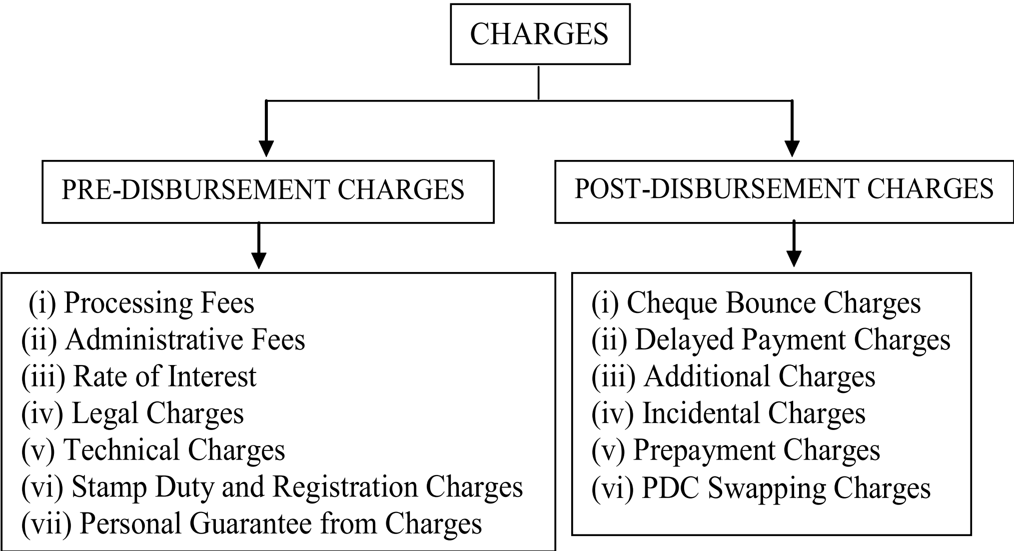
Different kinds of charges applicable to Housing Loan Products.

The different kinds of charges applicable to home loans are listed below, but all of these charges may or may not levy by all HFIs. These charges are broadly classified into two categories.

Pre-Disbursement Charges

(i) **Processing Charges:** This is a charge that is levied by most HFIs to cover the cost that they incur on the processing of loan application. This has to be paid at the time of submission of the application form. Most HFIs refund this fee if loan application is rejected. It is normally charged as a percentage of loan amount sanctioned or it may be charged as a flat fees based on loan amount. In case of excess fees corresponding to loan, it can be adjusted with subsequent charges which are to be paid by applicant.

(ii) **Administrative fees:** This charge is based on percentage on the loan amount sanctioned. It is collected by the HFI for the maintenance of customer's records, issuing



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(i) **Processing Charges:** This is a charge that is levied by most HFIs to cover the cost that they incur on the processing of loan application. This has to be paid at the time of submission of the application form. Most HFIs refund

this fee if loan application is rejected. It is normally charged as a percentage of loan amount sanctioned or it may be charged as a flat fees based on loan amount. In case of excess fees corresponding to loan, it can be adjusted with subsequent charges which are to be paid by applicant.

(ii) **Administrative fees:** This charge is based on percentage on the loan amount sanctioned. It is collected by the HFI for the maintenance of customer's records, issuing interest certificates, legal charges, technical charges etc. through the tenure of loan. It is to be paid after acceptance of offer letter given by HFI.

(iii) **Rate of Interest:** It is charges on the principal on either annual reducing method or monthly reducing method. There are two types of rate of interest, "Fixed rate of interest", and "Floating rate of interest". Applicant can opt for any of these types.

(iv) **Legal Charges:** Some HFIs levy legal charges that they incur on getting property document vetted by their panel of lawyer.

(v) **Technical Charges:** This charge is levied by some HFIs to meet their expenses on the technical site visits to the property.

(vi) **Stamp Duty and Registration Charges:** HFIs that go in for a registered mortgage pass these charges on to an applicant. These are rather heavy in certain states depending on the laws laid down by the State where the property is to be purchased.

(vii) **Personal Guarantee form Charges:** These charges are levied by HFIs who demand for guarantee. Since the personal guarantee provided by an applicant is to be stamped, so these charges are to be paid by applicant.

Post-Disbursement Charges

(i) **Cheque Bounce Charges:** In case the cheque through which an applicant is making payment to HFI gets dishonored, then some minimum charges are levied by bank. And these charges are to be recovered by an applicant.

(ii) **Delayed Payment Charges:** In case of delay of installment beyond due date. HFIs charge these charges to an applicant.

(iii) **Additional Charges:** These are levied as a percentage on the delayed payment charges by most HFIs. These charges are levied if an applicant fails to pay the dues within the stipulated time after delay has taken place.

(iv) **Incidental Charges:** This is payable in case the HFI sends a representative from their organization to collect their outstanding dues. It is normally charged at a flat rate per visit. These charges are levied by most HFIs.

(v) **Prepayment Charges:** It is penalty charged by HFIs from when the applicant makes either a part prepayment or a full prepayment of loan. This charge is levied on the amount prepaid by an applicant and not on the equated monthly installments (EMIs) that he pays. This charge is levied on the amount prepaid and not on the entire outstanding principal. These charges are gradually being discontinued by the HFIs.

(vi) **PDC Swapping Charges:** In case, an applicant wishes to swap the PDC's given by him to HFI for EMI repayments, some HFIs charge a flat fee for the same. Here PDC refers to "Post Dated Cheques".

The Typical Credit Documents that Need to be submitted to the HFI:

The given list is the exhaustive list of credit documents that need to be submitted for a general home loan product. The document varies from one HFI to another. But the general requirements are:

1. **Income Document:** It may be:

   (a) Salary slips for last three months.

   (b) Appointment letter

   (c) Salary Certificate

   (d) Relationship Agreement, if appointed as consultant.

   (e) Form 16 issued by an employer on applicant's name.

   (f) Last three years Profit and Loss Account Statement duly attested by a Chartered Accountant, if self employed.

   (g) Last three years Balance Sheets duly attested by a Chartered Accountant, if self employed.

   (h) Last three years Income Tax Returns duly filed and certified by the Income Tax Authorities.

2. **Proof of Employment:** It may be

   (a) Identity Card issued by employer.

   (b) Visiting Card

3. **Employer's Details** (in case of Private Limited Companies): Profile of employer on employer's letter head it is to be signed by a Senior Person in the organization comprising:

   (a) Name of Promoters / Directors

   (b) Background of Promoters / Directors

   (c) Nature of business activity.

(d) Number of Employees

(e) List of branches / factories

(f) List of Suppliers

(g) List of Clients / customers

(h) Turnover of employer

(i) Annual reports of the employers for the last two to three years.

4. **Proof of Age** (any one of the following):

(a) Passport

(b) Voter's ID Card

(c) PAN Card

(d) Ration Card

(e) Employer's Identity Card

(f) School Leaving Certificate

(g) Birth Certificate

5. **Proof of Residence** (any of the following)

(a) Passport

(b) Ration Card

(c) PAN Card

(d) Rent Agreement

(e) Bank Pass Book

(f) Allotment letter from company, if an applicant is residing in company quarters.

6. Proof of Name Change (if applicable)

(a) A copy of the official Gazette.

(b) A copy of the newspaper advertisement publicizing the name change.

(c) Marriage Certificate

7. Proof of Investment (if required)

(a) Bank Statement for the last six months of all operating and salary account.

(b) Bank statements for the last six months of all current accounts, if self employed.

(c) Any other photocopies of investment held, if required by HFI.

The name and the list of documents vary from state to state and it also depends on the type of property being financed. The broad outline of the documents which are generally required by most HFIs is given below:

1. Acceptance copy of the offer letter issued by HFI.

2. Title document of the property that includes:-

(a) Sale agreement duly registered.

(b) Allotment letter

(c) Registration Receipts

(d) Land Documents indicating ownership, if applicable

(e) Possession letter

(f) Lease Agreement, if applicable (Property bought from development authority)

(g) Mortgage deed, if HFI opts for a registered mortgage.

3. No Objection Certificate from developer, society or development authority as applicable.

4. Personal Guarantee, if applicable.

5. In case of alternate or additional security, documents for the same depending upon the security details.

6. Post Dated Cheques for EMIs.

These documents are indicative in nature and do not cover the entire list.

Type of Housing Finance

(i) Home Loans: A home loan is a loan taken from a Housing Finance Institution (HFI) to buy or to modify a property. The term property includes:

(a) Property – under construction

(b) Property – ready for occupation

(c) Resale Property

(d) Self Construction or own construction.

(ii) Home Extension Loan: A home extension loan is a finance taken from HFI to extend the built up area of an existing property. This could be by way of any of the following:

(a) Additional Floor Space Index (FSI) granted by the approving authority to construct an additional room.

(b) Enclosing the balcony with sliding windows or grills.

(c) Construction of an additional floor in the existing house.

(iii) **Land Loan:** A land loan is a loan taken from HFI to purchase the plot of land from either a developmental authority or a society or a developer.

(iv) **Home Equity Loan:** Home equity loan is especially designed to meet financial needs of a person who already owns a house. The loan amount is given against the existing property and as a customer the person can utilize these funds to meet any of his requirements.

20.4 HOUSING FINANCE SYSTEM IN INDIA

The implementation of housing finance policies presupposes efficient institutional arrangements. Although there were a large number of agencies providing direct finance to individuals for house construction, there was no well established finance system till the mid-eighties in as much as it had not been integrated with the main financial system of the country. The setting-up of the National Housing Bank (NHB), a fully owned subsidiary of the Reserve Bank of India, as an apex institution was the culmination of the fulfillment of a long overdue need of the housing finance industry in India. The system has also been characterized by the emergence of several specialised financial institutions that have considerably strengthened the organization of the housing finance system in the country. At present, there are about 320 housing finance companies, of which 26 are registered with the NHB and which account of 98 per cent of the total housing loan disbursed. A brief account of some of the institutions / agencies is given below:

20.3.1 Central and State Governments

Till the mid-eighties, the responsibility to provide housing finance rested, by and large, with the government. The Central and State Government indirectly support the housing building effort. The Central Government has introduced, from time to time, various social housing schemes. The role of the Central Government vis-a-vis these scheme is confined to laying down broad principles, providing necessary advice and rendering financial assistance in the form of loans and subsidies to the state governments and union territories. The Central Government has set up the Housing and Urban Development Corporation (HUDCO) to finance and undertake housing and urban development programmes, development of land for satellite towns, besides setting up of a building materials industry.

The Central Government provides equity support to the HUDCO and guarantees the bonds issued by it. Apart from this, both Central and state governments provide house building advances to their employees. While the Central Government formulates housing schemes, the State Governments are the actual implementing agencies.

20.3.2 Housing and Urban Development Corporation (HUDCO)

Objectives: HUDCO was established on 25th April 1970, as a fully owned Government of India enterprise, with the following objectives:

(i) To provide long-term finance for construction of houses for residential purposes or finance or undertake housing and urban development programmes in the country.

(ii) To finance or undertake the setting-up of new satellite towns.

(iii) To finance or undertake the setting-up of the building materials industries.

(iv) Administer the monies received, from the Government of India and other such grants, for purposes of financing or undertaking housing and urban development programmes.

(v) To subscribe to the debentures and bonds to be issued by the state housing boards, improvement trusts, development authorities and so on, specifically for the purpose of financing housing and urban development programmes.

In brief, the principal mandate of the HUDCO was to ameliorate the housing conditions of the low income group (LIG) and economically weaker sections (EWS).

Resource Base: The HUDCO was established with an equity base of Rs. 2 crore. Over the years, the equity base has been expanded by the Government. It has further been able to mobilize resources from institutional agencies like LIC, GIC, UTI, banks, international assistance (Kfw, OECF, ODA, USAID), as well as through public deposits.

Form of Assistance: The HUDCO extends assistance, benefiting masses in urban and rural areas, under a broad spectrum of programmes of housing, infrastructure, consultancy services and training.

Urban Infrastructure: The HUDCO has also been entrusted with the responsibility of financing urban infrastructure projects with additional equity support provide by the Ministry of Urban Development, Government of India. The infrastructure projects cover sectors of water supply, sewerage, drainage, solid waste management, transport nagars/terminals, commercial and social infrastructure, roads/bridges, area development projects and so on. The HUDCO plans to stress, in future, on expansion of urban infrastructure lending, housing delivery through expanded avenues including retail financing, increased consultancy assistance, services for projects in India and abroad, impetus to building, technology transfer initiatives and in-house research and training programmes with national/international working.

20.3.3 Insurance Organisations / Corporations

The LIC and GIC support housing activity both directly and indirectly. Besides subscribing to bonds of the HUDCO and state housing boards, LIC grants loans to the states for their rural housing programmes and to public sector companies for construction of staff quarters. Though the LIC has been granting loans directly to individuals, the thrust to housing finance was provided when, in June 1989, the LIC promoted a subsidiary for the purpose, namely the LIC Home Finance Ltd.

The GIC supports housing almost exclusively, indirectly, by subscribing to bonds/debentures floated by the HUDCO and state housing boards. It has also set up a housing finance subsidiary called the GIC Housing Finance Ltd. in July 1990, to enable it to lend directly to individuals.

20.3.4 Commercial Banks

The trend of commercial banks lending to individuals for housing emerged in the wake of the report of the working group on the Role of Banking System in Providing Finance for Housing Schemes (RC Shah Working Group, the RBI, 1978). They have been lending to the housing sector based on annual credit allocations made by the RBI. In terms of the RBI guidelines, scheduled commercial banks are required to allocate 1.5 per cent of their incremental deposits for disbursing as housing finance every year. Of this allocation, 20 per cent has to be by way of direct housing loans of which again at least half, that is, 10 per cent of the allocation has to be in rural and semi-urban areas. Another 30 per cent could be for indirect lending by way of term loans to housing finance institutions (HFIs), housing finance companies (HFCs) and public housing agencies for the acquisition and development of land and to private builders for construction. The balance 50 per cent is for subscription to the HUDCO, and the NHB bonds.

20.3.5 Cooperative Banks

The cooperative banking sector consists of state cooperative banks (SCBs), district central cooperative banks (DCBs) and primary urban cooperative banks (PUCBs). The first set of comprehensive guidelines for these cooperative banks were issued in 1984 by the RBI. Cooperative banks finance individuals, cooperative group housing societies, housing boards and others who undertake housing projects for the EWS, LIGs, and MIGs.

20.3.6 SHFSs

The State Housing Finance Societies (SHFSs) constitute another major source of funds in the residential mortgage market. These societies advance loans to the affiliated Primary Cooperative Housing Societies for construction of dwelling houses, purchase of land, additions and improvements to existing houses, purchase of house, and repayment of earlier mortgage debt. The terms and conditions of loans vary somewhat from state to state; they also vary with the location of the house, the borrower's income group, and the purpose of loan within the state. The maximum amount of a loan varies between 65 to 80 per cent of the value of land and buildings or some specified maximum amount, whichever is lower. The amount of loan is also linked with the primary society's shareholding in the apex society. The maturity period varies from 15 to 30 years, but 20 to 25 years is more common. The rate of interest charged is linked with the bank rate, and/or the respective society's own borrowing rate. In most cases the rate charged is the bank rate plus 3 per cent or the borrowing rate plus 1 to 3 per cent. The mortgages are annuity mortgages with equal monthly or quarterly installments of repayment during the life of the mortgage. However, sometimes half yearly or annual installments are also made. The major sources of funds for these institutions are: (a) investment in their share capital by the Government and cooperative institutions; (b) Loans from the

Government and LIC; (c) fixed deposits from individuals and institutions; (d) issue of debentures guaranteed by the Government.

20.3.7 HDFC

The Housing Development Finance Corporation Ltd. (HDFC) has been playing an important role in meeting housing finance requirements. The HDFC was set up in 1977 by the ICICI out of the consideration that a specialised institution was needed to channel household savings as well as funds from the capital market into the housing sector. It works through branch and representative offices. HDFC's loans were linked up with planned saving. Given the sum needed for a house, a part of it has to be in the form of saving contribution, and the rest was given by the HDFC in the form of a loan. While the saving part was 30 per cent, the loan portion was 70 per cent of the cost of the house. It discontinued home saving plan scheme from March 1993 because it had become unviable.

The sources of funds for the HDFC are: deposits collected through various deposit schemes, domestic long-term funds from commercial banks and financial institutions, long-term loans from international institutions such as the World Bank and United States Agency for International Development (USAID), and HDFC 10 year bonds.

20.4 NEW DEVELOPMENTS IN HOUSE FINANCING

Recently, some very important developments have taken place in the field of housing finance in India. They are: (1) the entry of the LIC in a major way in the direct household mortgage loan originations, (2) the entry of the commercial banking system in direct loan origination process, (3) the major initiatives by commercial banks to create housing finance subsidiaries along with the existing housing finance institutions or on their own, (4) the entry of GIC in the home loan origination process through a subsidiary, (5) the co-promotion of two regional housing finance

companies by the UTI (one with the SBI for the Eastern region, and other with the Canara Bank of the Southern region), (6) the floatation of Housing and Construction Investment Fund (1989) by the UTI for direct investment in construction project finance and real estate development, (7) the liberalization of guidelines by the RBI regarding supply of housing loans by commercial banks, and (8) the establishment of the National Housing Bank in July 1988.

As in other fields, the RBI has been actively involved in developing a sound and healthy institutional system for the provision of housing finance also. A committee appointed by the RBI under the chairmanship of C. Rangarajan had recommended an institutional set-up for housing finance comprising (a) regional and local level institutions (companies) in the public and private sectors for mobilizing household sector savings and providing home loans, and (b) a national level apex housing finance institution primarily to promote base level institutions, to co-ordinate the activities of institutions providing housing finance and connected with housing developments, and to extend financial support to and later regulate housing finance institutions. The recent changes mentioned above are in line with these recommendations. Some of these changes are discussed below.

20.4.1 Commercial Banks

The role of commercial banks in housing finance had remained negligible for long. The overall policy of banks and the guidelines issued by the RBI in 1979 in this respect had tended to restrict the flow of bank funds in the housing sector. The RBI revised these guidelines in November 1988 and took many steps to increase the flow of bank credit to the housing sector, particularly for the weaker sections.

First, the yearly quantum earmarked for housing finance by the banking system is now 1.5 per cent of incremental bank deposits during the preceding 12 month, and there is no objection to banks exceeding this level upto a reasonable

limit provided they have regard to their resources position and compliance with the statutory reserve requirements. Second, earlier, term loan granted by bank to housing finance companies other than HUDCO, HDFC and companies promoted / sponsored by commercial banks, were restricted to their net-owned funds. With effect from January 1990 such companies have been made eligible for term loans from banks to the extent of three times their net-owned funds. Third, with effect from October 1989, the restriction on the quantum of housing loan per individual (of Rs.3 lakhs) has been removed, and it is left to the banks to charge a higher rate of interest over the minimum rate of 16 per cent per annum on housing loans exceeding Rs.3 lakh per individual. Moreover, now such housing loans will not form a part of banks' housing finance allocation. Fourth, effective from October 1988, margin requirements for bank's housing loans have been fixed at 20 to 35 per cent; and the repayment period has been fixed at 15 years. The banks give housing loans against mortgage of property, government guarantee, LIC policy, government promissory notes, shares and debentures. The loans are now made available for repairs, additions, acquisition and development of land. Fifth, apart from individuals, housing finance institutions, private housing finance companies, and private builders also can obtain housing loans from banks.

20.4.2 Housing Finance Subsidiaries

Banks and financial institutions have now set up the following special housing finance subsidiaries:

(i) Canara Bank had sponsored a housing finance company, Canfin Homes Ltd., in 1988. It has branches in about 22 Indian cities and it also operates the Home Loan Account Scheme of the (NHB). It accepts fixed and cumulative deposits which enjoy certain income-tax and wealth-tax benefits. The fixed deposits are accepted for the periods ranging from 2 to 7 years.

(ii) The GIC set up GIC Grih Vitta Ltd. (GICGVL) in July 1990 as a joint ventue with its four subsidiaries, UTI, ICICI, IFC, HDFC, and SBI Capital Markets. GICGVL has introduced various schemes to hekp people to own their homes. Under its Apana Ghar Yojana, it gives housing loans between Rs.20,000 and Rs.3.5 lakh to 5.00 lakh with repayment facility on Equated Monthly Instalment (EMI) Basis. It has linked its activities with those of GIC Mutual Fund. For example, investors in GICRISE Unit Scheme will enjoy special benefits in terms of lower initial contribution, higher loan amount, lower EMIs, concessions in collateral security and so on in respect of its housing loans.

(iii) The LIC also set up, in 1991, a housing finance company, LIC Housing Finance Ltd. (LICHFL). It has already introduced two schemes, namely Jeevan Kutir and Jeevan Niwas. Under the former, individuals can get loans upto Rs.2 lakh depending on repayment capacity or up to 75 to 80 per cent of property value. These loans have a repayment period up to 20 years; and repayment is through monthly instalments and a small premium on Bima Sandesh Policy. Under the latter scheme, loans are given upto Rs.5 lakh, the repayment is to be made through monthly instalments or the proceeds of LIC policy over a period of 20 years.

Apart from these companies, three more housing finance companies have recently been set up, namely PNB Housing Finance Ltd. (PNBHFL), SBI Home Finance Ltd. (SBIHFL), and a State level housing finance institution of Gujarat Finance Corporation.

20.5 SUMMARY

Housing is an essential human need. The need for housing will therefore exist, as long as human beings exist in the world. It is in this contest that house

financing plays a key role in providing the necessary financial assistance for construction, extension and modification of housing. Provision of basic housing facility has been one of the priorities of developing countries. International financing agencies such as the World Bank is providing all the facilities and assistance to these countries for the purpose of housing development. Many factors have contributed to the growth of housing finance in India. Budgetary support provided by the government for housing in the form of tax incentives, relatively higher pay packets for employees, new heightened competition among the HFCs, etc. are important in this regard. Housing finance companies consider such factors as the loan amount, the tenure, cost of loan etc. before deciding to extend housing finance assistance. Among the agencies that provide housing finance facility, NHB, LIC, HDFC, HUDCO, etc. are important since they contribute more than 80 per cent of the funding required for housing development in India.

20.6 GLOSSARY

- **Houses Estate:** A large number of houses that are built together in a planned way.
- **Housing Finance:** A set of all financial arrangements that are made available by Housing Finance Companies (HFCs) to meet the requirements of housing development.
- **Housing Projects:** A group of houses for apartments usually built with government money, for poor families.
- **KfW:** The KfW, formerly KfW Bankengruppe (banking group), is a German state-owned development bank, based in Frankfurt. Its name originally comes from Kreditanstalt für Wiederaufbau ("Credit Institute for Reconstruction"). It was formed in 1948 after World War II as part of the Marshall Plan.

- **ODA:** Official development aid is a term coined by the Development Assistance Committee of the Organisation for Economic Co-operation and Development to measure aid. The DAC first used the term in 1969. It is widely used as an indicator of international aid flow. It includes some loans.

- **OECF:** OECF stands for Overseas Economic Cooperation Fund (Japan).

- **USAID:** The United States Agency for International Development is an independent agency of the United States federal government that is primarily responsible for administering civilian foreign aid and development assistance.

20.7 SELF ASSESSMENT QUESTIONS

Q1. What do you mean by house financing?

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Q2. Explain the role of central and state government in house financing?

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Q3. Explain the role of HUDCO in house financing?

Q5. Explain the role of insurance organisations in house financing?

Q6. Explain the role of commercial banks in house financing?

Q7. Explain the role of cooperative banks in house financing?

Q8. Explain the role of state housing finance societies in house financing?

Q9. Explain the role of HDFC in house financing?

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20.8 LESSON END EXERCISE

Q1. What kinds of business can be transacted by National Housing Bank?

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Q2. Give a brief overview of various institution/agencies involved in housing finance system.

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Q3. Discuss the recent developments that have taken place in the field of housing finance in India.

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Q4. Explain HUDCO in detail?

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20.9 SUGGESTED READINGS

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