1

INTRODUCTION TO FINANCIAL SERVICES

Unit Structure :

1.0 Objectives

1.1 Meaning of financial Services

1.2 Financial services in India – An Overview and Recent Developments

1.3 Characteristics of financial services

1.4 Functions of financial services

1.5 Classification / Types of financial services

1.6 Challenges in the Indian financial services sector

1.0 OBJECTIVES

The objective of this chapter is

1. To introduce the learners to the concept of financial services.

2. The learners will become familiarized with the meaning and scope of financial services in general and with reference to India.

3. The reader will also learn the financial services market constituents in India.

4. Along with this, the user will also learn about the growth of the financial services sector in India, problems with the Indian financial services sector.

1.1 MEANING OF FINANCIAL SERVICES

Financial services are an important part of our economic ecosystem. Financial services primarily refer to a broad range of activities like banking, insurance, investment services, brokerage services, consumer finance companies to name a few. Typically speaking, these services are restricted to activities of financial services firms and their professionals. These financial service providers provide financial products like different investments and their instruments. In simple terms, we can say that all types of activities which are financial in nature are a default part of financial services.

1.2 FINANCIAL SERVICES IN INDIA – AN OVERVIEW AND RECENT DEVELOPMENTS

India has a very diversified financial sector undergoing rapid expansion. This rapid growth is witnessed in terms of existing financial services and addition of new entrants to this market. Financial services sector in India includes commercial banks, insurance companies, NBFCs (Non-Banking financial companies), pension funds, mutual funds and scores of other smaller financial entities. Banking sector has witnessed tremendous growth with the introduction of new entrants like payment banks, Small finance banks and digital growth in Banking. The Government of India is relentlessly introducing liberalization reforms to enhance this industry. RBI has changed the financial services landscape by allowing easy fund access to Micro, Small and Medium Enterprises (MSMEs), setting up of MUDRA (Micro Units Development and Refinance Agency). Not only RBI, even SEBI and other regulatory agencies have aggressively changed the financial services landscape in the country. The combined initiatives of all the stakeholders have made the Indian financial services sector one of the most vibrant and robust in the world.

Let us look at some latest statistics to understand the spread of financial services in India. As of June 2021, Assets under management (AUM) of the mutual fund industry alone stood at Rs.33.67 trillion (USD449.29 billion). SIP (Systematic Investment Plan) alone saw investments worth Rs 96000 crore (USD 13.12 billion). Another important component of India's financial services sector is the Insurance industry. The amount of premium collected by insurance companies as the first premium of life insurance policies crossed Rs 2.60 lakh crore (USD 36.74 billion) in 2020. IN the same period, USD 4.25 billion was raised through 55 IPOs (Initial Public Offering). Explosive growth is seen across financial services despite the financial problems brought upon by the pandemic.

1.3 CHARACTERISTICS OF FINANCIAL SERVICES

a. Customer centric activities - Most of the financial services are heavily customer centric. Customer is at the centre of all the activities of these firms. Financial services cater to the very specific requirements of customers. Customers can be individuals as well as institutions. They are in constant touch with their customers so that newer products and services can be designed to cater to specific needs.

b. Information centric – Financial services are information centric. The service provider needs to gather relevant information, analyze them, and extract relevant pieces of information for suggesting customized services.

c. Intangibility – Intangibility is an important feature of services. Financial services are no different. One cannot see the dimensions of financial services like other goods and products, but one can experience the service offering. Branding and brand image is also an important element in maintaining the effectiveness of service offering.

d. Inseparability – The financial service providers and their services are inseparable. Creation of financial services and delivery of these services happen simultaneously.

e. Perishable – Like any other service, financial services are also perishable in nature. These services also strike a match between demand and supply. Like other regular services, they cannot be stored and will have to be offered as and when they are demanded by the customers.

f. Human Centric – The human element is the most dominant force in the financial services industry. Financial services require people who are thorough professionals and competent in their respective fields. They have to understand the customer requirements thoroughly and design and recommend products and services.

g. Customization: Financial services are highly customized in their product and service offering. Providing financial services also involves a varying degree of advisory services as well. These elements have to be customized. These services vary from one client to another. In simple words, financial services are heterogenous in nature.

1.4 FUNCTIONS OF FINANCIAL SERVICES

Financial services require a perfect blend of financial markets, financial intermediaries and financial products. When these three come together in harmony, a robust financial service ecosystem is created which is able to fulfill specific set of functions. You should remember that for orderly development of the economy, financial services should be able to function at the optimum level. Following are some of the key functions of financial services.

a. Mobilization of funds – Idle funds in the form of savings needs to be mobilized so that they can be put to productive use. The funds can be mobilized from individuals, institutions and corporate entities alike. These funds can be mobilized through financial instruments like shares, bonds & debentures, mutual funds etc.

b. Utilization of mobilized funds – Once the funds are mobilized, financial services are also responsible for ensuring their optimum utilization. Factoring, securitization, retail investing and other ways are used to ensure that the funds are utilized thoroughly. Maximum benefits can be reaped when money is used prudently.

c. Economic Development – As discussed in the earlier two points, mobilizing and channelizing savings into productive avenues of investments will help in economic development.

d. Risk Management – Insurance is an essential financial service. Insurance helps in effective risk management by transferring risk from the insured to the insurer.

e. Improving liquidity - Allocating and reallocating savings and investments helps in improving the liquidity scenario in the economy. Liquidity is important as it allows easy and smooth conversion of financial assets into cash.

f. Employment Opportunities – The Financial services sector is one of the largest employers in the country. Millions are employed by this sector.

1.5 CLASSIFICATION / TYPES OF FINANCIAL SERVICES

The term "financial services" is like a box of assorted cookies. There are a variety of institutions that provide means to save for the future, secure against risk and organize capital for investment and consumption. A wide range of services like raising funds, credit rating, underwriting, merchant banking, commercial banking, depository services, mutual funds, factoring and forfaiting and other services are covered.

Following are the ways and means in which we shall classify financial services.

1. Traditional Financial Services – Traditional financial services include all those that cater to both capital and money markets. Traditional financial services can further be classified into two avenues; a. Fund based services b. Fee based services

A) Fund Based Services – These are the services through which firms and institutions raise funds by issuing equity shares, debentures. Banks also play a vital role and provide loan capital to businesses. The broad areas in which the fund based financial service providers operate are;

a. Primary market and secondary market activities and operations.

b. FOREX market services.

c. Financial innovation and financial engineering services.

d. Specialized financial services.

The following are the different examples of fund-based service providers;

a. Factoring and Forfaiting

b. Consumer loans and credit

c. Bill Discounting

d. Hire Purchase

e. Lease financing

f. Insurance

g. Venture Capital

h. Housing finance

B) Fee Based Services – Fee based financial services are those where the financial institutions provide services where these firms earn a substantial income in the form of fees, brokerage, commission or dividends. The scope of operations of fee-based services include the following;

a. Managing IPO's and capital issues – Initial Public Offer refers to new issue of shares to general public. The procedure is very detailed and exhaustive. It requires assistance of merchant bankers, underwriters and other professional entities.

b. Management consultancy projects – Firms may require advisory and consultancy on many areas like legal, finance, regulatory to name a few. Professional entities help firms to navigate such complex issues for a fee.

c. Portfolio Management- Portfolio refers to holding of a basket of different securities and assets for wealth creation. Professional portfolio managers will render such services for a nominal fee.

d. Corporate Counselling – New firms, especially startup's require help for setting up of their operations and for upscaling. Corporate counselling helps build corporate culture and a robust work environment for internal efficiency.

e. Loan Syndication – Large activities requires huge loans. A single bank may not be in a position to provide a huge loan. So a group of banks come together to contribute a collective loan called loan syndication.

f. Stock Broking – Stock brokers are those intermediaries who help you to buy and sell shares and charge a small fee for facilitating the same.

g. Capital Restructuring – Sometimes, firms require external assistance to restructure their capital. It is required to maintain a healthy capital structure and financial solvency.

h. Mergers and Acquisition – Companies may go for expansion through merger with other companies or by acquiring other entities. The entire process is super critical and requires professional expertise for successful outcomes.

2. Modern Financial Services – Modern Financial Services are all those financial services that have evolved over the years. They cater to new and ever evolving requirements of clients.

Some of the modern financial services include but is not limited to the following;

a. Hedging of risk (Hedging is a risk management process. It involves financial risk management)

b. Project Advisory Services (Involves consultancy and advisory services to help entities with new ventures / expansion etc)

c. Rehabilitation and reconstructing of sick companies (It involves activities that will try to improve the financial condition of sick entities)

d. Registration and transfer, custodian, clearing services and credit rating services.

e. Asset Liability Management (It involves managing the assets and liabilities of the firm to ensure that the firm doesn't default on its liabilities and obligations).

1.6 CHALLENGES TO INDIAN FINANCIAL SERVICES SECTOR

Financial services sector, especially in India, is highly vibrant and robust. A wide variety of services cater to individual and institutional clients. Exponential growth brings a series of challenges along with it. Let us look at some of the challenges facing the Indian financial services sector.

1. Changing nature of regulations – The Indian financial sector has always struggled with regulations. One might say that we are over regulated and sometimes, these excessive regulations create problems and hindrances. Excessive regulations prevent institutions from being flexible. Our regulations should be such that investors rights are protected and the institutions flourish.

2. Shortage of talented and qualified professionals – The growth of financial services means there is a growing need for talented, certified and qualified professionals. However, such qualified and eligible workforce is not available. There is an urgent need to create a qualified, financially literate and talented pool of labor force.

3. Changes in consumer preferences – Customer needs and wants are ever changing. Their preferences are ever evolving. This means that companies will have to come up with new ways to reach out to customers. They have to innovate constantly. Changes in consumer preference is indeed a challenge that needs urgent addressing.

4. Unconventional segmentation of the market – Indian markets are so complex that navigating them is a challenge. This issue is magnified when one realizes that Indian markets are segmented in unconventional ways. There are problems with linkages due to this disjointed segmentation.

Chapter wise questions for practice.

Multiple Choice Questions

1. The availability of cash and other cash like marketable instruments that are useful in purchases and investments are comm only known as

   a. Liquidity

   b. Credit

   c. Marketability

2. ________ are the challenges faced by financial services entities in India

   a. Shifting consumer preference

   b. Complex segmentation of market

   c. Both a and b

3. Project management and risk management is part of ___________ financial services

   a. Traditional

   b. Modern

   c. Neo-Classical

4. Bill discounting and hire purchase is a _______ financial service

   a. Fund based

   b. Fee based

   c. Commission based

5. Capital Issues and loan syndication are _____ financial services

   a. Fund based

   b. Fee based

   c. Commission based

6. Issuing shares for the first time is part of __________ market operations

   a. Secondary

   b. Primary

   c. Tertiary

7. Trading of listed shares is a part of ___________ market operations

    a. Primary

    b. Secondary

    c. Tertiary

Explain the following terms in One or Two lines

a. Financial Services
b. Fund based services
c. Fee based services
d. Primary market
e. Secondary market
f. Liquidity

Answer the following questions in detail

1. Define 'Financial Services' and explain the recent developments in financial services arena.
2. What are the characteristics of financial services?
3. Explain the major functions of financial services
4. Explain the fund based and fee based financial services.
5. What are the challenges faced by financial services in India?

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2

MERCHANT BANKING

Unit Structure :

2.0 LEARNING OBJECTIVES

After reading this unit, Learner will be able:

- To understand the meaning, nature and functions of Merchant Banking
- To understand role of merchant banking in issue management.
- To understand the regulation of merchant bankers by SEBI

2.1 MERCHANT BANKING IN INDIA

A person may apply to the Board for the issuance of a certificate of registration using Form A.

When submitting an application for registration, the applicant must pay a non-refundable application fee of Rs. 50,000 via direct credit in the bank account via NEFT/RTGS/IMPS or any other mode permitted by the RBI, or by a demand draught made payable to the "Securities and Exchange Board of India" and payable in Mumbai or the respective regional office.

The application under sub-regulation (1) shall be made for any one of the following categories of the merchant banker namely:

(a) Category I, that is

(i) to carry on any activity of the issue management, which will, inter alia, consist of preparation of prospectus and other information relating to the issue, determining financial structure, tie up of financiers and final allotment and refund of the subscriptions; and

(ii) to act as adviser, consultant, manager, underwriter, portfolio manager

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

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

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

The minimum net worth requirement for acting as

merchant banker is given below

The minimum net worth requirement for acting as merchant banker is given below

Category	Net worth
Category I	Rs. 5 cores
Category II	Rs, 50 lakhs
Category III	Rs. 20 lakhs
Category IV	Nil

According to SEBI guidelines, any public issue or rights issue worth more than Rs. 50 lakhs must be managed by a Merchant Banker who is registered with SEBI. They will be governed by the code of conduct outlined in the regulations. The number of Issue Managers who can be associated with an Issue is limited by SEBI Regulations:

Size of the Issue	Permissible No. of Lead Managers
Less than Rs. 50 crores	2
Rs. 50 crores but less then Rs. 100 crores	3
Rs. 100 crores but less than Rs. 200 crores	4
Rs. 200 crores but less than Rs. 400 crores	5
Rs. 400 crores and above	5 or more

Before accepting an assignment relating to an issue, all lead managers must enter into an agreement with the relevant company outlining their rights and obligations. If more than one lead manager is involved, their responsibilities must be clearly defined. There will be a minimum underwriting agreement. A Lead manager is unable to manage an issue involving an associate company. During the issue period, no lead manager may exit.

Issue managers play an important role in raising funds through public securities offerings. Companies that are considering issuing new capital decide on issue managers after conducting extensive due diligence and carefully analysing the merchant banker's competence and capabilities to handle the issue. They provide valuable services in the preparation and drafting of the prospectus, pricing the issue, marketing and underwriting the issue, coordinating the activities of various agencies/institutions involved in this context to carry out legalities involved in the process, deciding the basis of allotment, making the allotment, despatch of share certificates/refund orders as the case may be, and finally, in the listing of shares on stock exchanges.

Activities of Merchant Banker:

SEBI has issued compendium of circulars to merchant bankers from time to time and broadly has divided these activities into two groups i.e., Pre-issue activities and Post-issue activities.

A. Pre-issue activities : Before a public offering, a merchant banker must obtain consent from the stock exchange to appoint managers, bankers, underwriters, and brokers, as well as advise the company on the appointment of auditors, board of directors, prospectus, and obtain consent from the company's legal counsel. Pre-issue management entails:

- obtaining SEBI approval;
- preparing a prospectus;
- selecting a registrar, advertising issues, underwriters, bankers, and brokers; and
- determining the price for their issues.

Some important aspects about these activitiesare discussed here.

1. Obtaining SEBI approval: Before issuing any capital, ensure that the proposed issue complies with the provisions of the SEBI guideline for disclosure and investor protection in terms of issue pricing, promoters, contribution, lock in period, reservation, and so on.

2. Holding of a General Meeting: If the Articles of Association require that shareholder consent be obtained, then a shareholder meeting shall be called.

3. Intimation to the Stock Exchange: A copy of the company's Memorandum and Articles of Association must be sent to the stock exchanges where the shares will be listed for approval.

4. Prospectus:A public issue is the sale of securities to the general public in accordance with the Companies Act of 2013 and SEBI guidelines. A public offering of equity shares is classified as

- Public issue
- Right issue
- Preferential issue (Private Placement)
- Content of a Prospectus:
- Date / country of incorporation
- Company principal activities
- Profit and loss a/c balance sheet and cash flow statement for the past three years.
- Statement of accounting principle
- Auditors reports with name and address.
- Material relates to financial position
- Analysis of sales by geographical area etc.
- Detail regarding issues of shares / deposit agreement.

Type of prospectus:

a. Offer document: Prospectus in the case of a public offering and right issue is filed with company registrars and stock exchanges. This offer document contains all of the company's information and assists an investor in making investment decisions.

b. Draft offer document: This refers to an offer document that is still in the draft stage. The draft offer document must be filed with SEBI within 21 days prior to submitting the offer document to ROC. The draft offer document should be posted on the SEBI website for public comment.

c. Red herring prospectus: This is a prospectus that does not include information such as the exact price and number of shares being offered. It contains information on the upper and lower price ranges.

d. Abridged prospectus: This prospectus is included with the application form of the Public issue.

e. Shelf prospectus: Under the Companies Act 2013, any financial institution or bank may file a shelf prospectus covering one or more securities issues or classes of securities. Specified in the prospectus filed with the company's registrar.

The benefit of a shelf prospectus is that the issuing institution does not have to file a new prospectus. The shelf prospectus has a one-year validity period.

5. Appointment of Intermediaries: a. Registrars to the issue: The Registrar of an IPO, also known as an Initial Public Offering, is in charge of processing the company's IPOs. These organisations are independent financial institutions that are registered with stock exchanges and SEBI. The company that is going public appoints these bodies. A registrar's primary role when issuing an IPO is to process IPO applications, distribute shares to applicants in accordance with SEBI guidelines,

process refunds via cheque and ECS, and transfer allocated shares to the applicant's demand accounts.

- Banker to the issue: Merchant bankers assist in the selection of appropriate bankers based on project proposals. Commercial bankers are merely financiers, and their activities include credit proposal, credit appraisal, and loan sanction.If a new company wants to do new issues, the banker must assist the following intermediary with newissue work.

- Underwriter: An underwriter agreement is a contract between the issuing company and a person or institution in which the latter guarantees that if the share is not fully subscribed. That person is referred to as an underwriter. Subscription is thus guaranteed even if the general public does not purchase from the issuing company. Underwriting forms and types:

o Full underwriting: An underwriter who accepts the entire subscription is referred to as a full underwriter.

o Partial underwriting: A partial share subscription by an underwriter is referred to as partial underwriting.

o Joint underwriter: More than two underwriters have subscribed as a joint underwriter.

o Sub-underwriter: One underwriter may appoint another underwriter to handle the subscription of shares.

o Firm underwriting: When an underwriter commits to purchasing or subscribing to a specific number of shares from the public, this is referred to as firm underwriting.

- Broker: Broker is a person who behaving as intermediary between buyer and seller to by securities and subscribe the securities.

- Advertising: Any person engaged in the creation, preparation, and display of advertisements concerning issues is referred to as an advertising agency. A merchant banker arranges a meeting with company representatives and an advertising agent to finalise the date of issuer's opening and closing. The media for publication can be finalised by the merchant banker.

- Printers: Printer is a person who prints the (i) Application form. (ii) Prospectus and (iii) Other issue material.

6. Fixing price for their issues: Different types of public issues

- Initial public offering (IPO): The first time shares issued by a new company are called an initial public offering (IPO), or the first sale of stock by a private company to the stock market.

- Follow on public offer (FPO): Follow up on public shares issued by a company that has already gone public through an IPO. An FPO is any company formed after the initial public offering.

- Right Issue: A right issue is the sale of securities in the primary market through the issuance of rights to be the existing shareholder.

- Offer for Sale: A company can list new shares in one of two ways.
  - By an offer sale which is a public invitation by intermediary.
  - By an offer for sale which is a public invitation by company.
- Green shoe option: A green shoe option is an option to allocate shares in excess of those included in the public offering and to operate a post-listing price stabilising mechanism for a period of no more than 30 days.

- E-IPO: A company that is preparing to offer securities to the public via an online stock exchange system.

- Private placement/placement with FIs, MFs, and so on: Private placement and preferential allotment involve only selling securities to sophisticated investors such as financial institutions, material funds, venture capital funds, and so on. The identity of investors in a preferential allotment is revealed when the issuing company seeks shareholder approval. In contrast, when the offer document is prepared for a private placement, the identity of the investors is unknown.

- Bought out deal: Bought out deal is a process of investment by a sponsor such direct investment is being made with understanding between the company and the sponsor to go for public offering in mutually agree time. A company will allot shares in full to sponsor. After certain period of agreed upon between sponsor and the company.

7. Pricing the issues: In a public offering, one of the most important challenges for a merchant banker is pricing. Appropriate pricing not only ensures the issue's success, but also provides a good return to the prospective well. Pricing is the value of a specific or per stock. Through the book building process, an issuer may determine the price of specified securities in consultation with the lead merchant banker.
   Parameters of issue pricing:

- price to earning ratio (P/E Ratio)
- price to book value ratio etc.

Pricing strategies for an issue:

- Differential pricing: Listed and unlisted companies may issue shares securities to firm allotment applicants at a price different from the price at which the net offer to the public is made.

- Price band: The issuer or issuing companies may specify a 20% price band in the document field with the SEBI. The final price will be determined later.

- Payment of discounts/commissions: The issuer company/promoters may not make any direct or indirect payment to any firm allotted in a public offering, whether in the form of a discount/ commission/ allowance or otherwise.

- Share denomination: Any denomination of equity shares can be issued in a public/rights issue.

B. Post issue management:

The stage following the issuance of securities to subscribers is known as the post-issue obligation. The major post-issue obligations concern participation in the allotment procedure, post-issue monitoring reports, resolving investor grievances, and coordination with intermediaries, among other things.

1. Procedure for allotment and the basis for allotment: The merchant banker, in collaboration with the MD of the recognised stock exchange and the issue's registrar, is responsible for ensuring that the basis of allotment is finalised in a fair and proper manner in accordance with Regulation 49 of the ICDR Regulations. Such shares should be allotted in such a way that the minimum allotment equals the minimum application size as determined and disclosed in the offer document.

2. Post-issue monitoring report: In the case of an IPO, the merchant banker must submit a post-issue monitoring report on the third day following the close of the issue's subscription.

3. Post-issue advertisement: Regulation 51 of the ICDR regulations imposes a duty on merchant bankers to ensure that a post-issue advertisement detailing subscription, the basis of allotment, the value and percentage of all applicants, the date of filing of listing application, and other details is published in at least one nationwide English and Hindi newspaper within ten days of the date of various activities.

4. Redressal of investors grievance: The Post-issue Lead Merchant Banker shall actively participate in post-issue activities such as allotment, refund, and despatch, and shall regularly monitor redressal of investor grievances arising from such activities.

5. Coordination with intermediaries: It entails coordinating with various agencies involved in post-issue activity, such as the registrar to issue, bankers to the issue, self-certified banks, and underwriter.

6. Certificate regarding the realization of stock investors and other requirement: : The Post-Issue Lead Merchant Banker shall submit to

the Board, within two weeks of the date of allotment, a Certificate certifying that the stock investments on which the allotment was finalised, have been realised.

7. SEBI's operational guidelines: Compliance requirements for merchant banker(s) in relation to operational guidelines include submission of draught and final offer documents, post-obligation instructions, penalty point issuance, and so on. These guidelines are available on the SEBI website.

2.2 REASONS FOR GROWTH OF MERCHANT BANKING

1. Globalization: After the reforms in 1991, the Indian economy got opened to foreign companies. This led to funds inflow from the foreign countries in Indian market. This led to growth of merchant banks in India as to ensure these inflows through proper legal way.

2. Increased Competition: As the economy has become more globalised, market scenarios have become more lucrative, and business opportunities have been more appealing to a variety of people. These factors shifted the Indian corporate sector, due to which there saw a significant expansion. This led merchant bankers to play a vital role in the corporate world by providing specialised services.

3. Changes in consumer trends: As a result of the entry of foreign companies into the market, there has been a significant alteration in the industrial and business sectors. The main benefit was that the Indian masses began to receive higher-quality products as Indian enterprises began to match the quality of foreign products. Financial products and instruments grew more significant in such circumstances.

4. Government Reforms: The government's involvement was minimised, while privatisation expanded. It also increased investment limitations and reduced direct interference, leading to an increase in the offer of international players.

5. Changes in consumer demographics: According to a Deloitte report published in September 2017, India has 65 percent of its population under 65 years old and that:

a) it sits on a demographic goldmine,

b) it is estimated that India has around 390 million millennials and about 440 million millennials in the GEN Zcohort,

c) the median population age is 27.3 years, compared to 35 years in China and 47 years in Japan.

With a growing workforce, there is a demand for more informed investment decisions and a wider range of possibilities.

6. Technology Advancement: Today's technology is assisting in the redefinition of operational modes and methodologies, allowing market players to pursue novel avenues for superior investment strategies. One example is the introduction of an electronic version of the dematerialization account, also known as the Dematerialization Account.

2.3 ORGANIZATION THAT CAN OFFER MERCHANT BANKING SERVICES IN INDIA

Here are the organizations that provide Merchant banking services in India:

a. Commercial Banks and their sub-banks

b. Foreign Banks e.g., Citi Bank, National Grindlays bank, etc.

c. State Level Financial Institutions are State Industrial Development Corporations(SIDC's) and State Financial Corporations (SFC).

d. India Financial Institutions and Development Bankse.g., ICICI, IFCI, IDBI, etc.

e. Private Financial Consultancy Firms and Brokers e.g., J.M. Financial and InvestmentServices Ltd., DSP FinancialConsultants, Kotak Mahindra, etc.

f. Professional Merchant Banking Houses.

g. Technical Consultancy Organisations.

2.4 MERCHANT BANKERS IN INDIA

There are more than 130 merchant bankers who are registered with SEBI. Here is the list of some significant ones:

Public Sector Merchant Bankers :

State Bank of Bikaner and Jaipur, Punjab National Bank, Bank of Maharashtra, Karur Vysya Bank, SBI Capital markets Ltd., IFCI Financial Services Ltd.

Private Sector Merchant Bankers :

Yes, Bank Ltd., ICICI Securities Ltd., Kotak Mahindra Capital Company Ltd., Axis Bank Ltd., Tata Capital Markets Ltd., Reliance Securities Ltd., Bajaj Capital Ltd., ICICI Bank Ltd.

Foreign Players in Merchant Banking :

Barclays Securities (India) Pvt. Ltd, FedEx Securities Ltd., Goldman Sachs (India) Securities Pvt. Ltd., DSP Merrill Lynch Ltd., Deutsche Equities India Private Limited, Morgan Stanley India Company Pvt. Ltd., Deutsche Bank

2.5 FUNCTIONS OF MERCHANT BANKERS

a. Raising finance: Merchant bankers assist their customers in obtaining funding through debenture issuances, stock purchases, bank loans, and other means. Filming takes place in both domestic and international markets. The funds generated by this strategy can be used to start a new project or company, or to expand and modernise an existing one.

b. Promotional activities are carried out by merchant bankers in the capacity of industrial business promoters. They enable developers to create innovations, define ventures, conduct feasibility studies, obtain permits from government agencies, and capitalise on opportunities. Merchant bankers may also help with political, technological, and collaborative projects on occasion.

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

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

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

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

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

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

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

j. Brokers in stock exchanges: They buy and sell stock in the stock market on behalf of consumers. They frequently conduct equities surveys, reminding consumers of the share to be purchased, the date of purchase, the amount of such acquisition, and the period during which these shares will be exchanged.

k. Project management: They assist customers in a variety of ways during the project management cycle. They direct the plant's position, the writing of the plant study, feasibility reports, and project finance preparation, as well as the sources of support, policy benefits, and concessions.

l. Advice on modernization and expansion: Advice on amalgamation, mergers, partnerships, partnerships, international alliances, market diversification, technology upgrades, joint ventures, and so on.

2.6 SERVICES OF MERCHANT BANKERS

The services of the Merchant Banker

I. Service based functions:

a. Project counselling and pre-investment studies: Project counselling entails preparing a project report, deciding on a project's funding strategy, evaluating the project report, and securing cash from financial institutions or banks, among other things. Merchant bankers advise corporate entities on project report preparation, which includes technical feasibility, marketing survey, and other project-related information such as management aspects, location, financing options, projected cost of production, working results, cash flow statements, and balance sheets.

Project reports are prepared for the following reasons :

- to obtain project approval from the appropriate authorities,
- to obtain financial assistance from financial institutions, banks, and other sources
- to make planned resource utilisation and project implementation within the specifiedtime frame,
- to investigate the market for the proposed product
- to gain an understanding of the specified technical process and engineering requirements for product manufacturing, and
- to make recommendations.

b. Credit syndication and project finance: Credit syndication refers to merchant banks' services in arranging and raising credit from financial institutions, banks, and other prominent investment organisations in order to finance clients' project costs or meet working capital requirements.There are three types of periodic sources of funds, viz.,

- Short Term Funds: can be obtained from commercial banks, trade credit, public deposits, business financing companies, and clients to cover working capital needs. These funds are usually set up for a very short period of time, such as a year.

- Medium Term Funds: State financial companies, commercial banks, and all-India financial institutions, industrial financing corporations of India (IFCI), industrial development bank of India (IDBI), investment institutions, and the general public provide medium-term money in the form of fixed deposits. These funds are often allocated for a period of five years and are required for permanent working capital, expansion, or asset replacement.

- Long Term Funds: Long term funds are those that are held for more than five years and are used to start a new project, modernise or diversify an existing unit of corporate entities, and for other purposes. Loan syndication is essentially concerned with the arranging of borrowed funds from various sources other than funds raised from the general public.

c. Capital Issue management: The management of issues for generating funds through various forms of instruments by firms is referred to as capital issue management. Merchant bankers in India provide a professional service in the management of capital issues. In reality, issue management is one of merchant bankers' primary responsibilities.

d. Underwriting of capital issues: Underwriting is a contract made between an issuing company and another party known as an underwriter who agrees to accept undersubscription of securities in exchange for a commission. A fully underwritten public issue instils confidence in the investing public, resulting in a favourable response to the issue. Keeping this in mind, companies that issue public securities must have a thorough understanding of the issue. Merchant bankers who manage an issue must make a careful decision after thoroughly reviewing the issue's details and the amount to be underwritten. Underwriters must be SEBI-authorized and registered merchant bankers, brokers, banks, and financial institutions, among other things.

e. Corporate counselling: Merchant banks provide expertise knowledge to a corporate entity by providing guidance in connection with government rules and regulations, appraising product lines and analysing their growth and profitability, and forecasting future market trends.This is an intermediary function that necessitates the ability to develop strategies, expert knowledge, skills, and experience in order to solve business problems.It ranges from managerial economics, financial and investment management to corporates, compliance of laws and the relatedlegal aspects etc.

f. Portfolio management: A portfolio is a collection of securities that includes stocks, bonds, and money market instruments. Portfolio management refers to the process of combining various asset classes in order to achieve the best possible return with the least amount of risk. Portfolio manager provides portfolio management services. Any person who, pursuant to a contract or arrangement with a client, advises, directs, or undertakes on behalf of the client the management or administration of a portfolio of securities or the client's funds is referred to as a portfolio manager. When performing portfolio management services, a merchant banker must inquire about the investment needs of clients, their tax bracket, risk tolerance, marketability and liquidity of securities, reasonable return on investment, and so on.

g. Stock broking and dealership: A broker is a self-employed individual or company who executes financial transactions on behalf of another party. In most cases, a broker will charge a commission to execute the orders.

   The term "dealer" refers to an individual or a company who buys and sells securities for their own account, either through a broker or on their own. Dealers are an important and critical market entity. A dealer acts as a principal in trading on his own account and plays a significant role, as opposed to a broker, who is merely a middleman.

h. Venture capital financing: When it is too early for a company to go to the capital market to raise funds, venture capital is essentially equity financing in relatively new companies. It entails not only equity investments, but also loan financing and convertible debt. The goal of venture capital financing is to earn capital gains on equity investments, with debt financing serving as a backup. Venture capital also provides business skills to the investee firm, which is known as a 'hands-on' management approach. The risk-return spectrum of venture capital financing is high.

i. Debenture trusteeship: A debenture trustee means a trustee of a trust deed for securing any issue ofdebentures of a body corporate. They provide services of safeguarding security and protect interest of debenture holders both in case of private.

II. Fund based functions:

a. Bill discounting: The holder of a time bill (payable after a specified period) does not have to wait until maturity or the due date. If he needs money, he can negotiate a discount on the bill with his banker. The banker credits the net amount in the customer's account after deducting a certain amount (discount). As a result, the bank purchases the bill and credits the customer's account with the bill amount less the discount. The drawee makes payment to the banker on the due date. If he does not pay, the banker will recover the money from the customer who has discounted the bill.

b. Venture capital: As explained above, venture capital is equity financing in relatively new companies, Here the merchant bankers provide the finance by themselves instead of helping to arrange for the venture capital.

c. Bought out deals: A bought out deal is a method of selling securities to the general public via a sponsor or underwriter (a bank, financial institution, or an individual). The securities are listed on one or more stock exchanges within a mutually agreed-upon time frame between the company and the sponsor. This option saves the issuing company the expenses and time associated with a public offering. The company may reimburse the cost of holding the shares, or the sponsor may offer the shares to the public at a premium in order to profit.

d. A lease is an agreement in which a company obtains the right to use a capital asset such as machinery in exchange for a fee known as lease rentals. The person (or company) who acquires the right is referred to as the lessee. He is not given ownership of the asset. He only obtains the right to use the asset. The person (or company) who grants the right is referred to as the lessor.

e. Leasing can be replaced with hire purchase. A hire purchase transaction is one in which goods are purchased and sold on the condition that payment is made in instalments. The buyer only receives possession of the goods. He is not given ownership. He obtains ownership only after the final instalment is paid.

f. Factoring: Factoring is an arrangement in which the factor purchases account receivables (arising from credit sales of goods/services) and pays the supplier or creditor in cash immediately. Thus, it is an arrangement in which a financial institution or banker purchases a firm's (client's) account receivables.

g. Forfaiting: Forfaiting is a type of financing for international trade receivables. It is the non-recourse purchase of receivables arising from the export of goods and services by a banker or other financial institution. The exporter relinquishes his right to future payment from the buyer to whom goods have been supplied to the forfaiter. Forfaiting is a technique that allows an exporter to sell his goods on credit while receiving payment well ahead of the due date.

Test your Understanding:

1. What are various types of prospectus?
2. What factors lead to Growth of Merchant bankers in India?
3. List the fee based services provided by the Merchant Banker.

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3

VENTURE CAPITAL FINANCING

Unit Structure :

3.0 OBJECTIVES

i) Learners will learn in details about venture capital financing and its growth in India.
ii) Learners will be acquainted with various facts and figures pertaining to venture capital funding in India.

3.1 INTRODUCTION & MEANING

The dearth of Capital financing remains one of the largest barriers for the businesses and start-ups in our country even today. The impact is even higher in cases where the entrepreneur is unknown, lacks previous experience or a brand, i.e an unknown technocrat. The Indian Information Technology sector and young lads have the huge unexplored potential for start-ups involving creativity and innovation but what pulls the strings back is the availability of initial capital investments. Due to limited credit score (CIBIL Score) and the non-existence of required documentation, the availability of loans from commercial banks and NBFC's is difficult. Raising public finance remains outside the gamut. Thus, the need for financing these ventures who involved substantial risk but at the same time have high potentialities was felt. This gave birth to the concept of venture capital financing. Venture capital refers to long term investment in form of equity and/ or conditional loans into these high-risk high potential business ventures.

The concept of venture capital is no new term in India but was first coined in 1986. However, it was at the infancy stage where adoption of asset class was carried upon by public financial institutions in consent with the government only. The initiation of the New Economic Policy in 1991 led to transformation with stakes now involving private venture capitalists from India and abroad. The growth remained underpinned until 2010, then scaling up the venture capital financing both in terms of numbers and capital.

A Venture Capital Fund may be registered in form of trust or company and has been defined to mean a fund established in the form of a trust or a company including a body corporate and registered with SEBI which –

i) has a dedicated pool of capital, raised in a specified manner, and

ii) invests in venture capital undertakings in accordance with these regulations.

3.2 FEATURES OF VENTURE CAPITAL FINANCE

1. Equity Capital: The investments here are in form of equity capital, therefore they not only provide finance but also bear the risk in the business.

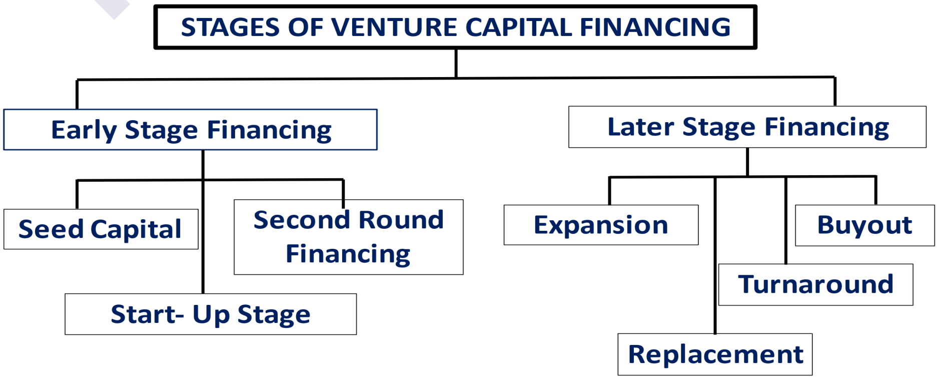
2. Returns to the investor: The investor here being the shareholder, the returns are in form of profits and not interests through participation in sale holdings. The conditional loans if provided earn royalties on sales in most cases.

3. Limited Participation in Management: Though the venture capitalist is technically the owner of the company their participation in managing the day-to-day affairs of the company is limited. They act as advisors, mentors and counsellors in the company.

4. High Degree of Risk: Venture capitalists invest in ventures that are floated by unknown technocrats and hence the element of risk and uncertainties are high.

3.3 STAGES OF VENTURE CAPITAL FINANCING

The business needs have always been evolving and need capital injections at various stages of its life cycle. The broad classification can be illustrated with help of below tree -diagram:



Source: Lalita Mutreja, CC BY-SA 4.0, via Wikimedia Commons

A) Early-Stage Financing: It can be further classified into Seed capital, Start-up Stage and Second Round Financing.

i) Seed Capital: This stage can also be referred to as pre-natal capital that is associated with the research and development of the venture. At this stage, the funds are required for laboratory testing or testing the waters of the product before initializing commercialization. At this stage, the decision as to whether the product is to be launched and/or with modifications is taken by the innovator. Being a high-risk proposition, the capital requirements at this stage are contributed by the developer. Venture Capitalists do provide this capital but in form of loans and not equity.

ii) Start- up Stage: Once the venture has been approved in its research and development, the need for financing the commercial launch is felt. The venture capitalists in most cases start their funding from this stage onwards. At this stage, venture capitalists screen the entrepreneurial capabilities along with the proposal before investing in the venture in form of equity and/ or conditional loans. The funds so invested herein have a wider time horizon.

iii) Second Round Financing: Liquidity injections or need for mid-term financing is met through venture capitalists financing in form of debt rather than equity. At this stage, the venture capitalists don't deliberate many discussions, as the ventures are more or less stable.

B) Later Stage Financing: Financial requirements of a business vary with its life cycle, once the business reaches its growth stage, huge financial requirements are once again required either to diversify or branch out in various directions. This financing is available in the following modes:

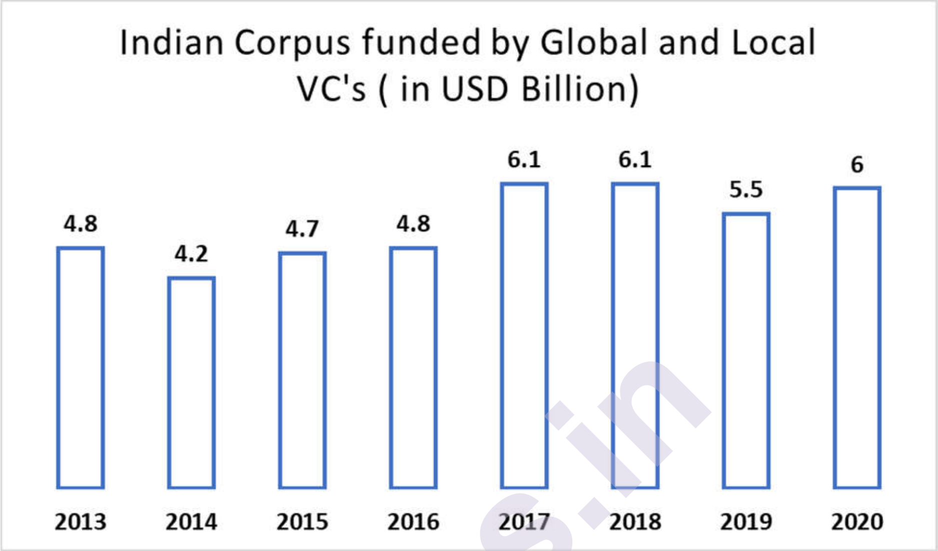
i) Expansion: As the business reaches to its peak, innovation and expansion are the key drivers for its sustenance in the long run. Where the venture cannot raise public finance directly, it may acquire or take over an existing venture. In the second scenario where the entrepreneur reaches its maximum equity, venture capitalists pump in debt funds in form of conditional loans.

ii) Replacement: When the promoters of the company intend to exit the investee company however the equity is not floated in the market but at the same time growth potential curves for 3-5 years, the venture capitalists now replace the promoter's equity with its funds.

iii) Turn Around: Ventures after a certain level reach maturity or need change at various levels i.e in form of product, organization or transformation that once again requires inflow of funds. Being risk in nature, in-depth scrutiny is conducted, consultancy too may be appointed. A substantial investment is done at this stage by the venture capitalists.

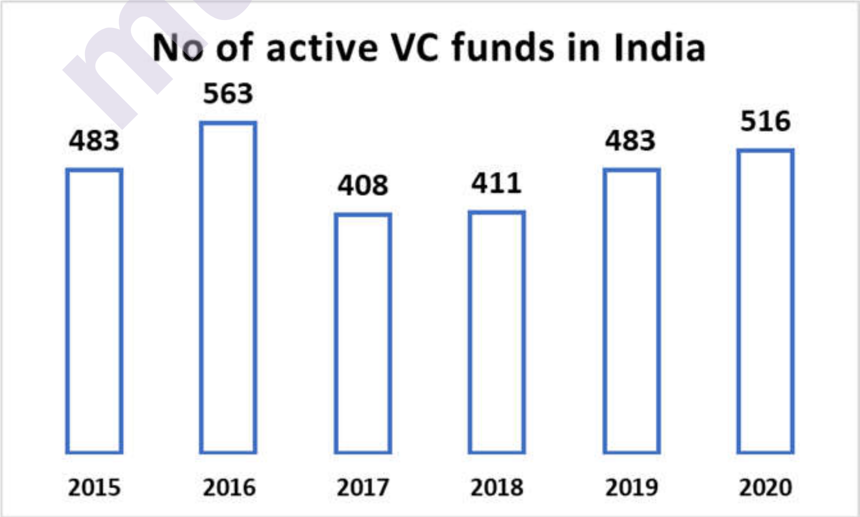
iv) Buyout: Set of passive shareholders that desire to exit from the venture are taken over by the active shareholders before offering it to the public or outsiders. This set of arrangements is known as buyout deals. These active shareholders need additional finance that can be met through venture capitalists.

3.4 VENTURE CAPITAL: INDIAN SCENARIO : FACTS AND FIGURES :



Source: Statista 2020.

The above graph displays the inflow of venture capital funds in Indian companies during the period 2013-2020. As visualized above, spectacular growth was achieved that jumped off from USD 4.8 billion to USD 6.1 billion during the period 2016-17 and continued to remain constant in 2018. Though it dipped off in 2019 and 2020 but the investments still continue to substantial in midst of COVID -19 foreseeing a huge potential.



Source: Bain VC deals database; Crunchbase; IVCA; Bain analysis

The number of active venture capitalists have witnessed a substantial increase even during the pandemic. The major venture capitalists are Tiger, Softbank, Inflection Point Ventures, Avataar Venture Partners, Coatue Management, Beyond Next Ventures, Titan Capital and Arkam Ventures.

Top start-ups that received more than $100M funding in 2020

Asset	Key investors	Stage of funding
Byju's"	Tiger Global, Alkeon, BlackRock, General Atlantic,	Late
	Bond Capital, Silver Lake, Sands Capital, Owl Ventures	
Zomato	Fidelity, Kora Management, Luxor Capital, Mirae Asset,	Late
	Tiger Global, Steadview, Temasek, D1 Capital	
FirstCry	SoftBank	Late
Unacademy*	SoftBank, Nexus, Sequoia, General Atlantic	Late
Dreamil	Tiger Global, TPG, ChrysCapital, Footpath Ventures	Late
Daily Hunt*	Google, Microsoft, Falcon Edge, Sofina Group	Late
Zenoti	Advent International, Tiger Global, Steadview Capital	Late
Swiggy*	Samsung Ventures, Korea Investment Partners,	Late
	Naspers, Tencent, Mirae Asset, Meituan-Dianping	
Postman	Charles River, Insight, Nexus	Late
Vedantu*	GGV Capital, Coatue Management, WestBridge,	Late
	Omidyar Network, Tiger Global	
Glance	Google, Mithril Capital	Late
Fresh To Home	Iron Pillar, Investment Corporation of Dubai	Late
PolicyBazaar	SoftBank	Late
Eightfold	Capital One Growth Ventures, General Catalyst,	Late
	Lightspeed	
HighRadius	Citi Ventures, ICONIQ Capital, Susquehanna Growth	Late
Eruditus	Sequoia, Prosus Ventures, Chan Zuckerberg Initiative,	Late
	Ved Capital, Leeds Illuminate	
CureFit	Temasek, Accel, Epiq Capital Fund, Satyadharma	Late
	Investments, Ascent, PraTithi, Chiratae	
Xpressbees	Gaja Capital Partners, Investcorp India, NVP India	Late
Bounce*	B Capital, Falcon Edge, Omidyar Network, Maverick,	Late
	Qualcomm, Accel, Chiratae, Sequoia	
MindTickle	Accel, Founder Fund, ICONIQ Capital, Qualcomm,	Late
	SoftBank	
Razorpay	Tiger Global, Sequoia, Matrix, Ribbit Capital,	Late
	Y Combinator	
Biofourmis	Sequoia, SoftBank, MassMutual, Openspace	Late

Source: Bain VC deals database; Crunchbase; IVCA; Bain analysis

3.5 SUMMARY QUESTIONS

1. Explain the need and importance of Venture Capital financing.
2. Discuss in brief the various stages of Venture Capital financing.
3. Write a short note on: i) Seed Capital ii) Features of Venture Capital.
4. Carve out Indian scenario with respect to Venture Capital Finance in India.

References :

1. Master Direction – Non-Banking Financial Company – Housing Finance Company (Reserve Bank) Directions, 2021; Retrieved from https://rbidocs.rbi.org.in/rdocs/notification/PDFs/MD10007CE48ADE2FB4BF981444FE1349E3B71.PDF\

2. https://nhb.org.in/en/

Additional Reading :

1. IFC Report: Evaluation of Leasing in India: March 2019:or Scan the below QR code

2. India Venture Capital Report 2021: IVCA: Bain and Company or Scan the below QR code

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4

SECURITIZATION

Unit Structure :

4.0 LEARNING OBJECTIVES

After learning this chapter, learners will be able to:

- understand the meaning of asset securitisation;
- describe various benefits of securitisation;
- Understand the difference between securitization and factoring
- appreciate the various instruments of securitisation;
- explain various steps involved in the securitisation process; and
- analyse securitisation developments in the Indian market.

4.1 DEFINITION

"Securitisation" means acquisition of financial assets by any [asset reconstruction company] from any originator, whether by raising of funds by such [asset reconstruction company] from [qualified buyers] by issue of security receipts representing undivided interest in such financial assets or otherwise;

4.2 MEANING OF SECURITIZATION

The process of converting illiquid loans into marketable securities is known as securitization. The lender sells to a third party his or her right to receive future payments from the borrowers and is compensated for it. As a result, the lender is repaid at the time of securitization. These borrowers' future cash flows are sold to investors in the form of marketable securities. In India, securitization is mostly done through trust structures, in which the underlying assets are sold to a trustee company, which holds the security in trust for investors. In this case, the trustee company is a special-purpose vehicle (SPV) that issues securities in the form of pass-through or pay-through certificates (PTCs). The underlying assets are legally owned by the trustee. Investors who hold PTCs have a beneficial interest in the underlying assets held by the trustee.

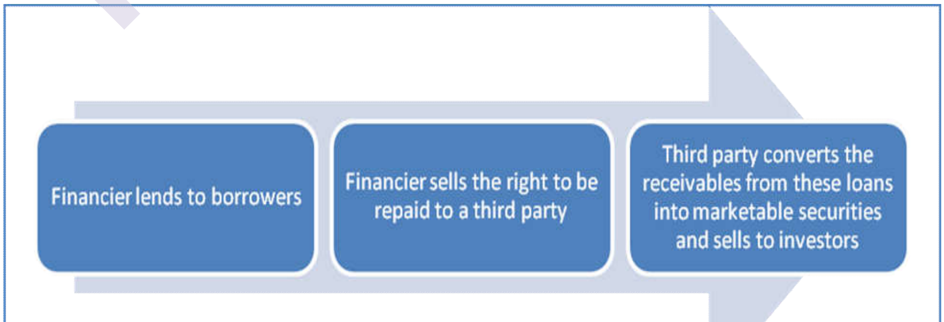


Fig 4.1 Securitization Process

4.2.1 PARTICIPANTS IN THE SECURITIZATION :

(i) Originator: They are original lender and seller of receivables. This is typically a bank, or an NBFC, or a housing finance company in India.

(ii) Seller: One who pools assets in order to securitize them. In India, the seller and the originator are frequently the same person or entity.

(iii) Borrower: The counterparty to whom a loan is made by the originator. Borrower payments (typically in the form of equated monthly instalments) fund investor payouts.

(iv) The Issuer (SPV). They are the entity who issues marketable securities (to which investors subscribe) and ensures that transactions are carried out on specific terms. In India, the SPV is usually established as a trust.

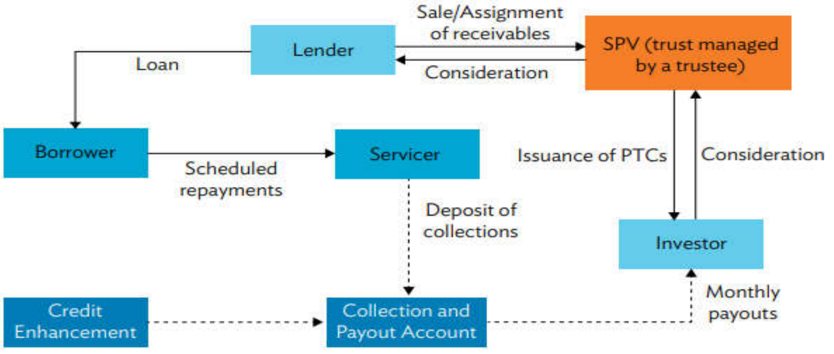
(v) Arranger: The securities are structured by investment banks. They work with other parties (such as investors, rating agencies, and legal counsel) to ensure that the transaction goes smoothly.

(vi) Investor: The person who buys securities. Banks, insurance funds, and mutual funds are the most common types of investors in India.

(vii) Credit Rating Agency: These agencies assess the risks associated with each transaction, impose credit enhancements commensurate with the PTCs' ratings, monitor transaction performance until maturity, and take appropriate rating actions.

(viii) Provider of credit enhancement. The originator is typically used as a facility to cover any shortfall in pool collections in relation to investor payouts. A third party can also provide the enhancement for a fee.

(ix) Servicer: The entity that collects periodic instalments due from individual borrowers, pays out to investors, follows up on delinquent borrowers, and provides the rating agency with periodic information about pool performance. In India, the originator is usually the servicer.



PTC = pass-through (or pay-through) certificate, SPV = special-purpose vehicle.
Source: CRISIL.

4.2.2 SECURITIZATION MECHANISM

Stage 1: The Identification Stage :

The first stage of securitization occurs when a financial institution or banker, known as the ORIGINATOR, pools his lending such as mortgages or account receivables into a homogeneous type based on interest rate, maturity period, and so on. As a result, the first stage is known as the Identification process stage.

Stage 2: Transfer of Assets to SPV :

The originator will transfer all of his assets to another institution, which will aid in the securitization process. SPECIAL PURPOSE VEHICLE (S.P.V) or Trust converts the assets into securities. The Trustees could be retired high court judges with experience in asset valuation and finance. There are also merchant bankers who act as SPVs and issuers. The reputation of merchant bankers will aid in the issuance of debt instruments, which will be oversubscribed.

Stage 3: Issue stage :

The SPV categorises various assets into various types of securities based on their maturity date and interest rate.

The SPV offers the following securities to investors:

- Pass through certificates: Pass through certificates receive payments from assets such as housing loans, from which payments for certificates of deposits are met as and when they are due.
- Pay Through certificates: In this case, multiple maturity structure certificates will be issued based on the maturing pattern of various assets, so that the respective certificates will be paid as and when the assets mature.
- Interest-only certificates: These certificates will pay interest based on the earnings from the assets securitized.
- Principal-only certificates: From asset realisation, only the principal amount will be paid on the certificates.

Stage 4: Redemption stage :

Payments received from various assets are used to redeem various credit instruments issued during the redemption stage of securitization. This is accomplished by the creator himself. In some cases, a separate servicing agent may be appointed to handle collection work in exchange for a commission. The servicing agent's job will be to discharge the assets by collecting principal and interest and settling the debt instruments.

For example, a housing loan may be collected with principal and interest, and debt instruments such as certificates of deposit may be satisfied as a result.

A pass through certificate, as previously mentioned, can be either with or without recourse. In the case of a recourse certificate, if payment is not made on time, the SPV will hold the originator liable. As a result, SPVs play an important role in resolving investor claims.

Stage 5: Credit rating stage :

As debt instruments issued to the public, the pass through certificate issued by SPV must be credit rated. The financial institutions issuing these debt instruments will be subjected to credit rating, which is legally required in some countries. Debt instruments are traded in the secondary market, particularly for interest swaps.

The following are the various assets which can be used for Securitization by financial institutions.

- Housing loan granted to individuals or institutions
- Hypothecation of vehicle loan
- Leasing finance, especially financial lease
- Supply bills belonging to government departments
- Outstanding on credit cards
- Long-term loans granted to reputed parties.

4.3 SECURITIZATION V/S FACTORING

While both factoring and securitization involve capitalising the company's receivables, there are significant differences between the two. Let us have a clear understanding about the same

Securitization	Factoring
1. Meaning	
Securitization is the process of converting illiquid assets into liquid assets by converting longer duration cash flows into shorter duration cash flows is known as securitization.	Factoring is an agreement between a bank and a company in which the financial institution purchases a company's book debts and pays the money to the company in exchange for receivables.
2. Parties to the Process	
In the case of securitization, there are many investors who invest in the securitized asset.	In the case of factoring, there are two parties involved viz. the bank and the company.
3. Credit Rating	
Since securitization involves many investors, it is necessary to obtain a credit rating before proceeding with receivables securitization.	Since factoring only involves two parties i.e. the bank and the company; no credit rating is required.

4. Duration of the securities involved in transactions	
Securitization is done for medium term or long term receivables of the company.	Factoring is used for short-term receivables ranging from one month to six months.
5. Credit Risk	
Securitization is done without recourse i.e.; Originator will take portion of credit risk.	Factoring can be with or without recourse.
6. Related	
Securitization is generally related to loans	Factoring is related to receivables

4.4 FEATURES OF SECURITIZATION

a. Marketability: The very purpose of securitization is to ensure that financial claims are marketable. As a result, the instrument is designed to be marketable. This is one of the most important characteristics of a securitized instrument, and the others that follow are mostly imported to ensure it. Marketability is comprised of two concepts:

(1) the legal and systematic possibility of marketing the instrument, and

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

Traditional mercantile law took a contemporaneous view of marketable documents in terms of the legal possibility of marketing the instrument. In most jurisdictions around the world, laws dealing with marketable instruments (also known as negotiable instruments) were mostly limited to what was in circulation at the time. If the instrument is loaded on to a few professional investors with no possibility of a liquid market, the purpose of securitization is defeated. A securitized instrument is given liquidity by either introducing it into an organised market (such as securities exchanges) or by one or more agencies acting as market makers, i.e.; agreeing to buy and sell the instrument at either pre-determined or market-determined prices.

b. Merchantable Quality: For a securitized product to be marketable, it must be of saleable quality. This concept is acceptable to merchants in normal trade in the case of physical goods. When applied to financial products, it means that the financial commitments embodied in the instruments are secure to the satisfaction of the investors. Because investor satisfaction is a relative term, the originator of the securitized instrument secures the instrument based on the investors' needs. Evaluation of quality and certification by an independent expert, i.e., rating, is common for widely distributed securitized instruments. The rating is intended to assist the lay investor, who is unlikely to be able to assess the level of risk involved. In the case of receivables securitization, the concept of quality changes dramatically, making rating a universal requirement for securitization. As previously stated, securitization is the purchase by investors of a claim on the debtors of the originator. As a result, the quality of the debtors' claim becomes important, allowing investors to respond purely on the credit rating of the debtors (or a portfolio of debtors) and thus make the instrument completely independent of the originators' own rating.

c. The primary goal of securitization is to distribute the product widely. The extent of distribution desired by the originator is based on a cost-benefit analysis of the costs and benefits that can be realised. Wider distribution has a cost benefit in that the issuer can market the product with a lower return, resulting in a lower financial cost to him. However, a large investor base entails high distribution and servicing costs.

   In practise, retail investors still struggle to understand securitization issues. As a result, the majority of securitizations are privately placed with professional investors. However, retail investors are likely to be drawn into purchasing securitized products in the future.

d. Commoditization: Securitization is a commoditization process in which the basic idea is to take the outcome of this process and place it in the capital market. Thus, the end result of any securitization process, regardless of its application, is the creation of certain instruments that can be traded on the market.

e. Homogeneity: The product must be in homogenous lots in order to be marketable.

4.5 PASS THROUGH CERTIFICATES

4.5.1 MEANING :

A Pass-Through Certificate (PTC) is a financial instrument that allows the certificate's holder or investor to earn a fixed income from the certificate's proceeds. It is issued to the investor in exchange for the asset or mortgage-backed securities that have been pooled together in a single securitized loan package held by the issuer. Such certificates are typically issued by financial institutions such as banks, asset management firms, and insurance companies. Customers of such institutions can obtain a large number of mortgages. These mortgages are bundled into a large investment and sold to other financial institutions such as asset management companies (AMC) or insurance companies. AMCs or Insurance Companies then create a debt instrument and sell it to the investor as a Pass-Through Certificate that delivers fixed income to the investor. To better understand Pass-Through Certificates, one must first understand the concept of Securitization. Banks offer a variety of loans, such as home loans, commercial loans, and auto loans. These loans generate revenue or receivables for lending institutions. As previously stated, securitization is the process of converting these receivables or income into debt instruments that are then sold to individual investors. As previously explained, a Special Purpose Vehicle is established to issue these debt instruments to investors. When an investor purchases these debt instruments, the Special Purpose Vehicle issues them a Pass-Through Certificate.

4.5.2 PARTIES INVOLVED IN THE PASS-THROUGH CERTIFICATE TRANSACTION :

a. The Originator: The transaction's creator is known as the originator. The originator creates the structures required to complete the transaction. The proceeds from the sale of the assets on Originator's books are received by the company.

b. The Special Purpose Vehicle: The Pass-Through Certificates are distributed to investors by the Special Purpose Vehicle. The SPV is typically governed by independent trustees/directors who act in their own best interests as a low-capitalized entity with narrowly defined purposes and activities.

c. The Investor: Individuals and institutional investors, such as Mutual Funds, Insurance Companies, Pension Funds, and other financial institutions, are examples of investors. They buy the certificates from the total pool of receivables and are paid in interest according to the pattern agreed upon by the parties.

4.5.3 BENEFITS OF PASS-THROUGH CERTIFICATE :

Pass-Through Certificates provide numerous advantages to both lenders and issuers

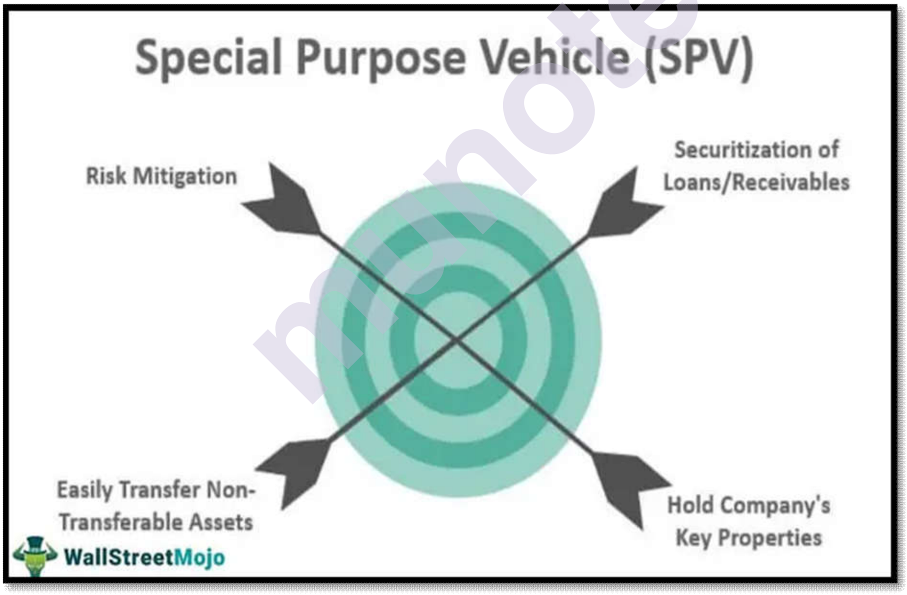
- Lenders can use Pass-Through Certificates to convert illiquid assets into cash-generating liquid assets.
- Securitization allows funds to be transferred from the inefficient debt market to the more efficient capital market.
- Securitization can help a company's debt-equity ratio.
- The underlying assets of Pass-Through Certificates are typically tangible. In the event of a default/failure to repay the loan associated with the object, the lender has the right to seize the item as payment.
- Because banks or other financial institutions package these loans into a securitized investment, such as a Pass-Through Certificate, potential investors may consider the investment to be more stable than other types of investments.
- Originators/Banks: Pass-Through Certificates are issued by originators or banks to protect themselves from risk by transferring their receivables to the government or other financial institutions that buy debt securities. The originators can write off these assets from their books, allowing them to make more loans to borrowers and increase their liquidity.
- Investors: Investing in Pass-Through Certificates can provide a steady stream of fixed income.

4.6 SPECIAL PURPOSE VEHICLE

4.6.1 MEANING :

A Special Purpose Vehicle (SPV), also known as a Special Purpose Entity (SPE) or a Special Purpose Corporation (SPC), is a legal entity formed for a single, well-defined, specific, and narrow purpose. An SPV can only be formed for lawful purposes and cannot be formed for activities that are prejudicial or contrary to public policy. It is primarily a business organisation of individuals or entities who are eligible to join the association. SPVs are primarily used to raise capital by collateralizing future receivables. SPVs are primarily formed to raise capital from the market. SPVs are formed as Companies only and are subject to the provisions, rules, and regulations of the Companies Act, 2013. They are an artificial juridical person. A SPV has the same rights and benefits as a company formed under the Companies Act of 2013. Members of an SPV are typically the companies and individuals who sponsor the entity. SPVs have a limited scope of operation, whereas other companies can carry out all of the activities permitted by the Memorandum of Association (MoA). In the case of an SPV, the MoA is quite narrow. This is done primarily to reassure lenders who are concerned about their investment.

4.6.2 PURPOSE OF SPECIAL PURPOSE VEHICLE



a. Risk Mitigation :

Any company's regular operations involve a significant amount of risk. The establishment of SPVs assists the parent company in legally isolating the risks involved in projects or operations.

b. Securitization of Loans/Receivables :

One of the most common reasons for forming an SPV is to securitize loans and other receivables. In the case of mortgage-backed securities, the bank can simply create an SPV to separate the loans from the other obligations it has. As a result, this special purpose vehicle allows its investors to receive any monetary benefits before the company's other debtors or stakeholders.

c. Easily Transfer Non Transferable Assets :

For the purpose of easily transferring non-transferable assets, an SPV is formed to own such assets. If the parent company wishes to transfer the assets, it sells the SPV as a whole rather than splitting them up or obtaining multiple permits. Such situations arise during mergers and acquisitions processes.

d. Hold Company's Key Properties :

An SPV is sometimes formed to hold the property of a company. When property sales outnumber capital gains for the company, it will choose to sell the SPV rather than the properties. It will assist the parent company in paying taxes on capital gains rather than the proceeds of the property's sale.

4.6.3 ADVANTAGES OF SPECIAL PURPOSE VEHICLE :

a. By forming SPVs, private companies and institutions can gain easier access to capital markets.

b. The most common reason for forming an SPV is to securitize loans; generally, the interest rates payable on securitized bonds are lower than those offered on the parent company's corporate bonds.

c. Since the assets of the company can be held by the SPV, they are safe and secure. When a company experiences financial difficulties, it reduces the credit risk for investors and stakeholders.

d. The SPV's credit rating remains good, so investors are confident in purchasing the bonds.

The company is owned entirely by its shareholders and investors.

4.6.4 LIMITATIONS OF SPECIAL PURPOSE VEHICLE :

a. The company would have to take back the assets if the SPV was closed, which would incur significant costs.

b. The establishment of a special purpose vehicle may limit the parent company's ability to raise funds.

c. Direct control over some of the parent's assets may be diluted, which may reduce the company's ownership at the time of dilution.

d. There is a high risk of severe complications for the companies that created these special vehicles if the regulations change.

e. If the SPV sells an asset, the parent company's balance sheet will suffer.

f. Because it lacks the same market credibility as the sponsor or parent company, the special purpose vehicle may have less access to capital and raise capital from the public.

4.7 SECURITISABLE ASSETS

All financial assets can be securitized by definition, but most loans and other assets that generate receivables (such as commercial or consumer debt) can be converted into a tradeable item with monetary value. Scrutinization assists businesses in raising funds and generating additional income from financial debts or assets, allowing banks to lend out more money while investors diversify their portfolios and earn higher returns.

All of these instruments fall into one of two categories of securities:

Asset-backed securities :

Commercial debt, student loans, Bank loans to businesses, Automobile loans and other non-mortgage loans are examples of asset-backed securities. These are recorded as assets in the books of the financial institution providing the credit. The government has authorised these organisations to pursue the personal assets of defaulters who fail to make timely payments.

Mortgage-backed securities :

Mortgage-backed securities are bonds that are backed by real estate or loans with collateral in the form of a vehicle, for example. Investors who purchase these securities receive interest payments on the underlying debts, as banks frequently request that borrowers send the interest amount directly to these investors.

4.8 BENEFITS OF SECURITIZATION

4.8.1 BENEFITS TO THE ORIGINATORS :

a. Risk Management: Capital can be better used by reconfiguring portfolios to better meet risk-weighted capital adequacy norms.

b. Unblocks Capital: Properly structured securitisation transactions allow originators to focus on the expansion of their franchise rather than the expansion of their capital base. Originators' competitive advantage will be built on efficient marketing, tighter credit management, and lower cost of servicing rather than the ability to raise capital. Competitors' costs and capabilities are no longer muted; rather, they are highlighted and magnified.

c. Overcomes Uncertainty of Profit and increases Profitability: Securitisation directly rewards better credit quality by lowering the costs of credit enhancement and funding. This provides a clear incentive for institutions to improve loan origination quality. In short, originators who ensure higher credit quality are compensated.

d. Better Financial Position: Securitisation allows weaker firms to exit without triggering a downward spiral. Consider the recent performance of the NBFC sector. The emphasis on limiting access to public deposits by NBFCs, regulators, and rating agencies has forced even established NBFCs out of businesses that they have successfully run for decades. If the emphasis had been on assisting these institutions in securitizing their assets, their financials would have improved and fewer risks would have been retained on their balance sheets.

4.8.2 BENEFITS TO THE INVESTOR :

a. Quality Investment: Securitization provides wise investment options that provide investors with dependability by providing mortgaged and asset-backed securities.

b. Better Returns: Through the securitization process, investors gain access to superior returns. It provides securities of companies with a stronger market position.

c. Diversified portfolio: Securitized bonds offer investors a well-diversified portfolio created by pooling the assets of a company. These instruments differ from other types of investments.

d. Less Credit Risk: Because the assets offered through the securitization process are rated by good credit rating agencies, they carry a lower degree of credit risk. In the market, such assets have a higher creditworthiness.

4.8.3 BENEFITS TO THE FINANCIAL SYSTEM :

a. Securitisation divides the lending and funding process into discrete steps, allowing for specialisation and economies of scale. As a result, the system's overall costs are reduced, and consumers pay lower borrowing costs in the end.

b. The economy's asset turnover rate is increasing. Housing Finance Companies, for example, may have insufficient balance sheet size to absorb the entire risk but can securitize loans in excess of what they are comfortable with.

c. As a result of the preceding, the volume of resources available increases significantly. This is significant given that our economy as a whole, and specific sectors like housing and infrastructure in particular, are capital-strapped. Eg: Mortgage securitisation allows a breakaway from the "specialist circuit" of housing finance into a larger pool of resources. Furthermore, securitisation facilitates the flow of funds from capital-rich to capital-poor regions.

d. Risk is redistributed from high default to low default regions in unison with the flow of funds across regions. Securitised instruments reach a broader market, provide more appropriate instruments, and are more resilient to market cycles than conventional debt.

e. Credit, liquidity, interest rate, forex, and catastrophe risks are separated and distributed to market intermediaries best suited to absorb them. As a result, the financial system becomes more stable.

f. The debt market as a whole grows in depth. Other countries' experiences have confirmed this fact. Capital markets can play a more direct role in infrastructure and other long-term projects.

4.9 NEW GUIDELINES ON SECURITIZATION

The Reserve Bank of India (RBI) has issued separate master directions on loan exposure transfer and standard asset securitization. These master directives were issued after taking into account public comments on draft rules issued on June 8, 2020. Based on the examination of the comments received, the Reserve Bank has issued the Master Direction – Reserve Bank of India (Securitisation of Standard Assets) Directions, 2021.

Unless otherwise specified, the provisions of these directions apply to the following entities (collectively referred to as lenders in these directions):

Scheduled Commercial Banks (excluding Regional Rural Banks); All India Term Financial Institutions (NABARD, NHB, EXIM Bank, and SIDBI); Small Finance Banks (as permitted under Operating Guidelines for Small Finance Banks dated October 6, 2016 and as amended from time to time); and All Non-Banking Financial Companies (NBFCs) including Housing Finance Companies (HFCs). These directions will be applicable to securitisation transactions undertaken subsequent to the issue of these directions.

General requirements for securitisation:

A. Assets eligible for securitisation

Lenders, including Indian bank overseas branches, shall not engage in securitisation activities or assume securitisation exposures as described below:

a. Re-securitisation exposures;

b. Structures in which short-term instruments, such as commercial paper, are issued against long-term assets held by

a. Re-securitisation exposures;

b. Synthetic securitisation; and

c. Securitisation with the underlying assets listed below:

i. revolving credit facilities

ii. restructured loans and advances in the specified period;

iii. exposures to other lending institutions;

iv. refinance exposures of AIFIs; and

v. Loans with bullet payments of both principal and interest.

B. Minimum Retention Requirement (MRR)

The MRR is primarily intended to ensure that originators continue to have a vested interest in the performance of securitised assets, allowing them to conduct proper due diligence on loans to be securitised.

a. The MRR for underlying loans with original maturities of 24 months or less shall be 5% of the book value of the loans being securitized.

b. The MRR for underlying loans with original maturities of more than 24 months, as well as loans with bullet repayments, as specified in Clause 6 proviso, shall be 10% of the book value of the loans being securitised.

C. Standards of Origin :

Underwriting standards for securitised exposures should not be less stringent than those applied to exposures retained on the originator's balance sheet.

D. Priorities for payment and observability :

To avoid unexpected repayment profiles during the life of a securitisation, the priorities of payments for all liabilities in all circumstances should be clearly defined at the time of securitisation, and appropriate legal comfort regarding their enforceability should be provided.

E. Maximum Retained Exposures by Originators :

An originator's total exposure to securitisation exposures belonging to a specific securitisation structure or scheme should not exceed 20% of the total securitisation exposures created by such structure or scheme.

F. Issuance and Listing :

The minimum ticket size for securitisation notes issuance shall be Rs.1 crore. Listing of securitisation notes, particularly in relation to specific product classes, such as RMBS, and/or generally above a certain threshold, is recommended but not required. In any case, any offer of securitisation notes to fifty or more people in an issuance would be required to be listed in accordance with Securities and Exchange Board of India regulations.

G. Conditions to be satisfied by the special purpose entity :

The SPE must meet the following requirements:

a. Any transaction between the originator and the SPE must be conducted at arm's length.

b. In its title or name, the SPE and the trustee should not resemble or imply any connection or relationship with the originator of the assets.

c. Except as expressly permitted by these guidelines, the originator should have no ownership, proprietary, or beneficial interest in the SPE. The originator should not own any stock in the SPE.

d. The originator should not have more than one non-veto representative on the SPE board, provided the board has at least four members and independent directors are in majority.

e. If the SPE is established as a trust, the originator shall not exercise control over the SPE and the trustees, either directly or indirectly, and shall not settle the trust deed, if any. The originator is not permitted to have any ownership, proprietary, or beneficial interest in the trustees. The trust deed, if any, should detail the functions to be performed by the trustee, their rights and obligations, as well as the investors' rights and obligations in relation to the securitised assets. The trustee should only perform trusteeship functions with respect to the SPE and should not conduct any other business with the SPE.

These are some of the highlight features of the new guidelines on securitization.

4.10 SUMMARY

Asset securitisation is the process of packaging, underwriting, and selling loan assets and future receivables arising from trade and business activities as securities. The originator (seller of loan assets), trust or company (special purpose vehicle), merchant bankers, rating agencies, and institutional investors, among others, are all involved in the securitisation process. Loan assets and receivables can be securitized either with or without recourse. In the securitisation process, three instruments are used: pass through certificates, pay through certificates, and stripped securities.The first securitisation transaction in India occurred in 1991, when ICICI Ltd. and Citi Bank agreed to securitize ICICI Ltd.'s loan assets. Since then, the securitisation market has grown slowly but steadily. Many commercial banks and mortgage lenders have securitized their loan portfolios. In the near future, India's securitisation market is expected to grow significantly.

4.11 EXERCISE

A. Choose the correct alternative

1. The process of selling trade debts of a client to a financial intermediary is called _________.

(a) Sale (b) Securitisation (c) Factoring (d) Bill Discounting

2. The term _____ is defined as a central location for keeping securities on deposit.

(a) Depository (b) Instrument (c) Institutions (d) Broker

3. The Certificate of Initial Registration for an underwriter with Securities and Exchange Board of India remains valid for how many years?

(a) 3 (b) 4 (c) 5 (d) 7

4. There are ________ categories of Merchant bankers.

(a) two (b) three (c) four (d) five

5. For the assets with original maturity of more than 24 months, the minimum retention requirement is __________ of the cash flows.

(a) 5% (b) 10% (c) 12% (d) 15%

Answer: 1 – (b); 2 – (a); 3 – (c); 4 – (c); 5 – (b)

Answer in Brief :

1) What exactly do you mean by "securitisation"?

2) Explain to originators and investors the various benefits of securitisation.

3) Describe the securitisation process.

4) Define the roles of the various parties involved in the securitisation process.

5) What are the various securitisation instruments?

6) Describe the characteristics of asset securitization as a structured financial product in the Indian market.

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5

HIRE PURCHASE FINANCE

Unit Structure :

5.0 Learning Objectives

5.1 Hire Purchase System: An Introduction

5.2 Meaning of Hire Purchase

5.3 Hire Purchase Agreement

5.4 Characteristics of Hire Purchase System

5.5 Terminologies Used In Hire Purchase Agreement

5.6 Advantages And Disadvantages of Hire Purchase System

5.7 Distinguish Between Lease Financing And Hire Purchase

5.8 Understanding Instalment Credit

5.9 Sources Of Finance In India

5.10 Exercise

5.0 LEARNING OBJECTIVES

- Understand the basics of Hire Purchase system
- Understanding the advantages and disadvantages of Hire Purchase system
- Clearly distinguish between Lease financing and hire purchase
- Understand the intricacies of instalment credit and its types
- Learn in detail the different sources of finance in India

5.1 HIRE PURCHASE SYSTEM: AN INTRODUCTION

The demand for luxurious consumer goods has recorded an upsurge in the last decade, but the real increase in the purchasing power has failed to grow parallelly. This gap between demand and actual purchasing power has given rise to hire purchase system.

Under hire purchase system the hire purchaser can get the full possession of goods immediately on payment of the installment over the stipulated time specified in the agreement. This enables the hire purchaser to fulfill his demand without making the full payment at once. However, the ownership is transferred from the hire vendor to the hire purchaser only after the payment of the last installment. In this case even if the last installment is defaulted the hire vendor possess the right to repossess the goods without compensating the hire purchaser.

5.2 MEANING OF HIRE PURCHASE

Hire purchase is a method of purchasing expensive consumer items in which the buyer makes a down payment and then pays the remainder plus interest in instalments. In the United Kingdom, the term hire purchase is often used, although in the United States, it is more commonly known as an instalment plan. However, there may be a distinction between the two: With some payment arrangements, the buyer obtains ownership rights as soon as the contract with the seller is signed. Ownership of the product is not officially transferred to the buyer until all payments have been made under a hire purchase arrangement. Hire purchase agreements are similar to rent-to-own deals in that the lessee has the option to purchase at any time throughout the contract, such as rent-to-own autos. Hire purchase, like rent-to-own, can help consumers with bad credit by spreading the expense of pricey things that they would otherwise be unable to pay over a longer period of time. However, it is not the same as a credit extension because the customer does not technically own the goods until all payments are made.

Hire purchase arrangements provide more protection to the seller than other sales or leasing options for unsecured items because ownership is not transferred until the end of the agreement. This is because the things can be repossessed more readily if the buyer fails to make the repayments.

5.3 HIRE PURCHASE AGREEMENT

A hire purchase agreement is one in which goods are let on hire and the hire has the option to purchase them in accordance with the terms of the agreement, and it includes agreements in which:

1. Possession of goods is delivered by the owner thereof to a person or condition that such person pays the agreed amount in periodic instalments.

2. The property in the goods will pass to such a person upon payment of the final instalment.

3. Such a person has the right to cancel the agreement at any time before the property is transferred. Each Hire Purchase Agreement must be in writing and signed by all parties involved.

5.4 CHARACTERISTICS OF HIRE PURCHASE SYSTEM

1. The seller delivers the goods to the buyer.

2. Buyer agrees to pay the hire purchase price (i.e., cash price + interest)

3. Instalments are treated as hire charges until the last instalment is paid.

4. Following the payment of the final instalment, ownership is transferred to the buyer.

5. In the event of a buyer payment default, the seller has the right to repossess the goods, as ownership remains with the seller until the final instalment is paid.

   Because of the hire purchase nature of these transactions, transactions with the aforementioned characteristics are referred to as hire purchase transactions.

5.5 TERMINOLOGIES USED IN HIRE PURCHASE AGREEMENT

1. Hire Purchaser: He is buyer in hire purchase agreement.

2. Hire Vendor: He is seller in a hire purchase agreement.

3. Cash Price: It is the amount to be paid for outright purchase in cash.

4. Down Payment: It is the of initial payment payable by the hire purchaser at the time of entering into a hire purchase agreement.

5. Hire Purchase Price: It is the total amount payable by the hire purchaser to the hire vendor of goods are purchased under the hire purchase system.

5.6 ADVANTAGES AND DISADVANTAGES OF HIRE PURCHASE SYSTEM

Advantages of Hire Purchase System

1. Hire purchase agreements, like leasing, enable enterprises with inefficient working capital to deploy assets.

2. Since the payments are recorded as expenses, it may be more tax-efficient than traditional loans - though any savings will be offset by any tax gains from depreciation.

3. Hire purchase agreements can be used by businesses that require expensive machinery, such as construction, manufacturing, plant hire, printing, road freight, transport, and engineering, as well as startups with little collateral to obtain lines of credit.

4. A hire purchase arrangement can boost a company's return on assets and return on capital employed (ROCE) (ROA). This is because the corporation does not have to incur as much debt to acquire assets.

Disadvantages of Hire Purchase System

1. Hire purchase agreements are frequently more expensive in the long term than paying in full for an asset purchase.

2. This is due to the fact that they can have substantially higher interest rates. They can also represent more administrative complexity for businesses.

3. Furthermore, hire purchase and instalment systems may entice individuals and businesses to purchase products that are beyond their means. They may also end up paying an extremely high interest rate, which is not required to be declared publicly.

4. As long as the requisite minimum payments have been made, hire purchase customers can return the products, declaring the original agreement unenforceable.

5. Purchasers, on the other hand, suffer a significant loss on returned or repossessed products since they lose the money, they have paid toward the purchase up to that point.

5.7 DISTINGUISH BETWEEN LEASE FINANCING AND HIRE PURCHASE

Following points showcase the difference between Hire purchase and Lease financing

Characteristics	Leasing	Hire purchasing
ownership	With the finance company, the lessor	It is transferred to the hirer on the payment of the last installment
Depreciation	Lessor, and not the lessee is entitled to claim depreciation tax shield	The hirer is entitled to claim depreciation tax shield
Capitalization	Done in the books of lessor	Done in the books of hirer
Payments	The entire lease payments are eligible for tax computation in the books of lessee	Only the hire interest is eligible for tax computation in the books of hirer
Magnitude	Used as a source of finance, usually for acquiring high cost assets such as machinery, ships etc	Used as a source of finance, usually for acquiring low cost assets such as automobiles, office equipments etc
Maintenance of asset	Lessee in case of financial, Upkeep is the responsibility of the lessor in the case of operating lease	It is the hirer's responsibility to ensure the maintenance of the asset bought
Nature of asset	Asset- as a fixed asset of the lessor	Shows the asset either as a stock in trade or as receivables
Down payment	No down payment required	It is required

5.8 UNDERSTANDING INSTALMENT CREDIT

Instalment credit is just a loan that you make fixed payments on over a specified time period. The loan's interest rate, repayment duration, and fees will all determine how much you pay each month. Mortgages, vehicle loans, and personal loans are all examples of instalment loans. Timely payments on instalment loans, like other credit accounts, can help you earn and maintain good credit. If you qualify for an instalment loan, your credit score will determine your interest rates and conditions. When you take out an instalment loan, you borrow a certain amount of money and make fixed monthly payments until the debt is paid off. An instalment loan might be repaid over months or years. Its interest rate could be constant or variable, which means it could rise or fall in the future. Additional expenses, such as origination or late fees, may apply to instalment loans. Before taking out an instalment loan, it's critical to carefully read the loan agreement to understand exactly how much you'll pay.

There are different types of instalment loans. Let us discuss a few of them;

Mortgage: Mortgage is a loan used to purchase a home. The house itself serves as security, so if you fail to make payments, your lender may repossess it. Mortgages are typically available in 10, 15 or 30-year durations, with either a fixed or adjustable interest rate. You'll also have to pay closing expenses, fees, and maybe private mortgage insurance if your down payment is less than 20% of the home's purchase price.

Car loan: Car loans, like mortgages, often need a down payment. The more your down payment, the less your instalment loan will be. A automobile loan, like a mortgage, uses your vehicle as collateral, which means your car could be repossessed if you do not pay the loan as agreed.

Personal loan: A personal loan can be used for a variety of objectives, such as debt consolidation or financing a home improvement. Personal loans are unsecured, which means they are not secured by collateral, such as mortgages or auto loans. As a result, depending on your credit score, their interest rates might be as high as 36%.

Quite often, instalment loans are confused with Revolving credit. Let us understand the difference between the two.

A revolving credit account, unlike an instalment credit account, allows you to carry a balance from month to month. Revolving accounts include credit cards and home equity lines of credit.

You determine how much to charge each month and how much to repay on a revolving credit account. When you carry a balance from month to month, interest is added to your overall balance. While you are not forced to pay off the entire balance each month, the lender will offer you with a credit limit, or the maximum amount you can charge. It will also assign you a minimum monthly payment, which may vary according on your balance. Your credit score may decrease if you miss payments or are late.

Instalment loans can help you attain some of the most frequent and desired financial goals, such as owning a home or a car, by allowing you to repay a purchase over time. Making on-time instalment loan payments and repaying the debt as agreed will improve your credit. However, like with any sort of credit, only seek out loans that you truly require, and check your credit score before applying to see what interest rates you may be eligible for. Take the effort to enhance your credit score if necessary before applying to guarantee you get the best rate and conditions possible.

5.9 SOURCES OF FINANCE IN INDIA

Typically, a household not only invests from its own savings, but it also has excess that it lends to other units through financial institutions. Banks, capital markets, and so on.

The business's savings, which include depreciation and retained earnings, are typically less than its investment. As a result, it borrows from financial institutions as well. The government, too, finances a portion of its investment using cash generated internally.

These are the results of a surplus of tax and other income over consumption spending + transfers. If and when a shortfall occurs, it borrows from the financial system. Approximately half of all investment is self-financed.

1. Equity and Bonds - A significant portion of the funding for fixed investments [buildings, machinery, etc.] comes from various types of equity or shares, such as ordinary, cumulative, and non-cumulative preference shares. These shares carry varying degrees of risk and are tailored to the temperament of different investors. The recent tendency is to issue shares in ten rupee denominations to allow the greatest number of individuals to engage in providing long-term finance. The creditworthiness of industry promoters and the profitability of industries determine how much money savers put in stocks. In this manner, industries are not burdened with interest, and hence do not become embroiled in issues as a result of this during a recession or depression.

2. Internal Sources of Finance - The saving of the unit itself is one source that is quantitatively significant. It could be a family, a business, or the government. Typically, a household not only invests from its own savings, but it also has excess that it lends to other units through financial institutions. Banks, capital markets, and so on. The business's savings, which include depreciation and retained earnings, are typically less than its investment. As a result, it borrows from financial institutions as well. The government, too, finances a portion of its investment using cash generated internally. These are the results of a surplus of tax and other income over consumption spending + transfers. If and when a shortfall occurs, it borrows from the financial system.

3. Public Deposits - Public deposits are another source. It is also a debt product, mostly used for short-term financing. People under this system deposit their money with these companies or managing authorities for a period of six months, a year, two years, or three years. Depositors receive a fixed rate of return. They have the right to request a refund at any time. Companies need this money to meet their working capital requirements. However, this source of funding is untrustworthy because depositors can request a refund at any time. And if the refund occurs at a time when a corporation is in desperate need of finances, things become even more complicated.

4. Loans from banks - Commercial banks can also give funds for short-term needs or working capital. Loans are made with the assurance of government securities and company shares. Overdraft and credit limit loans are made available. Commercial banks are often hesitant to invest in stock purchases. The reason for this is that most public deposits are for a limited period of time, and banks cannot afford to incur any risks by investing public funds in stocks. They can, however, do something by purchasing corporate debentures.

5. Managing agency system - Managing agents provided a crucial service in the promotion of industries inside the country in the past when there was a severe scarcity of industrial finance and an almost complete lack of financial institutions, and the capital market in the true sense did not even exist. Of course, it is true that the majority of their funds were used to develop consumer products industries. However, over time, the system developed flaws and became beset by major deficiencies. The management of so many units, both good and bad, and the production of a wide range of products resulted in certain ills. The payments that managing agents collected for themselves, such as interest on their money, commission for their services, and so on, were excessive and out of proportion to the firms' paying ability and/or the work accomplished by those agents. For these reasons, the government outlawed the system in 1970.

6. Indigenous Bankers - Despite the emergence of new financial institutions, indigenous bankers provide financial assistance to a few large-scale companies, particularly during times of stress, for both fixed capital and working capital. However, they have primarily financed small-scale businesses. In the absence of adequate institutional finance, many industries have been forced to rely on indigenous bankers. These banks impose exorbitant interest rates, making financing an expensive proposition. However, the role of these banks, even as a source of funding for small businesses, is dwindling.

7. Development Finance Institutions - These institutions, which were established with the assistance of the government to fill a void in industrial finance and to advance the goal of planning, cater to the needs of both large and small companies. Industrial Development Bank of India, Industrial Finance Corporation of India, Unit Trust of India,

and General Insurance Corporation of India, Industrial Reconstruction Bank of India, State Financial Corporations, and State Industrial Development Corporations are the new institutions that provide industrial finance. These institutions provide a large amount of funding for the establishment of new industries, as well as for addressing their various needs in various forms. These also ensure and monitor the use of money in predetermined ways. As such, they are consistent with the current industrial development scenario.

8. Foreign Capital - External capital has been used to supplement domestic finance in satisfying the needs of industrial financing, primarily for long-term purposes. This has taken several shapes. Foreign help (concessional loans) from foreign countries and foreign institutions (such as the World Bank) has been extended to the government. Some of this aid has also gone to the private sector. A portion of foreign capital have come through foreign corporations with Indian subsidiaries in our country or Multinational Corporations with Indian branches. Some international companies have contributed capital as part of direct investments or collaborations with Indian firms. Non-resident Indians have also made investments in partnership with Indians. Thus, there are numerous sorts of industrial finance. And so are financial instruments. Several of them are modems. Shares, debentures, and financial institution loans are examples. The old ones, such as public deposits, managing agents' finances, and indigenous bankers' finances, are on the decline. This is correct, as these are neither sufficient nor acceptable for satisfying the needs of current industrial growth.

5.10 EXERCISE

Write a note on:

1. Parties to hire purchase agreements
2. Installment credits

1. What is hire purchase agreement? Which are the terminologies used in hire purchase agreements?
2. State the advantages and disadvantages of hire purchase agreements.
3. Distinguish between hire purchase and lease financing.
4. What is installment credit? Explain few types of installment credit?
5. Write a note on sources of finance in India.

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HOUSING FINANCE

Unit Structure :

6.0 OBJECTIVES

i) Learners will learn in conceptual and theoretical framework of housing finance in India

ii) Learners will understand the role of National Housing Bank.

iii) Learners will be exposed to facts and data as adapted from RBI.

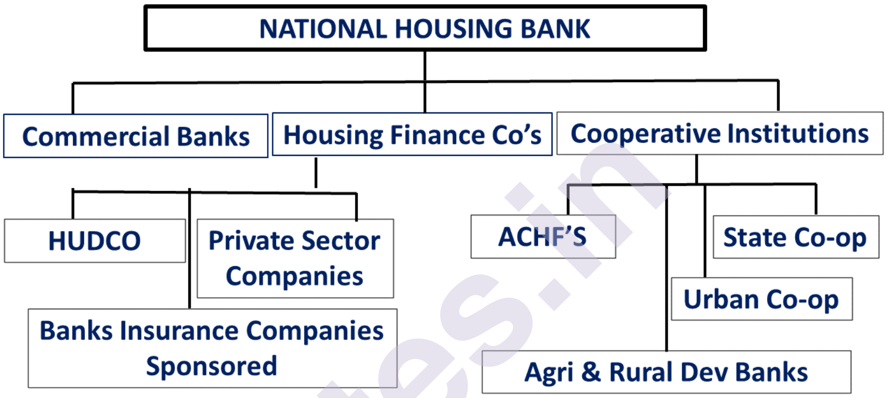
6.1 HOUSING FINANCE : INTRODUCTION & MEANING

With improved penetration of housing finance during the last decade, the Real Estate Industry in India has turned out to be the second largest growing sector with providing employment to millions. Increasing demand due to nuclearization of families, High Disposable Income, Incentives from government and increased verticals of housing finance availability has led to the growth of the housing finance industry in its length and breadth. Pradhan Mantri Awas Yojana–Urban (PMAY-U) further gave an impetus to the this sector. The home loan market recorded a CAGR of 18% during the fiscal period of 2014-19 with low priced housing segment contributing to 80% market share of housing finance market. This rising trend is witnessed not only in top 50 districts of the country but also smaller districts of the country with nuclearization of families acting as major growth driver.

Institutional Framework of Housing Finance in India

National Housing Bank is the apex institution that acts as refinancing agency, the regulatory body in terms of housing finance and at the same time acts as an ancillary body to state and public authorities aligned towards housing and development project. The entire ecosystem is broadly categorized into Commercial Banks, Housing Finance companies and co-operative institutions that directly acts as financial agents to direct consumers and project finance intermediaries. The entire housing finance ecosystem can be glanced with the help of below tree diagram:

Institutional Framework of Housing Finance in India.



Source: Lalita Mutreja, CC BY-SA 4.0, via Wikimedia Common

6.2 STATUTORY REGULATORY FRAMEWORK OF HOUSING FINANCE COMPANIES IN INDIA (AS ADAPTED FROM RBI)

Principal business and housing finance :

1. "Housing finance company" shall mean a company incorporated under the Companies Act, 2013 that fulfils the following conditions:

a. It is an NBFC[1] whose financial assets, in the business of providing finance for housing, constitute at least 60% of its total assets (netted off by intangible assets). Housing finance for this purpose shall mean providing finance as stated at clauses (a) to (k) of Para 2 below.

b. Out of the total assets (netted off by intangible assets), not less than 50% should be by way of housing financing for individuals as stated at clauses (a) to (e) of Para 2 below.

2. "Housing Finance" shall mean financing, for purchase/ construction/ reconstruction/ renovation/ repairs of residential dwelling units, which includes:

a. Loans to individuals or group of individuals including co-operative societies for construction/ purchase of new dwelling units.

b. Loans to individuals or group of individuals for purchase of old dwelling units.

c. Loans to individuals or group of individuals for purchasing old/ new dwelling units by mortgaging existing dwelling units.

d. Loans to individuals for purchase of plots for construction of residential dwelling units provided a declaration is obtained from the borrower that he intends to construct a house on the plot within a period of three years from the date of availing of the loan.

e. Loans to individuals or group of individuals for renovation/ reconstruction of existing dwelling units.

f. Lending to public agencies including state housing boards for construction of residential dwelling units.

g. Loans to corporates/ Government agencies for employee housing.

h. Loans for construction of educational, health, social, cultural or other institutions/ centres, which are part of housing projects and which are necessary for the development of settlements or townships (see note below).

i. Loans for construction meant for improving the conditions in slum areas, for which credit may be extended directly to the slum-dwellers on the guarantee of the Central Government, or indirectly to them through the State Governments.

j. Loans given for slum improvement schemes to be implemented by Slum Clearance Boards and other public agencies.

k. Lending to builders for construction of residential dwelling units.

All other loans including those given for furnishing dwelling units, loans given against mortgage of property for any purpose other than buying/ construction of a new dwelling unit/s or renovation of the existing dwelling unit/s as mentioned above, will be treated as non-housing loans and will not be falling under the definition of "Housing Finance".

Note: Integrated housing project comprising some commercial spaces (e.g. shopping complex, school, etc.) can be treated as residential housing, provided that the commercial area in the residential housing project does not exceed 10 per cent of the total Floor Space Index (FSI) of the project.

3. The above criteria will be applicable from the date of this circular. Registered HFCs which do not currently fulfil the criteria as specified in Para 1, but wish to continue as HFCs, shall be provided with the following timeline for transition:

Timeline	Minimum percentage of total assets towards housing finance	Minimum percentage of total assets towards housing finance for individuals
March 31, 2022	50%	40%
March 31, 2023	55%	45%
March 31, 2024	60%	50%

Such HFCs shall be required to submit to the Reserve Bank, a Board approved plan within three months including a roadmap to fulfil the above-mentioned criteria and timeline for transition. HFCs unable to fulfil the above criteria as per the timeline shall be treated as NBFC – Investment and Credit Companies (NBFC-ICC) and they will be required to approach the Reserve Bank for conversion of their Certificate of Registration from HFC to NBFC-ICC. Application for such conversion should be submitted with all supporting documents meant for new registration together with an auditor's certificate on principal business criteria and necessary Board resolution approving the conversion.

Net Owned Fund (NOF) Requirement :

4. In exercise of the powers conferred by clause (b) of sub-section (1) of Section 29A of the National Housing Bank Act, 1987, and all powers enabling it in that behalf, the Reserve Bank hereby specifies Rupees twenty crore as the minimum net owned funds required for a company to commence housing finance as its principal business or carry on the business of housing finance as its principal business.

   Provided that a housing finance company holding a Certificate of Registration (CoR) and having net owned fund of less than Rupees twenty crore, may continue to carry on the business of housing finance, if such company achieves net owned fund of Rupees fifteen crore by March 31, 2022 and Rupees twenty crore by March 31 2023.

5. It will be incumbent upon such HFCs whose NOF currently stands below Rupees twenty crore, to submit a statutory auditor's certificate to Reserve Bank within a period of one month evidencing compliance with the prescribed levels as at the end of the period indicated above. HFCs failing to achieve the prescribed level within the stipulated period shall not be eligible to hold the Certificate of Registration (CoR) as HFCs and registration for such HFCs shall be liable to be cancelled. Such companies, who wish to be treated as NBFC – Investment and Credit Companies (NBFC-ICCs), will be required to approach RBI for conversion of their CoR from HFC to NBFC-ICC. Application for such conversion should be submitted with all supporting documents meant for new registration together with an auditor's certificate on principal

business criteria (PBC) and necessary Board resolution approving the conversion.

Applicability of directions issued by Reserve Bank

6. The following master directions, as amended from time to time, shall apply mutatis mutandis to all HFCs:

a. Master Direction – Monitoring of Frauds in NBFCs (Reserve Bank) Directions, 2016.

b. Master Direction – Information Technology Framework for the NBFC Sector dated June 08, 2017.

7. The following instructions, as further detailed in the Appendix shall apply *mutatis mutandis* to all HFCs:

a. **Definition of public deposits** as contained in Master Direction – Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 2016. Additionally, any amount received from NHB or any public housing agency shall also be exempted from the definition of public deposit.

b. **Implementation of Indian Accounting Standards:** HFCs shall maintain a prudential floor in respect of impairment allowances and follow instructions on regulatory capital.

c. **Loans against security of shares:** HFCs lending against the collateral of listed shares shall maintain a Loan to Value (LTV) ratio of 50% for loans granted against the collateral of shares. Any shortfall in the maintenance of the 50% LTV occurring on account of movement in the share prices shall be made good within seven working days.

d. **Loans against security of single product – gold jewellery:** HFCs shall maintain a Loan-to-Value (LTV) Ratio not exceeding 75 per cent for loans granted against the collateral of gold jewellery, and shall put in place a Board approved policy for lending against gold.

e. **Levy of foreclosure charges:** HFCs shall not impose foreclosure charges/ pre-payment penalties on any floating rate term loan sanctioned for purposes other than business to individual borrowers, with or without co-obligant(s).

f. **Guidelines on Securitization Transactions and reset of Credit Enhancement:** HFCs shall carry out securitization of standard assets and transfer of assets through direct assignment of cash flows and the underlying securities. In doing so, HFCs, among other things, shall conform to the minimum holding period (MHP) and minimum retention requirement (MRR) standards.

g. **Managing Risks and Code of Conduct in Outsourcing of Financial Services:** It is imperative for HFCs outsourcing their activities that they ensure sound and responsive risk management practices for effective oversight, due diligence and management of risks arising from such outsourced activities.

h. **Guidelines on Liquidity Risk Management Framework:** All non-deposit taking HFCs with asset size of □100 crore and above and all deposit taking HFCs (irrespective of asset size) shall pursue liquidity risk management, which inter alia should cover adherence to gap limits, making use of liquidity risk monitoring tools and adoption of stock approach to liquidity risk. It will be the responsibility of the Board of each HFC to ensure that the guidelines are adhered to. The internal controls required to be put in place by HFCs as per these guidelines shall be subject to supervisory review.

i. **Guidelines on Liquidity Coverage Ratio (LCR):** HFCs shall maintain a liquidity buffer in terms of LCR, which will promote resilience of HFCs to potential liquidity disruptions by ensuring that they have sufficient High Quality Liquid Asset (HQLA) to survive any acute liquidity stress scenario lasting for 30 days. Guidelines on LCR will be applicable to HFCs as per the following timeline:

i) All non-deposit taking HFCs with asset size of □10,000 crore & above, and all deposit taking HFCs irrespective of their asset size:

From	**December 01, 2021**	**December 01, 2022**	**December 01, 2023**	**December 01, 2024**	**December 01, 2025**
Minimum LCR	50%	60%	70%	85%	100%

ii) All non-deposit taking HFCs with asset size of □5,000 crore & above, but less than □10,000 crore with the timeline as:

From	**December 01, 2021**	**December 01, 2022**	**December 01, 2023**	**December 01, 2024**	**December 01, 2025**
Minimum LCR	30%	50%	60%	85%	100%

8. **Exposure of HFCs to group companies engaged in real estate business :** In case of companies in a group engaged in real estate business, HFCs may undertake exposure either to the group company engaged in real estate business or lend to retail individual home buyers in the projects of such group companies. In case HFC prefers to undertake exposure in group companies, such exposure by way of lending and investing, directly or indirectly, cannot be more than 15% of owned fund for a single entity in the group and 25% of owned fund for all such group entities. The HFC would in all such cases follow arm's length principles in letter and spirit.

6.3 CHALLENGES CONFRONTED BY HOUSING SECTOR FINANCE IN INDIA

Every Rs one lakh home loan adds Rs 2.9 lakhs to the economy, such is the importance of housing finance both at the demand and supply side. However, in midst of COVID 19 the challenges of Housing Finance Sector have been wide and deeper. The turbulence experienced in both the real estate construction sector as well as consumer's affordability have led to declined in the housing sector finance. Following are few challenges confronted by the Housing Sector Finance in India

1. Credit Growth: The credit growth is expected to slower down in the coming period of 2-3 years due to slip off of cashflows of the consumers due to reduction in pays, job loss, adding safety cushion etc. On other hand due to increase in steel prices and delays in existing construction the real sector too has been patchy. This has led to delay in loan disbursements and addition in credit growth has received a severe blow.

2. Lower Profitability: With increased in non-performing assets and restructuring plans, the over profitability margins have witnessed a downfall.

3. Fiscal Liquidity crunch: With the collapse of DHFL, the fiscal liquidity crunches the risk aversion has been high leading to deceleration of housing sector credit.

4. Increased Costs: The increased costs of the HFC's have further led to decline in the loan borrowings further widening the income and revenue gaps.

5. Decline in Asset Quality: The asset quality has witnessed a weak credit appraisal and decline in credit backing due to erratic macro-economic parameters coupled with absence of stern bankruptcy laws. The COVID wave has further impacted the asset quality.

6.4 HOUSING INDUSTRY IN INDIA: SWOC ANALYSIS

Strengths:

1. Huge Finance Market: The housing finance industry holds total outstanding loan amount of Rs 20.4 trillion (RBI Report 2020) out of which housing finance companies occupy the dominant position.

2. Strong Institutional Framework: Indian housing finance ecosystem is well carved serving right at grassroot levels by housing finance companies, co-operative banks, NBFC's and commercial banks who serve the customers while at the other end, NHB provides refinance to these financing institutes.

3. Favorable Regulatory Framework: Recent reforms in tax wherein two residential properties are now allowed by an individual as well refund in stamp duty and GST for the purchase of the first residential property have further boosted this sector.

Weakness :

1. Huge NPA: With present scenario wherein income levels have shrinked, the existence of NPA's have increased pressurizing the credit growth of the lending institutes.

2. Stability in Interest Rates: Frequent fluctuations in repo rate and reverse repo rate lead to changes in home loan interest rates.

Opportunities :

1. Nuclear Family Systems: With increasing nuclear family system being practiced, there is an upsurge in the demand of home loans.

2. Increased in Disposable Income: Increased income of the individuals and existence of more working members in the family have led to increased capacity of families to buy home.

3. Increased Penetration: Increased penetration of housing finance with availability of wide consortium of banks, NBFC's, housing finance companies that at the same time empower customers with improved bargaining power.

Challenges :

1. High Inflation: The inflation rates have been ever rising impacting the entire ecosystem of fiscal and public finances.

2. Uncertainty: Due to presence of COVID -19 the element of uncertainty and fear amongst the individual has increased. This has led to keep increased in demand for liquidity and has also impacted loan paying capacity of an individuals.

6.5 NATIONAL HOUSING BANK: INTRODUCTION

With a vision to promote in stability in housing finance sector, the Government Of India enacted the National Housing Bank Act, 1987 which led to the formation of National Housing Bank on July 8, 1988 as an apex institute with entire paid up capital subscribed by the Reserve Bank of India. It's head office is located in New Delhi.

The Preamble of the National Housing Bank Act, 1987 describes the basic functions of the NHB "… **to operate as a principal agency to promote housing finance institutions both at local and regional levels and to provide financial and other support to such institutions and for matters connected therewith or incidental thereto** …"

Source : National Housing Bank Act, 1987

The broad objectives of the NHB are as below-

1. To act as facilitator and refinance to promote housing.
2. To provide a robust, healthy, cost-effective housing finance system in the country.
3. To integrate and align the housing finance into the mainstream of financial system of the country.
4. To make available housing finance at affordable rates.
5. To penetrate deeper across the regions and income groups for assuring availability of housing finance services.

The major milestones achieved are stated as below –

1. In 1990-91: NHB was recognized as Public Financial Institution
2. In 1992-93: With an aim to reach out to the large population, it launched the refinance schemes for Slum Development Projects.
3. In 1994-95: Launched Unsecured Bonds and established prudential norms with Housing Finance Companies.
4. In 2002-03: Defined Liberalized Refinance Scheme for Housing Loans.
5. In 2006-07: Established the first housing index of India i.e NHB Residex.
6. In 2007-08 Established finance to Rural Housing Fund with NHB.
7. In 2009-10: Formed Asia Pacific Union for Housing Finance
8. In 2012 NHB was awarded with Skoch Financial Inclusion Awards for its project, “Energy Efficient New Residential Housing in India.
9. In 2014-15 : It was appointed as Nodal agency under Pradhan Mantri Awaz Yojana
10. In 2017-18: The National Housing Bank Act, 1987 was amended under the Finance Act, 2018 wherein the share capital was transferred from RBI to Central Government.

6.6 DISBURSEMENT OF FUNDS UNDER REFINANCE SCHEMES OF NHB.

DISBURSEMENTS BY NATIONAL HOUSING BANK UNDER ITS REFINANCE SCHEMES

₹ Crore)

Year (July-June)	Housing Finance Companies		Banks		Others		Total	
	Disbursements	Outstanding	Disbursements	Outstanding	Disbursements	Outstanding	Disbursements	Outstanding
1	2	3	4	5	6	7	8	9
2000-01	762	3344	106	150	141	830	1008	4325
2001-02	719	3750	85	211	219	984	1024	4946
2002-03	1772	4629	798	935	140	1044	2710	6607
2003-04	1851	4736	1284	2259	118	1056	3253	8052
2004-05	2623	4928	5404	6720	35	819	8062	12467
2005-06	1840	4888	3791	10428	2	952	5633	16268
2006-07	1210	4915	4280	14011	10	348	5500	19274
2007-08	1189	4750	7398	11758	0	268	8587	16776
2008-09	7055	10324	3799	5972	0	166	10854	16461
2009-10	3544	11146	4335	8153	229	505	8108	19804
2010-11	3309	10891	8414	11037	312	653	12035	22581
2011-12	5302	13288	8994	14799	93	477	14390	28564
2012-13	7693	16402	9848	17268	0	328	17541	33998
2013-14	9633	22086	8223	17137	0	215	17856	39438
2014-15	7390	24300	14367	19555	90	176	21847	44031
2015-16	10852	29735	10678	23172	60	157	21590	53064
2016-17	16779	40277	5855	14335	50	193	22684	54804
2017-18	11508	38116	13363	20416	50	193	24921	58725
2018-19	21736	50145	3391	18786	50	163	25177	69094
2019-20	27551	64653	3707	17951	0	149	31258	82753
2020-21	26905	71389	7325	13135	0	149	34230	84673

Notes : 1. Data for 2020-21 are provisional.

2. Banks include Private Sector, Public Sector, Foreign Banks and Regional Rural Banks (RRBs).

3. Others include Urban Co-operative Banks (UCBs), Agriculture and Rural Development Banks (ARDBs) and Apex Co-operative Housing Finance Societies (ACHFs).

4. NHB follows July-June financial year.

Source: National Housing Bank.

6.7 SUMMARY QUESTIONS

1. Write a SWOC analysis of Housing Finance sector in India
2. Write in brief about National Housing Bank of India
3. Critically evaluate the housing finance sector in India in light with its growth prospects and challenges.
4. Discuss in brief the regulatory and statutory norms of Housing Finance in India as laid down by RBI.

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7

STOCK BROKING

Unit Structure :

7.0 LEARNING OBJECTIVE

After reading this learner will be able to:

- Understand the role of the stock broker and sub-broker.
- Discuss duties and responsibilities of the broker and sub-broker.
- Explain the code of conduct of the broker and sub-broker.

7.1 INTRODUCTION

A stock market is an organised market in which securities are traded. It is made up of investors, brokers or stock exchange members, stock exchanges, companies, and regulatory authorities. Securities traded on the stock exchange include a variety of long-term financial instruments issued by corporations to meet their financial obligations. A recognised stock exchange is defined as the one, which is recognised by the Government. Every stock exchange provides a platform between the general public and corporate entities seeking to raise long-term resources. As a result, it is accountable for:

Maintaining fairness in stock exchange trading,

Maintaining discipline in the members' activities

Maintain operational transparency and efficiency.

Stock exchange transactions can be made only through the member. So let us understand about the broker and sub broker in detail in this unit.

7.2 STOCK BROKER

Stock broker is defined as "stock broker" means a member of a stock exchange. A stockbroker is a regulated financial market representative who facilitates the buying and selling of securities on behalf of financial institutions, investor clients, and firms. A stockbroker may also be referred to as a registered representative or a broker. Stock trading, as well as the purchase and sale of stocks on national stock exchanges, is typically handled by a stockbroker. Stockbrokers deal with both institutional and retail customers. A stockbroker's primary responsibility is to obtain and execute buy and sell orders. To invest in securities, many market participants rely on stockbrokers' knowledge and expertise about market dynamics. A stockbroker can work independently or as part of a brokerage firm.

7.2.1 APPLICATION FOR REGISTRATION OF STOCK BROKERS

- A stock broker must submit an application for the issuance of a certificate in 'Form A' to the stock exchange or exchanges to which he is admitted as a member.

- The stock exchange shall forward the application form to the Board as soon as possible but no later than thirty days after receipt.

- Any application made by a stock broker prior to these regulations came into force in the 'Form A' shall be treated as an application made in pursuance of sub-regulation (1) and dealt with accordingly provided that the requirement of the payment of fees shall be the same as is referred to in sub-regulation (1) of regulation 10.

7.2.2 FURNISHING OF INFORMATION, CLARIFICATION

The Board may require the applicant to provide additional information or clarifications regarding securities transactions and related matters in order to consider the application for a certificate. If required, the applicant or its principal officer must appear before the Board for personal representation.

7.2.3 CONSIDERATION OF APPLICATION

For the purpose of granting a certificate, the Board shall consider all matters relating to buying, selling, or dealing in securities, particularly whether the stock broker—

(a) is eligible to be admitted as a member of a stock exchange;

(b) has the necessary infrastructure, such as adequate office space, equipment, and manpower, to effectively discharge his activities; and

(c) has any prior experience in the business of buying, selling, or dealing in securities.

(d) is subjected to disciplinary proceedings under the rules, regulations, and byelaws of a stock exchange involving himself or any of his partners, directors, or employees in connection with his business as a stockbroker;

(e) The Board may consider the criteria specified in Schedule II of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008 when determining whether an applicant or a stock broker, sub-broker, trading member, or clearing member is a fit and proper person.

7.2.4 CRITERIA FOR FIT AND PROPER PERSON

(1) The Board may consider any consideration it deems appropriate in determining whether an applicant or intermediary seeking registration under one or more of the relevant regulations is a "fit and proper person," including but not limited to the following criteria –

(a) Financial integrity;

(b) Absence of convictions or civil liabilities;

(c) Competence;

(d) Good reputation and character;

(e) Efficiency and honesty; and

(f) Absence of any disqualification to act as an intermediary as stipulated in these regulations.

(2) If a person receives any of the following disqualifications, he will not be considered a "fit and proper person" for the purposes of granting or

renewing a certificate to act as an intermediary or continuing to act as an intermediary under any one or more of the relevant regulations.

(a) the applicant or the intermediary, as the case may be, or its whole-time director or managing partner, has been convicted by a Court of any crime involving moral turpitude, economic crime, securities laws, or fraud;

(b) the applicant or the intermediary has been ordered for winding up;

(c) the applicant or the intermediary, as the case may be, or its whole-time director or managing partner, has been convicted by a Court of any crime involving moral turpitude, economic crime, securities laws, or fraud;

(d) the Board or any other regulatory authority has issued an order, other than a suspension of certificate of registration as an intermediary, restraining, prohibiting, or debarring the applicant or the intermediary, or its whole-time director or managing partner, from dealing in securities in the capital market or from accessing the capital market, and the period specified in the order has not expired after three years.

(e) the Board has issued an order cancelling the applicant's or intermediary's certificate of registration on the grounds of insider trading, fraudulent and unfair trade practises, or market manipulation, and three years have not passed since the order was issued;

(f) the Board or any other regulatory authority has issued an order withdrawing or refusing to grant any licence / approval to the applicant or the intermediary, or its full-time director or managing partner, that has a bearing on the capital market, and the order has not expired after three years;

Provided that the Board may for reasons to be recorded in writing, allow the applicant or the intermediary, to seek registration before the lapse of three years as specified in clauses (d), (e) and (f).

(g) the applicant or intermediary is financially unsound;

(h) any other reason, to be recorded in writing by the Board, that renders such applicant or intermediary, or its full-time director or managing partner, unfit to operate in the capital market in the Board's opinion.

7.2.5 PROCEDURE FOR REGISTRATION

When the Board is satisfied that the stockbroker is eligible, it shall issue a certificate in 'Form D' to the stockbroker and notify the stock exchange or exchanges, provided the stock broker holds a certificate of registration for membership in a recognised stock exchange with nationwide trading terminals is eligible for trading on the SME platform. SME platform means a trading platform of a recognised stock exchange having nationwide trading terminals and permitted by the Board to list the securities issued.

7.2.6 CONDITIONS FOR GRANT OF REGISTRATION

(a) the stock broker is a member of any stock exchange;

(b) he must follow the stock exchange's rules, regulations, and bye-law that apply to him;

(c) if the stock broker wishes to change his status or constitution, he mustobtain prior approval from the Board before continuing to act as such after the change;

(d) he must pay fees charged by the Board in the manner specified in these regulations; and

(e) Within one month of receiving the complaint, he shall take adequate steps to address the investors' grievances and keep the Board informed of the number, nature, and other details of the complaints received from such investors.

7.2.7 STOCK BROKERS TO ABIDE BY CODE OF CONDUCT

The stock broker holding a certificate shall at all times abide by the Code of Conduct as specified in Schedule II

A. General:

(1) Integrity: A stockbroker must uphold high standards of integrity, promptitude, and fairness in all aspects of his business.

(2) Exercise of due skill and care: A stockbroker must conduct all of his business with due skill, care, and diligence.

(3) Manipulation: A stockbroker shall not engage in manipulative, fraudulent, or deceptive transactions or schemes, nor shall he spread rumours with the intent of distorting market equilibrium or gaining personal gain.

(4) Malpractice: A stockbroker shall not, either alone or in concert with others, create false markets or engage in any act detrimental to the interests of investors or interfere with the fair and smooth operation of the market. A stockbroker shall not engage in excessive speculative trading in the market above reasonable levels that are not commensurate with his financial soundness.

(5) Compliance with statutory requirements: A stockbroker must follow all provisions of the Act as well as any rules or regulations issued by the Government, the Board, or the Stock Exchange from time to time that apply to him.

B. Obligation to the Investor

(1) Order Execution: In his dealings with clients and the general investing public, a stockbroker shall faithfully execute orders for buying and selling securities at the best available market price and shall not refuse to deal with a Small Investor solely on the basis of the volume of business involved. A stockbroker must promptly notify his client of the execution or non-execution of an order, make prompt payment for securities sold, and arrange for prompt delivery of securities purchased by clients.

(2) Contract Note: A stockbroker shall issue a contract note to his client [or client of the sub-broker, as the case may be] for all transactions in the form specified by the stock exchange without delay.

(3) Breach of Trust: A stockbroker shall not disclose or discuss with any other person, or make improper use of, the details of the client's personal investments and other confidential information learned in the course of his business relationship.

(4) Business and Commission:

(a) A stockbroker may not promote the sale or purchase of securities solely to generate brokerage or commission.

(b) A stockbroker shall not provide false or misleading quotations to clients or provide any other false or misleading advice or information with the intent of inducing him to do business in particular securities and thereby earning brokerage or commission.

(5) Dealings with Defaulting Clients: A stockbroker may not deal or transact business with a client who has failed to fulfil his obligations in relation to securities with another stockbroker, either directly or indirectly.

(6) Fairness to Clients: When dealing with a client, a stockbroker must disclose whether he is acting as a principal or as an agent while also ensuring that there is no conflict of interest between him and the client. In the event of a conflict of interest, he shall notify the client and shall not seek a direct or indirect personal advantage from the situation, nor shall he regard the client's interests as inferior to his own.

(7) Investment Advice: A stockbroker shall not make an investment recommendation to any client who may be expected to rely on it to acquire, dispose of, or retain securities unless he has reasonable grounds to believe that the recommendation is suitable for such a client.

Investment advice in publicly accessible media—

(a) A stock broker or any of his employees shall not render, directly or indirectly, any investment advice about any security in the publicly accessible media, whether real-time or non-real-time, unless he has disclosed his interest, including the interest of his dependent family members, and the employer's long or short position in the said security, while rendering such advice.

(b) If an employee of the stock broker is providing such advice, he must also disclose the interests of his dependent family members and the employer, as well as their long or short positions in the security.

C. Stockbrokers in Relation to Other Stockbrokers

(1) Conduct of dealings: When comparing unmatched transactions, a stockbroker must work with the other contracting party. A stockbroker must not knowingly and wilfully deliver documents that are marked as bad delivery, and must work with the other contracting party to replace documents that are marked as bad delivery as soon as possible.

(2) Protection of Clients Interests: A stockbroker must work with other stockbrokers to protect his clients' rights to dividends, bonus shares, right shares, and any other right related to such securities.

(3) Stock-Broker Transactions: A stock-broker must carry out his transactions with other stock-brokers and meet his obligations in completing the settlement of those transactions.

(4) Publicity and Advertising: A stockbroker may not advertise his business publicly unless the stock exchange permits it.

(5) Client Inducement: A stockbroker may not use unfair means to attract clients from other stockbrokers.

(6) False or Misleading Returns: A stockbroker must not neglect, fail, or refuse to submit required returns, and must not make any false or misleading statements on any returns required to be submitted to the Board and the stock exchange.

7.2.8 PROCEDURE WHERE REGISTRATION IS NOT GRANTED

(1) If an application for a certificate does not meet the requirements specified, the Board may reject the application after providing a reasonable opportunity to be heard.

(2) The Board shall communicate the refusal to grant the registration certificate to the concerned stock exchange and to the applicant within thirty days of such refusal, stating the reasons for the rejection.

(3) An applicant who is dissatisfied with the Board's decision may apply to the Board for reconsideration of its decision within thirty days of receiving such notification.

(4) The Board shall reconsider an application and communicate its decision in writing to the applicant and the relevant stock exchange as soon as possible.

7.2.9 EFFECT OF REFUSAL OF CERTIFICATE OF REGISTRATION

A stock-broker whose application for certificate grant has been denied by the Board shall not buy, sell, or deal in securities as a stock-broker on or after the date of receipt of the communication.

7.2.10 PAYMENT OF FEES AND THE CONSEQUENCES OF FAILURE TO PAY FEES

(1) Every applicant eligible for a certificate must pay the fees in the manner specified. Provided, however, that if sufficient cause is shown, the Board may allow the stockbroker to pay such fees at any time before the expiration of six months from the date such fees become due.

(2) If a stockbroker fails to pay the fees outlined in Regulation 10, the Board may suspend the registration certificate, at which point the stockbroker ceases to buy, sell, or deal in securities as a stockbroker.

Test your Understanding

1. State the concept of "fit and proper person" for appointment as Broker
2. State whether True or False: A broker has to be an individual.

7.3 SUB-BROKER

A sub-broker is defined as "sub-broker" means any person not being a member of stock exchange who acts on behalf of a stock broker as an agent or otherwise for assisting the investors in buying, selling or dealing in securities through such stock brokers. A sub-broker is an agent who works for a stock exchange trading member. A sub-broker must be registered with both the Securities and Exchange Board of India (SEBI) and a local stock exchange. Sub-brokers assist their clients in purchasing and selling securities on the stock exchange. They provide them with information on various securities. They also forward the trading orders of their clients to the trading member or brokerage firm with which they are affiliated. They receive a percentage of the brokerage commission in exchange for the service provided.

7.3.1 REGISTRATION AS SUB-BROKER

(1) No sub-broker shall act as such unless he possesses a certificate issued by the Board in accordance with these regulations.

(2) Under sub-regulation (1), no new certificate is required if a sub-broker simply changes his affiliation from one stock broker to another stock broker who is a member of the same stock exchange.

(3) Subject to the provisions of regulation 12A, no new certificate under sub-regulation (1) is required where a registered sub-broker is affiliated with a stock broker who is eligible to trade on the SME platform.

SME platform means a trading platform of a recognised stock exchange having nationwide trading terminals and permitted by the Board to list the securities.

7.3.2 APPLICATION FOR REGISTRATION OF SUB-BROKER

(1) An application by a sub-broker's for grant of the certificate must be submitted in 'Form B.'

(2) A recommendation letter in 'Form C' from a stockbroker of a recognised stock exchange with whom he is to be affiliated, as well as two references, one from his banker, must be submitted with the application for registration under sub-regulation (1) above.

(3) The application form must be submitted to the stock exchange of the stockbroker with whom he will be affiliated.

(4) Upon receipt of an application under sub-regulation (3), the stock exchange shall verify the information contained therein and certify that the applicant meets the eligibility criteria set forth in sub-regulation (3).

(5) The eligibility criteria for registration as a sub-broker shall be as follows, namely:

(i) In the case of an individual;

(a) the applicant is at least 21 years old;

(b) the applicant has not been convicted of any offence involving fraud or dishonesty;

(c) the applicant has at least passed the 12th standard equivalent examination from an institution recognised by the Government; and

(d) the applicant is a fit and proper person.

(ii) in the case of a partnership firm or a body corporate, the partners or directors, as the case may be, shall comply with the requirements contained in clauses (a) to (c) of sub-regulation (i);

(iii) the applicant has the necessary infrastructure, such as adequate office space, equipment, and manpower, to carry out his activities effectively; and

(iv) the applicant is a person recognised by the stock exchange as a sub-broker affiliated to a member broker of the stock exchange.

(6) Within 30 days of receipt of the application, the stock exchange shall forward to the Board the application in Form 'B' of such applicant, along with the recommendation letter in Form 'C' issued by the stock broker with whom he is affiliated and the recognition letter in Form 'CA' issued by the stock exchange.

7.3.3 PROCEDURE FOR REGISTRATION

(1) If the Board determines that the sub-broker is eligible, it shall issue a certificate in 'Form E' to the sub-broker and notify the stock exchange or exchanges, as applicable.

(2) Subject to the terms and conditions, the Board may issue a certificate of registration to the applicant laid down in sub-regulation (1) of regulation 12A.

7.3.4 CONDITIONS OF REGISTRATION: [UNDER REGULATION 12A (1)]

Any registration granted by the Board under regulation 12 shall be subject to the following conditions, namely

(a) he shall abide by the stock exchange's applicable rules, regulations, and bye-laws;

(b) where the sub-broker proposes to change his status or constitution, he shall obtain prior approval of the Board for continuing to act as such after the change; (c) he shall pay fees charged by the Board in the manner provided in these regulations; and

(d) he shall take adequate steps for the redressal of the investors' grievances within one month of the date of receipt of the complaint and keep the Board informed about the number, nature, and other particulars of the complaints received from such investors; and

(e) he is authorised in writing by a stock-broker who is a member of a stock exchange to affiliate himself in buying, selling, or dealing in securities.

(2) Nothing in clause (b) of sub-regulation (1) affects the obligation to obtain a new registration under section 12 of the Act where applicable.

7.3.5 PROCEDURE WHERE REGISTRATION IS NOT GRANTED

(1) If an application for a certificate granted under regulation 11A does not meet the requirements specified in regulation 11A, the Board may reject the application after providing a reasonable opportunity to be heard.

(2) The Board shall communicate the refusal to grant the certificate to the concerned stock exchange and to the applicant in writing within thirty days of such refusal, stating the reasons for the rejection.

(3) An applicant who is dissatisfied with the Board's decision under sub-regulation (2) may apply to the Board for reconsideration of its decision within thirty days of receiving such intimation.

(4) The Board shall reconsider an application made under sub-regulation (3) and communicate its decision in writing to the applicant and the relevant stock exchange as soon as possible.

7.3.6 EFFECT OF REFUSAL

A person whose application for the grant of a certificate has been refused by the Board shall cease to carry on any activity as a sub-broker on and from the date of the communication of refusal under regulation 13.

7.3.7 GENERAL OBLIGATIONS AND INSPECTION

(1) The sub-broker shall

(a) pay the fees specified in Schedule III;

(b) abide by the Code of Conduct specified in Schedule II;

(c) enter into an agreement with the stock-broker defining the scope of his authority and responsibilities;

(d) comply with the stock exchange's rules, regulations, and bye-laws; and

(e) not be affiliated with more than one stock broker of one stock exchange.

(2) Except for the books and documents referred to in clauses (h), (i), (j), (l), and (m) of sub-regulation (1) of regulation 17, the sub-broker shall keep and maintain the books and documents specified in regulation 17.

7.3.8 DIRECTOR NOT TO ACT AS SUB-BROKER

No director of a stock broker shall act as a sub-broker to the same stockbroker

Test your understanding:

1. State the procedure for registration of a Sub-Broker.
2. State whether true or false: Director of a stock broker shall act as a sub-broker to the same stock broker.

7.4 FOREIGN BROKER

Stocks of companies within a geographical boundary of a country is expected to be known to all residents of that country. Foreign stocks, on the other hand, are the securities of companies based in countries other than the domestic country. Giant companies that are not based in India are a profitable investment option, just as blue-chip companies in India are. Choose a broker who is based in India but has connections with foreign brokers. All reputable and high-performing Indian stock brokers have direct links and ties with their respective foreign brokers. An overseas trading account in such a domain can be easily opened and operated, allowing you to invest in foreign stocks.Some of the most active brokers also have offices in India, making it easy for investors to visit them and get answers to their questions. Some Indian mutual funds and exchange-traded funds (ETFs) are similarly structured to invest in foreign markets.

As a result, investors can invest in such funds, with their money going directly into foreign equities.

Investing Options:

- Through international funds, you can invest across borders.
- Regional investment is also facilitated by Regional Funds, which allow investors to invest in regions such as Europe, Asia, and the Middle East.
- Sector investment is also facilitated, as one can invest in sectors such as gold, energy, and so on across a wide range of countries.
- Country funds facilitate country-wide investment.
- ADRs and GDRs

7.5 TRADING AND CLEARING MEMBERS

Trading Members: are members of SEBI-registered stock exchanges who are authorised to trade on behalf of their clients or on their own account (proprietary trades). According to SEBI regulations, each trading member is assigned a unique TM-ID.

Trading cum Clearing Members (TCM): is a Clearing Member (CM) of the exchange who is also a Trading Member (TM). The majority of large brokers are TCMs. TCMs of this type can clear and settle their own proprietary trades, client trades, and trades of other TMs and even Custodial Participants.

7.5.1 APPLICATION FOR REGISTRATION OF TRADING MEMBER OR CLEARING MEMBER

A trading member of a derivatives exchange or derivatives segment of a stock exchange may apply for a certificate of registration in Form AA of Schedule I, through the concerned derivatives exchange or derivatives segment of a stock exchange of which he is a member.

A clearing member 34[or self-clearing member] of a clearing corporation or clearing house of a derivatives exchange or derivatives segment of a stock exchange shall apply for a certificate of registration in Form AA of Schedule I, through the concerned clearing corporation or clearing house of which he is a member.

Provided that a trading member who also seeks to act as a clearing member 35[orself-clearing member] shall make separate applications for each activity in Form AAof Schedule I.

The derivatives exchange, segment, clearing house, or corporation, as applicable, shall forward the application to the Board as soon as possible but no later than thirty days from the date of receipt.

7.5.2 FURNISHING OF INFORMATION, CLARIFICATION, ETC.

(1) To consider the application for a certificate, the Board may require the applicant or the concerned stock exchange, segment, clearing house, or corporation to provide any additional information or clarifications regarding derivative trading and settlement and related matters.

(2) If required, the applicant or its principal officer must appear before the Board for personal representation.

7.5.2 CONSIDERATION OF APPLICATION

(1) The Board shall grant a certificate relating to dealing and settlement in derivatives, specifically whether the applicant—

(a) is eligible to be admitted as a trading member of a derivatives exchange and/or a clearing member of a derivatives exchange or derivatives segment of a stock-exchange or clearing corporation or house; and

(b) has the necessary infrastructure, such as adequate office space, equipment, and man-power, to effectively carry out its operations.

(c) is subjected to disciplinary proceedings under the rules, regulations, and byelaws of any stock exchange involving himself or any of his partners, directors, or employees in connection with his business as a stock broker, member of a derivatives exchange or segment, or member of a clearing house or corporation;

(d) Is subject to any financial liability owed to the Board under these regulations.

(2) In addition to meeting the requirements of sub-regulation (1), an applicant who wishes to act as a trading member must have a net worth as specified by the derivatives exchange or segment from time to time, and the trading member's approved user and sales personnel must have passed a certification programme approved by the Board.

(3) In addition to meeting the requirements of sub-regulation (1), an applicant who wishes to act as a clearing member must have a minimum net worth of Rs. 300 lacs and deposit at least Rs. 50 lacs or more with the clearing corporation or clearing house of the derivatives exchange or derivatives segment in the form specified from time to time.

(4) In addition to meeting the requirements of sub-regulation (1), an applicant who wishes to act as a self-clearing member must have a minimum net worth of Rs. 100 lacs and deposit a sum of Rs. 50 lacs or more with the clearing corporation or clearing house of the derivatives exchange or derivatives segment in the form specified from time to time.

the expression'net worth' shall mean paid up capital and free reserves and other securitiesapproved by the Board from time to time (but does not include fixed assets, pledgedsecurities, value of member's card, non-allowable securities (unlisted securities), baddeliveries, doubtful debts and advances (debts or advances overdue for more thanthree months or debts or advances given to the associate persons of the member),prepaid expenses, losses, intangible assets and 30% value of marketable securities

7.5.4 PROCEDURE FOR REGISTRATION

When the Board is satisfied that the applicant is eligible, it shall issue a certificate in Form DA of Schedule I to the applicant and notify the derivatives segment of the stock exchange, derivatives exchange, clearing corporation, or clearing house, as applicable.

7.5.5 PROCEDURE WHERE REGISTRATION IS NOT GRANTED

(1) If an application for the grant of a certificate under regulation 16A does not meet the requirements specified in regulation 16C of the Regulations, the Board may reject the applicant's application after giving the applicant a reasonable opportunity to be heard.

(2) The Board shall communicate the refusal to grant the certificate of registration within 30 days of such refusal to the concerned segment of the stock exchange, clearing house, or corporation, as well as to the applicant, stating the reasons for the rejection.

(3) If an applicant is dissatisfied with the Board's decision under sub-regulation (2), he or she may apply to the Board within thirty days of receiving such information for a review.

(4) The Board shall reconsider an application made under sub-regulation (3) and communicate its decision in writing to the applicant and the relevant segment of the stock exchange, clearing house, or corporation as soon as possible.

7.5.6 EFFECT OF REFUSAL OF CERTIFICATE OF REGISTRATION

An applicant whose application for the grant of a certificate of registration has been denied by the Board shall not deal in or settle derivatives contracts as a member of a derivatives exchange, derivatives segment, clearing corporation, or clearing house on or after the date of receipt of the communication under sub-regulation (2) or sub-regulation (4) of regulation 16E.

7.5.7 PAYMENT OF FEES AND CONSEQUENCES OF FAILURE TO PAY FEES

(1) Every applicant who is eligible for a certificate as a trading or clearing member [or self-clearing member] must pay the fee and in the manner specified in Schedule IV.

(2) If a trading or clearing member [or self-clearing member] fails to pay the fees specified in sub-regulation (1), the Board may suspend or cancel the registration certificate after giving the trading and clearing member [or self-clearing member] an opportunity to be heard, and the trading and clearing member [or self-clearing member] shall cease to deal in or settle the derivatives contract as a member of the derivatives segment of the exchange or derivatives exchange or clearing corporation or clearing house.

7.5.8 TRADING MEMBER / CLEARING MEMBER [OR SELF-CLEARING MEMBER] TO ABIDE BY THE CODE OF CONDUCT ETC

(1) The code of conduct specified for stock brokers in Schedule II applies mutatis mutandis to trading members and clearing members, and such members must abide by it at all times.

(2) Trading and clearing members must follow the code of conduct outlined in the rules, bye-laws, and regulations of the derivatives exchange or derivatives segment of the exchange.

(3) Before executing an order on behalf of a prospective client, trading members must obtain information about that client in the 'know your client' format specified by the Board.

(4) The trading member must provide prospective clients with a 'risk disclosure document' in the form specified, disclosing the risk inherent in trading in derivatives.

(5) The trading or clearing member must deposit margin or any other deposit and adhere to the position or exposure limits set by the Board or the relevant exchange, segment, clearing corporation, or clearing house from time to time.

(6) The provisions of sub-regulations (1) to (5) apply to a self-clearing member in the same way.

(Mutatis mutandisis used when comparing two or more things to say that although changes will be necessary in order to take account of different situations, the basic point remains the same)

Test your Understanding:

1. Who is foreign broker?
2. State whether true or false: A person who is trading member can also act a s clearing member
3. State the steps to be taken if the application for registration as Trading member is rejected.

7.6 STOCK TRADING (CASH AND NORMAL)

Cash trading is simply the purchase and sale of securities with cash on hand rather than borrowed capital or margin. Most brokers provide cash trading accounts as the default account type. Since no margin is required, these accounts are easier to open and maintain than margin accounts. Long-term investors may prefer these accounts because they do not typically buy securities on margin or require quick trading settlements. The settlement date is the day when the transaction is considered to be consummated and the buyer is required to complete full payment. Stock trades in cash accounts used to take up to three business days to settle, but that was reduced to two days in 2017. T+2 refers to the trade date plus two business days in the market.

7.6.1 Advantages of Cash Trading

1. Unlike margin and derivative trading, there is no time limit for buying and selling stocks in cash trading.
2. In the cash trading segment, one can hold the stocks for as long as one wants until he or she achieves the desired profit.
3. Cash trading has a higher chance of profit than other methods of trading in the stock market.
4. In cash trading, one must pay the full price of the stocks that one wishes to purchase; while this may appear to be a limitation, it will undoubtedly prevent an investor from exceeding the limit.
5. Because one cannot invest more than the fund allows, one can effectively control the loss, even if prices fall.

7.6.2 Disadvantages of Cash Trading

1. The most significant disadvantage of cash trading is the exorbitant brokerage and taxation that you must pay for delivery trading.
2. Typically, the brokerage for cash trading is ten times that of margin trading. Of course, you can reduce this brokerage rate by using online stock trading portals, where the brokerage rate is significantly lower than that of traditional brokerage houses, but it is still higher than the margin trading brokerage.

7.7 STOCK TRADING (DERIVATIVES)

A Derivative is a financial instrument whose value is derived from the value of anunderlying asset. The underlying asset can be equity shares or index, precious metals,commodities, currencies, interest rates etc. A derivative instrument does not have anyindependent value. Its value is always dependent on the underlying assets.

7.7.1 Types of Derivatives

The most common types of derivatives are:

(a) Forwards: A forward is a contract between two parties to buy or sell an underlying asset at a future date for a predetermined price on the date of contract. Both contracting parties are committed and obligated to honour the transaction regardless of the underlying asset's price at the time of delivery. Contract terms and conditions are customised because forwards are negotiated between two parties. Forwards contracts are negotiated bilaterally between two parties in OTC (Over the Counter) markets and are not traded on the Stock Exchange.

(b) Futures: A futures contract is a legally binding agreement to buy or sell an asset on a publicly traded exchange. The contract specifies when the seller must deliver the asset and how much it will cost. A futures contract's underlying asset is typically a commodity, stock, bond, or currency. In terms of fundamental economics, futures markets are identical to forward markets. Contracts, on the other hand, are standardised, and trading is centralised (on a stock exchange). There isn't a counterparty. Increasing the time to expiration in futures markets, unlike forward markets, does not increase counter party risk. Futures markets are much more liquid than forward markets.

(c) Options: An option is a contract that grants the right, but not the obligation, to buy or sell the underlying at a specified price and on or before a specified date. While the buyer of an option pays the premium and acquires the right to cancel the contract at any time, the writer/seller of an option receives the premium along with the obligation to sell/purchase the underlying asset if the buyer exercises his right.

Types of Options:

(i) Call Options: A call option grants the holder the right to purchase a predetermined amount of the underlying asset at the strike price on a predetermined date.

(ii) Put Options: A put option, on the other hand, grants the holder the right to purchase a predetermined amount of the underlying asset at the strike price on a predetermined date.

(d) Swaps: A swap is a two-party derivative contract that involves the exchange of pre-agreed-upon cash flows from two financial instruments. The notional principal amount is commonly used to calculate cash flows (a predetermined nominal value). Each cash flow stream is referred to as a "leg."

Types of Swaps:

(i) Interest rate swap: Two parties agree to exchange one stream of future interest payments for another based on a fixed notional principal amount. Interest rate swaps, in general, involve the exchange of a fixed interest rate for a floating interest rate.

(ii) Currency swap: Parties swap principal and interest payments denominated in different currencies. Swap contracts are frequently used to protect another investment position from currency exchange rate fluctuations.

(iii) Credit default swap: It protects against the default of a debt instrument. The premium payments are transferred to the seller by the buyer of a swap. If the asset fails, the seller will reimburse the buyer for the asset's face value, and the asset will be transferred from the buyer to the seller.

(iv) Commodity swap: These derivatives are designed to exchange floating cash flows based on a commodity's spot price for fixed cash flows based on a commodity's pre-agreed price. Contrary to popular belief, commodity swaps do not involve the exchange of actual commodities.

7.7.2 Participants of Derivatives Market:

Participant in the derivative market can be divide them into the following categories based on their trading motives:

(i) Hedgers: Hedgers are stock market traders who are risk-averse. They intend to use derivative markets to protect their investment portfolio from market risk and price fluctuations. They accomplish this by taking an opposing position in the derivatives market. In this way, they transfer the risk of loss to those who are willing to accept it. They must pay a premium to the risk-taker in exchange for the available hedging.

(ii) Speculators: They are risk-seekers in the derivative market . They want to take risks in order to profit. In comparison to the hedgers, they have a completely opposing viewpoint. This difference of opinion allows them to profit handsomely if their bets are correct. The speculator retains the premium and profits.

(iii) Margin traders: A margin is the minimum amount you must deposit with your broker in order to participate in the derivative market. It is used to reflect your daily losses and gains based on market movements. It allows you to gain leverage in derivative trades while maintaining a large outstanding position. In the derivative market, however, you can own a three times larger position, i.e. if you have Rs. 2 lakhs, you can enter into contracts worth Rs 6 lakh with the same amount. In the derivative market, even minor price changes result in larger gains/losses than in the stock market.

(iv) Arbitrageurs: These are people who profit from low-risk market imperfections. They buy low-priced securities in one market while selling them at a higher price in another. Only when the same security is quoted at different prices in different markets can this occur.

7.7.3 Advantages and Disadvantages of Derivatives

Advantages

- **Risk diversification:** As the value of the derivatives is linked to the underlying asset's value, the contracts are primarily used to hedge risks. For example, an investor may buy a derivative contract whose value moves in the opposite direction of an asset owned by the investor. Profits from the derivative contract may thus offset losses from the underlying asset.

- **Underlying Asset pricing:**Derivatives are frequently used to determine the underlying asset's price. For example, futures spot prices can be used to approximate commodity prices.

- **Market efficiency:** Derivatives are thought to improve the efficiency of financial markets. The payoff of assets can be replicated using derivative contracts. As a result, in order to avoid arbitrage opportunities, the prices of the underlying asset and the associated derivative tend to be in equilibrium.

- **Access to previously unavailable assets or markets:** Derivatives can assist organisations in gaining access to previously unavailable assets or markets. By using interest rate swaps, a company can obtain a lower interest rate than would be available through direct borrowing.

Disadvantages

- **High risk:** Derivatives' high volatility exposes them to potentially massive losses. The complex design of the contracts makes valuation extremely difficult, if not impossible. As a result, they have a high inherent risk.

- **Speculative characteristics:** Derivatives are widely regarded as a speculative tool. Unreasonable speculation may result in massive losses due to the extremely risky nature of derivatives and their unpredictable behaviour.

- **Counter-party risk:** While derivatives traded on exchanges generally undergo extensive due diligence, some contracts traded over-the-counter do not include a due diligence benchmark. As a result, there is a risk of counter-party default.

- **Market sensitivity and volatility:** Due to the high volatility of the derivatives market, many investors and traders avoid it. Most financial instruments are extremely sensitive to small changes, such as changes in the expiration period, interest rates, and so on, making the market extremely volatile.

- **Complexity:** Because of the derivatives market's high risk and sensitivity, it is frequently a very complex subject. Because derivatives trading is so difficult to understand, the general public avoids it, and they frequently use brokers and trading agents to invest in financial instruments.

7.8 GENERAL OBLIGATIONS AND RESPONSIBILITIES APPLICABLE TO BROKER/SUB-BROKER/CLEARING MEMBER/SELF-CLEARING MEMBER

7.8.1 GENERAL OBLIGATIONS AND RESPONSIBILITIES (Chapter IV)

(1) Every Stock Broker must keep and maintain the following books of account, records, and documents: (a) Transaction Register (Sauda Book); (b) Clients ledger; (c) General ledger; (d) Journals; (e) Cash book; (f) Bank pass book; (h) Member's contract books showing details of all contracts entered into by him with other members of the same exchange or counterfoils or duplicates of memos of confirmation issued to such other members; (j) Written consent of clients in respect of contracts entered into as principals; (k) Margin deposit book;

Every stock broker is required to keep books of account and other records for a minimum of five years.Every stock broker must appoint a compliance officer who is in charge of monitoring compliance with the Act, rules and regulations, notifications, guidelines, instructions, and so on issued by the Board or the Central Government, as well as resolving investor complaints. Any noncompliance observed by the compliance officer must be reported to the Board immediately and independently.

7.8.2 PROCEDURE FOR INSPECTION (CHAPTER V)

(a) **Board's right to inspect:** Where the Board believes it is necessary, it may appoint one or more persons as inspecting authority to conduct inspections of the stock brokers' books of account, other records, and documents to ensure that the books of account and other books are maintained in the required manner and that the provisions of the Act, rules, and regulations are followed.

(b) **Procedure for inspection:** Before conducting any inspection under regulation 19, the Board shall provide reasonable notice to the stock broker. However, if the Board is satisfied that such notice is not in the best interests of the investors or the public, it may, by written order, direct that the inspection of the stock broker's affairs be conducted without such notice. Upon being authorized by the Board, the inspecting authority shall conduct the inspection, and the stockbroker being inspected shall be bound to discharge his obligations.

(c) **Obligations of stock-broker on inspection by the Board:** Every director, proprietor, partner, officer, and employee of a stockbroker who is being inspected shall assist the authority in inspection and produce such books, accounts, and other documents in his custody, as well as to provide him with such statements and information relating to the transactions as the said officer may require. The stock-broker shall allow the inspecting authority reasonable access to the premises occupied by such stock-broker or any other person on his behalf, as well as reasonable facilities for examining any books, records, documents, and computer data in the stock-or broker's any other person's possession, and shall provide copies of documents or other materials which, in the inspecting authority's opinion, are relevant.

(d) Submission of report to the Board: The inspecting authority must submit an inspection report to the Board as soon as possible. Following consideration of the inspection or investigation report, the Board shall take whatever action it deems fit and appropriate.

(e) Appointment of an Auditor: Board may appoint a qualified auditor to investigate into the books of account or the affairs of the stock-broker

7.8.3 PROCEDURE FOR ACTION IN CASE OF DEFAULT (CHAPTER VI)

A stock broker who violates any of the provisions of the Act, rules, or regulations may faceone or more of the following penalties:

(i) **Monetary penalty under Section VIA of the Act** for the violations such as: Failure to file any return or report with the Board, or to furnish any information, books, or other documents within 15 days of the Board's issue of notice, or to keep books of account or records in accordance with the Act, rules, or regulations framed thereunder or to address investor grievances within 30 days of receiving notice from the Board or to issue contract notes in the form and manner prescribed by the Stock Exchange or to deliver any security or make payment to the investor within 48 hours of trade settlement.

(ii) **Penalties as specified, including suspension or cancellation of a stock broker's certificate of registration** for violations such as: (i) ceases to be a member of a stock exchange; or (ii) is declared a defaulter by a stock exchange and is not re-admitted as a member within six months; or (iii) surrenders his certificate of registration to the Board; or (iv) is found by the Board to be not a fit and proper person under these or any other regulations; or (v) has been declared insolvent or an order for winding up has been passed. (vi) Any of the partners or any full-time director has been convicted by a court of competent jurisdiction of a moral turpitude-related offense; or (vii) fails to pay the fee specified in Schedule III of these regulations. (viii) fails to comply with the rules, regulations and bye-laws of the stock exchange of which he is a member

(iii) **Prosecution in accordance with Section 24 of the Act** in case of: (i) Dealing in securities without first obtaining a certificate of registration as a stock broker from the Board.

(ii) Trading in securities, providing trading floor, or assisting in trading outside of a recognized stock exchange in violation of the Securities Contracts (Regulation) Act of 1956.

(iii) Securities or index market manipulation.

(iv) Participating in insider trading.

(v) Engaging in fraudulent and unfair business practices.

(vi) Failure without reasonable cause—(a) to produce to the investigating authority or any person authorized by him in this regard any books, registers, (b) to appear personally before the investigating authority or to answer any question posed to him by the investigating authority; or (c) to sign the notes of any examination taken down by the investigating authority.

(vii) Failure to pay penalty imposed by the authority.

These provisions of Chapters IV, V and VI of shall mutatis mutandis apply to sub-broker or a clearing member and self-clearing member or clearingmember or self-clearing member.

7.9 SUMMARY

A stock broker must be a member of a stock exchange and hold the necessary SEBI certificate before dealing with securities on behalf of investors. He must provide excellent service to investors, the stock exchange, and the SEBI. He is responsible for keeping the necessary books of accounts and records. He must fulfil general obligations, such as paying SEBI fees, and follow the code of conduct, as well as allow the SEBI or stock exchange authorities to inspect his records and transactions. He is responsible for ensuring fair play. The investor, on the other hand, should not be swayed by the broker's advice and should use his or her own discretion.

A sub-broker is defined as "any person who is not a member of a stock exchange who acts on behalf of a stock broker as an agent or otherwise for assisting investors in buying, selling, or dealing in securities through such stock brokers." A sub-broker is an agent who works for a stock exchange trading member. A sub-broker must be registered with both the Securities and Exchange Board of India (SEBI) and a local stock exchange.Trading Members: are members of SEBI-registered stock exchanges who are authorized to trade on their clients' or their own behalf (proprietary trades). Each trading member is assigned a unique TM-ID under SEBI regulations.Trading cum Clearing Members (TCM): A Trading Member (TM) who is also a Clearing Member (CM) of the exchange (TM). TCMs account for the vast majority of large brokers. This type of TCM can clear and settle their own proprietary trades, client trades, trades of other TMs, and even trades of Custodial Participants.

7.10 EXERCISE

A. Choose the correct alternative:

1. ________ is not a member of stock exchange but acts on behalf of stock Broker as an agent.

(a) Sub-Broker (b) Clearing Member (c) Jobbers (d) Trading Member

2. ________ is the oldest stock exchange in India.

(a) Calcutta Stock Exchange (b) National Stock Exchange

(c) Bombay Stock Exchange (d) Metropolitan Stock Exchange

3. ______ act as agent to the investors.

(a) Stock Broker (b) Registrar (c) Proprietor (d) Lessor

4. Which type of derivative instrument is unregulated.

(a) Swap (b) Futures (c) Options (d) Forward

Answers:

7. A _________ grants the holder the right to purchase a predetermined amount of the underlying asset at the strike price on a predetermined date

(a) put option (b) call Option (c) swap option (d) forward option

1 – (a); 2 – (c); 3 – (a); 4 – (d); 5 – (b)

B. Answer the following

1. List down the code of conduct for the Stock broker.
2. State the obligation of Stock Broker towards Investor.
3. Write a short note on Foreign Broker.
4. State the code of conduct laid down for the trading member / clearing member or self-clearing member.
5. Write a note on different types of derivatives instruments.

References:

https://www1.nseindia.com/index_nse.htm

https://www.sebi.gov.in/index.html

https://www.sebi.gov.in/legal/regulations/feb-2022/securities-and-exchange-board-of-india-stock-brokers-regulations-1992-last-amended-on-february-23-2022-_56447.html

Rules and Regulations laid down by the SEBI

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8

DEPOSITORY SERVICES

Unit Structure :

8.0 LEARNING OBJECTIVE

After reading this unit, learner will be able to understand:

- Depository Services its meaning, role of depositories and their services
- Advantages of depository system;
- Functioning of depository system;
- Depositories in India – NSDL & CSDL;
- Depository participants (DPs) and their role Custodial services - meaning; obligations and responsibilities of custodians; code of conduct

8.1 MEANING AND ROLE OF DEPOSITORIES AND THEIR SERVICES IN INDIA

Depositories are important institutions in the Indian capital market, and their operations are similar to those of banks. Their role is activated when an investor makes an investment decision. SEBI has registered two depositories in India: National Securities Depository Limited (NSDL) and Central Depository Services (India) Limited (CDSL). Both NSDL and CDSL permit share dematerialization, or holding shares in electronic form. As a result, the depository is held accountable for the safekeeping of your securities portfolio. Depositories also assist the transfer of securities from one account to another based on the account holder's instructions. Depositories handle the transfer of ownership of securities. With all of your personal information, scrips, and the number of units of each scrip held by the individual, several corporate actions or transactions, such as the issuance of bonus shares or annual dividends, are carried out via depositories, which serve as an important intermediary in the entire process.

So, in addition to functioning as a safe-keeper of your securities, the depository provides services related to securities transactions. The depositories provide the primary service of dematerialization of shares through depository participants. The risk of counterfeit or fake securities, faulty delivery, and so forth is reduced with dematerialization. Allows for the instant transfer of shares from one DP account to another without the imposition of stamp duty. The nomination process has been simplified. Any change in correspondence address recorded with the DP is automatically registered with all companies in which an individual owns stock. Allows for the holding of multiple securities in a single account, such as debt, equities, or government securities.

8.2 ADVANTAGES OF THE DEPOSITORY SYSTEM

A well performing depository system offers a range of benefits as follows;

1. The risk of physical certifications is eliminated -Previously, investors were subject to a variety of hazards when dealing with actual shares, including: 1. The risk of stock theft and 2. Certificates lost in transit. Electronic trading using a demat account has greatly simplified the procedure.

2. Immediate transfer and registration of securities - Before depositories, it could take anything from 15 days to a month to transfer shares. You have to complete a transfer form and send it to the SEBI's office. However, settlement is now done electronically after market hours and within a few days.

3. Depositories have contributed to reduced costs for the investors - The reasons can be attributed to Paperwork reduction, Transactions are simple and rapid. There are no courier fees, and much more. As broker costs are lowered, the savings are passed on to investors in the form of lower brokerage fees.

4. Reduces Paperwork and makes processes easy - You can download and examine the status of your portfolio digitally at any time and from any location.

5. Elimination of problems due to changes in KYC details - Assume you have a portfolio of 50 different companies' stocks. You want to modify your address and bank account information for all of them today. Previously, you had to courier your paperwork to each company for any little update. However, you may now just update the information in your Demat account, and the depository will update it for all of the firms in your portfolio.

6. Providing a safety net to the investors - Depositories regularly monitor and assess many aspects of investor protection. This includes: DP activity inspections on a regular basis. The platform's transactions are encrypted from beginning to end. Depositories purchase insurance coverage. It enables DP to compensate investors for losses incurred as a result of errors, omissions, or carelessness.

8.3 FUNCTIONING OF THE DEPOSITORY SYSTEM

When you open a Demat account with your depository participant, you will be given access to a trading platform. You put purchase and sell orders on this site. Let's break down the procedure with a basic example. Assume you want to buy Infosys stock at Rs 1,706. You use your trading platform to issue a market order and purchase 10 shares. After the trading day, you will receive 10 shares of Infosys in your Demat account two working days later. The depository transfers ownership of these shares to you. Let's imagine the price climbs to Rs 2,000 after a month and you want to sell the shares. You put another order to sell the shares using your trading platform. The shares in your Demat account will be deducted in the backend. In exchange, the same amount will be credited to your account two working days after the trade day. Following that, NSDL or CDSL will transfer ownership of the shares to the next buyer. When you sell shares from your Demat, the depository charges a small DP selling fee. When you sell a delivery from your Demat account, you will be charged.

8.4 DEPOSITORIES IN INDIA - NSDL AND CDSL

The process of purchasing and selling shares is possible in India thanks to depositories, and as an investor, you should be aware of the two operational depositories. There are two depositories in India: National Securities Depositories Ltd (NSDL) and Central Securities Depositories Ltd (CSDL) (CDSL). Both depositories retain your financial securities in dematerialised form, such as shares and bonds, and permit trading on stock exchanges. To use the depositories and begin your investing experience, you must first open a Demat account and a trading account. Always remember to open the best Demat account with a reputable stockbroker because it will assist you in making sound investment decisions.

NSDL – Let us look at a few facts about NSDL. NSDL is India's oldest and largest depository. It began operations in Mumbai in 1996. It was the first depository to offer electronic trading services. According to SEBI data, NSDL has around 2.4 crore active investors and over 36,123 depository participant service centres spread across 2,000 cities. NSDL is entrusted with the electronic storage of the following financial securities: stocks, bonds, debentures, commercial documents, and mutual funds. NSDL provides a wide range of services, including: dematerialisation, rematerialisation, transfers between depositories, off-market transfers, securities lending, and collateral and mortgage of securities.

CDSL – Along with NSDL, CDSL is the second depository in the country. CDSL began operations in Mumbai in 1999 and is the country's second-largest depository after NSDL.It, like NSDL, provides all services, such as keeping financial securities in electronic format and facilitating trade and order settlement. This central depository, like NSDL, holds all types of stocks and securities.

According to SEBI data, it has about 5.2 crore active client accounts and approximately 21,434 depository participant service centres.

In terms of investor services, there is no significant difference between holding a Demat account with a DP registered with NSDL or CDSL. Both are SEBI-regulated and offer identical trading and investing services. The only distinction between the two depositories is in their operational markets. While NSDL's principal operational market is the National Stock Exchange (NSE), CDSL's primary market is the Bombay Stock Exchange (BSE).

8.5 DEPOSITORY PARTICIPANTS (DP'S) AND CUSTODIAL SERVICES

A Depository Participant (DP) is referred to as an Agent of the Depository in India. They act as go-betweens for the depository and the investors. The connection between the DPs and the depository is governed by a Depositories Act agreement between the two. A DP is a legal entity that has been registered as such with SEBI under subsection 1A of Section 12 of the SEBI Act. According to the Act's regulations, a DP may only provide depository-related services after receiving a certificate of registration from SEBI. As of 2012, there were 288 NSDL DPs and 563 CDSL DPs registered with SEBI. Clearing members but not trading members are custodians. They settle trades executed by other trading members on behalf of their clients. A trading member may delegate a specific trade to a custodian for settlement. The custodian must confirm whether or not he intends to settle the trade. NSE Clearing distributes the liability to the custodian if the custodian confirms the deal. If the trade is rejected by the custodian, the obligation is allocated back to the trading member. Custodians Clearing members must request a Custodian Participant (CP) code from Clearing Corporation for each customer for whom they desire to clear and settle. Custodians provide services such as transaction settlements, account management, dividend collection, interest payments, foreign exchange, and tax assistance in addition to storing securities. The rates charged vary depending on the services requested by the clients. Some firms impose a quarterly fee based on the total value of the assets under custody. A custodian may also receive authority to assert control over assets using a power of attorney. This means that the custodian can act on behalf of the client, such as changing investments or making payments. If the investment advisor is given custody of customer funds, he or she must observe the Securities and Exchange Board of India's custody guidelines (SEBI). Banks, registered brokers, registered dealers, and certain people are the only entities that can be called competent custodians. These entities will be accountable for informing customers when certain operations are carried out on their behalf or while utilising their assets. Account statements must also be given to consumers to keep them up to date on the current status of their assets.

8.6 EXERCISE

Answer the following:

1. State the meaning and role of Depository Services in financial system.
2. State the major Depositories in India and explain about them in brief.
3. Explain the role of custodial services its meaning; obligations and responsibilities of custodians; code of conduct

Write Short notes on:

1. Advantages of depository system.
2. Functioning of depository system.

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