

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 commonly 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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BANKS AND NON-BANKING FINANCIAL COMPANIES (NBFCs)

Unit Structure

2.0 Objectives of this chapter

2.1 Introduction to Banking in India

2.2 Evolution of Banking in India

2.3 Different types of banks in India

2.3.1 Central Banks

2.3.2 Commercial Banks

2.3.3 Co-operative Banks

2.3.4 Regional Rural Banks

2.3.5 Special Purpose Banks

2.3.6 Small Finance Banks and

2.3.7 Payments Banks.

2.4 Non- Banking Financial Companies

2.4.1 Meaning

2.4.2 Types of NBFC

2.4.3 Significance of NBFCs in India

2.0 OBJECTIVES OF THIS CHAPTER

- After going through this chapter, the learner will,
- Understand the importance of banking in India
- Realize the key role played by different banks
- Learn the different types of banks in India including neo - banking entities.
- Understand the meaning of NBFCs.
- Learn the different types of NBFCs in India and their significance

2.1 INTRODUCTION TO BANKING IN INDIA

Banking system is one of the most important financial services out there. It does the crucial function of mobilizing deposits and channelizing them to productive areas of the economy. It is primarily responsible for matching the demand and supply aspects of money in the economy. Banking sector in India is governed and regulated by the Reserve Bank of India (RBI). Banking sector is integral to economic growth and development. It also plays an important role in implementing various welfare schemes of the government. Overall, Banking aims to transform the lives of people by bringing economic accessibility and prosperity.

2.2 EVOLUTION OF BANKING SYSTEM IN INDIA

Modern banking as we know, originated in the last decade of the 18th century. One of the earliest banks established was the Bank of Hindustan in 1770. It went bankrupt in 1830. State Bank of India (SBI) is the largest and one of the oldest banks still in existence. SBI began its journey as Bank of Calcutta in June 1806. In 1809, it was renamed as the Bank of Bengal. Bank of Bengal, Bank of Bombay and Bank of Madras merged in 1921 to form the Imperial Bank of India. This became the State bank of India (SBI) in 1955. Reserve Bank of India was established as the central bank of the country in 1935, under the Reserve Bank of India Act 1934. Bank nationalization is a cornerstone event in the modern Indian Banking system. In 1969, 14 major private banks were nationalized. In 1980, 6 more private banks were nationalized. This ushered in major reforms in the banking system and gave a boost to economic growth and development. Even post recent mergers, these banks dominate the banking sector even today due to their sheer size and widespread network.

The Indian banking sector is classified into two broad categories viz scheduled and non-scheduled banks. The scheduled banks are those which are included in the 2nd schedule of RBI Act 1934. The scheduled banks include all nationalized banks, private banks and foreign banks. A commercial bank is a generic term and both scheduled and non-scheduled banks are part of commercial banks and they are governed by the Banking Regulation Act, 1949.

The government constantly strives to make banking accessible to all and also bring in continuous reforms in the banking sector. The Pradhan Mantri Jan Dhan Yojana (PMJDY) and many other schemes promote inclusive banking and has ensured that 99% of the eligible population has a bank account. Small Finance Banks (SFBs), Micro Finance Institutions (MFIs) and Payments Banks have also made the banking scene more exciting and robust.

2.3 A BRIEF UNDERSTANDING OF THE DIFFERENT TYPES OF BANKS IN INDIA

In easy terms, banks as we know are financial institutions that perform the functions of accepting deposits and giving loans. There are different types

of banks in India, each with their own set of functions and responsibilities. Each of these banks serve a unique purpose as well.

Let us have a look at some of the prominent types of banks in the country.

2.3.1 Central Bank

The Reserve Bank of India (RBI) is the central bank of the country. It is the regulator of the banking sector in India and oversees the activities of all the banks in our country. Every country has their own central bank. It acts as the banker to the government. It is responsible for issuing currency notes and for enforcing the monetary policy. It is also called the bankers bank and is responsible for beginning innovation and reforms in the banking system. It is the apex bank in the country and runs the country's financial system.

2.3.2 Cooperative Bank

Cooperative banks are typically small sized banks that are governed by the laws of the respective state governments where they are registered. Their primary task is to promote social welfare by offering loans at concessional rates. There are three levels of cooperative banks in the country. Tier 1 State cooperative banks are regulated by RBI, laws of the state government and NABARD (National Bank for Agriculture and rural Development). District Cooperative banks are at Tier 2 whereas village / rural cooperative banks at Tier 3. These banks usually get concessions in CRR and SLR requirements.

2.3.3 Commercial Banks

Commercial Banks include all Public sector banks, Private Banks and even the Foreign Banks in the country. Social Welfare and generating profits are their main motive. The primary source of funds is public deposits and caters to the banking requirements of all. They operate in urban, semi urban and rural regions.

2.3.4 Regional Rural Banks

Regional Rural Banks (RRBs) are a special kind of commercial bank that specifically caters to the rural farm sector and focuses on agricultural and allied lending. These banks are jointly owned by the central government, state government and a commercial bank. They are governed by the Regional Rural Bank Act, 1976. An interesting aspect is that an RRB cannot open branches in more than three districts which are geographically connected.

2.3.5 Special Purpose Banks

These banks cater to specific set of objectives. Some of the popular Special Purpose banks are;

- a. SIDBI - Small Industries Development Bank of India (SIDBI) provides finance to small businesses to cater to their technology and

equipment requirements. They are very vital for the growth of small businesses in the country.

- b. NABARD - National Bank for Agriculture and Rural Development (NABARD) is a special bank that caters to the needs of people in rural areas. Village industries, Handicrafts, agriculture and other agricultural and allied industries depend on financial support from NABARD .
- c. EXIM Bank - Export Import Bank of India (EXIM) is a special bank that specifically finances Import Export transactions. It is a vital institution that promotes foreign trade.

2.3.6 Small Finance Banks - Small Finance Banks (SFBs) cater to the money requirements of small businesses, micro institutions and the largely neglected unorganised sector. These banks are of recent origins and provide banking to the vast unbanked segment in the unorganised sector.

2.3.7 Payments Banks - Payments Banks are of recent origin and represent innovations in the banking sector. Payment Banks can only accept deposits upto Rs 1,00,000. They cannot issue any loans or undertake lending activity of any sort. They provide services like door to door banking, internet and mobile banking, issuing ATM and debit cards and other innovative mobile application based services like bill payments, money transfers etc.

2.4 NON BANKING FINANCIAL COMPANIES (NBFC)

2.4.1 Meaning of NBFCs - A Non Banking Financial Company (NBFC) is not a bank, but is a company registered under Indian Companies Act, 1956. NBFCs provide loans and advances. They cannot accept deposits from the public like a normal bank.

If NBFCs can also issue loans and advances, you must be wondering what distinguishes them from a regular bank. Well, there are certain differences. Following are the major differences between the both;

- a. NBFCs cannot accept demand deposits from the general public. They can only issue loans. Banks, however, are in the business of accepting deposits and giving loans.
- b. NBFCs are not part of the banking payment and settlement system. This means that NBFCs cannot issue cheques to their customers.
- c. The Deposit Insurance facility provided by the Deposit and Credit Guarantee Corporation is available only to bank customers. This facility is important in case a bank becomes bankrupt and deposit holders are compensated. However, this facility is not available to customers of NBFCs.
- d. Another major difference is the manner in which NBFCs are constituted. NBFCs are registered under Companies Act 1956 whereas banks are governed by the Banking Regulation Act, 1949.

2.4.2 Types of NBFCs

NBFCs are typically classified by their size and the nature of activity they specialize in. Following are some of the different types of NBFCs;

- a. Asset Finance Company - Asset Finance Company (AFC) is one of the most popular and the most known type of NBFC. These institutions finance purchase of assets and contribute to economic development. These institutions finance buying of electronic items, automobiles and other assets and equipment required for carrying out certain kinds of specific businesses.
- b. Investment Company - Investment Companies (IC) finance buying of various securities like shares and bonds.
- c. Infrastructure Finance Company - Infrastructure Finance Company (IFC) are a special type of NBFC and they are required to deploy at least 75% of their assets in infrastructure loans. They finance big ticket infrastructure projects.
- d. Loan Company (LC) - Loan Company is a special kind of NBFC that provides loans of all types not covered by an Asset Finance Company.

2.4.3 Significance and Importance of NBFCs

NBFCs play a very vital role in promoting an all inclusive growth by catering to different financial needs of entities not part of regular mainstream banking. NBFCs are also leaders when it comes to creating innovative financial products and services. In the process, they create huge employment opportunities and bring in explosive growth in rural areas and among the large unbanked segment by giving them access to credit. Their primary customers also include MSMEs (Micro, Small and Medium Enterprises) and NBFCs provide them the valuable finance they need access to. Let us look at some more benefits that NBFCs bring with them.

1. They are important for mobilizing savings in the country and converting into meaningful investments.
2. They help in the development of financial markets and bring in more depth and vibrancy in the markets.
3. Helps in economic development of the marginalised and economically vulnerable groups and entities.
4. It aids to increase the capital stock of the company by aiding in capital formation.
5. It has given huge impetus to growth of technology in the country. This has led to growth of fintech (financial technology) based companies and startups. Most NBFCs use technology intensively.

Practice questions at the end of this chapter**Multiple Choice Questions**

1. Banking sector comes under which of the following sectors
 - a. Marketing sector
 - b. Servicesector**
 - c. Industrial sector
 - d. _____
2. NBFC performs great role for finance in
 - a. Wholesale sector
 - b. Big Scale industries
 - c. SmallscaleandRetailsector**
3. NBFC is a company registered under
 - a. The Indian Contract Act
 - b. The Companies Act, 1956
 - c. The RBI Act**
4. ----- cater to the micro finance needs of unorganized sector
 - a. [Small Finance Banks](#)
 - b. Reserve Bank of India
 - c. Foreign Banks
5. _____ caters to the financial needs of agriculture and allied industries.
 - a. Small Finance Banks
 - b. NABARD**
 - c. Unit Trust of India

Explain the meaning of the following terms in One or Two lines

- a. Commercial Bank
- b. Central Bank
- c. NBFC
- d. NABARD
- e. Payments Banks.

Answer the following questions in detail

- a. Explain the evolution of the banking sector in India
- b. Write in detail the different types of banks in India
- c. What is an NBFC. What are the differences between a Bank and an NBFC
- d. Explain the different types of NBFCs in India
- e. Explain the significance of NBFCs.



REGULATORY ASPECTS IN INDIA

Unit Structure

3.0 Objectives of this chapter

3.1 Introductions to regulations – Meaning of regulations, Two aspects of regulations.

3.2 Regulators in India – 3.2.1 SEBI, 3.2.2 RBI, 3.2.3 IRDA

3.0 OBJECTIVES OF THIS CHAPTER

After the successful completion of this chapter, the learner will;

- Realize and understand the need and importance of regulations in financial sector.
- Learn in brief about the role and functions of SEBI
- Learn in brief about the role and functions of RBI.
- Learn in brief about the role and functions of IRDA.

3.1 INTRODUCTION TO REGULATIONS

Regulations are an important part of and an integral aspect of any financial system. Regulations are required for the orderly growth of the financial sector and the entire economy. Regulations are required to maintain the integrity of the financial system and its components. Failure of banks and other financial services create larger systematic problems for the economy. It is the job of different regulators to oversee regulations of their respective domains. Sound regulations aim to enforce existing laws, prevent scams and financial frauds, prosecute current cases of financial misconduct, investigate complaints and protect the interests of investors and clients. In simple terms, regulations ensure that all stakeholders have confidence in the financial system.

There are two aspects of regulations;

1. Prudential Regulations: These norms are in place to ensure that firms have the requisite amount of money to remain solvent. These regulations are in place to make sure that the institutions and intermediaries are governed properly and there are appropriate risk controls measures in place. These rules prevent a systemic failure of the financial services ecosystem.
2. Investor Protection: A vital aspect of regulations is protecting the rights of investors. The Indian financial system is characterized by a large number of small investors who bring in small savings and

deposits into the system. It is absolutely essential that their interests are protected. Investors' rights need to be managed properly and their complaints need to be addressed at the earliest.

3.2 REGULATORS IN INDIA

The regulatory system in India is such that the regulators are placed at the top of the hierarchy and they are responsible for managing all aspects of that particular financial market / service. Following are some of the key regulators in the Indian context.

3.2.1 Securities and Exchange Board of India (SEBI)

Securities and Exchange Board of India (SEBI) is the nodal regulator of securities and commodities markets in India. It is directly placed under the jurisdiction of the Ministry of Finance, Government of India. Although SEBI was established in 1988, it gained statutory status and power only in 1992 under SEBI Act, 1992. Before SEBI was established, Controller of Capital Issues was the regulator of Capital Markets in India. It is headquartered in Mumbai and has regional offices in New Delhi, Chennai, Ahmedabad and Kolkata. The membership structure of SBI is such that it has;

- a. One chairman nominated by the Union Government of India.
- b. Two members / officers nominated by the UNion Finance Ministry
- c. One member nominated by the reserve Bank of India
- d. The remaining five members are appointed by the Union Government of India out of whom three shall be full time members.

The scope of SEBI covers the three broad groups of market participants;

- a. Market Intermediaries
- b. Issuers of securities
- c. Investors

To ensure that SEBI does not falter in its functioning, it acts as a quasi legislative, quasi judicial and quasi executive functions. These three makes SEBI a very potent market regulator. Over the years, SEBI has brought in plenty of market reforms which has made Indian markets at par with the best in the world.

The functions of SEBI can be categorized into two areas a. Regulatory Functions and b. Developmental Functions.

Regulatory Functions of SEBI

- a. Regulation of Stock Exchanges and other related self regulated organizations.

- b. Regulation of Brokers, Sub brokers, Registrars to the issue, Underwriters etc.
- c. Regulation of Portfolio Managers and collective investment schemes like Mutual Funds.
- d. Prevention of unfair market practices like insider trading and other fraudulent practices.
- e. Regulating any other areas concerning capital markets.

Developmental Functions of SEBI

- a. Promoting Investor education and creating awareness about stock markets.
- b. Conducting market related research and publishing information useful to all market participants.
- c. Promotion of self regulatory organizations and drafting guidelines for compliance and disclosure.
- d. Undertaking training and development of different intermediaries.

3.2.2 Reserve Bank of India (RBI)

The Reserve Bank of India is the central bank of the country. It is the apex bank and the principal regulator of the Banking sector in the country. The main objectives of RBI is to issue currency notes and to create a stable monetary policy. In other words, the actions of the RBI have a direct bearing on the economic growth and stability of the country.

The Reserve Bank of India is driven by a 21 member central board of directors. It has 1 Governor, 4 Deputy Governors, 10 Government Nominated Directors, 2 Finance Ministry representatives (who usually are Economic Affairs Secretary and Finance Affairs Secretary) and 4 Directors who represent the 4 local boards at New Delhi, Mumbai, Kolkata and Chennai. Each of these Boards consist of 5 members who adequately represent the regional banking landscape.

Following are some of the key functions of the Reserve Bank of India

1. Issuing Bank Notes - One of the most important functions of the RBI is issuing currency notes and coins of all denominations except Re1 which is issued by the Ministry of Finance. Along with issuing notes and coins, it is also responsible for the effective distribution of these notes and coins across the length and breadth of the country.
2. Custodian of reserves of commercial banks - The RBI acts as the custodian of cash reserves collected from other commercial banks. Commercial Banks are required to maintain CRR (Cash reserve ratio) at a rate decided in the monetary policy.

3. Banker to the Government - A major function of the central bank is to act as the banker to the government. The RBI is responsible for maintaining and operating all the deposit accounts of the central government. In international financial institutions like IMF and World Bank, RBI represents the government of India.
4. Custodian of foreign exchange reserves - RBI is responsible for maintaining the nation's FOREX reserve. It is absolutely essential especially for dealing with any Balance of Payment crisis. FOREX imbalance may cause an economic crisis of huge proportions.
5. Lender of Last Resort - The central bank acts as the banker to all banks. In fact it is the responsibility of the RBI to monitor the financial health of all banks in the country. RBI provides commercial banks with loans in case the commercial bank is facing any financial crisis.
6. Controller of credit in the economy - To achieve the monetary policy goals, the central bank is responsible for controlling the credit creation function of commercial banks. RBI uses qualitative and quantitative methods to regulate and control the flow of money in the economy. Interest rates and money supply regulations are required to achieve objectives related to inflation, consumption and liquidity.

3.2.3 Insurance Regulatory and Development Authority of India (IRDAI)

Insurance Regulatory and Development Authority (IRDA) is the regulator of the overall insurance business in India. It works under the directives of the Ministry of Finance and is tasked with the important task of regulating and licencing insurance and reinsurance business in the country. It was set up under the IRDA Act, 1999 and is headquartered in Hyderabad, Telangana.

Section 4 of the IRDA Act, 1999 gives guidelines about the composition of governing members. IRDA is governed by a 10 member body which comprises 1 chairman, 5 fulltime members and 4 part time members. All the members are appointed by the Government of India.

Insurance business is classified into life and general insurance. Life Insurance as the name suggests covers life insurance policies. General Insurance on the other hand includes all the non life insurance business like health insurance, motor vehicle insurance, commercial insurance, travel insurance to name a few. We can see that the scope of IRDA is very vast.

Following are some of the key functions of IRDA

- a. IRDA has the sole authority over issuing, modifying, renewing, suspending or cancelling the licenses of insurance companies.
- b. Specifying the code of conduct and monitoring the activities of surveyors and assessors.

- c. IRDA settles disputes between insurers and other insurance intermediaries.
- d. It is tasked with maintaining the overall financial soundness of insurance companies.
- e. A key primary function is to safeguard the rights and interest of the policyholders.
- f. IRDA is tasked with ensuring orderly growth of insurance business in the country. This is to ensure that economic development through insurance business is maintained at an optimum level.
- g. IRDA also acts as a quasi judicial agency and is responsible for settling disputes and redressing grievances of policy holders.
- h. Another key function is monitoring the premium rates charged and regulating any other business which benefits insurance business.

Practice questions at the end of the chapter;

Multiple Choice Questions

1. IRDA was established in the year _____
 - a. 2000
 - b. 1999
 - c. 1987

2. Regulation of capital markets is the job of _____
 - a. RBI
 - b. SEBI
 - c. PFRDA

3. Promoting investor awareness is a _____ function of SEBI
 - a. Regulatory
 - b. Developmental
 - c. Quasi-judicial

4. Motor vehicle insurance is a part of _____.
 - a. Life Insurance
 - b. General Insurance
 - c. Marine Insurance

5. The overall responsibility of regulating the entire banking sector lies with _____
- RBI
 - SEBI
 - IRDA

Explain the meaning of the following terms in One or Two lines

- Regulations
- Developmental functions of SEBI
- Life Insurance
- Composition of IRDA
- Composition of SEBI

Answer the following questions in detail;

1. Explain the meaning of 'Regulations' and elaborate the need for regulations in the financial sector in India.
2. Write a note on the key role and functions of SEBI
3. Explain the critical functions of RBI
4. Explain the need and importance of IRDA
5. Describe the set-up and composition of RBI and IRDA.



FACTORING, FORFAITING AND BILL DISCOUNTING

Unit Structure

- 1.0 Objectives
- 1.1 Introduction to Factoring
- 1.2 Types of Factoring
- 1.3 Factoring Process
- 1.4 Advantages and Disadvantages of Factoring
- 1.5 Introduction to forfaiting
- 1.6 Process of Forfaiting
- 1.7 Advantages and disadvantages of Forfaiting
- 1.8 Introduction to Bill Discounting
- 1.9 Difference between factoring and bill discounting

4.0 OBJECTIVES

- After the successful completion of this chapter, the learner shall;
- Understand the meaning and nature of factoring
- Learn the different types of factoring and the process involved in factoring
- Learn the merits and demerits of using factoring services
- Understand the meaning and nature of forfaiting services
- Learn the process of forfaiting along with its benefits and disadvantages
- Learn the meaning and process of bill discounting and differentiate between factoring, forfaiting and bill discounting.

4.1 INTRODUCTION TO FACTORING

Factoring is an important financial service in a way that it helps businesses to manage its accounts receivables in a better way. It is a type of debtor finance in which a business will sell its accounts receivables invoices to a third party at a discount against which it will receive cash. The third party will recover the money from debtors at a subsequent date. This

arrangement is important to meet current and immediate cash requirements. The third party that buys the accounts receivables is called a factor. The factor essentially becomes the funding source in this arrangement. Factoring is an important function as it enables cash injection into the business.

4.2 TYPES OF FACTORING SERVICES

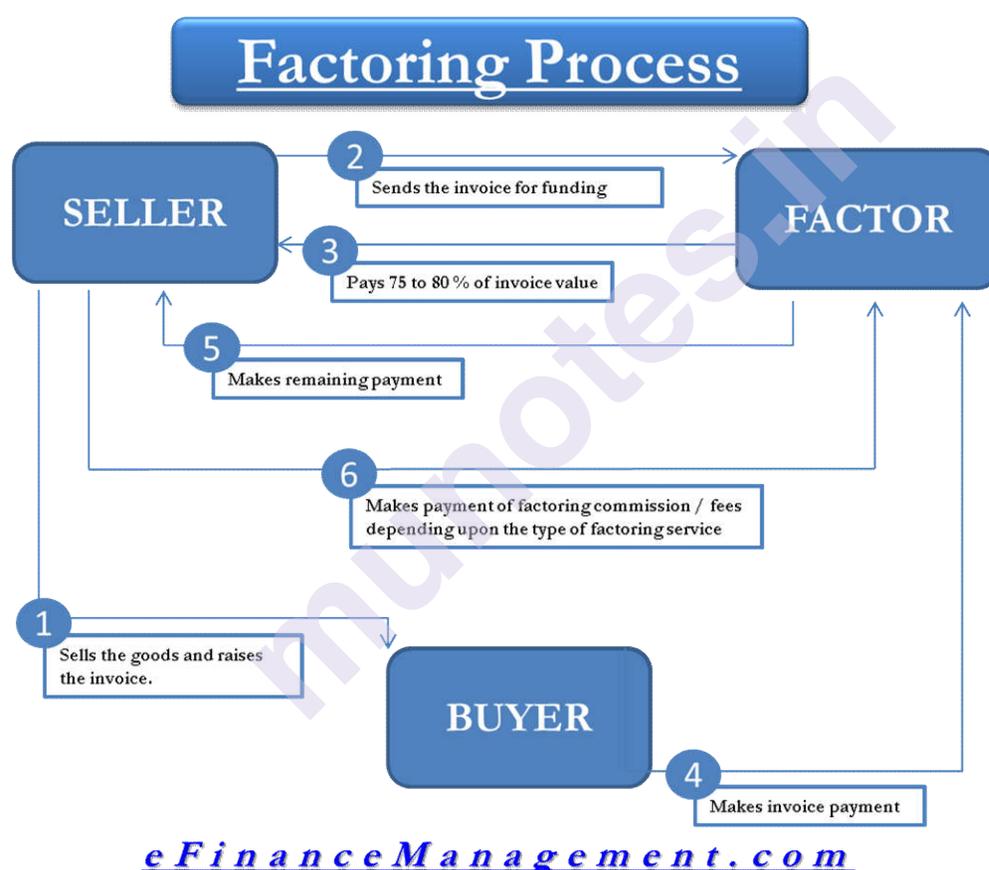
1. Recourse Factoring - In this type of factoring services, if the factor fails to recover the bill amount from the customer, the same is collected from the seller of goods. The entire risk of bad debts lies with the seller of goods. The commission charged by the factor is comparatively low.
2. Non - Recourse Factoring - In this type of factoring, the risk of bad debts lies with the factor. The factor bears the risk in case of the bill default by the customer. For bearing this risk, the factor will charge a higher commission.
3. Domestic Factoring - This is the type of factoring where the customer, seller of goods and the factor are from the same country.
4. Export Factoring - This is also known as international factoring or cross border factoring. This type of factoring involves 4 parties. It involves the seller of goods (the exporter), exporter's factor, the customer (the importer) and the importer's factor.
5. Disclosed and Undisclosed factoring - In case the bill / invoice mentions the name of the factor, it becomes a disclosed factoring. If the invoice has no mention of the details of the factor, it is called undisclosed factoring.
6. Advance Factoring - This type of factoring provides the seller of goods a pre advance on uncollected and non due receivables. A certain mutually agreed rate of interest is charged.
7. Maturity Factoring - It is a type of factoring where the factor will settle and pay the bill amount at the end of the collection period or when the money is collected from the customer.

4.3 FACTORING FRAMEWORK

Factoring enables a business access to immediate capital based on future income through receivables management. Accounts receivable represents money owed to the business from its customers. Following is the framework of factoring;

1. The seller sells the goods to the buyer on credit and raises the invoice.
2. The seller sells the invoice to the factor. The factor will verify the authenticity of the invoice.

3. After verification, the factor will pay around 75% - 80% of the bill amount.
4. The factor will wait for the customer to pay the bill amount. Once the bill amount is received by the factor, the factor will pay the balance to the seller of the goods.
5. The agreement between the seller of goods and factor decides the type of factoring agreement, interest charged and the rate of commission.
6. The commission / interest charged by the factor can be upfront or it can be in arrears.
7. In case of a non-recourse factoring, the factor bears the risk of bad debts. In such cases, the commission charged will be much higher.



4.4 ADVANTAGES AND DISADVANTAGES OF FACTORING

The advantages are as follows;

1. Factoring services reduce the credit risk of the seller of the goods. The risk usually gets managed by the factor.
2. The business is able to manage working capital requirements in a better way. This is because the factor provides money against invoices.
3. Cash flow and liquidity is greatly improved in the organization.

4. The receivables collection cost of the business drastically gets reduced.

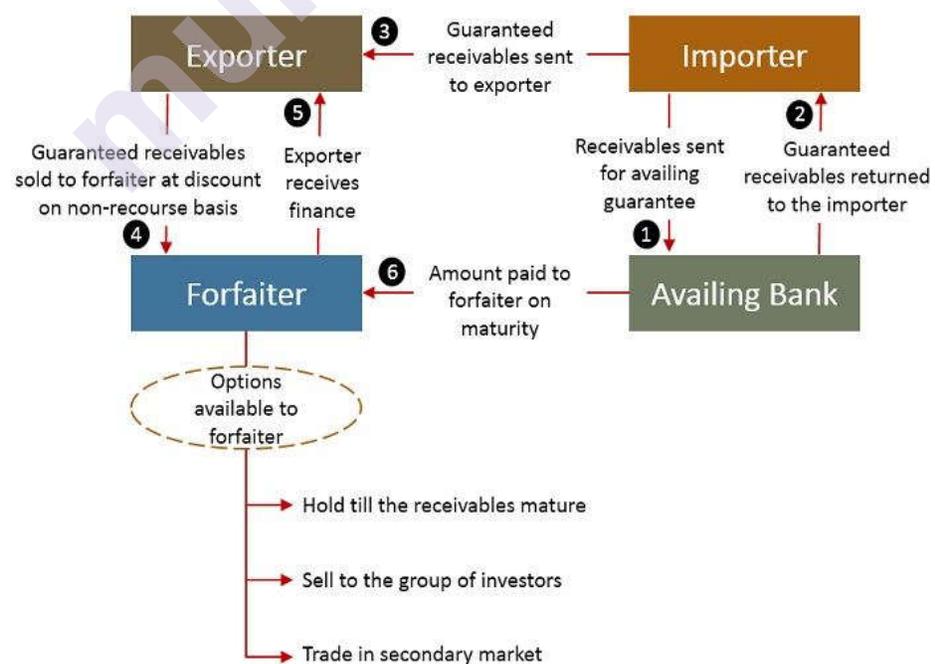
The disadvantages are as follows;

1. The cost of factoring is usually high. This is true especially in case of non-recourse factoring.
2. The relations between the seller and the buyer of goods can become stressful as the factor ends up collecting the money from the customer.
3. Bad behavior of the factor especially during bill collections can damage the goodwill of the business.
4. Details like sales, customer details which usually a business will not reveal to outside entities is shared with the factor.

4.5 FORFAITING

Forfaiting is a novel method similar to factoring which allows exporters to obtain cash by selling their long term and medium term foreign accounts receivable. The entire transaction is executed at a discount. Forfaiting is usually without recourse only. The forfaiter could be a separate department in a bank that provides such specialized services. Since forfaiting is without recourse, the entire risk of default is borne by the forfaiter. Although forfaiting seems very similar to factoring, one key difference is forfaiters typically work with large exporters who sell capital goods or commodities or are involved in large projects which require extended periods of credit. This also ensures that the seller (exporter) is completely protected against payment default by the importer. Complete credit protection provides peace of mind for the seller (exporter).

4.6 Process of Forfaiting (sample chart provided below)



1. Goods are sold by the exporter (seller) to the importer (buyer), on credit which extends upto 5 years.
2. A series of bills / promissory notes are drawn by the importer in favour of the exporter, for the bill amount to be paid in future. This also includes a certain rate of interest.
3. The bills / promissory notes issued are guaranteed by a recognized international bank, often importer's banker. The guaranteeing bank assures that it covers the failure in payment of the buyer if any. The bank may recover the money from the importer in case the importer defaults.
4. The notes so availed, are sold by the exporter to the forfaiter (exporter's banker), at a discount on a non-recourse basis.
5. Now, when the forfaiter buys those notes, it can hold these notes until it gets matured and recover the bill amount.

4.7 LET US NOW LOOK AT THE ADVANTAGES AND THE DISADVANTAGES OF FORFAITING

Advantages of Forfaiting

- Forfaiting is a mechanism that ensures immediate cash to the exporter. This improves the cash flow and liquidity management.
- Since forfaiting is without recourse, the seller (exporter) is protected from the risk of non payment of dues and it also eliminates the collection cost.
- Risk is quite low as banks of both the importer and the exporter are involved in the process.
- For the banks, it becomes an excellent system for earning good profits especially when currency appreciates.
- It is a completely easy to manage system as it converts credit sale into cash sale

Disadvantages of Forfaiting

- Forfaiting deals with importers and exporters and involves bills in foreign currencies. Forfaiting is not available in all currencies and only a few major currencies are considered.
- Forfaiting reduces the risk for exporters, however, since the risk is transferred to the forfaiter, it leads to a higher export cost.
- The higher export cost is borne by the importer, which is included in the standard pricing.
- Forfaiting facility is not extended to all transactions. Only a select few transactions become eligible under this scheme.

4.8 BILL DISCOUNTING

Bill discounting is an arrangement in which a company's unpaid invoices which are due are sold to a financier. The financier is usually a bank or a specialised financial institution. This arrangement is to allow businesses to have access to short term financial assistance. This also helps maintain adequate liquidity and assist in the working capital management. Bill discounting is also called invoice discounting. Bill Discounting is applicable only on those trade debts which are supported by accounts receivable.

Bill Discounting may sound like factoring at the outset. However there are differences between Bill Discounting and Factoring.

4.9 Factoring V/s Bill Discounting (Please convert this table into an image to avoid plagiarism)

BASIS FOR COMPARISON	BILL DISCOUNTING	FACTORING
Meaning	Trading the bill before it becomes due for payment at a price less than its face value is known as Bill Discounting.	A financial transaction in which the business organization sells its book debts to the financial institution at a discount is known as Factoring.
Arrangement	The entire bill is discounted and paid, when the transaction takes place.	The factor gives maximum part of the amount as advance when the transaction takes place and the remaining amount at the time of settlement.
Parties	Drawer, Drawee and Payee	Factor, Debtor and Client
Type	Recourse only	Recourse and Non Recourse
Governing statute	The Negotiable Instrument Act, 1881	No such specific act.
Financier's Income	Discounting Charges or interest	Financier gets interest for financial services and commission for other allied services.

Practice questions at the end of the chapter

Multiple Choice Questions

1. Sales Ledger Administration is available in the following factoring services

- a. Without Recourse factoring
- b. With recourse factoring
- c. **Invoiced discounting**

2. Credit Protection is available in

- a. **Without Recourse factoring**
- b. With recourse factoring
- c. None of the above

3. Under forfaiting the client is able to get credit facility to the extent of

- a. **100% of the value of the export bill**
- b. 80% of the value of the export bill
- c. 90% of the value of the export bill

4. Full service factoring is often

- a. **Recourse factoring**
- b. Non-recourse factoring
- c. Agency factoring

5. The process of selling trade debt of a client to a financial intermediary is called

- a. **Factoring**
- b. Securitisation
- c. Materialisation

6. services are mainly provided to foreign investors.

a. Custodial Services

b. Financial Services

c. Factoring Services

7. The Idea of providing factoring services was first thought of in India by

a. Tandemcommittee

b. Malhotracommittee

c. Vaghulcommittee

Explain the following terms in One or Two lines

- Factoring
- Forfaiting
- With recourse factoring
- Without Recourse factoring
- Bill Discounting

Write the answers to the following questions in detail;

1. Explain the term 'Factoring' and explain the types of factoring
2. Describe the process of factoring with a suitable diagram
3. Distinguish between factoring and forfaiting
4. What is Forfaiting and explain its process with a suitable diagram
5. Explain the advantages and disadvantages of factoring
6. Explain the advantages and disadvantages of forfaiting
7. Distinguish between bill discounting and factoring.



ISSUE MANAGEMENT AND INTERMEDIARIES

Unit Structure

- 5.1 Introduction
 - 5.1.1 Process of IPO
 - 5.1.2 Process of issue of debt securities
- 5.2 Issue management
 - 5.2.1 Indian scenario
 - 5.2.2 Merchant banking in India
 - 5.2.4 Reasons for growth of merchant banking
 - 5.2.5 Organization that can offer merchant banking services in India
 - 5.2.6 Merchant bankers in India
- 5.3 Functions of merchant bankers
- 5.4 Services of merchant bankers
- 5.5 Underwriter to an issue
 - 5.5.1 Underwriting objectives
 - 5.5.2 The following are the key characteristics of an underwriting agreement
 - 5.5.3 Different types of underwriting
 - 5.5.4 Classification of underwriters
 - 5.5.5 Capital adequacy requirement
 - 5.5.6 Registration and renewal fee
 - 5.5.7 Underwriting commission
 - 5.5.8 General responsibilities
 - 5.5.9 SEBI guidelines
- 5.6 Banker to an issue
 - 5.6.1 Registration
 - 5.6.2 Characteristics of bankers to an issue

5.6.3 General obligations and responsibilities

5.7 Brokers to the issue

5.7.1 Brokers' appointment

5.7.2 Conditions for grant of certificate of registration as broker

5.7.3 Conditions for brokerage

5.8 Summary

5.9 Exercise

5.0 LEARNING OBJECTIVES:

- To understand the process of fund raising through issue management.
- To understand the terminologies associated with issue management.
- To understand the activities involved in pre-issue and post- issue management.
- To understand the legal environment for issue management.

5.1 INTRODUCTION

Every corporate form of organisation whether existing or new requires funds for the starting the business or running or expansion of existing business. One of the basic sources of finance is raising funds by issue of shares. The process of issue management and listing involves the services like suggesting of proper capital structure to reduce the cost of capital, advising the clients on regulatory compliance, pre issue and post issue management, legal compliances etc.

5.1.1 PROCESS OF IPO



Step 1: Appointment of an Underwriter or Investment Bank: These financial experts carry out the IPO process on behalf of the company. They act as intermediaries between the company and the investors.

Step 2: This IPO step involves creating a registration statement along with a draft prospectus, also known as the Red Herring Prospectus (RHP). The Companies Act requires the submission of RHP.

Key components of RHP:

- a. Definitions: Contains definitions of industry-specific terms.
- b. Risk Factors: This section describes threats that can affect a company's finances.
- c. Using Proceeds from IPO: This section mentions how the funds raised from investors are used.
- d. Industry Description: This section describes the company's operations across the industry segment. For example, if a company belongs to Pharma sector, the section contains forecasts and forecasts for that sector.
- e. Business Clause: This section describes the company's key business activities.
- f. Administration: This section contains information about key personnel.
- g. Financial Description: This section consists of financial statements and audit reports.
- h. Legal Information and Other Information: This section describes on going proceedings against a company, along with other information.

This document must be submitted to the Corporate Registration Authority 3 days before offer open to public. In addition, the registration notification submitted must comply with applicable rules. After submission, the company can submit an IPO application to SEBI.

Step 3: Verification by SEBI

Market controller, SEBI then confirms the information provided by the organization. After getting the confirmation from the SEBI, organization can declare a date for its IPO.

Step 4: Making an application to the Stock Exchange

The company now has to make an application to the stock exchange for floating its initial issue.

Step 5: Creating Buzz of IPO

Before an IPO opens to the public, the enterprise endeavours to create a buzz within the marketplace with the aid of using roadshows. Over a length of weeks, the executives and team of workers of the enterprise will put it up for sale the approaching IPO throughout the country. This is essentially an advertising and marketing and marketing tactic to draw

capacity investors. The key highlights of the enterprise are shared with diverse people, inclusive of commercial enterprise analysts and fund managers. The executives undertake diverse user-pleasant measures, like Question and Answer sessions, multimedia presentations, institution meetings, on-line digital roadshows, and so on.

Step 6: Pricing of IPO

There are two types of IPO system:

a. Fixed rate issue: In a fixedrate issue, the rate at which stocks will be offered and allotted is informed to the buyers in advance.

b. Book building issue: In book building issue, issuer offers a 20% range within which buyers can bid for the stocks. The final issue price is determined after the bidding is closed. This 20% range is known as an IPO price bandwidth. Both retail and institutional consumers are known as to publish their bids inside this price range.

Step 7: Allotment of Shares

Once the IPO price is finalised, the company alongwith the underwriters will decide the number of shares to be allotted to every investor. In the case of over-subscription, partial allotments may be made or the excess application may be rejected. The IPO shares are normally allotted to the bidders within 10 working days of the closing bidding date.

The book is the collection of bids which are available in for the IPO, is open to all buyers. In different words, the call for the stocks supplied at different price is to be held for all investors whether existing or potential. No bid rate may be less than the IPO ground rate, that is the lower bound of the band. Neither it can be more than the IPO cap rate, that is upper bound of the band. The book is usually open for three days, and the bidders can revise their bids as long as the book is open.

Issuers opts for book building issue over fixed price issue because this system offers them the possibility to find out the rate and call for. This way, the issuer is capable of ensuring that the difficulty generates as a whole lot value in the direction in which market is inclined. The rate at which the shares is subsequently offered is known as the cut-off rate. This is the best rate at which all of the shares are supplied may be offered.

5.1.2 PROCESS OF ISSUE OF DEBT SECURITIES

A company can also raise funds by issuing debt instruments in the form of a public offering or a right offering. Primarily, the arrangements to be made and the procedures involved are the same as in the case of an equity issue. SEBI (Disclosure and Investor Protection) Guidelines 2000 still include some unusual provisions. Some of its key provisions are highlighted below.

a) The offer document for such an issue should include the following information:

- the interest rate for debentures that can be freely determined by the issuer company,
- The amount of the premium on conversion, the time period of conversion,
- In the case of PCDs/NCDs, the redemption amount, maturity period, and yield on redemption of the PCDs/NCDs
- Complete information about the terms of offer or purchase, including the name(s) of the party offering to buy, the khokhas (non-convertible portion of PCDs), and the khokhas (non-convertible portion of PCDs).
- The discount at which such an offer is made, as well as the effective price for the investor as a result of that discount
- The current and future equity ratios, as well as the long-term debt ratio,
- Servicing behaviour on existing debentures, payment of interest on term loans and debentures on due dates

b) Such a public or rights issue of debt instruments (including convertible instruments), regardless of maturity or conversion period, is only permissible if a credit rating has been obtained and disclosed in the offer document. All issues worth Rs100 crore or more will be rated by two different credit rating agencies. All credit ratings, whether accepted or rejected, must be disclosed in the offer document. Furthermore, all credit ratings obtained by the issuer company for any listed security during the three years preceding the issue should be disclosed.

c) If the issue is a debt with a maturity of more than 18 months, the issuer must appoint debenture trustees holders regardless of whether the debentures/bonds are secured or not. The offer document must include their names. The issuer company must execute a trust deed in favour of the debenture trustees within six months of the issue's closing. The trustees should be given the necessary powers to protect the interests of debenture holders. They also have the right, in consultation with the institutional debenture holders, to appoint a nominee director to the company's board of directors.

d) The offer document should list the assets that will be used to create the security, as well as their charge ranking (s). The security/asset cover to be maintained, the basis for its computation, the valuation methods, and the frequency with which such valuation should be disclosed should all be disclosed. The security must be created within six months of the issuance of the debentures. If the issuing company intends to create a charge for debentures with maturities of less than 18 months, the charge particulars must be filed with the ROCs in accordance with the Companies Act. Where no charge is to be created on such debentures, the issuer company must ensure compliance with the provisions of the Companies (Acceptance of Deposits) Rules, 1975, because unsecured

debentures/bonds are treated as "deposits" for the purposes of the Companies (Acceptance of Deposits) Rules, 1975.

e) While filing the draft offer document, the merchant banker should file with SEBI certificates from their bankers stating that the assets on which the security is to be created are free of encumbrances and that the necessary permissions to mortgage the assets have been obtained from financial institutions or banks in cases where such assets are encumbered.

f) In the following cases, a letter of option containing disclosures about credit rating, debenture holders resolution, option for conversion, justification for conversion price, and such other terms as SEBI may prescribe from time to time should be filed with SEBI through an eligible merchant banker:

In the case of a roll-over of non-convertible portions of partly convertible debentures (PCDs)/non-convertible debentures (NCDs) issued by a listed company, the non-convertible portions of PCDs/NCDs issued by a listed company, the value of which exceeds Rs 50 lakh, can be rolled over without changing the interest rate subject to the following conditions:

- Debenture holders are required to redeem their debentures in accordance with the terms of the offer document.
- A roll-over is performed only when debenture holders have sent their positive consent and not because their negative response has not been received.
- Before a rollover, a new credit rating is obtained within six months of the redemption date and communicated to debenture holders prior to the rollover.
- When such a roll-over occurs, a new trust deed is executed; and
- In the case of rolled-over debentures, new security is created. However, if the existing trust deed or security documents provide for the continuation of the security until the redemption of debentures, no new security may be created.

In the case of conversion of PCDs/FCDs into equity capital:

- If the convertible portion of any instrument issued by a listed company, such as PCDs, FCDs, etc., exceeds Rs 50 lakh and the conversion price was not fixed at the time of issue, holders of such instruments should be given the mandatory option of not converting into equity capital.
- In cases where such instrument holders are to be given an option, if any instrument holder does not exercise the option to convert the debentures into equity at a price determined in the general meeting of shareholders, the company must redeem that portion of the debenture at a price not less than its face value within one month of the last date by

which the option is to be exercised; the provision of sub-clause (c) above would not apply if such redemption is made.

- If the non-convertible portion of PCDs or Non-Convertible Bonds/Debentures are to be rolled over with or without a change in the interest rate(s), debenture/bond holders who wish to withdraw from the scheme will be given the option to do so. Rollover may be granted only when debenture/bond holders have sent their positive consent and not because their negative response has not been received. Before rolling over any non-convertible bonds, debentures, or nonconvertible portion of PCDs, a new credit rating must be obtained within six months of the redemption date and communicated to bond/debenture holders. The letter of option regarding roll over shall be filed containing disclosure with regard to the credit rating, bond/debenture holder resolution, option for conversion and such other terms which the Board may stipulate from time to time.

- If the non-convertible portion of PCDs or Non-Convertible Bonds/Debentures are to be rolled over with or without a change in the interest rate(s), debenture/bond holders who wish to withdraw from the scheme will be given the option to do so. Rollover may be granted only when debenture/bond holders have sent their positive consent and not because their negative response has not been received. Before rolling over any non-convertible bonds, debentures, or nonconvertible portion of PCDs, a new credit rating must be obtained within six months of the redemption date and communicated to bond/debenture holders.

- Debentures cannot be issued for the purpose of acquiring shares or making loans to any group company. This requirement would not apply to the issuance of fully convertible debentures with a conversion period of 18 months or less. The issuer company should determine and disclose the premium amount and time of conversion. The issuer company has complete control over the interest rate on debentures.

Test your Understanding:

What is book building issue?

What is IPO?

What does PCD, FCD, NCD stands for?

5.2 ISSUE MANAGEMENT

Issue management involves issue of all kind of securities like equity shares, preference shares and debentures or bonds in the procedures as discussed above. The services of issue management also include marketing of capital issues, of existing companies, including rights issues and dilution of shares by letter of offer are included in it. The issue management activities are divided into two parts:

Pre-issue

5.2.1 INDIAN SCENARIO

In India the functions of issue management are carried out by the merchant bankers. In India, a merchant banker is defined as “an individual who is who is involved in the business of issue management either by making arrangements regarding buying, selling or subscribing to the securities as a manager, advisor, consultant in relation to such an issue management.”

Merchant banking in India was firstly set up in India by National Grindlays in 1967; followed by the Citi Bank in 1970. SBI became the first commercial bank to set up a distinct division for merchant banking in the year 1972, followed by ICICI in 1973, and then various other commercial banks started these services viz. PNB, Bank of India, UCO Bank, etc. However, the credit for increase in merchant banking in India goes to introduction of FERA in 1973, after which, various banks such as IDBI and IFCI entered into this market.

5.2.2 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 than 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 activities are 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 new issue 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:
 - Full underwriting: An underwriter who accepts the entire subscription is referred to as a full underwriter.

- Partial underwriting: A partial share subscription by an underwriter is referred to as partial underwriting.
 - Joint underwriter: More than two underwriters have subscribed as a joint underwriter.
 - Sub-underwriter: One underwriter may appoint another underwriter to handle the subscription of shares.
 - 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.

5.2.4 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.

5. 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 Z cohort,
- 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.

5.2.5 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 Bank e.g., ICICI, IFCI, IDBI, etc.

- e. Private Financial Consultancy Firms and Brokers e.g., J.M. Financial and Investment Services Ltd., DSP Financial Consultants, Kotak Mahindra, etc.
- f. Professional Merchant Banking Houses.
- g. Technical Consultancy Organisations.

5.2.6 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

5.3 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. Financing 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, international alliances, market diversification, technology upgrades, joint ventures, and so on.

5.4 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 specified time 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 related legal 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 of debentures of a body corporate. They provide services of safeguarding security and protect interest of debentureholders 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.

5.5 UNDERWRITER TO AN ISSUE

Underwriters provide a guarantee for public subscriptions in exchange for a commission. After merchant bankers, the Underwriters take the lead in public offerings, where they play a critical role. The underwriting is required for the public offering. The stock exchange regulations clearly state that no stock broker may underwrite more than 5% of a public issue, and the appointment of broker underwriters must be approved by the relevant stock exchange. Typically, bankers can underwrite up to 10% of a public offering.

5.5.1 UNDERWRITING OBJECTIVES

The following are the Underwriting objectives:

- It ensures the sale of securities at a desired price.
- It facilitates the provision of funds during the company's financial crisis.
- The Underwriter assists the new company in registration.

5.5.2 THE FOLLOWING ARE THE KEY CHARACTERISTICS OF AN UNDERWRITING AGREEMENT

- In some cases, the Underwriter may be unable to sell the issues. Unsold securities are distributed amongst underwriters in the agreed-upon proportion.
- The offering price must be maintained in order for the securities to be distributed successfully.
- On the closing date, the company delivers the securities to the manager and receives the payment.
- The manager must make the final accounting for each underwriter at the end of the underwriting. He must also pay the commissions and account for the expenses incurred.

- Underwriting is insurance for newly issued public securities. It is one of the methods used to sell securities.

5.5.3 Different Types of Underwriting

The various types of underwriting agreements are as follows:

- **The Purchase Contract:** In this case, shares are sold to underwriters at a predetermined proportion. Several underwriters will come to an agreement to buy the company's securities.
- **Agreement between Underwriters and Representatives:** This is a contract between Underwriters and Representatives or Managers. The agreement covers all aspects of the issuance of securities, including: to fix the time of the offering; To reserve a proportion of securities for the selected dealers and institutions; To place, date, and deliver securities; Provisions for terminating and settling the underwriters' account; Underwriters' responsibility
- **The selling agreement:** The selling agreement: In this method, the issuer company will enter into a contract with the dealers to subscribe for new securities. The agreement specifies the offering price, the selling concession, and the delivery and payment terms.

5.5.4 CLASSIFICATION OF UNDERWRITERS

Underwriters in India may be classified into:

1. **Institutional Underwriters:** The Institutional Underwriters are as follows:

- **Development Banks:** Development banks are also referred to as industrial banks. They have long-term deposits and are capable of making long-term investments. Industrial banks assist businesses by underwriting their shares and debentures. When an Industrial Unit approaches an industrial bank for underwriting shares and direct financial aid, the industrial banks investigate the industry's prospects, the soundness of the financial requirements, the feasibility and utility of the schemes. Some of the Development banks are Industrial Finance Corporation of India (IFCI), Industrial Development Bank of India (IDBI), Industrial Credit and Investment Corporation of India (ICICI) among others
- **Commercial Banks:** Routine banking is handled by commercial banks, also known as public banks. Their primary goals are lending and underwriting. A few of them have been providing services as loan syndicators and issue managers. Commercial banks typically act as passive agents, supplying forms only on request rather than on their own initiative, and earning brokerage as a result.
- **Insurance Companies:** Insurance companies are primarily investment firms, not development organisations. The premier insurance institutions in the country are the Life Insurance Corporation (LIC) and the General Insurance Corporation (GIC). These two traditional

investment institutions provide funds primarily to provide liquidity to investments for the development of the corporate sector. These corporations' goals are direct lending to industry, subscription to shares and bonds to special industrial financial institutions, and capital market purchases of joint stock company securities.

- **State Finance Corporations:** The State Financial Corporations are also involved in underwriting business for stimulating the capital market.
- **Unit Trust of India:** The Unit Trust of India is another traditional investment institution that excels as an organisational tool due to certain activities. It is involved in the continuous sale of units, the redemption of units at Net Asset Value (NAV), and the convenience of small investors.

2. **Non-Institutional Underwriters:**

In India, there are two types of non-institutional underwriters:

- **Stock brokers:** Stock brokers act as intermediaries in the primary and secondary markets for the purchase and sale of securities. These individuals have a network of brokers working for them that stretches the length and breadth of the country. They are referred to as sub-brokers. These individuals spread the message and publicise the various issues in the offering. They quickly provide application forms and even go so far as to collect money from investors. They are extremely important in the field of underwriting. Persuasion is a tool that brokers can use to influence their clients.
- **Individuals/Investment Companies:** Individuals/Investment Companies raise funds from a large number of investors by selling shares. The pooled funds are managed by the experts for the purpose of purchasing financial assets. The benefits of the capital market will outweigh those of the shareholders. Investment companies are classified into two types: (a) Fixed Investment Trusts and (b) Management Investment Trusts.

5.5.5 CAPITAL ADEQUACY REQUIREMENT

- (1) The capital adequacy requirement referred to in sub-regulation (d) of regulation 6 shall not be less than rupees twenty lakhs;
- (2) Notwithstanding anything contained in sub-regulation (1),-
 - a) every stock broker who acts as an underwriter shall fulfil the capital adequacy requirements specified by the stock exchange of which he is a member;
- (1) The capital adequacy requirement referred to in sub-regulation (d) of regulation 6 shall not be less than rupees twenty lakhs;
- (2) Notwithstanding anything contained in sub-regulation (1),-
 - a) every stock broker who acts as an underwriter shall fulfil the capital adequacy requirements specified by the stock exchange of which he is a member;

(b) every merchant banker who acts as an underwriter shall fulfil the capital adequacy requirements specified in regulation 7 of the Securities and Exchange Board of India (Merchant Banker) Regulations 1992.

5.5.6 REGISTRATION AND RENEWAL FEE

Underwriters had to pay ₹ 5 lakhs as registration fee and ₹ 2 lakhs as renewal fee every three years from the fourth year from the date of initial registration. Failure to pay renewal fee leads to cancellation of certificate of registration.

5.5.7 UNDERWRITING COMMISSION

- It can be paid in cash, fully paid-up shares, debentures, or a combination thereof
- Underwriting commission is not payable on amounts taken up by promoters, employees, directors, friends, and business associates.
- Commission is payable on the entire issue underwritten, regardless of whether the entire issue is taken over by the public.
- Unless otherwise specified, commission is calculated on the issue price.
- Companies Act, 2013 provides that payment of commission should be authorized by Articles of Association and the maximum commission payable will be as under:

	On amounts developing on the underwriters (%)	On amounts subscribed by the public (%)
(A) Equity Shares	5%	5%
(B) Preference Shares/ Convertible and Non-Convertible Debentures		
For amounts upto 5 lacs	2.5%	2.5%
For amounts in excess of 5 lacs	2%	1%

5.5.8 GENERAL RESPONSIBILITIES

Other than the underwriting commission, an underwriter cannot benefit directly or indirectly from underwriting the issue. An underwriter's maximum obligation under all underwriting agreements cannot exceed twenty times his net worth. The agreement requires underwriters to

subscribe for securities within 45 days of receiving notification from the issuers.

Every Underwriter should keep the following accounts:

If the Underwriter is a body corporate:

- a copy of the balance sheet and profit and loss account as specified in the Companies Act, 2013; and
- a copy of the auditor's report as specified in the Companies Act, 2013.

If the Underwriter is not a corporation,

- The records pertaining to all sums of money received and expended by them; and the matters pertaining to the receipt and expenditure
- Their financial assets and liabilities

5.5.9 SEBI GUIDELINES

- According to the SEBI guidelines the following factors are to be fulfilled:
- The minimum requirement of 90% subscription is mandatory for each issue of capital to the public. This clause is applicable for both public and rights issue.
- If the company is unable to collect the issued amount from the public subscription and accepted development from the underwriters, the amount is refunded.
- The underwriting agreement must be submitted to the stock exchanges.
- The underwriter's registration number must be quoted in all correspondence with the SEBI, government authorities, and clients.
- The SEBI may issue warning letters or penalty advances in order to forewarn underwriters about their omissions.
- The SEBI developed the model underwriting agreement to standardise the legal relationship between the issuing company and the underwriters.
- The total underwriting obligations under all agreements should not be more than twenty times the underwriter's network.

Test your Understanding:

1. List the services provided by an Underwriter.
2. State guidelines provided by the SEBI for Underwriters.

5.6 BANKER TO AN ISSUE

'Banker to an Issue' refers to a scheduled bank or such other banking company as the SEBI may specify from time to time, that engages in all or any of the following activities:

- Acceptance of application and application monies;
- acceptance of allotment or call monies;
- refund of application monies;
- payment of dividend or interest warrants

5.6.1 REGISTRATION

To carry on activity as a banker to issue, a person must obtain a certificate of registration

from the SEBI. The SEBI grants registration on the basis of all banker-related activities, with particular attention to the following requirements:

- a) The applicant has the necessary infrastructure, communication and data processing facilities, and manpower to effectively carry out his activities;
- b) The applicant/any of the applicant's directors is not involved in any securities market litigation/has not been convicted of any economic offence;
- c) The applicant is a scheduled bank; and
- d) The grant of a certificate is in the best interests of the investors.

Fees for Registration

1. A non-refundable fee of ₹ 25,000 must be paid with an application for registration under regulation 3 sub-regulation (1A) or a renewal application under regulation 8 sub-regulation (1A).
2. Within 15 days of receiving intimation from the Board, each banker to an issue must pay a registration fee of Rs. 10 lakhs at the time of the Board's grant of certificate.
3. Every banker to an issue must pay a renewal fee of Rs. 5 lakhs every three years, beginning with the fourth year from the date of initial registration, within 15 days of receiving notice from the Board.

5.6.2 CHARACTERISTICS OF BANKERS TO AN ISSUE

Bankers to the issue, as the name implies, are in charge of ensuring that funds are collected and transferred to Escrow accounts. While one or more banks may act as both issuers and collectors of securities, others may only collect applications for securities and remit remittances through their

numerous branches in various locations. Banks are expected to provide timely information and records to the company and the lead manager in order to monitor and progress the issue work.

5.6.3 GENERAL OBLIGATIONS AND RESPONSIBILITIES

- Every banker to an issue is required to keep books of account, records, and documents.
- Every banker involved in an issue is required to provide information to the SEBI when required.
- Every banker to an issue must enter into an agreement with the body corporate acting as banker to an issue.
- Every banker to an issue must immediately notify the SEBI if the Reserve Bank takes disciplinary action against the banker to an issue in relation to issue payment work. Every banker involved in an issue must follow the code of conduct.
- Each banker assigned to an issue must appoint a compliance officer who is responsible for monitoring compliance with the Act, rules and regulations, notifications, guidelines, instructions, and so on issued by the SEBI or the Central Government and for redressal of investors' grievances.

5.7 BROKERS TO THE ISSUE

Meaning: Brokers are persons who are primarily concerned with obtaining subscriptions to the issue from prospective investors.

5.7.1 BROKERS' APPOINTMENT

- The appointment of brokers is optional.
- There is no limit to the number of brokers who can be appointed.
- The performance of brokers is within the knowledge of the leading merchant bankers acting as issue managers.
- The company consults with the stock exchange and sends letters to all active brokers across all exchanges. It obtains their prior permission to act as issue brokers.
- The prospectus should disclose the basic details such as the names and addresses of the brokers, and it should be filed with the Registrar of Companies along with a copy of the broker's consent letter.

5.7.2 CONDITIONS FOR GRANT OF CERTIFICATE OF REGISTRATION ASBROKER

- He should be the member of any stock exchange.

- He must follow the rules, regulations, and bye-laws of the stock exchange to which he belongs.
- He must pay the registration fees in the manner specified in the regulations.
- Within one month of receiving complaints, he must take appropriate steps to address the investors' grievances.

5.7.3 CONDITIONS FOR BROKERAGE

- Brokerage may be paid within the limits and subject to the other conditions specified.
- The brokerage rate for all types of public issues of industrial securities is set at 1.5 percent, regardless of whether the issue is underwritten or not.
- Brokerage on private placements of capital is permitted at a maximum rate of 0.5 percent for listed companies.
- The mailing costs and other out-of-pocket expenses for canvassing public issues must be borne by the stock brokers, and the companies make no payment on that account.
- A provision to that effect must be included in the agreement between the broker and the company.
- Brokerage is **not permitted** in the case of promotional directors, their friends and employees, or in the case of rights issues taken up or renounced by existing shareholders.
- Brokerage is **not payable** when applications are made by institutions/bankers against their underwriting commitments or on amounts devolving on them as underwriters as a result of the issues being undersubscribed.
- The issuing company is expected to pay brokerage within two months of the date of allotment and to provide the broker with the particulars of allotments made against applications bearing their stamp free of charge upon request.
- Cheques for brokerage on new issues and underwriting commissions should be made payable at par at all locations where recognised stock exchanges are located.
- The rate of brokerage payable must be is enclosed in the prospectus.

Test your Understanding:

1. Who can be a Banker to an issue?
2. State whether the following statement is true or false: It is compulsory to appoint Broker to an issue.

5.8 SUMMARY

Before beginning issue management, a merchant banker assesses an investment project's financial, technical, and economic viability. A project can be funded in a variety of ways. Because of changes in economic policy, the number and type of issues in the primary market increased dramatically during the 1990s. The companies have attempted to raise funds by issuing securities through public offerings, rights offerings, and private placements. This necessitates meticulous planning and a well-defined marketing strategy. Aside from a variety of pre- and post-issue activities, certain activities relating to the stock exchange, SEBI, and other agencies such as bankers, registers, and so on must be handled. Marketing an issue entails launching an aggressive sales campaign, determining the best media mix, and organising conferences. Furthermore, it is critical for a merchant banker to determine the best time to launch the issue. Another critical aspect of issue management is issue pricing, in which a merchant banker must consider both qualitative and quantitative factors when determining the premium component of the issue. A merchant banker's primary concern should be investor protection. He must try to protect investors from unjustified losses if the share price falls below the issue price after listing. Some merchant bankers have retained a provision for share buybacks under the safety net scheme. Managing an issue also necessitates that the merchant banker adhere to the legal and regulatory framework established by the Companies Act of 1956, the Securities Contracts (Regulation) Act of 1957, and the SEBI guidelines. In recent years, information technology has also had an impact on the issue management process, and the concept of e-IPO has emerged.

5.9 EXERCISE

A. Choose the correct alternative:

1. The minimum number of Issue Managers who can be associated with an Issue is limited by SEBI Regulations if the size of the issue is less than ₹ 50 crore is

- (a) 2 (b) 3 (c) 4 (d) 5

2. To act as underwriter, adviser, consultant to an issue a merchant banker has to register itself under

- (a) Category I (b) Category II (c) Category III (d) Category IV

3. Certificate of registration from _____ is mandatory for underwriters.

- (a) State Bank of India (b) Insurance Regulatory and Development Authority
(c) ICICI (d) Securities and Exchange Board of India

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

- (a) 2 (b) 4 (c) 1 (d) 3

5. Prospectus is the most important document to come out with _____ issue

- (a) Private (b) Public (c) Company (d) Social Issue

1 – a; 2 – c; 3 – d; 4- (d)

B. State whether True or False

1. Appointment of Banker to an issue is the first step in the issue of share.

2. Banker to an issue is required to register with SEBI.

3. Merchant Banker are required to look after the process of issue only till the issue is made.

5. Private banks cannot register as Merchant Bankers.

5. Stock Broker is a member of recognised stock exchange who deals in securities on behalf of clients

1- False; 2 – True; 3. False; 5. False 5. True

B. Answer the following

1) Discuss the various sources of funding available to existing and new businesses for project implementation.

2) What factors should be considered before deciding on a public issue proposal?

3) Describe the key aspects of the post-issue activities in detail.

4) Steps for registration of “Banker to an issue”

5) Write a note on Underwriting commission

Reference:

<https://moneymint.com/merchant-banking-in-india/#:~:text=In%20India%2C%20a%20merchant%20banker,to%20such%20an%20issue%20management.%E2%80%9D>

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STOCK BROKING

Unit Structure

- 6.0 Learning Objectives
- 6.1 Introduction
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 - 6.2.1 Application for registration of stock broker.
 - 6.2.2 Furnishing information, clarification, etc.
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- 6.3 Sub-broker
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- 6.6.2 Furnishing of information, clarification etc.
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- 6.6.4 Procedure for registration.
- 6.6.5 Procedure where registration is not granted.
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- 6.6.8 Trading member / clearing member [or self-clearing member] to abide by the Code of Conduct etc.
- 6.6 Stock Trading (Cash and Normal)
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- 6.8 General obligations and responsibilities applicable to Broker/Sub-Broker/Clearing member/Self-clearing member
 - 6.8.1 General obligations and responsibilities (chapter IV)
 - 6.8.2 Procedure for inspection (Chapter V)
 - 6.8.3 Procedure for action in case of default (chapter VI)
- 6.9 Summary
- 6.10 Exercise

6.0 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.

6.1 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.

6.2 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.

6.2.1 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.

6.2.2 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.

6.2.3 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 bylaws 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.

6.2.4 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.

6.2.5 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.

6.2.6 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-laws that apply to him;

- (c) if the stock broker wishes to change his status or constitution, he must obtain 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.

6.2.7 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.

6.2.8 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.

6.2.9 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.

6.2.10 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.

6.3 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.

6.3.1 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.

6.3.2 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.

6.3.3 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.

6.3.4 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.

6.3.5 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.

6.3.6 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.

6.3.7 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.

6.3.8 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.

6.4 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

6.5 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.

6.5.1 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[or self-clearing member] shall make separate applications for each activity in Form AA of 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.

6.5.2 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.

6.5.3 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 securities approved by the Board from time to time (but does not include fixed assets, pledged securities, value of member's card, non-allowable securities (unlisted securities), bad deliveries, doubtful debts and advances (debts or advances overdue for more than three months or debts or advances given to the associate persons of the member), prepaid expenses, losses, intangible assets and 30% value of marketable securities

6.5.4 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.

6.5.5 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.

6.5.6 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.

6.5.7 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.

6.5.8 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 mutandis 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 as a clearing member
3. State the steps to be taken if the application for registration as Trading member is rejected.

6.6 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.

6.6.1 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.
6. Because one cannot invest more than the fund allows, one can effectively control the loss, even if prices fall.

6.6.2 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.

6.7 STOCK TRADING (DERIVATIVES)

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

6.7.1 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.

6.7.2 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.

6.7.3 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.

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

6.8.1 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.

6.8.2 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

6.8.3 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 face one 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.

6.9 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.

6.10 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:

6. 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.
6. Write a note on different types of derivatives instruments.

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Rules and Regulations laid down by the SEBI



SECURITIZATION

Unit Structure

- 7.0 Learning objectives
- 7.1 Definition
- 7.2 Meaning of Securitization
 - 7.2.1 Participants in the Securitization
 - 7.2.2 Securitization mechanism
- 7.3 Securitization v/s Factoring
- 7.4 Features of securitization
- 7.5 Pass through certificates
 - 7.5.1 Meaning
 - 7.5.2 Parties involved in the pass-through certificate transaction
 - 7.5.3 Benefits of pass-through certificate
- 7.6 Special purpose vehicle
 - 7.7.1 Meaning
 - 7.7.2 Purpose of special purpose vehicle
 - 7.7.3 Advantages of special purpose vehicle
 - 7.7.4 Limitations of special purpose vehicle
- 7.7 Securitisable Assets
- 7.8 Benefits of Securitization
 - 7.8.1 Benefits to the originators
 - 7.8.2 Benefits to the investor
 - 7.8.3 Benefits to the financial system
- 7.9 New guidelines on securitization
- 7.10 Summary
- 7.11 Exercise

7.0 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.

7.1 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;

7.2 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.

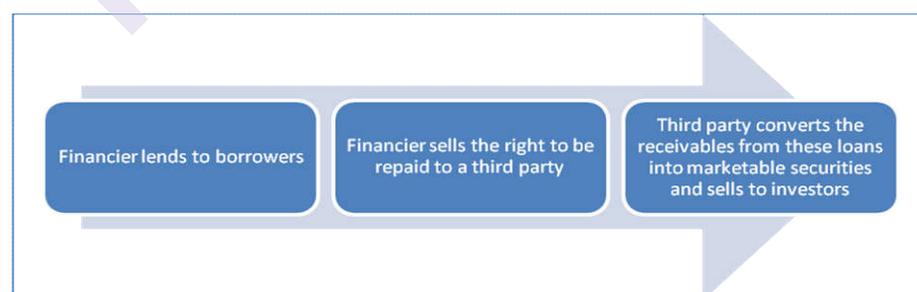
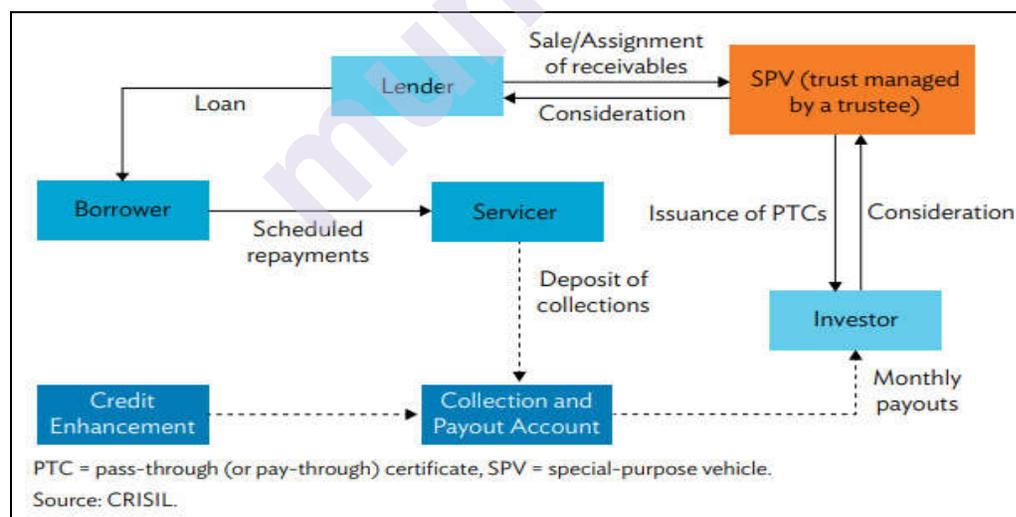


Fig 7.1 **Securitization Process**

7.2.1 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.



7.2.2 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.

7.3 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

7.4 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.

7.5 PASS THROUGH CERTIFICATES

7.5.1 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.

7.5.2 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.

7.5.3 BENEFITS OF PASS-THROUGH CERTIFICATE

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

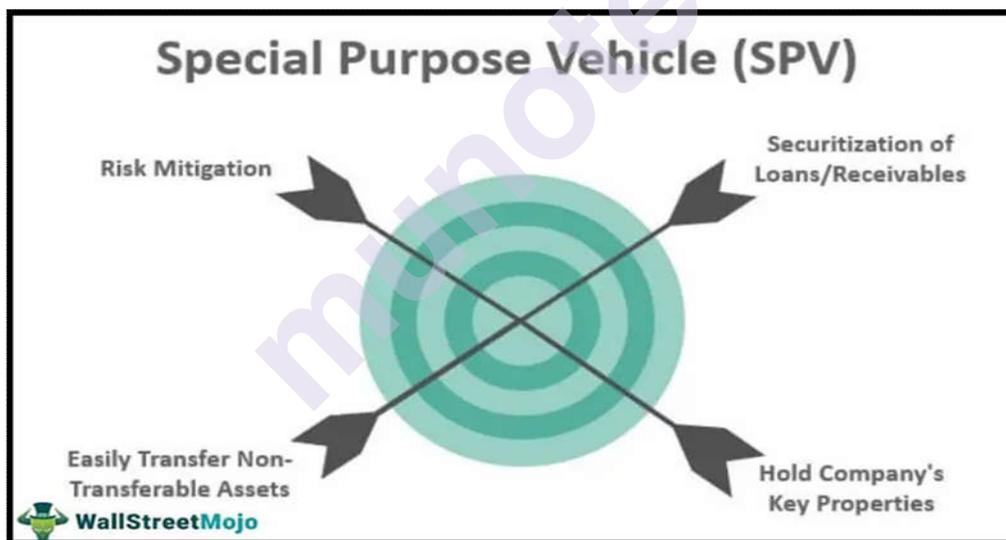
- Lenders can use Pass-Through Certificates to convert illiquid assets into cash-generating liquid assets.
- Securitization allows funds to be transferred from the inefficient debt market to the more efficient capital market.
- Securitization can help a company's debt-equity ratio.
- The underlying assets 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.

7.6 SPECIAL PURPOSE VEHICLE

7.6.1 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.

7.6.2 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.

7.6.3 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.

7.6.4 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.

7.7 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.

7.8 BENEFITS OF SECURITIZATION

7.8.1 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.

7.8.2 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.

7.8.3 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.

7.9 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.

7.10 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.

7.11 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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FINANCIAL SERVICES AND ITS MECHANISM

Unit Structure

- 8.0 Objectives
- 8.1 Introduction & Meaning
- 8.2 Types of Leases
- 8.3 Advantages and Disadvantages of Leasing
- 8.4 Leasing in India
- 8.5 Legal Aspects of Leasing in India
- 8.6 Hire Purchase: An Introduction
- 8.7 The Difference between Hire Purchase and Installment Sale
- 8.8 Summary Questions

8.0 OBJECTIVES:

- i) Learners will learn in details about leasing and hire purchase system.
- ii) Learners will understand the regulatory aspects of leasing and hire purchase system.
- iii) Learners will be capable of distinguishing between leasing and hire purchase system.

Financial Services is a broad consortium that includes an array of services right from insurance, real estate, investments, digital payment systems and money management at corporates and individual levels. The scope of financial services has been evolving for decades now and presently turns out to be the second-fastest-growing sector in the global markets. The financing services in the form of leasing finance, hire-purchase and venture capital have provided a great push to start-ups and innovative tech-ups in a big way to meet the long-term financial needs. This unit deals with the theoretical framework of leasing, hire purchase and venture capital in India.

8.1 LEASE FINANCE: INTRODUCTION AND MEANING:

Lease is defined as a contractual agreement between two parties wherein one party who owns the asset/ equipment (known as the lessor) lends the asset/ equipment for use to another party (known as lessee) for periodical rental payments for a pre-defined period. The agreement however can be renewed over a period of time. At the end of the agreement, the lessee returns the asset/ equipment to the lessor. It is a temporary transfer of the asset/equipment. In other words, the ownership remains intact only the right to use is temporarily transferred.

A lease is a contractual procedure calling for the lessee (user) to pay the lessor (owner) for use of an asset. The lease usually involves two parties which include the lessor (owner) and the lessee (user). In this arrangement, the lessor transfers the right to use to the lessee in return for the lease rentals agreed upon. The lease agreement can be made flexible enough to meet the financial necessities of both parties (Maheshwari, 1997).

The components of the lease agreement are as follows:

1. Parties to the agreement: There are a minimum of two parties to this agreement i.e lessor and lessee. But with growing complexities and demand broker forms part of the agreement.
 - a. Lessor: The party that owns the asset/ equipment is known as the lessor.
 - b. Lessee: The party that uses the asset/equipment for periodic payments.
 - c. Lease Broker: The party that acts as a liaison between the lessor and lessee in closing the deals. They are generally merchant bankers who act as lease brokers.
2. Lease Assets: The assets that can be leased are vehicles, equipment, machinery, land, factory building etc.
3. Term of Lease: The agreement vividly specifies the lease period and clause for its renewal.
4. Payment Terms: The amount and the terms of payment are well specified in the lease agreements.
5. Mode of Termination: The contractual agreement may be terminated at the discretion of the lessor or lessee as defined in the agreement. Generally, on the following terms the agreement is terminated:
 - a. The lessor sells the asset/ equipment to the third party
 - b. The lessee/ lessor terminates the agreement
 - c. The period of the agreement comes to an end.
6. Other Terms and Conditions: The agreement explicitly mentions the other terms and conditions such as restrictive use, insurance coverage, repairs and maintenance, tax responsibility etc.

8.2 TYPES OF LEASES

The Indian Accounting Standard 17 deals with types of leases in India, however, from 1st Jan 2019 IFRS 16 superseded it. The IFRS 16 provides for a single accounting model for recording lease transactions wherein the term of the lease exceeds 12 months. The variation in terms of leasing leads to the classification of leases in the following groups

A. Terms of Lease

1. Finance Lease V/s Operating Lease

The lease is classified as a finance lease when the lessor transfers substantial risks and awards associated with the leased equipment to the lessor and **the lease term exceeds 75% of the economic life of the asset**. The periodic payments are charged in such a way that amortize the asset value over the given period and add profit to the lessor. The title of the asset may or may not be transferred at the end of the lease depending upon the arrangements between the two parties. Generally, with the balloon payment, the lessee takes over the ownership of the asset at the end of the lease term. The primary object of the lessor is to recover the capital investment and make a profit out of the leased asset. This type of lease is therefore known as **Full Payout Leases**. The assets acquired under the financial lease are recorded **in the Balance sheet** of the lessee. The assets leased under this arrangement is railway wagons, heavy machinery, ships, aircraft, land and building etc. To cite MIDC (Maharashtra Industrial Development Corporation) lands are leased to the industries that fall under this category.

On other hand operating lease is one that is for a shorter period of time wherein the lessee doesn't enjoy full rights and rewards attached to the asset/ equipment. The typical period lease ranges from **1- 3 years**. Under this type of lease, the lessor apparently rents out the support services involving a fixed payment. This type of lease is also known as a **service lease**. It is often treated as an offshore balance sheet item with rental payments charged under the **Profit and Loss Account** of the lessee. The assets leased under this arrangement are computers, telephones, furniture, music systems etc.

B. Method of Lease

2. Sale and Leaseback V/s Direct Lease

Sale and Leaseback is also known as Indirect Lease wherein, the lessee sells his asset/ equipment to the lessor with a pre-agreement that it would be leased back to the lessee for a fixed rental payment and tenure. Thus, the lessee can now receive the capital invested and the lessor on other hand earns fixed income and ownership of the asset.

Direct Lease on other hand generally involves three parties, the equipment supplier, the lessor and the lessee. The lessor either owns the asset or acquires it from the supplier and then leases it out to the lessee on pre-defined terms and conditions. In the case where equipment supplier and lessor are the same, it is known as bipartite lease and when different it is known as Tripartite Lease.

C. Parties to Lease

3. Single Investor V/s Leveraged Lease

Under a Single investor lease, there are two parties to the contract i.e. the lessor and lessee. The lessor purchases the asset through a debt-equity mix and rents out it to the lessee for periodic payments. The debt so raised for the equipment is at the liability of the lessor alone and in case of default, the lessee cannot be held i.e without recourse from the lessee.

In the case of the leveraged lease, there are three parties to the agreement the lessor who contributes through equity, the financier also known as lender (debt financier) and the lessee. The lender here has full recourse to the lessee in case of default payments. Such a transaction is routed through the trustee who is entitled to look after the interests of the lessor and lessee. The sum paid towards rental are distributed first towards the loan payment i.e. lender and then to the lessor.

D. Geographical Area.

4. Domestic V/s International Lease

When all the parties to the contractual lease agreement reside in the same country it is known as a domestic lease.

The international lease agreements are further classified into import lease and cross border lease. When lessor and lessee reside in the same country but the asset/ equipment supplier belongs to a foreign land it is known as import lease. This is because the lessor imports the asset/ equipment to the native land of the lessor and lessee in order to execute the transaction.

On another hand, if the lessor or lessee belong to different countries such a contractual agreement is known as cross border lease. The country of asset/equipment supplier remains immaterial here. In the case of cross border lease, the terms of the contract are complex and involve substantial risks.

8.3 ADVANTAGES AND DISADVANTAGES OF LEASING

A. Advantages to the Lessee:

1. **Balanced Cash Flow out:** The lessee can acquire the full rights to the use of asset without involving a huge one-time immediate payout. On other hand the capital so saved can be invested to meet the other business requirements. This can help the lessee to meet its working capital requirements effectively and efficiently.
2. **Cheaper and Quick Source of Financing.** :Considering the time value of money and huge capital outlay required leasing option acts as cheaper source of finance for the equipment. Also, the formalities involved are eased out in comparison to purchase of asset thereby reducing both the time and efforts involved.

3. **Use and Control of Assets:** The lessee in case of financial lease has a complete access to the full use of the equipment without dilution and invasion of the financier. This leads to non-restrictive use of asset as against where institutional finance is involved.
4. **Tax Benefits:** Periodical Leasing payments are classified as revenue payments and hence receive a tax benefit.
5. **No Risk of Obsolescence:** Since the ownership rests with the lessor, the risk of obsolescence is also with him.

B. Advantages to the Lessor

1. **Security:** Since the ownership rests with the lessor, in case of any default payments by the lessee, the asset/ equipment can be reinstated.
2. **Tax Benefits:** The lessor can claim the depreciation for the asset leased thereby incentivizing through tax benefits without an actual cash payout.
3. **Trading on Equity:** The lessor enjoys the benefits of trading on equity thereby earning higher returns. The returns are generally higher than the cost of borrowings.

Disadvantages of Leasing to the lessee.

A. Disadvantages to the Lessee:

1. The lessee though makes a substantial payment towards the assets, the benefits of capital appreciation vests with the lessor alone.
2. In case of lock in period involved the lessee is at obligated to make the payments even if the asset/ equipment has become obsolete or renders minimal value addition.
3. The lessee though cannot claim for the depreciation of the asset is responsible for maintenance and wear and tear of the asset/ equipment.

B. Disadvantages to the Lessor:

1. **High Payback Period:** The capital investment involved in the buying out the asset/ equipment is huge, whereas the returns in form of rental payments involve a high payback period.
2. **High Risk of Obsolescence:** With constant changes in the technological environment the risk of obsolescence confronted is high.
3. **Changes in Price Level:** With the lessee receiving fixed amount of payments, the changes in price level are not accounted for accurately and cost of replacement of the asset/ equipment is also high.

8.4 LEASING IN INDIA

The concept of lease finance was pioneered in 1973 in Chennai (formerly known as Madras) by “First Leasing Company of India Pvt Ltd”. It was jointly started by Farouk Irani and A.C Muthia and enjoyed monopoly for over 7 years until 1980’s and promoted by professionals from Citibank. Witnessing the phenomenal growth prospects of the leasing finance, in

1980's 20th Century Finance Corporation was floated. This attracted the other players to step into the shoes of lease finance, thereby gearing the industry in the Indian economy. The next five-year period witnessed a rapid growth of leasing finance companies in India jumping from mere 2 companies in 1981 to 339 companies by the end of 1986 with leased value of assets amounting to Rs 2395.5 million. (Annual RBI report 1987). With New Economic Policy in 1991 coupled with Dahotre Commission Recommendations, RBI widened the scope of banking functions in 1994 wherein banks themselves turned out to act as leasing companies.

The leading categories of leasing companies existing in India presently can be classified as below-

1. Banking Sector: Both the public and private banking sectors do provide industrial leasing services in India. The major players here as below-

- Industrial Credit & Investment Corporation of India (ICICI)
- Industrial Finance Corporation of India (IFCI)
- Industrial Investment Bank of India (IIBI)
- Small Industries Development Corporation (SIDC)
- State Industrial Investment Corporation (SIIC)

2. Non-Banking Financial Companies: The popularity of NBFC's has grown immensely during the last decade due to reduced processing time, quick disbursement of funds, limited documentation and close informal relations with customers. This has helped them gain a cutting edge over other financial institutions in indulging into ancillary activities of leasing, hire purchasing, insurance. The specialized arm of NBFC categorized as Asset Finance Company primarily provide leasing and finance of assets. Eg Sundaram Finance Ltd, Anagram Finance Ltd and DCL finance Limited specialize in leasing services.

3. Non-Banking Non-Financial Companies (NBNFC): The companies that don't indulge in banking or financing activities are categorized as NBNFC. They deal into providing operating lease services such as IT equipment's, furniture, elevators etc for a shorter period of time for rental payments. Eg Origa Leasing Solutions Ltd, OPC Assets Solutions Pvt Ltd, Fujitsu India etc.

4. Specialised entities

- a. Car finance companies
- b. Captive financing arms of Vendors and Original Equipment Manufacturers.
- c. Cab aggregators
- d. Indian Railway Finance Corporation

Note: Uber Model operates under leasing agreement. Car leasing is one of most popular models of leasing in India.

8.5 LEGAL ASPECTS OF LEASING IN INDIA

There exists no umbrella act for leasing in India however they are governed by the Indian Contract Act 1872 and The Transfer of Property Act 1881. The four characteristics features of lease of a movable asset are

1. The subject matter of lease is goods.
2. The ownership vests with lessor
3. The possession and rights to use goods is transferred to lessee.
4. On termination of contract, the goods are redelivered to the lessor by the lessee.

Registration with RBI: Any company dealing with financial lease and whose 50% or more assets are financial assets and its 50% or more gross income is derived from these financial assets needs to mandatorily get itself registered with RBI apart from its registration under Indian Companies Act 1956 as amended in 2013.

Accounting Aspects: The IAS 17 and AS19 deals with leasing in India however with convergence of IFRS, the IFRS 16 superseded the IAS 17.

Taxation Aspect: The lease transactions are subject to GST tax in India. The provision of Input Tax credit too is applicable.

Stamp Duty: The lease agreements are subject to state law prevailing to stamp duty. In states where no separate provisions are laid down, it is governed by Indian Stamp Act 1899.

8.6 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.

The thin line of difference between the hire purchaser and installment sale is the right of ownership. In case of installment sale, the right to ownership is transferred immediately whereas in case of hire purchase agreement it is paid only at after the last installment is paid.

The hire purchase transaction too is governed by IAS 17, AS 19 and IFRS 16.

8.7 THE DIFFERENCE BETWEEN HIRE PURCHASE AND INSTALLMENT SALE

Sr. no	Point of Difference	Hire Purchase	Installment Sale
1.	Governing Act	Hire Purchase Act 1972	Sale of Goods Act 1930
2.	Ownership	Transferred on payment of last installment	Transferred immediately as in case of normal sale transaction
3.	Return of Goods	The hire-purchaser can return the goods before the ownership is transferred	The goods are not returnable.
4.	Recourse to the Seller in case of Default	The hire vendor can take the re-possession of the goods in case of even single default	The seller can file a suit against the buyer but re-possession of goods cannot be taken unless ordered by court.
5.	Parties Involved	Hire Purchaser and Hire Vendor	Buyer and Seller
6.	Total Amount Includes	Down-payment + Hire charges	Down-payment + Interest.

Difference between Lease and Hire Purchase

Sr. no	Point of Difference	Hire Purchase	Leasing Period
1.	Governing Act	Hire Purchase Act, 1972	Indian Contract Act 1872 and Transfer of Property Act, 1881
2.	Ownership	Transferred on payment of last installment	The ownership may or may not be transferred depending upon type of lease.
3.	Depreciation	Claimed by the Hire Purchaser	Claimed by the Lessor
4.	Duration	Shorter Period of time	Longer Period of time
5.	Parties Involved	Hire Purchaser and Hire Vendor	Lessor and Lessee
6.	Total Amount Includes	Down-payment + Hire charges	Rental Payments only. No down payment is required.

8.8 SUMMARY QUESTIONS

1. Explain the concept of Leasing. Discuss its advantages and disadvantages.
2. Discuss in brief the regulatory aspects of leasing in India.
3. State the various types of leases.
4. Write short note on: i) Financial Lease ii) Operating Lease iii) Hire-purchase system.
5. Distinguish between Leasing and Hire purchase system.



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HOUSING FINANCE

Unit Structure

- 9.0 Objectives
- 9.1 Introduction & Meaning
- 9.2 Statutory Regulatory Framework of Housing Finance Companies in India
- 9.3 Challenges confronted by Housing Sector Finance
- 9.4 Housing Industry in India: SWOC Analysis
- 9.5 National Housing Bank: Introduction
- 9.6 Disbursement of Funds under Refinance Schemes of NHB.
- 9.7 Summary Questions

9.0 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.

9.1 HOUSING FINANCE: INTRODUCTION & MEANING

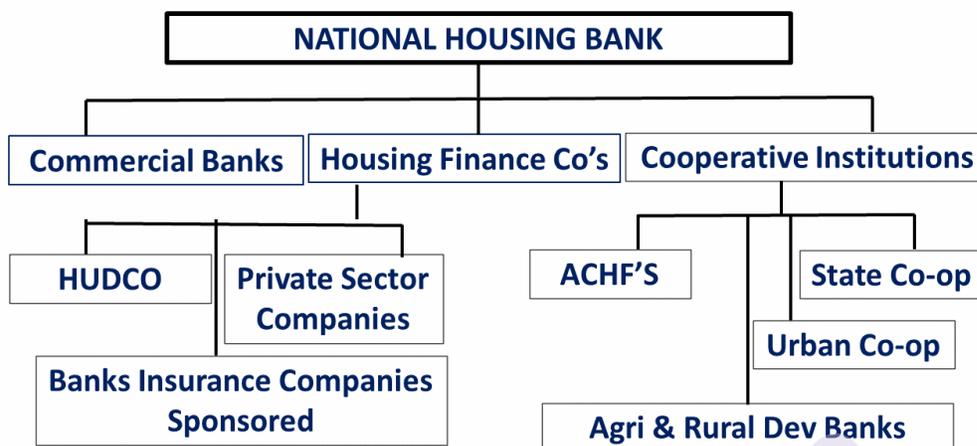
With improved penetration of housing finance during the last decade, the Real Estate Industry in India has turned out to be the second largest growing sector with providing employment to millions. Increasing demand due to nuclearization of families, High Disposable Income, Incentives from government 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

9.2 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 NBFC¹ 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.

9.3 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.

9.4 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 shrunk, 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.

9.5 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.

9.6 DISBURSEMENT OF FUNDS UNDER REFINANCE SCHEMES OF NHB.

DISBURSEMENTS BY NATIONAL HOUSING BANK UNDER ITS REFINANCE SCHEMES								
(Rs. Crore)								
Year (July- June)	Housing Finance Companies		Banks		Others		Total	
	Disburse ments	Outsta nding	Disburse ments	Outstan ding	Disburse ments	Outsta nding	Disburs ements	Outstan ding
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.								

9.7 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.



VENTURE CAPITAL FINANCING

Unit Structure

- 10.0 Objectives
- 10.1 Introduction & Meaning
- 10.2 Features of Venture Capital Financing
- 10.3 Stages of Venture Capital Financing
- 10.4 Facts and Figures
- 10.5 Summary Questions

10.0 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.

10.1 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 –

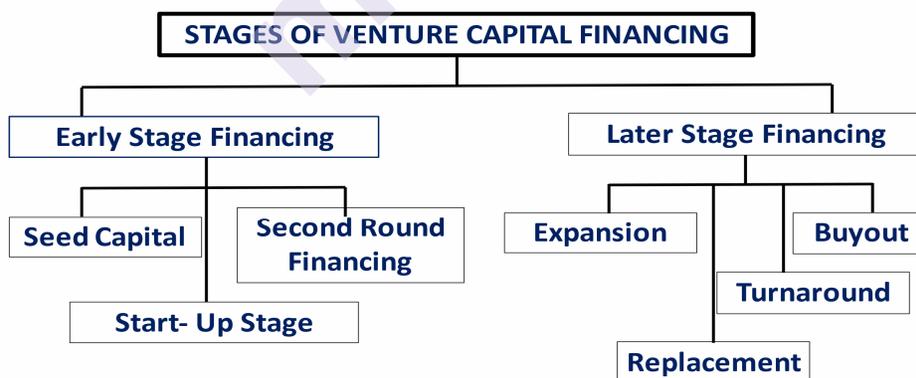
- i) has a dedicated pool of capital, raised in a specified manner, and
- ii) invests in venture capital undertakings in accordance with these regulations.

10.2 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.

10.3 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:

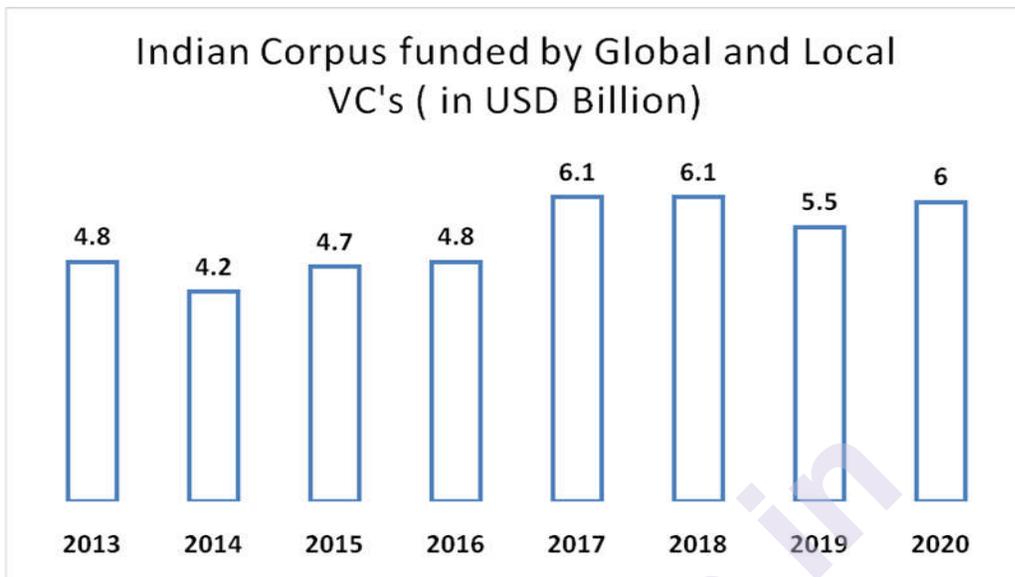
i) **Expansion:** As the business reaches to its peak, innovation and expansion are the key drivers for its sustenance in the long run. Where the venture cannot raise public finance directly, it may acquire or take over an existing venture. In the second scenario where the entrepreneur reaches its maximum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

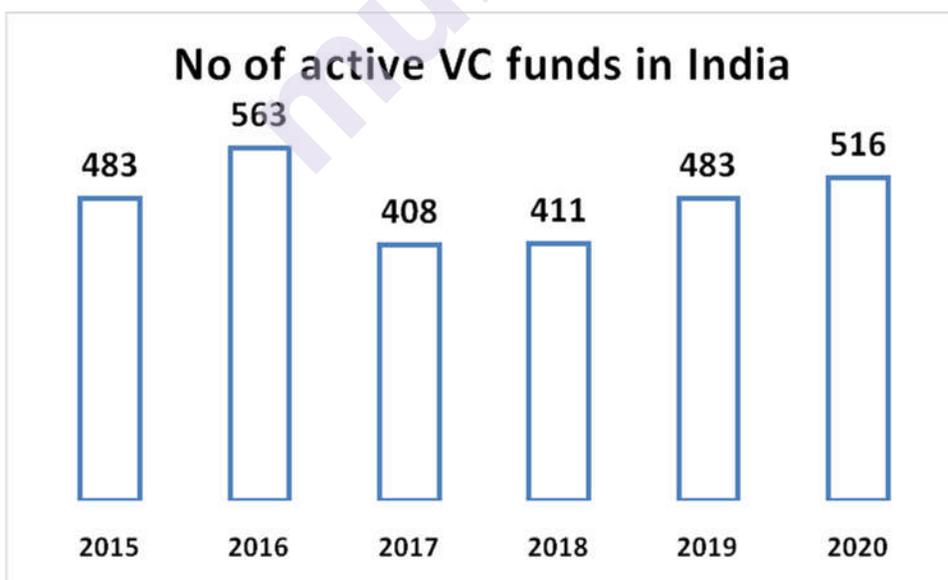
iv) **Buyout:** Set of passive shareholders that desire to exit from the venture are taken over by the active shareholders before offering it to the public or outsiders. This set of arrangements is known as buyout deals. These active shareholders need additional finance that can be met through venture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

10.4 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 be 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
DailyHunt*	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
FreshToHome	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

10.5 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.

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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



munotes.in

CONSUMER FINANCE AND CREDIT RATING

Unit Structure

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11.1.1 Sources of consumer finance

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11.1.3 Types of Products

11.1.4 Consumer Finance Practice in India

11.1.5 Mechanics of Consumer Finance

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11.0 INTRODUCTION:

“When business offers finance to the customers with the help of professional financing companies it is known as consumer finance” the main motive of this process is to provide the consumer to pay for goods or services that they couldn't pay directly in cash or credit card. This helps to bridge the gap between the buyer and seller enabling them with easy cash availability. Consumer finance is helpful for both consumer financing company as well as consumers. In other words, **Consumer finance is a type of lending that provides credit to a customer for personal or domestic use.**

When a business or retailer offers customer financing choices to its consumers, the term "consumer financing" refers to the use of either the customer's own funds or the funds of a lending firm or bank. This enables the consumer to purchase an item that they would otherwise be unable to afford or would prefer not to pay for with cash. Typically, the term refers to debt for common goods and services.

11.1 SOURCES OF CONSUMER FINANCE

1. Commercial banks:

Commercial banks give loans to people who can afford to pay them back. Loans are the sale of money's use by those who have it (banks) to those who want it (borrowers) and are willing to pay a price for it (interest). Consumer loans, home loans, and credit card loans are all forms of loans that banks make. Consumer loans are for monthly instalment purchases that are repaid with interest. Cars, yachts, furnishings, and other expensive durable goods account for the majority of consumer loans. Residential mortgages, home construction, and home upgrades are all possible uses for housing loans. Within prearrangement, credit card loans may be accessible in the form of cash advances.

2. Savings and Loan Associations (S&Ls):

Personal instalment loans, home renovation loans, second mortgages, education loans, and savings account loans are all available through savings and loan associations. Savings and loan associations lend to creditworthy individuals, and collateral is often required. Savings and loan associations loan rates vary depending on the amount borrowed, the term of the loan, and the collateral.

Because S&Ls lend depositors' money, which is a relatively affordable source of capital, their interest rates are often lower than those of other types of lenders.

3. Credit Unions (CUs):

Credit unions are non-profit cooperatives that serve members who share a common interest. Credit unions are typically able to offer better loan and savings terms than commercial institutions due to their non-profit status and cheaper costs. Because sponsoring firms offer employees and office space, and because some corporations agree to collect loan payments and savings instalments from members' salaries and apply them to credit union accounts, the credit union's costs may be reduced.

Personal loans and savings accounts are frequently offered at a good rate by credit unions. CUs typically have fewer prerequisites and offer speedier loan service than banks or savings and loans.

4. Consumer Finance Companies (CFCs):

Personal instalment loans and second mortgages are the specialty of consumer finance companies. Consumers with no credit history can frequently borrow from CFCs without putting up any collateral. CFCs are generally eager to lend money to clients who are having trouble obtaining credit elsewhere, but the interest rate is greater because the risk is more.

The interest rate is determined by the loan balance as well as the repayment plan. CFCs handle loan applications fast, frequently the same day they are submitted, and tailor repayment plans to the borrower's financial situation.

5. Sales Finance Companies (SFCs):

If you've ever purchased a car, you've probably come across the option of financing the purchase through the manufacturer's financing business. These SFCs allow you to pay for large-ticket things over a longer length of time, such as a car, major appliances, furniture, computers, and stereo equipment.

You don't deal with the SFC directly, but the dealer will usually advise you that your instalment note has been sold to a sales financing firm. You then make your monthly payments to the SFC rather than the dealer from whom you purchased the goods.

6. Life Insurance Companies:

You can normally borrow up to 80% of the accrued cash value of a whole life (or straight life) insurance policy from an insurance company. Loans against some policies are not required to be repaid, but the remaining loan sum is deducted from the amount your beneficiaries receive after you die.

Compounding interest works against you, therefore it's critical to repay at least the interest component. Because they assume no risks and incur no collection fees, life insurance companies charge lower interest rates than other lenders. The cash value of the policy serves as collateral for the loans.

7. Pawnbroker:

Pawnbrokers, who have recently become popular, are an unusual but widespread source of secured loans. They take possession of your home and lend you a piece of its value. You receive your property back if you repay the loan and interest on schedule. If you don't, the pawnbroker will sell it, though you can ask for an extension. The interest rates charged by pawnbrokers are greater than those charged by other lenders, but you don't have to apply or wait for approval. What is the main attractiveness of pawnbrokers? They don't ask many questions.

8. Loan Sharks:

These predatory lenders do not have a state-issued licence to operate in the lending industry. They demand exorbitant interest rates for refinancing, repossession, and late payments, and they only give you a limited amount of time to repay. They're well-known for adopting violent or criminally motivated collection practises. Stay away from them. They are, after all, unlawful.

9. Family and Friends:

Your relatives may be your finest source of credit at times. All such transactions, however, should be handled professionally; otherwise, misunderstandings may arise, jeopardising family relationships and friendships.

If the IRS learns about an intra-family "loan," it can "impute interest" on it, which is revenue for the lender but not deductible for the borrower. An IRS audit can also have a negative impact on family relationships.

10. Traders:

Traders are the most common companies that deal with consumer credit. Sales finance firms, hire buy companies, and other financial institutions fall under this category.

11.1.2 Types of Consumer Finance

The term "consumer loan" refers to the type of loan extended to consumers to fund specific items or purposes. Typically, consumers avail of loans for financing home purchases, debt consolidation, education, general living expenses, etc. On the other hand, growing small businesses

take on loans to fund working capital requirements, equipment purchase and real estate, inventory purposes, etc. In short, there is a wide variety of consumer loan products available in the market, and thus it is important for consumers to understand their own needs before availing of any of the products. This article will provide a brief understanding of consumer loans and their different types.

Types of Consumer Loan

1. Mortgage

A mortgage is a secured loan given by a bank to a consumer for buying a house, which usually costs much more than what an average person earns in a year. This type of loan is stretched over a longer period of time to ease out monthly installments, the most common mortgage being a 30-year fixed-rate loan.

2. Auto Loan

An auto loan is either extended by a bank or the car dealer itself to finance the purchase of a vehicle. The term of a typical auto loan ranges from 2 years to 7 years. The tenure is shorter, and the down payment is larger for an auto loan due to the rapid car value depreciation. It is typically secured in nature.

3. Education Loan

The objective of an education loan is to fulfill the education needs of a student by paying the college/tuition fees. In this way, students are able to pursue their life goals through proper education. This is an unsecured type of loan, and the repayment only starts few months after the student's graduation from college.

4. Personal Loan

A personal loan caters to various day-to-day needs of the borrower. It is the most versatile type of loan in the consumer loan market due to its wide range of end-use purposes, including debt consolidation, vacations, etc. This type of loan usually has a long tenure and can be either secured or unsecured in nature.

5. Refinance Loan

As the name suggests, this type of loan is used to refinance an existing loan. In fact, a refinance loan can be used to refinance any of the abovementioned loans. Typically, it has a fixed payment with a lower interest rate, which primarily attracts consumers.

11.1.3 Types of Products:

1. Revolving Credit:

Revolving credit is a type of credit that allows an account holder to borrow money indefinitely up to a defined monetary limit while returning a portion of the current balance due in monthly instalments. Each payment replaces the account holder's available funds, minus the interest and fees charged. eg: credit card

2. Fixed Credit:

The interest rate on a fixed rate loan does not fluctuates. When a loan is taken, a fixed rate of interest is locked and the rate and monthly payments remain the same throughout the payback period. It's easier to arrange budget and prevent skipping payments if a steady monthly payment is known.

eg; Term loan

3. Cash Loan:

A cash loan is one in which the borrower receives the funds in cash. A personal loan can be granted to a private individual, and a business loan can be issued to a company. A consumer takes loan from a bank or a financial institution for the purchase of product for personal use.

eg: Personal loan

4. Secured Finance:

Secured loans are commercial or personal loans that require some form of collateral to be repaid. A bank or lender can ask for collateral for significant loans that are being used to buy a specific asset or when your credit ratings aren't good enough to qualify for an unsecured loan. Because secured loans provide a reduced risk to lenders, they may offer cheaper interest rates to borrowers. Certain secured loans, such as negative credit personal loans and short-term instalment loans, can, nevertheless, have higher interest rates.

5. Unsecured Loans:

An unsecured debt or obligation is one that is not supported by any kind of collateral. Collateral, which is found in secured debt, is property or other valuable assets that a borrower delivers as a way to secure the loan. In an unsecured loan, the lender will give money based on other parameters that the borrower meets. Credit history, income, employment position, and any outstanding debts are among the qualifying considerations.

6. Credit Card

It is the most commonly used and popular among the various types of consumer loans. A borrower usually uses it to buy daily need items, such as groceries, apparel, etc., on credit. The rate of interest charged on this type of loan is a bit on the higher side, and thus failure to pay on time can attract a very high penalty.

1.1.4 Consumer Finance Practice in India:

Consumer finance has enormous potential and is a highly profitable and bankable activity, especially in a low-interest environment. However, there are concerns about credit bureaus, supplier alliances, product

innovation, and consumer protection. India is regarded as the world's second-fastest-growing country, after China. India has recently developed as a primarily industrialised and service-oriented economy. This fact is supported by the consistent growth rate over the last few years. The combination of economic liberalisation and a young population has resulted in an increase in income and purchasing power. Young people's thoughts have been caught by international companies and trends. Aspiring for higher-quality items, a fast-changing lifestyle, and larger expectations for personal growth have all become the norm.

An ordinary man who previously disliked credit is now in favour of it for shopping convenience, financing housing, autos, consumer durables, and even vacations. The traditional cautious mindset has shifted, and borrowing against future earnings is now a common occurrence in India.

The Indian customer can choose from a variety of financing options provided by a variety of banks and other financial institutions. Commercial banks have now reached an agreement with non-banking finance companies to address the rising demand for consumer finance as a result of increased consumer goods product offerings. Consumer finance has grown at a rate that is commensurate with the country's supply of goods. The disadvantage is that the retail loan boom will increase household indebtedness.

Although financial systems change from country to country, there are numerous similarities among financial service providers. Below are few mentioned common service providers:

- a) Central bank
- b) Banks
- c) Financial institutions
- d) Money and capital markets and
- e) Informal financial enterprises.

1. Demand for credit-fuelled consumption:

With India's financial industry evolving at an unparalleled rate, the country's credit demand has been steadily increasing over the years. The emergence of India's "affluent middle class" and rural economic growth are shifting consumer spending habits and driving the majority of the country's consumption growth. From March 2000 to March 2021, India's domestic credit growth averaged 15.1%, fueled mostly by retail loans and increased credit card use. With 22 million Indian customers seeking for new credit every month, the Indian consumer credit market continues to grow at a faster rate than most other major economies across the world.

2. Increase in the purchasing power of an average Indian:

India spends more than twice as much as countries like Brazil on consumer goods. Over the last five years, private final consumption expenditure has risen steadily, reaching INR 123.1 Mn (USD 1.70 Mn) in

2020. In the last five years, India's household debt has increased at an annualised rate of almost 13%.

3. A shift in the demographic profile of the consumer:

India is one of the world's newest countries, with more people of working age joining the workforce every day. Millennials and Gen-Z, the next generation, have better access to education, jobs, and higher earnings, causing them to abandon frugality in favour of increased consumer expenditure. Consumers are spending more on aspirational categories including lifestyle products, consumer durables, and jewellery as their income levels improve. Domestic consumption in India has expanded 3.5 times in the last decade, from INR 31 trillion (USD 0.42 trillion) to INR 110 trillion (USD 0.42 trillion) (USD 1.50 Tn).

4. Changing customer landscape – the rising role of fintech:

Fintech, the fastest-growing industry that serves both consumers and corporations, has been dubbed the "invention of the decade." When banks dominated India's financial services business, fintechs carved out their own niche by focusing on customers from urban and rural areas who were turned down by banks owing to a lack of credit history or collateral. The fintech industry has introduced the notion of 'sachet packaging' for simple access to financial products — available anytime, anywhere, and in any number. With increased client demands, the introduction of e-commerce, and the widespread use of smartphones the Indian fintech ecosystem has grown manifold in the last few years.

5. Growth Trends:

- a. In comparison to Secured Products, which increased at a CAGR of 17% from 2017 to 2020, Unsecured Products had a 38 percent increase in loan books.
- b. With the rise of consumerism and financial institutions, new loans were sanctioned at a 39 percent annual growth rate between FY18 and FY20. Unsecured loans accounted for the majority of the growth, with a CAGR of 49%.
- c. There has been a rise in credit growth to tier 3 and tier 4 markets for lending. Low-ticket, high-volume lending goods like as two-wheelers, entry-level vehicles, and inexpensive homes have seen a strong increase in these markets. Given the skew of the working population, metros remain the largest lending markets.
- d. With a contraction of 7.5 percent in the second quarter of 2020 to 21, the Indian economy recovered faster than projected. After April 2020, a V-shaped recovery began, and the current fiscal year is predicted to be one of high economic growth.
- e. Legacy banking systems are preparing the way for technology-driven new-age lending systems that will provide mass-market tailored financial products and services.

- f. The rise in rural India's income has resulted in increased demand for micro insurance. Consumer Finance and Credit Rating

Source : A review of India's Credit Ecosystem by Experian

1.1.5 Mechanics of Consumer Finance:

As a small company owner, you have a number of payment alternatives to offer your consumers to make purchasing your products and services more convenient. The following are by far the most prevalent methods of payment:

1. Debit cards
2. Cheques
3. Credit Card
4. Cash
5. Online transfer
6. E-wallets etc

Need:

When it comes to unbanked and underbanked clients, many businesses with high average prices on their products or services face circumstances where customers put off important purchases due to their financial status. Many of these consumers simply do not have sufficient credit lines or funds in their checking accounts to cover the transaction. As a result, these organisations either lose the customer or develop their own in-house financing scheme, which can be a risky endeavour if the consumer does not pay in full on time.

Requirement:

Fortunately, there is a new payment option in the form of consumer finance that can be used in these circumstances. Consumer financing, often known as "customer financing" or "retail financing," allows you (the merchant) to provide customers an affordable monthly payment plan for financing transactions, with loan approvals occurring in seconds at the point of sale.

Way of receiving consumer finance:

This niche form of financing, known as consumer retail financing, allows you as a merchant to instantly provide a way for your customers to finance their purchase by allowing them to apply for a 6 – 24 month instalment loan within minutes at checkout to finance the purchase of your products or services. The merchant is charged an upfront fee and/or a monthly service fee for this type of financing.

Platform:

Typically, the platform will create partnerships with a variety of financial services businesses in order to provide diverse solutions through a single platform. They might, for example, partner with traditional banks, credit unions, alternative loan firms, leasing companies, rent-to-own companies, and others.

Approval:

The customer will fill out one brief application at the point of sale, and the system will decide the optimal package to recommend based on their risk profile. Once the "approved" signal is displayed, the specifics are displayed, allowing the consumer to decide whether or not to join the programme.

Interest:

Some retail finance platforms allow your business to make money on the loans provided as well, by marking up the interest rates and costs that are being provided to your customer.

Loan sanction:

When a consumer accepts a loan option and electronically signs the papers, they typically receive a receipt, and you are then permitted to provide the customer with the items or services they require. The sum of the purchase is deposited into your bank account within 24 to 72 hours. The financing business will subsequently begin deducting the agreed-upon payments for the loan transaction from your customer's bank account.

1.1.6 Consumer Credit Scoring:

A credit score is a numerical representation of a consumer's creditworthiness based on the consumer's credit record, and it measures the likelihood of the consumer defaulting on a credit obligation. Consumers' credit scores also influence the marketing offers they get, such as credit card offers.

Each element that helps forecast who is most likely to repay a debt is given points in a credit scoring system. A credit score is a total number of points that helps estimate how creditworthy a customer is, or how likely he or she is to repay a loan and make payments on time.

The use of scoring models in credit operations is becoming increasingly prevalent as a result of their multiple advantages:

1. application processing time is reduced, resulting in cheaper expenses.
2. credit risk assessment that is objective.
3. improved employee productivity
4. Use of adequate financial collateral is a possibility.
5. Keeping tabs on the credit portfolio for any bad debts

6. projections and credit methods that are more accurate

Factors influencing credit scoring:

When deciding whether or not to give a loan, many variables are considered. These include the borrower's attributes (who they are), their financial status, the amount of the loan requested, the loan's purpose (what it will be used for), and the type of collateral. Because of the complexity of these factors, the risk is calculated using both quantitative and qualitative methods.

The quantitative analysis begins with an assessment of the customer's financial situation based on their monthly income and expenses. It may also include a cash flow analysis of the customer's accounts as well as a review of the customer's credit history. While the qualitative assessment considers factors such as marital status, education, or work status - for natural individuals - and legal form, industry in which they operate, or accounting method - for businesses.

Past customer activities that have a negative impact on credit scores are also important:

1. late instalment payments and other obligations,
2. overspending on credit cards
3. exceeding credit card limitations, making a massive number of commitments
4. There isn't any credit history.

Before providing money, the financier should always analyse the customer's ability to repay. Several measures are used to analyse a customer's believability and repayment capacity. Consumer credit scoring systems, often known as credit rating methods, are used to determine a customer's credit worthiness and repayment potential.

These strategies provide criteria for admitting or rejecting a customer, as well as determining a customer's creditworthiness. Dunham Greenberg Formula, Specific Fixed Formula, and Machinery Risk Formula are three of the most widely utilised techniques. Credit Bureau of Information India Ltd is India's largest credit rating agency for personal consumer finance (CBIL)

A. Dunham Greenberg Formula:

This technique is based on the following factors:

- i) the customer's employment history,
- ii) income level,
- iii) financial situation,

- iv) type of security offered,
- v) payment history.

It emphasises the customer's income level and previous records. The customer's numerous aspects/parameters are assigned points using this procedure. It is ranked out of a possible 100 points. An applicant with a credit score of greater than 70 is regarded to have strong credit.

The points allotted to various aspects are:

Parameters	Score (Points)
Applicants employment record	20
Applicant's income	25
Applicants finance	10
Type of security offered	20
Past payment record	25
Total	100

B. Specific Fixed Formula:

Another credit rating formula is this one. It emphasises

- i) Age,
- ii) Gender,
- iii) Residence Stability,
- iv) Occupation,
- v) Type of Industry,
- vi) Employment Stability, and
- vii) Customer Assets in determining a customer's credit worthiness.

Each of these criteria has a specific score assigned to it. Borrowers with a score of more than 3.5 are classified as "great borrowers," while those with a score of more than 2.5 but less than 3.5 are classified as "marginal borrowers."

The method of scoring is as follows:

Parameters	Credit Score
Age	0.1 - 0.5
Gender	0.4
Stability of residence	0.042 - 0.42
Occupation	0.16-0.55
Industry	0.21
Stability of employment	0.059 - 0.59
Assets	0.20 - 0.45

C. Machinery Risk Formula:

The amount of the down payment, monthly salary, and length of service are all factors in this strategy. Essentially, this strategy is based on the customer's current financial situation and projected income earning capacity. Generally, government departments use this strategy to advance loans to their personnel. The following formula is used to compute the loan amount to be approved.

Loan amount = Down payment + (0.124 x monthly income) + (6.45 x length of service in months)

1.1.7 Case for and against consumer credit:

Consumer loans, in all of their forms, have benefits and drawbacks, and must be utilised prudently for maximum benefit. Many of us can use credit to buy a car or a house with a mortgage and financial loans, or to pay for education or furnishings with a credit card, or even to buy clothes when we don't have cash but need to extend our wardrobe. Many people profit from good consumer credit use, yet reckless consumer credit use results in massive debt and distress.

Case for Consumer Credit:**Flexibility and convenience:**

Credit can be used to make online purchases or to avoid carrying significant quantities of cash when shopping, renting a car, dining out, or doing other forms of entertainment. Many people's only option in an emergency, such as when their roof has to be fixed or their car requires a new gearbox, is to use credit.

Rewards:

Consumers can benefit significantly from utilising credit cards if they are used responsibly. Many department stores and car dealerships provide clients with favourable financing options, such as late payments and cheap interest rates. Credit cards frequently offer cashback, frequent flyer miles, and reward points to cardholders. These advantages and awards are free

money for consumers who resist the impulse to overspend and remove money from their credit cards each month.

Building credit history: If one establishes a good payment history for consumer credit accounts, such as credit cards and personal loans, and otherwise manage your credit responsibly, consumer credit can be a useful tool for improving credit score.

Increasing credit score: Your credit score can be boosted by a track record of timely payments on credit cards, loans, and other forms of consumer credit.

Protecting against fraud:

Contactless cards, virtual card numbers, card-locking capabilities, and little to no cardholder liability for unauthorised purchases are just a few ways to protect yourself against fraud with credit cards.

Reimbursing certain purchases:

When a consumer is not satisfied with an item bought, but the merchant won't accept a return, certain credit card companies will refund you for your purchase.

Case Against Consumer Credit:

Costs of financing: Taking out a loan involves borrowing money that you don't have. Financing costs, or the fee charged to the consumer for the privilege of borrowing money, are included in such loans. When a person makes a payment on a line of credit, finance or interest costs must be paid first, and the leftover amount of the payment is utilised to cover the whole amount. Financing charges can swallow up to three-quarters of a payment, causing the borrower to wait longer for payment. Interest rates are calculated using the card's annual percentage rate and the borrower's credit or payment history. The higher your credit score, the more likely you are to receive a cheaper interest rate.

Debt: Borrowing, unfortunately, encourages people to spend more than they earn, resulting in debt. The level of a consumer's debt is determined by his vigilance in using credit and his ability to repay it, which can quickly grow from hundreds to thousands of dollars.

Temptation:

Since credit cards are so easy to use, they also make it easy to overspend.

Interest charges:

If one buys something and don't pay it off right away, they'll be responsible for not only the purchase price but also the interest charges. To put it another way, if one wants to balance on card, everything he/she buys will cost a bit more.

Fees:

Cash advances may come with costs as well as hefty interest rates. Furthermore, you could wind up paying more in interest and fees than you save in discounts or cash back. Make sure the advantages outweigh the disadvantages.

Monthly review:

One should check bills every month to be sure it accurately reflects purchases and that there are no indicators of fraudulent usage of cards. Scammers are particularly interested in credit cards.

Tricky Short-term teaser rates:

A low interest rate may appear to be a wonderful deal, but many people are surprised to learn that it was only for a limited time. You may end up paying significantly more in interest than you anticipated if you don't read the fine print.

11.2 PLASTIC MONEY:

- 1) Growth of plastic Money Services in India
- 2) Types of Plastic Cards – Credit Card – Debit Card – Smart Card – Add – on Cards, Performance of Credit Cards and Debit Cards, Benefits of credit Cards, Dangers of Debit Cards, Prevention of Frauds and Misuse, Consumer Protection, Indian Scenario.
- 3) Smart cards – Features, Types, Security Features and Financial Applications.

Plastic Money:**1.2.1 Introduction:**

Customers of many Indian and international banks now have credit cards. The issuing bank will have a tie-up with a number of companies that will honour the credit cards, ranging from 10 to 12 lakh, including hotels, hospitals, and department stores. Credit cards will be issued by this issuing bank to persons with a regular monthly income in excess of a certain amount, creditworthiness as measured by wealth and income, and corporate executives and their top brass. The bank is willing to take a chance on that particular cardholder is provided a loan facility with a 30-45-day repayment period, and there is a risk of default.

Since the early 1980s, commercial banks in India, beginning with numerous foreign institutions, have been issuing those cards. The usage of a credit card replaces and replaces the use of cash. It raises the amount of money on hand and accelerates the velocity of money to the point where idle money is used to buy goods and services. Because credit cards provide overdrafts and additional borrowing capability, they can

supplement the existing money supply while also reducing the use of cash, which is subject to wear and tear.

1.2.2 Growth of Plastic Money Services in India:

Edward Bellamy proposed the concept of utilising plastic money to make purchases in 1887. He published a book called "Looking Backward," in which he portrays his ideal society. He coined the phrase "credit card" in this work. Since then, technological improvements have allowed this concept to become a reality.

All of this began with a few rupees saved in his local bank and progressed to billions of rupee loans raised by syndicate banks and financial organisations capable of financing projects in any country on the planet. Nonetheless, these banking majorities were strongly reliant on their retail base of borrowers and savers. As worldwide competition strengthened in the late 1970s and early 1980s, almost all bankers began to focus on the retail market segment.

The debit card was created out of the remains of its older sibling, the credit card. Plastic money has surged in popularity in recent decades, from 274 million transactions in 1990 to 8.15 billion transactions in 2002, challenging credit cards as the favoured payment card. As it stands, the debit card industry has always been a multibillion-dollar engine that drives bank profits and point-of-sale consumer purchases - but it is also starting to alter traditional payment options in the corporate and other sectors.

Credit cards are one of the banking products that serve to the needs of the retail segment, which has experienced a recent increase in its number in GP. This evolution had been aided greatly by technological advancements, and it would not have been conceivable without these advancements.

Modern customers and clients can no longer imagine banking without the use of plastic cards. As a cash substitute, credit and debit cards have largely replaced cheques. Both provide a higher level of security than cash and are commonly accepted.

Plastic money's major characteristics of user friendliness and feasibility have made it popular not only in India but around the world.

- **Credit cards usage for travel bookings:**

Consumers began to make reservations with credit cards, and it has since become a lifestyle choice for the majority of city dwellers.

- **Electronic transactions grew strongly with the help of Reserve Bank of India (RBI)**

Consumers who had been doing their shopping online for a long time turned to net banking instead of cash on delivery since it was more convenient and faster. This included grocery shopping online, particularly in major cities like Bangalore, Hyderabad, Mumbai, Delhi, Chennai, and Kolkata.

- **Mobile banking applications become common for all banks**

Smart phones have become one of the most popular methods of banking. To provide customers with a convenient and safe banking experience, nearly every major bank in the country, whether private or public, has created mobile applications for all major smartphone operating system platforms, including Android, iOS, and Windows.

Security

Anyone can make use of money that has been misplaced. If you lose a credit or debit card, you can phone the 24.7 hotline and report it to the bank, ensuring that your card is safeguarded from unlawful usage. Various banks may have different liability policies, so check with your bank to see if they have any liability waivers.

Popularity:

The popularity of online purchasing has resulted in a higher use of plastic cards than in past years. The urban population and the greater adoption of cards by organised shops were the primary drivers. Both grocery and non-grocery retailing saw significant usage.

Baseline growth

The number of people who have a credit card has increased by 9.8% in the last year. Alternative payment methods including mobile wallets and prepaid debit cards accounted for 3% of all digital transactions. In FY15, the debit card base increased by 40%. However, the number of PoS terminals increased little. On a year-over-year basis, the number of PoS terminals increased by only 6%.

Number of transactions

Over the years from 2011 to 2015 debit card transactions have expanded at a CAGR of 36.5 percent, while credit card transactions have climbed at a CAGR of 21 percent. Debit cards have grown 30% year over year, while credit cards have grown 23%. At point-of-sale terminals, debit card transactions account for 57% of total card transactions.

The Currency of Modern India

The Indian card market is competitive with the world's best. Here are several indicators to consider. Profitable application: To prevent fraud, credit cards can be used online with a separate security number. Profitability has improved as a result. Even school tuition and healthcare expenditures are increasingly being paid with credit cards.

Players' safety requirements for preventing abuse are among the best in the world. For example, each transaction over a certain amount is instantly referred to the issuing bank, which phones the cardholder on their mobile phone to confirm the purchase in a matter of seconds.

The product features are also among the greatest in the globe. Almost all credit cards come with normal perks like free accident insurance, heavily discounted medical insurance, and more. The cardholder is given the option of converting a large credit card transaction into a loan with a cheaper interest rate spread over a longer term.

1.2.3 Types of Plastic cards:

Credit Card:

A credit card is a tiny rectangular piece of plastic or metal issued by financial institutions that allows you to borrow money from a pre-approved limit to make purchases. The credit limit is set by the issuing institution based on your credit score and history. A higher credit score and a longer credit history will usually result in a greater credit limit. When you swipe a debit card, the money is removed from your bank account, however when you swipe a credit card, the money is deducted from your pre-approved limit.

Users can pay with their credit cards or utilise them for online purchases by swiping them. To prevent penalty charges, make sure that the borrowed amount is repaid within the specified time frame when you apply for a credit card. The card issuer keeps your credit card information safe at all times. To avoid fraud, you should never give out your credit card information to anyone.

Types of Credit card:

- **Travel credit card:**

Flight, bus, and rail tickets, cab bookings, and other travel expenses can all be reduced with the use of a travel credit card. Every purchase earns you reward points. These points can be converted to earn air miles, which may be used to gain discounts on future reservations. With travel credit, you may also get free access to VIP airport lounges, book discounted tickets, and more.

Fuel credit card:

Fuel surcharge waivers can help save money on transportation expenditures when one use a fuel credit card. Purchases of fuels made with these credit cards might also help earn bonus points. Also significant fuel savings throughout the course of the year can be made.

Reward credit card:

On particular purchases and transactions, this sort of credit card offers expedited reward points. You can use the bonus points you earn to get discounts on future purchases or to pay off your credit card bills on a monthly basis.

Shopping credit Card:

Shopping credit cards can be used at linked stores both online and offline to get discounts on purchases and transactions. Year-round, get cashbacks, discount coupons, and more.

Secured credit card

Take advantage of a secured credit card to complement your fixed deposit investment and take advantage of excellent interest rates. This type of credit card, when used correctly, can help customers improve their credit scores.

Advantages of Credit Card:

Purchase protection

Credit cards provide additional security in the form of insurance for purchases made with the card that may be lost, damaged, or stolen. If you want to file a claim, you can use the credit card statement to vouch for its validity.

Record of expenses

Each purchase made with a credit card is recorded, and a complete list is delivered with your monthly credit card statement. This can be used to track and determine your spending and purchases, which can be helpful when creating a budget or filing taxes. Lenders also send you fast alerts every time you swipe your card, letting you know how much credit you have left as well as how much you owe.

Flexible credit:

Credit cards have an interest-free period, which is a period of time during which you will not be charged interest on your outstanding credit. If you pay off the entire balance owing by your credit card bill payment date, you can get free, short-term credit for 45-60 days. As a result, you can get a credit advance without having to pay the fees that come with carrying a balance on your credit card.

Incentives and offers:

Many credit cards come with several offers and incentives to encourage you for using your card. These could range from cash back to accumulating rewards points each time you swipe your card, which can then be redeemed for air miles or used to pay off your outstanding card balance. Lenders may also give discounts on credit card purchases, such as aeroplane tickets, vacations, or significant purchases, allowing you to save money.

EMI facility:

You can choose to put a major purchase on your credit card as a way to defer payment if you don't want to spend all of your savings on it.

Furthermore, you have the option of paying for your item in equal monthly instalments, guaranteeing that you do not pay a large sum for it and depleting your bank account. Paying through EMI is less expensive than taking out a personal loan to pay for a large purchase like a television or a refrigerator.

Building a line of credit

Credit cards give you the ability to build up a credit line. This is critical because it allows banks to see your active credit history, which is based on your credit card repayments and usage. Credit card usage is frequently used by banks and financial institutions to assess a potential loan applicant's creditworthiness, making your credit card vital for future loans or rental applications.

Easy access to credit:

The most significant benefit of a credit card is the ease with which it may be used to obtain credit. Credit cards work on the principle of deferred payment, which means you can use your card now and pay for your purchases later. The money used does not leave your account, so you don't have to worry about depleting your bank account every time you swipe.

Disadvantages of Credit Card:

Credit card fraud:

There's a chance you've been a victim of credit card fraud, though it's not particularly prevalent. With technological advancements, it is now possible to clone a card and obtain access to personal information, allowing another person or entity to make purchases on your card. Check your statements for any strange purchases and notify your bank right once if you suspect card fraud. If the fraud is established, banks will normally waive charges, so you won't have to pay for purchases made by the thief.

High interest rate:

If you do not pay your bills by the due date, the balance will be carried forward and interest will be applied. This interest accumulates over time on purchases made after the interest-free period has ended. Credit card interest rates are relatively high, with an average of 3% each month, or 36 percent per year.

Ease of overuse:

Although your bank balance remains the same with revolving credit, it may be tempting to charge all of your purchases to your card, leaving you uninformed of how much you owe. This could lead to you overspending and owing more than you can repay, starting a debt cycle with high interest rates on future payments.

Hidden costs:

Credit cards appear to be simple and uncomplicated at first glance, but they have a lot of hidden fees that can quickly add up. Late payment costs, joining fees, renewal fees, and processing fees are just a few of the taxes and fees that come with credit cards. Missing a card payment can result in a penalty, and making many late payments can result in your credit limit being reduced, which can hurt your credit score and future credit prospects.

Minimum due trap:

The most significant disadvantage of a credit card is the minimum due amount displayed at the top of a bill statement. Many credit card holders are misled into believing that the minimum amount is the total amount owed, when in fact it is the minimum amount that the company expects you to pay in order to continue receiving credit facilities. As a result, customers assume their bill is low and spend even more, accruing interest on their outstanding balance, which can quickly add up to a large and unmanageable sum.

Debit Card:

If a debit card is used, money is deducted directly from the consumer's checking account. They are sometimes known as "check cards" or "bank cards," and can be used to purchase products or services, as well as to obtain cash from an automated teller machine or a merchant who will allow you to add an additional amount to a purchase.

A debit card (also known as a bank card or check card) is a type of plastic payment card that allows the cardholder to access his or her bank account(s) at a financial institution electronically. Some cards feature a stored value that can be used to make a payment, although most send a message to the cardholder's bank to withdraw funds from a payee's designated bank account. When making purchases, the card can be used instead of cash where it is accepted. In some circumstances, the primary account number is assigned solely for usage on the Internet, and no physical card is issued.

Advantages of Debit Card:

Debit card can be easily obtained:

Most banks provide a free debit card when you open a savings or current account. Make sure you fill out all of the appropriate paperwork in order to acquire your debit card.

Free insurance coverage

Debit cardholders are also entitled to free insurance coverage. Bankers offer such insurance options in order to attract new consumers and retain existing ones. They offer free insurance to their cardholders in the following categories:

- a) Insurance for debit card loss,
- b) purchase insurance,
- c) personal insurance,
- d) accident insurance,
- e) travel insurance, and so on.

However, depending on the type of debit card used, different types of insurance are provided at no cost to cardholders. Bankers who give debit cards to their customers bear the cost of insurance premiums.

Gifts on redeeming points

As previously stated, a debit card can be used to earn bonus points through a reward programme. These points can be redeemed by the cardholder at any merchant website and/or outlet that the bank has already authorised (within the card's expiration period). While redeeming accrued points, the cardholder has an understanding of its merit in terms of monetary value, and then proceeds to claim presents virtually equal to that amount.

Earns Bonus Points:

Nowadays, competition among debit card suppliers (banks) is fierce. Most banks now provide bonus points to encourage their cardholders (customers) to use their debit cards to make purchases. Banks can provide such points to their cardholders since merchants, not banks, manage the incentive scheme. As a commission, a merchant gives the bank a modest cut-off or percentage of each successful sale. This commission is then split or divided by the bank with the original purchase's holder (as a reward). As a result, it finally assists the cardholder in earning bonus points on chosen financial transactions made with a debit card.

Easy to Manage:

When going to outstations or overseas, a debit card is incredibly convenient to carry, handle, and maintain. It readily fits in any pocket because it is tiny, thin, flat, and light. Even with only two fingers, it is incredibly easy to manipulate. It is also not difficult to manage. A cardholder just needs to take the necessary precautions to ensure that: To avoid damaging the sensitive surface of a debit card, it is usually covered with a thick plastic cover.

It is not subjected to tainted water or heat.

It is not folded by mistake, which helps to keep it from breaking.

It is carefully put in a handy spot that one recalls.

Instant Withdrawal of Cash:

The debit card allows for immediate cash withdrawals from any nearby ATM. This saves the holder the time and effort of going to the bank's office and waiting in a large line. In other words, it can be used as an ATM card to meet the cash needs of its owner at any time and in any location.

Immediate Transfer of Funds:

The quick transfer of funds into the merchant's or dealer's bank account is ensured by using a debit card. At the time of purchases of goods and receptions of services, such a transfer of funds occurs almost instantly. Its use eliminates the need to go to a bank's office and make a manual cash transfer into the merchant's or dealer's bank account. As a result, it saves time and provides ease, safety, and comfort to its owner in his or her financial tasks.

Alternative to Cash :

A debit card is a type of payment that can be used to complete a variety of cash-related financial transactions. It can be used to make purchases and to get services. There is no need to carry a huge sum of money when it is present. As a result, it helps travellers avoid carrying large amounts of cash and reduces the chance of loss due to theft, damage, and other factors.

Nominal Fee:

An annual fee is charged by the bank that issues the debit card for the issuance and maintenance of the card. This is a very small cost to be charged. The fee is usually charged once a year or once a year by the bank. The debit cardholder's bank account is automatically debited (deducted) for such a fee.

Prepaid Card:

A debit card is similar to a prepaid card. It is, because the holder's bank account already has a significant amount of cash in it. It allows the value of the transaction (i.e. purchases) to be carried forward to the extent of the available balance in the holder's bank account.

Disadvantages of Debit Card:

Identity theft:

Debit cards are only safeguarded by a personal identification number (PIN), which is an encrypted number. This PIN will not keep you safe from identity theft. Anyone having the card can access the account if the PIN is known.

Transaction limit:

In most circumstances, the issuing bank restricts the maximum amount that a customer can withdraw or transfer. This impedes business transactions where the volume and value of the amount involved are significant.

Terminal Dependent

Debit card transactions can only be processed by merchants who have an electronic terminal. Furthermore, a consumer can only access his or her account from a location where the issuing bank has an outlet terminal.

Smart Card:

A smart card, also known as a chip card or an integrated circuit card (ICC or IC card), is a physical electronic identification device that regulates resource sharing. It's usually a plastic card the size of a credit card with an integrated circuit (IC) chip embedded in it. To connect to the inner chip, many smart cards feature a grid of metal contacts. Others are contactless, while others are a combination of the two. Smart cards can be used for personal identification, authentication, data storage, and application processing.

Identification, banking, mobile phones (SIM), public transportation, computer security, schools, and healthcare are some of the applications. Smart cards have the potential to provide effective security authentication for single sign-on (SSO) within businesses. A number of countries have used smart cards to provide their residents with.

Advantages of a smart card:-**1. More secure:-**

Smart cards offer the most security and anonymity of any financial or transaction card on the market. They employ more secure encryption and authentication technology than previous payment card systems.

2. Safe to transport:-

Another advantage of having a smart card is its use in the banking industry. These cards enable the bearer to carry large sums of stolen money. They are also secure because the cards are easily changeable and the individual would need to know the pin number to access the store value.

3. Offer a variety of benefits:

Cards with embedded intelligence Offer retailers, financial institutions, and other card issuers with a number of benefits such as speedier transactions, more sales, lower expenses, easier bookkeeping, and fewer losses.

4. **Time-saving:-**

Making a payment using a smart card saves time because its microchip carries non-encrypted data about the owner and the user does not have to directly supply information for authentication.

Disadvantages of smart card:-

1. **Easily Lost:-**

Smart cards are thin and compact, and they can be easily misplaced if the user is careless. Because smart cards have various functions, their loss could be quite inconvenient. You would be extremely inconvenienced for several days if you lost a card that serves as a debit card, transit pass, and workplace key.

2. **Security:-**

The disadvantage from using smart cards is the lack of protection they provide. Swipe cards are less secure than these.

They are not, however, as safe as some members of the public believe.

This gives people a false sense of security, and they may not be as careful about securing their card and the information it contains.

3. **Slow Adoption:**

Not every store or restaurant will have the hardware required to utilise these cards as a payment card. One reason for this is that as technology becomes more secure, it becomes more expensive to develop and operate. As a result, some establishments may levy a basic minimum cost for paying using smart cards rather than cash.

4. **Possible Risk of Identify Theft:-**

Hardware hacking can cause data on smart cards to be altered or corrupted. Based on the quantity of information they can contain on an individual, they are like treasure to crooks seeking a new identity.

Add-on Cards:

Add-on cards, also known as supplemental cards, are cards given to other cardholders at the request of the primary cardholder, such as a spouse or child. Even if the Add-On card holder has the same credit limit as the primary card user, he or she cannot be held legally accountable for credit card payments. All expenses incurred on an Add-On card are billed to the principal card holder. The application can be used by the primary cardholder to apply for Add-On cards online. The user can apply for an Add-On card by selecting the supplied option. The user can customise the Add-On card by selecting the name that will be imprinted on it, as well as the credit and cash limits.

To apply for an Add-On card:

1. From the **Relationship** list, select the relation of the person for whom the Add-On card is required.
2. In the **Name on Card** field, enter the name of the Add-On card holder.
3. In the **Required credit limit** field, enter the desired credit limit for the Add-On card.
4. In the **Required cash limit** field, enter the desired cash limit for the Add-On card.
5. In the **Delivery Location** field, select the appropriate delivery address.
 - a. If you select the **My Address** option;
 - a. From the **Select Address** list, select the appropriate option. Based on the option selected, the complete home/ work address of the user as maintained by the bank is displayed.
 - b. If you select the **Branch Near Me** option;
 - i. From the **City** list, select the desired city.
 - ii. From the **Branch Near Me** list, select the desired branch.

The complete address of selected branch appears.

6. Click **Apply**.
OR
Click **Cancel** to cancel the transaction.
7. The **Review** screen appears. Verify the details, and click **Confirm**.
OR
Click **Cancel** to cancel the transaction.
8. The success message appears, along with the service request number.
9. Click **Go to Dashboard** to go to Dashboard.
OR
Click **Go To Account Details** to go to the accounts page.

1.2.5 Benefits of Credit Card:

Purchase protection

Credit cards provide additional security in the form of insurance for purchases made with the card that may be lost, damaged, or stolen. If you want to file a claim, you can use the credit card statement to vouch for its validity.

Record of expenses

Each purchase made with a credit card is recorded, and a complete list is delivered with your monthly credit card statement. This can be used to track and determine your spending and purchases, which can be helpful when creating a budget or filing taxes. Lenders also send you fast alerts every time you swipe your card, letting you know how much credit you have left as well as how much you owe.

Flexible credit:

Credit cards have an interest-free period, which is a period of time during which you will not be charged interest on your outstanding credit. If you pay off the entire balance owing by your credit card bill payment date, you can get free, short-term credit for 45-60 days. As a result, you can get a credit advance without having to pay the fees that come with carrying a balance on your credit card.

Incentives and offers:

Many credit cards come with several offers and incentives to encourage you for using your card. These could range from cash back to accumulating rewards points each time you swipe your card, which can then be redeemed for air miles or used to pay off your outstanding card balance. Lenders may also give discounts on credit card purchases, such as aeroplane tickets, vacations, or significant purchases, allowing you to save money.

EMI facility:

You can choose to put a major purchase on your credit card as a way to defer payment if you don't want to spend all of your savings on it. Furthermore, you have the option of paying for your item in equal monthly instalments, guaranteeing that you do not pay a large sum for it and depleting your bank account. Paying through EMI is less expensive than taking out a personal loan to pay for a large purchase like a television or a refrigerator.

Building a line of credit

Credit cards give you the ability to build up a credit line. This is critical because it allows banks to see your active credit history, which is based on your credit card repayments and usage. Credit card usage is frequently used by banks and financial institutions to assess a potential loan applicant's creditworthiness, making your credit card vital for future loans or rental applications.

Easy access to credit:

The most significant benefit of a credit card is the ease with which it may be used to obtain credit. Credit cards work on the principle of deferred payment, which means you can use your card now and pay for your purchases later. The money used does not leave your account, so you don't have to worry about depleting your bank account every time you swipe.

1.2.6 Dangers of Debit Card:

1. Fraud protection:

If a wallet is stolen, the fraud protection on debit card isn't as robust as it is on a credit card. When using a credit card, the liability for fraudulent payments is usually limited. With a debit card, you might be held liable for unauthorised access charges. Furthermore, some banks will hold the customer entirely responsible if debit card is used fraudulently for pin-based purchases. Furthermore, if a thief uses credit card, one can refuse payment while the credit card company investigates the suspected fraud. If a burglar uses the stolen debit card, they can drain bank account in moments and then probably wouldn't be able to get your money back until your bank investigates.

2. Building credit:

A debit card will not benefit you if you do not yet have a credit history or if you are attempting to restore your credit score. On the other hand, if you routinely neglect to make credit card payments, using a debit card may prevent you from further harming an already blemished credit report.

3. Merchant disputes

If one goes to restaurant for lunch or dinner and deny receipt, and the waiter does some error in charging you are unaware of the error until you use your debit card again and it is declined. When you arrive home, you check with your bank and discover the problem. Obviously, the merchant would most likely restore your money (preferably with a strong apology), but it will take several days for the money to be returned to your account. In the interim, you must contact your bank to get any overdraft fees reversed.

4. Fees:

If you make the majority of your transactions with a debit card, you must be especially conscientious about keeping track of your account balance. Your card may not be denied if you overcharge by a few dollars (or even a few hundred). The bank may allow your charge to go through but then charge you up to \$34 in overdraft fees. These costs quickly build up to more than the interest charged by a credit card if you carried a minor balance from one month to the next. Debit cards have spending limits as well. Credit cards have spending limits, but that is your credit limit.

1.2.7 Prevention of Frauds and Misuse

1. Prevention of frauds of Debit Card:

a. Use a Secured Network:

Do not perform financial transactions online if you are using your mobile device or computer in a public area or on an unprotected network.

b. Protect Your Computer and Mobile Devices:

Install firewall, anti-virus, and anti-spyware software on your computer and mobile devices, and keep it up to date.

c. Beware of Phishing Scams:

When you check your email or conduct business online, make sure you know who you're dealing with. A phishing website set up by an identity thief may look to be from your bank or another company with which you have an account. In reality, the scammer is seeking to obtain your personal information, as well as your bank account.

d. Don't Keep All Your Money in One Place:

If your bank account is hacked, you'll need to be able to get cash from somewhere else to pay for basics and keep up with your bills.

e. Destroy Old Debit Cards:

Some shredders will handle this for you; otherwise, having an outdated card around puts your information at risk.

f. Stick to Bank ATM:

Bank ATMs are more secure (with video cameras) than automated teller machines found in convenience stores, restaurants, and other locations.

g. Don't Make Purchases With Your Debit Card:

Instead of using a debit card, use a credit card, which provides better fraud protection.

h. Go Paperless:

You may avoid having your bank account information stolen from your inbox by opting for paperless bank statements. When you're finished with your bank statements and debit card receipts, shred them with a paper shredder to significantly reduce the danger of bank account information being stolen from your trash.

i. Get Banking Alerts:

You may sign up for banking alerts in order to check your balance and recent transactions online every day. When certain activity occurs on your accounts, such as a withdrawal in excess of the amount you select or a change of address, your bank will notify you through email or text message.

2. Prevention of frauds of Credit Card:

1. Choosing secured websites for credit cards:

While credit cards are convenient, it is critical that you only use them on secure websites. The website's address solely utilises 'https' rather than

'http'. In addition, the website should display the secured lock in the bottom right corner or, in some browsers, at the top. Use a website with strong encryption software. To avoid being taken advantage of, never shop online using public computers.

2. Signing card:

Another thing to remember is to sign the back of your credit card as soon as you get it. This will prevent someone else from using your credit card if it is stolen.

3. Checking credit card statements:

Reviewing credit card statements on a regular basis is another way to keep credit cards safe. Any unexpected purchases or small-dollar debits could be a sign of fraud. Furthermore, ensure that credit card bill is received on time. A late delivery could indicate identity theft, and it should be notified to the credit card provider as soon as possible.

4. Being careful at an ATM:

At an ATM machine, one must exercise caution. One must ensure there isn't anything attached to the ATM slot that could be used to steal credit card information when it is swiped. If one finds anything similar, contact the bank right once.

5. Keeping an eye at the time of transaction:

If a cashier takes too long to finish a transaction, card may be checked for information utilising skimming machines. Keeping a tight eye on who is using your card and ask for returning it as soon as possible.

6. Buying identity theft insurance and card protection plans:

Theft of identity is becoming more common these days. It comprises taking someone's identity and using it to acquire credit in their name. Identity theft and false charges insurance has been created by some insurers, such as Tata AIG. It safeguards you against unauthorised charges made to your credit card by someone posing as you. ICICI bank, HDFC bank, and Axis bank offer card protection programmes as well. You'll be able to block all of your lost cards with a single phone call if you join up with them. One can also be able to replace any cards that were missing. There are several membership options to choose from.

1.2.8 Consumer Protection:

The Consumer Protection Bill, **1986** seeks to provide for better protection of the interests of consumers and for the purpose, to make provision for the establishment of Consumer councils and other authorities for the settlement of consumer disputes and for matter connected therewith.

It seeks, inter alia, to promote and protect the rights of consumers such as-

- (a) the right to be protected against marketing of goods which are hazardous to life and property;
- (b) the right to be informed about the quality, quantity, potency, purity, standard and price of goods to protect the consumer against unfair trade practices;
- (c) the right to be assured, wherever possible, access to an authority of goods at competitive prices;
- (d) the right to be heard and to be assured that consumers interests will receive due consideration at appropriate forums;
- (e) the right to seek redressal against unfair trade practices or unscrupulous exploitation of consumers; and
- (f) right to consumer education.

1.2.9 Indian Scenario:

Debit and credit cards have provided relief to those who have struggled to withdraw cash through banks and ATMs in the post-demonetisation period. Despite the fact that plastic money has been here for decades, rate of adoption in India tend to be low.

In March 2016, there were 24.51 million credit cards and 661.8 million debit cards in India, according to RBI statistics. However, between March 2015 and March 2016, the number of transactions was only 72.22 million and 112.87 million, respectively.

These figures would, without a doubt, have improved from demonetisation. However, for those who remain cautious of plastic money and are hesitant in cheques and demand draft, there are a few additional options that can be quickly exercised from their cell phones.

E-Wallets

In the absence of cash in the market, e-wallets such as Paytm are growing. An e-wallet is a mobile application that may be downloaded from the Internet and installed on a mobile device such as a smartphone.

UPI

The Unified Payment Interface is a key differentiator in Indian banking. The UPI, which was introduced in 2016, is currently available through most of the banks.

It was established by the National Payments Corporation of India, which is backed by the Reserve Bank of India. It enables you to transfer money in actual time for free utilizing your bank account linked to its net banking application or any third-party UPI app.

If you live in a linked, urban location, you can meet the majority of your transactional needs with plastic money or Internet money. There is a worldwide movement to digitise the economy by reducing reliance on paper currency. You can contribute to this gradual transformation by becoming acquainted with electronic transfers and assisting those around you in adopting technology. It is safe, secure, and provides numerous benefits.

Although UPI 2.0 includes numerous improvements that will improve collection points more convenient and secure during transactions, the addition of certain new features may increase adoption. Several potential aspects are depicted below:

Smart Cards:

The smart card is all about converting a tiny rectangular piece of card into a 'smart' piece of card. These cards are extremely comfortable to take in our wallets or back pockets. This is where the primary benefit of smart cards may be observed. Banks, stores, educational institutions, and offices, among others, are using these cards for a variety of transactions. Though these cards come in a variety of sizes and shapes, they all serve that purpose: the technology that powers them. Any transaction may now be made more secure and convenient thanks to smart cards. The technology employed allows users to save unique personal information. Smart cards have increased the ease and protection of any transaction. The technology used allows users to save unique personal information.

A smart card cannot function on its own. To work, it requires a smart card reader. The card includes an embedded memory chip in the form of a contact pad. When the touch pad is removed from the card, it no longer functions as a smart card. The contact pad in the card reader makes touch with the reader and performs the processing. As a result, it aids you in transactions via POS (point of sale) or another medium. There are, however, two types of cards: contact and contactless. Because of their ease of use, contactless cards are becoming increasingly popular.

Features :

1) Authentication:

For those that choose to acquire them, these cards provide authentication techniques that can be used to validate individuals, devices, or applications that want to use the data on the card chip. This feature can preserve the cardholder's privacy while also lowering the chance of loss or loss and the problems that can arise as a result of it.

2) Secure data storage

These cards provide protection for their carrier data and can only be handled by individuals with suitable access privileges by the smart card operating system. This is possible by storing personal user data on the card rather than the central database.

3) Encryption:

They offer cryptographic services such as key generation, safe key storage, retail, and digital signing. Which can be used to safeguard one's privacy. A smart card system, for example, can generate a digital signature for an e-mail message, allowing e-mail to be validated. This prevents tampering with the communication and gives the receiver confirmation of its creation. The fact that the signature key came from a smart card lends confidence to the site's origin and destination.

4) Strong device security:

Smart cards are difficult to tag because they have a built-in resistance to tampering. Smart card chips include a variety of hardware and software features for detecting, interacting with, and assisting in the tampering of potential attacks.

5) Secure communications:

They act as a barrier between both the card and its user. Smart card security allows the user to send and collect information in a secure and private manner.

6) Biometrics:

They propose a dynamic template storage system that can be used to improve privacy in biometric systems, store dynamic templates, and conduct biometric matching activities. One of the most notable examples is the use of smart cards to store fingerprints rather than databases.

7) Personal device:

The smart card is, without a doubt, linked to its holder. Smart-card plastic is frequently personalised, resulting in an even greater bond with the cardholder. This attribute can be utilised to increase physical privacy in the health care system, such as patient data storage and medical care.

Types of Smart Cards

Classification based on mechanism.

Based on the working mechanism of the cards, they are being classified into three:

- Contact Smart Cards
- Contactless Smart Cards
- Hybrid Cards

1. Contact Smart Cards:

This is the most prevalent type of smart card. ATM cards, major credit cards, SIM cards, and other similar items come under this group. Cards are

put into card readers, which read the stored information on the contact pad and perform transactions as needed.

2. Contactless Smart Cards

These cards, as the name says, do not require a reader. It uses Near Field Communication technology or radio frequencies to establish wireless communication between the smart card and the device you wish to use.

3. Hybrid Cards:

Hybrid cards are dual-capacity cards. These cards are compatible with both contact and contactless card readers. These cards are quite uncommon in use.

Classification based on configuration

1. Memory cards:

These cards are only used for short periods of time. It only has the ability to read, write, and save data. The memory capacity of these cards is rather limited, and they are frequently destroyed after use. Once stored, data on this type of card cannot be updated or changed.

2. Microprocessors:

Microprocessors function similarly to minicomputers and feature volatile memory. These are small enough to fit in our pockets. These feature a large amount of memory, allowing you to write, read, rewrite, edit, and change data as needed.

Security Features:

Smart Cards' self-contained nature makes them immune to assault because they do not rely on potentially exposed external resources. As a result, Smart Cards are frequently employed in applications that demand high security and authentication.

Technology and security are inextricably linked. Crackers develop clever methods of accessing ostensibly encrypted information on cards => Card producers must develop more sophisticated locks and keys => Crackers devise better methods to circumvent these... generating an unending improvement loop in which both sides drive each other to use and build better technology.

There are four different aspects of the Smart Card security:

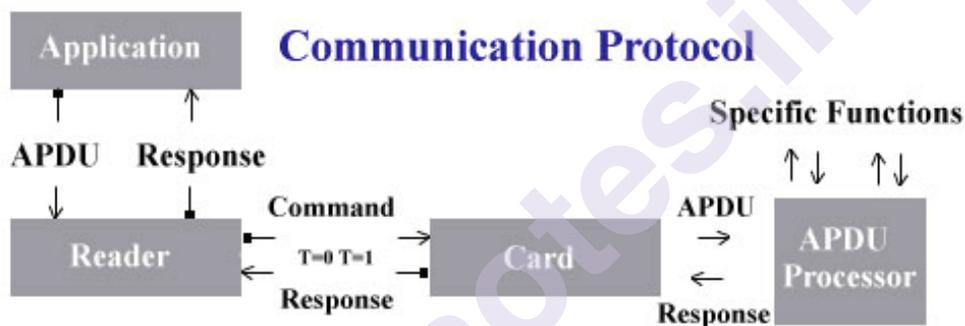
- Communication
- Hardware
- Operating System (OS)
- Software

Communication with the outside world

Small data packets known as APDUs are used to interact between a Smart Card and a Card Accepting Device (CAD) (Application Protocol Data Units). The following qualities of this interaction make it more difficult for third parties to successfully attack the system:

- For sending information, a serial bi-directional transmission line (ISO standard 7816/3),
- In half duplex mode, at a low bit rate (9600 bits per second), is used (data only travels in one direction at a time)
- The communication follows a complex protocol, which is detailed below.

Every external device that communicates with the card, on the other hand, makes it more vulnerable to assault via the communication link.



To identify each other, the Smart Card and the CAD employ a mutual active authentication mechanism. The card creates a random number and transmits it to the CAD, which encrypts it with a shared encryption key before returning it to the card. The resulting result is then compared against the card's own encryption. The operation can then be reversed by the pair.

Once communication has been established, each message sent and received between the pair is authenticated with a message authentication code. This is a combination of data, an encryption key, and a random number. If the data is changed (for any reason, including transmission issues), the message must be reissued. The data can also be authenticated using a digital signature if the chip has enough memory and computing power.

Hardware Security:

The EEPROM stores all data and passwords on a card and can be deleted or updated by an odd voltage supply. As a result, certain security processors include sensors that detect environmental changes. This technology, however, is not frequently utilised since it is difficult to establish the proper amount of sensitivity and there is a voltage fluctuation

when power is delivered to the card. Other successful attacks include heating the controller to a high temperature or focussing UV light on the EEPROM, so destroying the security lock. When the card is cut and the processor is removed, the most damaging physical attacks occur. The chip's layout can then be reverse engineered.

Operating System Security

Smart Card data is arranged in a tree hierarchy. This has one master file (MF or root) and multiple elementary files (EF) as well as several dedicated files (DF). DFs and MFs represent directories, while EFs represent files, analogous to the structure in any conventional PC operating system. These two hierarchies differ, however, in that DFs can also include data. The headers of DF, EF, and MF contain security aspects similar to user privileges associated with a file/directory in a common operating system. Any application can navigate the file tree, but it can only move to a node if it has the necessary permissions.

Software Security:

Software developers also help to Smart Card security by providing adequately encrypted data and transfers in their products. To assist them in achieving this aim, hardware-based or operating-system-based instructions and libraries enabling advanced cryptographic algorithms have been developed.

Most modern attacks are designated as class 3 attacks, which means that either the costs of breaking the system are significantly greater than the cost of the system itself, or the cracker must expend several or hundreds of years of computer power to break into a single transaction. Technology advances quicker than cracker approaches. As a result, each new generation of technology usually protects against threats that the preceding generation was vulnerable to.

Financial Applications

Banking & Retail

ATM cards, credit cards, and debit cards are some of the most frequent applications for smart cards. Many of these cards are "chip and PIN" cards, which need the consumer to provide a four- to six-digit PIN number, while some are "chip and signature" cards, which just require a signature for verification.

Fuel cards and public transit/public phone payment cards are two further financial and retail applications for smart cards. When the chip is filled with monies, they can also be used as "electronic wallets" or "purses" to pay for modest items such as groceries, laundry services, cafeteria food, and taxi rides. Because cryptographic methods safeguard the transaction of money between the smart card and the machine, there is no need for a bank link.

11.3 CREDIT RATING:

Meaning, Origin, Features, Advantages of Rating , Regulatory Framework, Credit rating Agencies , Credit Rating Process, Credit Rating Symbols, Credit Rating Agencies in India, Limitations of Rating

11.3.1 Meaning

A credit rating is a specific credit agency's assessment of an entity's (government, business, or individual's) ability and desire to meet its financial obligations completely and on time. A credit rating also indicates the likelihood of a debtor defaulting. It also represents the credit risk borne by a debt instrument, whether it is a loan or a bond issuance.

A credit agency assesses a debtor's credit rating by examining the qualitative and quantitative characteristics of the organisation in question. Internal information provided by the organisation, such as audited financial statements and annual reports, as well as external data, such as analyst reports, published news stories, general industry analysis, and estimates, may be used to source the information.

A credit agency is not engaged in the transaction and is thus expected to provide an independent and unbiased evaluation of the credit risk represented by a specific organisation seeking to raise funds through loans or bond issuance. At the moment, three major credit rating agencies dominate 85 percent of the global ratings market: Moody's Investor Services, Standard and Poor's (S&P), and Fitch Group. To express credit ratings, each agency use a distinct but strikingly comparable rating style.

Objectives of Credit Rating

Credit rating aims to:

- 1) Provide great information to investors at a reasonable cost;
- 2) Establish a solid foundation for optimum risk-return framework;
- 3) Borrowers should be subjected to appropriate discipline.
- 4) Contribute to the development of public policy guidelines on institutional investment.

11.3.2 Origin

In 1841, the first mercantile credit agency was created in New York to assess merchants' ability to meet their financial obligations; later, it was taken over by Robert Dunn. This agency produced its first rating guide in 1859. The second agency was founded by John Bradstreet in 1849, which later merged with the first agency to become Dunn and Bradstreet in 1933, which eventually became the owner of Moody's Investor Service in 1962. Moody's has been around since roughly 100 years. These ratings did not have a substantial impact on the market until 1936, when a new rule prohibiting banks from utilising Moody's ratings was adopted.

Investing in speculative bonds or bonds with a poor credit rating to reduce the danger of default and financial loss. This technique was swiftly replicated by other businesses and financial institutions, and reliance on credit agencies soon became the standard.

The first Indian CRAs appeared in the late 1980s, with credit Rating Information Services of India Limited ("CRISIL") being created in 1987. CRISIL, Fitch Ratings India Private Ltd., Investment Information and Credit Rating Agency ("ICRA"), Credit Analysis & Research Ltd ("CARE"), Brickwork Rating India Pvt Ltd., Infomercials Valuation and Rating Pvt Ltd, and SME Rating Agency of India Ltd, ("SMERA") are the seven CRAs currently registered with SEBI.

Major growth factors of rating in India

The key driver of Credit Rating Agency growth in India is higher average national income growth of 5.8 percent from 1981 to 1990 and industrial expansion of 10.5 percent from 1989 to 1990. Following 1991, there was a general increase in per capita spending capacity in India due to a large inflow of capital in numerous areas such as the banking sector, industrial sector, infrastructure sector, insurance industry, and several others. As the number of body corporates and individual investors increased, so did the value and volume of total investments.

The country's political instability exacerbated the financial crisis, to the point where the only way to handle the acute fiscal deposit was to conform to the dramatic restructuring of the Indian economy advocated by the IMF and World Bank in exchange for the credit given. Foreign investment in the domestic market rose as a result of the deregulation, particularly in underdeveloped sectors such as the corporate bond market. The markets were exceedingly volatile, with stock exchange turnover increasing from Rs. 6364 crores in 1984 to Rs. 194000 crores in 1986.

Another reason for the growth of Credit Rating Agency's is the witnessing of massive capital market scams such as the Harshad Mehta Scam and the Ketan Parekh Scam, which led market participants and regulators to recognise the need for transparency and investor education to mitigate the risks associated with the market. Regulators implemented criteria for banks or the general public to obtain a credit rating in order to obtain credit facilities above a certain threshold, such as the RBI's Basel II Norms.

11.3.3 Features of Credit Rating

The following are the features of Credit Rating

1. Rating is Based on Information

Any rating based solely on publicly available information has major limitations, and the success of a rating agency will be heavily reliant on its ability to gain access to privileged information. Cooperation from the issues, as well as their willingness to give even sensitive material, are

critical prerequisites. The rating agency must keep confidential information obtained throughout the rating procedure private.

2. Many Factors Affect Rating:

The rating is not established by a fixed mathematical method. The final ranking is based on the management quality, corporate strategy, economic forecast, and international environment. A number of certified professionals are involved in the rating process to assure uniformity and reliability.

3. Rating by More than One Agency

Debt issues are frequently rated by more than one agency in well-developed capital markets. And it is natural for ratings given by two or more agencies to differ, such as when a debt issuance is rated AA+ by one agency and AA or AA- by another. It will be exceptional if one agency awards an AA rating while another assigns a BBB grade.

4. Monitoring the Already Rated Issues:

A rating is an opinion formed on the basis of available information. Many factors can have an impact on the issuer's ability to service its debt. As a result, it is critical that rating agencies closely monitor issues and upgrade or lower ratings based on the conditions following extensive interaction with the issuers.

5. Publication of Ratings:

In India, ratings are only conducted at the request of issuers, and only ratings that are re-accepted by issuers are released. Thus, if a rating is accepted, it is published, and any later adjustments resulting from the agency's monitoring will be published, although such changes are not agreeable to the issuers.

6. Right of Appeal Against Assigned Rating:

If an issuer is dissatisfied with the rating issued, he may seek a review and provide any additional information deemed relevant. The rating agency will conduct a review and then make its final conclusion. Unless the rating agency ignored important evidence during the initial assessment, the chances of the rating being revised on appealing are slim.

7. Rating of Rating Agencies

Informed public thought will be the standard against which credit ratings will be judged, and the success of a rating agency is defined by the quality of services provided, reliability, and honesty.

8. Rating is for Instrument and not for the Issuer Company:

The crucial thing to remember is that ratings are always done for a specific issue, not for a firm or an issuer. Two instruments issued by the same company may have different ratings, especially if their maturities are significantly different or one of the instruments is backed by additional credit reinforcements such as guarantees.

9. Credit Rating not Applicable to Equity Shares:

Credit rating is, by definition, an opinion on the issuer's ability to service debt. Because equity is in the nature of venture financing, there is no pre-determined service obligation. As a result, credit ratings do not apply to stock options. Entrepreneur's Obligation to Suppliers, Creditors, and Depositors.

10. Time Taken in Credit Rating Process

The rating procedure is quite extensive. It entails, among other things, analysing published financial information, visiting the issuer's offices and workings, intensive meetings with the issuer's senior managers, discussions with auditors, bankers, creditors, and so on. It also entails an in-depth examination of the sector as a whole, as well as some environmental scanning. All of this takes time; it may take a rating agency 6 to 8 weeks or more to make a conclusion.

11.3.4 Advantages of Credit Rating:

1. Information:

Credit rating information conveys the relative ranking of the default loss likelihood for a certain fixed-income investment in comparison to other relevant instruments. The credit rating system enables the common investor to recognise risk perception in relation to debt instruments and familiarises investors with the risk profile of debt products.

2. Systematic Risk Evaluation:

A systematic risk assessment is required for the efficient deployment of resources. Credit rating enables the corporate issuer of a financial instrument to provide every prospective investor with the chance to conduct a complete risk assessment.

It enables a diverse group of investors to get a meaningful and consistent judgement about the relative credit quality of the instrument, especially when they lack the necessary credit rating abilities.

3. Professional Competency:

A credit rating agency that possesses the necessary abilities, abilities, and authority provides a professional service that allows for the use of well-researched and scientifically assessed opinions regarding the relative ranking of various debt instruments based on their credit quality.

4. Easy to Understand:

Credit ratings are symbolic and thus simple to comprehend. The rating attempts to establish a correlation between risk and return. Investors use the rating to analyse the overall risk of the product by comparing the provided rate of interest to the rate of return (for the specific degree of risk), with the goal of selecting the risk-return preferences.

5. Low Cost:

A professional credit agency's credit rating is important not just for individuals/small investors, but also for organised institutional investors. It serves as a low-cost addition to the house appraisal system. It serves as a low-cost addition to the house appraisal system.

6. Efficient Portfolio Management:

Large investors can utilise credit ratings to diversify their portfolios by selecting appropriate instruments from a wide range of investment possibilities. Such investors could make use of the information offered by rating agencies by closely monitoring upgrades and downgrades and adjusting their portfolio mix through secondary market trading.

7. Index of Faith:

Credit rating serves as an ideal indicator of the market's confidence in the issuers. This will eventually serve as a guide for investing selections.

8. Wider Investor Base:

When compared to unrated securities, credit ratings have a larger investor base. Rating provides a broad group of investors with specific capabilities for analysing every investment opportunity and assisting them in making well-informed decisions about their investment.

9. Benchmark:

A credit rating agency's view is widely trusted by investors. This could allow issuers of highly rated products to enter the market even in difficult market situations. Furthermore, a credit rating serves as a foundation for estimating the additional return (above and beyond a risk-free return) that investors seek as compensation for the increased risk they bear. When compared to unrated securities, credit ratings have a larger investor base.

10. Effective Monitoring:

Ratings could be used as input by stock market intermediates such as brokers and dealer to manage their risk exposure.

11.3.5 Regulatory Framework:

The Securities Exchange Board of India SEBI regulates CRAs in India. Through the SEBI (Credit Rating Agencies) Regulations, 1999 ('CRA Regulations,' SEBI was one of the first regulators in the world to provide a complete framework for the regulation of CRAs.

The CRA Regulations cover the following areas-

1. **Registration:** In general, the CRA Regulations require that CRAs be companies sponsored by people with credit rating experience, such as financial institutions or individuals with a net worth of more than 100 crore rupees. To carry out the operation of generating credit ratings, CRAs must have a minimum net value of 5 crore rupees, as well as suitable facilities, professionals, and personnel. Furthermore, registration would be granted only if the applicant's registration is in the best interests of investors and the securities market.
2. **Obligations:** The CRA Regulations require CRAs to carry out their duties in line with the agreement of their involvement with the issuer, as well as the Regulations' baseline principles. CRAs must follow SEBI's Code of Conduct, which requires them to carry out their duties with honesty, 's professionalism, independence, and secrecy. Furthermore, CRAs are obligated to monitor their rating throughout the life of the securities evaluated and to conduct periodic assessments of their rating.
3. **Disclosure:** According to the CRA Regulations, CRAs must keep and disclose their ratings in a specific manner. They require CRAs to keep a copy of their ratings notes, ratings issued, terms of engagement, records of rating committee decisions, and fees charged for ratings for at least five years.
4. **Conflicts of interest:** The Regulations make an initiatives to minimize potential conflicts. They provide that CRAs may not rate securities by themselves promoter or partners. Furthermore, CRAs must maintain an arm's length link between credit rating and other activities.\
5. **Accountability and Enforcement:** The Regulations require CRAs to conduct an internal audit, transmit information to SEBI as needed,⁴³ and be open to inspection and inquiry by SEBI. ⁴⁴ They further state that CRAs may be held accountable for any violation of the SEBI Act or any of the Rules or Regulations enacted under it. They may also be held responsible under Chapter V of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008.

Until 2008, there were no significant modifications to the regulatory framework for CRAs. However, following the global financial crisis, in which CRAs were deemed complicit, a 'Committee on Comprehensive Regulation for Credit Rating Agencies' was formed to review the

regulatory system. The Committee stated that "at first glance, there appears to be no immediate cause for worry concerning the operations and activities of CRAs in India, even in light of the recent financial crisis." However, existing rules must be strengthened by drawing relevant lessons from the current crisis." Following that, SEBI made various adjustments to the regulatory framework for CRAs.

SEBI published circulars revising its regulatory framework in 2010, recognising the critical role of CRAs in financial markets and the need of CRA transparency. SEBI published circulars outlining the standards for CRA internal audits and requiring CRAs to provide greater disclosures. SEBI mandated CRAs to provide default matrices of securities and to keep explanatory notes for each rating or surveillance they performed.

So far, SEBI has exclusively controlled the rating of debt instruments. CRAs, on the other hand, evaluated a wide range of products, including bank loans, overdraft facilities, and letters of credit. All of these rating operations went unchecked. However, SEBI issued a circular in 2012 stating that CRAs would "follow the applicable requirements pertaining to rating process and procedures and its records, accountability and disclose, evasion of potential conflicts of interest, code of conduct, and so on, as recommended in the Regulations and circulars issued by SEBI from time to time" for rating of other instruments as well.

SEBI released a circular in 2016 outlining instructions for improving CRA standards and increasing openness in their operations. This circular mandates CRAs to publicly publish their rating criteria and rating processes, to standardise press releases for rating actions, to report rating both in cases of non-acceptance and non-cooperation by issuers, and to disclose a delay in rating. Ratings are reviewed on a regular basis. Furthermore, the circular mandates CRAs to hold rating analysts accountable and to improve the functioning and evaluation of rating committees.

Despite ongoing development of the regulatory environment in India, several worries about CRA regulation remain. These will be discussed in the following chapter.

11.3.5 Credit Rating Agencies:

Credit Rating Agencies in India

Credit Rating Agencies (CRA) evaluate the creditworthiness of businesses and other entities. In layman's terms, these agencies assess a debtor's ability to repay the loan as well as their credit risk. SEBI (Credit Rating Agencies) Regulations, 1999 of the Securities and Exchange Board of India Act, 1992 govern all credit rating agencies in India. CRISIL, CARE, ICRA, SMREA, Brickwork Rating, India Rating and Research Pvt. Ltd, and Infomerics Valuation and Rating Private Limited are the seven credit agencies in India.

Ratings are assigned to organisations or entities by credit rating agencies. Companies, state governments, non-profit organisations, countries, securities, special purpose entities, and local governmental bodies are among the entities rated by credit rating agencies. Before assessing an entity's credit, credit rating companies analyse numerous variables such as its financial statements, level and kind of debt, lending and borrowing history, ability to repay the loan, and past debts. Once a credit rating agency rates the entities, it offers further information to the investor, who then analyses and makes an informed investment decision. A low credit rating suggests that the entity is likely to default. The credit ratings assigned to entities serve as a standard for financial market regulations. Credit ratings are issued by organisations such as Moody's Investors Service and Standard and Poor's (S&P) based on extensive research.

Some of the Top Credit Rating Agencies in India are:**1. Credit Rating Information Services of India Limited (CRISIL)**

CRISIL is one of India's oldest credit rating firms. It was first introduced in the country in 1987, and the company went public in 1993. CRISIL, headquartered in Mumbai, began grading infrastructure in 2016 and celebrated its 30th anniversary in 2017. In 2017, CRISIL purchased an 8.9 percent share in the CARE credit rating agency. In 2018, it created India's first index to benchmark the performance of foreign portfolio investors' (FPI) fixed-income assets in the rupee and dollar markets. The portfolio of the organisation comprises mutual fund rankings, ULIP rankings, CRISIL coalition index, and so on.

2. ICRA Limited

ICRA Limited is a public limited corporation based in Gurugram that was founded in 1991. Previously, the organisation was known as Investment Information and Credit Rating Agency of India Limited. ICRA was a joint venture between Moody's and many Indian financial and banking service organisations before going public in April 2007. Currently, the ICRA Group includes four subsidiaries: Consulting and Analytics, Data Services and KPO, ICRA Lanka, and ICRA Nepal. Moody's Investors Service, the multinational credit rating agency, is currently ICRA's largest stakeholder. Corporate debt, financial rating, structured finance, infrastructure, insurance, mutual funds, project and public finance, SME, market linked debentures, and other products are all part of ICRA's product offering.

3. Credit Analysis and Research limited (CARE)

CARE, which was founded in 1993, provides credit ratings in areas such as corporate governance, debt ratings, financial sector, bank loan ratings, issuer ratings, recovery ratings, and infrastructure ratings. CARE, headquartered in Mumbai, provides two types of bank loan ratings: long-term debt instruments and short-term debt instruments. The organisation also provides ratings for Initial Public Offerings (IPOs), real estate,

renewable energy service companies (RESCO), financial assessments of shipyards, Energy service companies (ESCO), and numerous educational institution courses. CARE Ratings has recently expanded its services to include valuation of stock, debt instruments, and market related debentures. Furthermore, the company has formed a new worldwide credit rating agency called ARC Ratings in collaboration with four partners from South Africa, Brazil, Portugal, and Malaysia. ARC Ratings has begun operations and has completed sovereign ratings of countries such as India.

4. Brickwork Ratings (BWR):

Canara Bank promotes Brickwork Rating, which was founded in 2007. It provides ratings for bank loans, small and medium-sized enterprises (SMEs), corporate governance ratings, municipal corporations, capital market instruments, and financial institutions. It also evaluates NGOs, tourism, IPOs, real estate investments, hospitals, IREDA, educational institutions, MFI, and MNRE. Brickwork Ratings has been designated by the Reserve Bank of India (RBI) as an external credit assessment agency (ECAI) to conduct credit ratings in India.

5. India Rating and Research Pvt. Ltd:

Fitch Group's wholly owned subsidiary in India is India Ratings. It provides credit ratings to insurance companies, banks, corporate issuers, project finance, financial institutions, finance and leasing firms, managed funds, and municipal governments. The company is also recognised by the Reserve Bank of India and the National Housing Bank, in addition to SEBI.

6. Acuite Ratings & Research Limited:

Acuité Ratings & Research Limited is a full-service credit rating firm that is registered with the Securities and Exchange Board of India (SEBI). In 2012, the company was accredited by the RBI as an External Credit Assessment Institution (ECAI) for Bank Loan Ratings under BASEL-II guidelines. Since then, it has assigned over 8,300 credit ratings to various securities, debt instruments, and bank facilities of companies from all over the country and across all industries. It is registered and has its headquarters in BKC, Mumbai.

7. Infomerics Valuation and Rating Private Limited:

Infomerics Valuation and Rating Private Limited, an RBI-accredited and SEBI-registered credit agency, was founded by top financial professionals and is now led by Mr. Vipin Mallik. The credit bureau attempts to provide unbiased and extensive credit worthiness analysis and evaluation to NBFCs, banks, corporations, and small and medium-sized businesses. They determine an organization's creditworthiness through their rating and grading system. Infomerics aids in the reduction of information asymmetry between investors and lenders. Keeping transparency as a core objective, the credit bureau ensures that all of their clients receive full and accurate reports and data.

11.3.6 Credit Rating Process:



1. Issuing formal request:

The credit rating process begins when the issuer (the person or entity seeking a credit rating) submits a formal credit rating request to credit rating agencies. Specifically, CRISIL. When a credit rating agency approves the application. The issuer company and the rating agency reach an agreement.

The following are the terms of the agreement:

1. It requires the CRA (Credit Rating Agency) to maintain the confidentiality of the Company's information.
2. The issuer company has the option to accept or reject the rating.
3. The issuer company must provide accurate material and information to the CRA in order for it to be rated.

2. Assigning Analytical Team:

In the second step, the Credit Rating Agency (CRA) assigns the job and responsibilities of credit rating to an analytical team. The analytical team

is in charge of project and assignment evaluation. The team is typically made up of two members/analysts with relevant business experience.

3. Obtaining Financial Information

The analytical team will gather all of the necessary information from the client or issuer company in this case. The analytical team gives the issuer firm with a list of the required information as well as strategies for negotiations.

The analytical team examines information pertaining to the company's financial statements, cash flow estimates, and other pertinent data.

4. Research and Meeting with management:

To obtain a deeper understanding of the client's operations, the analytical team visits the company's plant or factory and speaks with executives. This includes recognising and documenting the major elements that determine production level, quality, and cost.

Direct meetings with the issuing firm's management are maintained since this enables the CRA (Credit Rating Agency) to incorporate or disclose non-public material in a rating determination and permits the rating to be forward-looking.

5. Discussion Meeting

When all of the study is completed, the team will meet with an internal committee comprised of top analysts from credit rating agencies to analyse the findings in depth. All of the issues affecting the company have been identified. An opinion about the ranking is created as well. The team's analysis results are finally delivered to the rating committee's senior authority.

5. Final Rating Meeting:

This is the final authority meeting for assigning ratings, and the analytical team's job concludes. The only phase in which the issuer does not participate directly is the rating committee meeting. Now, the final authority will scrutinise facts, findings, and factors such as political, social, and other considerations. The credit rating agency will assign the actual Credit Rating after considering all of the results, facts, and other information.

6. Informing Assigned Rating:

After assigning the rating grade, CRA will notify the issuer company of the rating as well as the reasons for the credit rating. The issuer corporation can now accept, refuse, or give additional information to be reviewed again. The credit rating rejected by the issuer corporation should be kept private and not made public.

7. Announcing to the Public:

Once the issuer accepts the rating, credit rating organisations distribute ratings to the public via printed reports, newspapers, and other media.

8. Monitoring the company:

Once the company has opted to accept the rating, CRAs are required to monitor the accepted ratings for the duration of the instrument or according to the time specified in the contract. The CRA must regularly examine all ratings in light of new political, economic, and financial developments, as well as industry trends.

All of this data is evaluated on a regular basis to identify significant changes. If a credit rating changes, the CRA will make the modified rating public via media and printed publications.

11.3.7 Credit Rating Symbols in India

The ratings scale in India is divided into ratings for :

- 1) Long term debt instruments.
- 2) Short term debt instruments
- 3) Long term structured finance instruments
- 4) Short term structured finance instruments
- 5) Credit Ratings - Fixed Deposit Scale
- 6) Credit Ratings - Corporate Credit Scale

Rating symbols should have CRA's first name as prefix. Like in the below table:

1) Long term debt instruments:

- 1) AAA :Instruments with this rating are considered to have the highest level of safety in terms of timely payment of financial obligations. These instruments have the lowest credit risk.
- 2) AA: Instruments having this rating are considered to offer a adequate level of safety in terms of prompt servicing of financial obligations. These instruments have a very low credit risk.
- 3) A: Instruments with this rating are considered to offer a moderate level of safety in terms of timely servicing of financial obligations. These instruments have a low credit risk.
- 4) BBB: Instruments with this rating are considered to have moderate risk of default regarding timely servicing of financial obligations.

5) B : Instruments with this rating are considered to have high risk of default regarding timely servicing of financial obligations.

6) C: Instruments with this rating are considered to have very high risk of default regarding timely servicing of financial obligations.

7) D: Instruments with this rating are in default or are expected to be in default soon.

("+") may apply '+' (plus) or '-' (minus) signs for ratings from 'AA' to 'C' to reflect comparative standing within the category.

b) Short term Debt Instruments:

1) A1: Instruments with this rating are considered to have very strong degree of safety regarding timely payment of financial obligations. Such instruments carry lowest credit risk.

2) A2: Instruments with this rating are considered to have strong degree of safety regarding timely payment of financial obligations. Such instruments carry low credit risk.

3) A3: Instruments with this rating are considered to have moderate degree of safety regarding timely payment of financial obligations. Such instruments carry higher credit risk as compared to instruments rated in the two higher categories.

4) A4: Instruments with this rating are considered to have minimal degree of safety regarding timely payment of financial obligations. Such instruments carry very high credit risk and are susceptible to default.

5) D: Instruments with this rating are in default or expected to be in default on maturity.

'+' (plus) sign for ratings from 'A1' to 'A4' to reflect comparative standing within the category.

C) Long term structured Finance Instruments:

1) AAA (SO) - Instruments with this rating are considered to have the highest degree of safety regarding timely servicing of financial obligations. Such instruments carry lowest credit risk.

2) AA (SO)- Instruments with this rating are considered to have high degree of safety regarding timely servicing of financial obligations. Such instruments carry very low credit risk.

3) A (SO) - Instruments with this rating are considered to have adequate degree of safety regarding timely servicing of financial obligations. Such instruments carry low credit risk.

4) BBB (SO) - Instruments with this rating are considered to have moderate degree of safety regarding timely servicing of financial obligations. Such instruments carry moderate credit risk.

5) BB (SO) - Instruments with this rating are considered to have moderate risk of default regarding timely servicing of financial obligations.

6) B (SO) - Instruments with this rating are considered to have high risk of default regarding timely servicing of financial obligations.

7) C (SO) - Instruments with this rating are considered to have very high likelihood of default regarding timely payment of financial obligations.

8) D (SO)- Instruments with this rating are in default or are expected to be in default soon.

* '+' (plus) or '-' (minus) signs for ratings from 'AA' to 'C'.

D) Credit Ratings - Short Term Structured Finance Scale

1) A1(SO) - Instruments with this rating are considered to have very strong degree of safety regarding timely payment of financial obligation. Such instruments carry the lowest credit risk.

2) A2(SO) - Instruments with this rating are considered to have strong degree of safety regarding timely payment of financial obligation. Such instruments carry low credit risk.

3) A3(SO) - Instruments with this rating are considered to have moderate degree of safety regarding timely payment of financial obligation. Such instruments carry higher credit risk as compared to instruments rated in the two higher categories.

4) A4(SO) - Instruments with this rating are considered to have minimal degree of safety regarding timely payment of financial obligation. Such instruments carry very high credit risk and are susceptible to default.

5) D(SO) - Instruments with this rating are in default or expected to be in default on maturity.

* '+' (plus) sign for ratings from 'A1(SO)' to 'A4 (SO)' to reflect comparative standing within the category.

E) Credit Ratings - Long Term Credit Enhancement (CE)

1) AAA(CE) - Instruments with this rating are considered to have the highest degree of safety regarding timely servicing of financial obligations. Such instruments carry lowest credit risk.

2) AA(CE) - Instruments with this rating are considered to have high degree of safety regarding timely servicing of financial obligations. Such instruments carry very low credit risk.

3) A(CE) - Instruments with this rating are considered to have adequate degree of safety regarding timely servicing of financial obligations. Such instruments carry low credit risk.

4) BBB(CE) - Instruments with this rating are considered to have moderate degree of safety regarding timely servicing of financial obligations. Such instruments carry moderate credit risk.

5) BB(CE) - Instruments with this rating are considered to have moderate risk of default regarding timely servicing of financial obligations.

6) B(CE) - Instruments with this rating are considered to have high risk of default regarding timely servicing of financial obligations.

7) C(CE) - Instruments with this rating are considered to have very high likelihood of default regarding timely payment of financial obligations.

8) D(CE) - Instruments with this rating are in default or are expected to be in default soon.

*Modifiers {"+" (plus) or "-" (minus)} will be used with the rating symbols for the categories AA (CE) to C (CE). The modifiers reflect the comparative standing within the category.

F) Credit Ratings - Short Term Credit Enhancement (CE)

1)A1(CE) - Instruments with this rating are considered to have very strong degree of safety regarding timely payment of financial obligation. Such instruments carry the lowest credit risk.

2) A2(CE) - Instruments with this rating are considered to have strong degree of safety regarding timely payment of financial obligation. Such instruments carry low credit risk.

3) A3(CE) -Instruments with this rating are considered to have moderate degree of safety regarding timely payment of financial obligation. Such instruments carry higher credit risk as compared to instruments rated in the two higher categories.

4) A4(CE) - Instruments with this rating are considered to have minimal degree of safety regarding timely payment of financial obligation. Such instruments carry very high credit risk and are susceptible to default.

5) D(CE) - Instruments with this rating are in default or expected to be in default on maturity.

*Modifier {"+" (plus)} will be used with the rating symbols for the categories A1 (CE) to A4 (CE). The modifier reflects the comparative standing within the category.

G) Credit Ratings - Fixed Deposit Scale

1) FAAA ("F Triple A") Highest Safety: This rating indicates that the degree of safety regarding timely payment of interest and principal is very strong.

2) FAA ("F Double A") High Safety : This rating indicates that the degree of safety regarding timely payment of interest and principal is strong. However, the relative degree of safety is not as high as for fixed deposits with 'FAAA' ratings.

3) FA Adequate Safety: This rating indicates that the degree of safety regarding timely payment of interest and principal is satisfactory. Changes in circumstances can affect such issues more than those in the higher rated categories.

4)FB Inadequate Safety: This rating indicates inadequate safety of timely payment of interest and principal. Such issues are less susceptible to default than fixed deposits rated below this category, but the uncertainties that the issuer faces could lead to inadequate capacity to make timely interest and principal payments.

5) FC High Risk: This rating indicates that the degree of safety regarding timely payment of interest and principal is doubtful. Such issues have factors present that make them vulnerable to default; adverse business or economic conditions would lead to lack of ability or willingness to pay interest or principal.

6) FD Default: This rating indicates that the fixed deposits are either in default or are expected to be in default upon maturity.

7) NM Not Meaningful: Instruments rated 'NM' have factors present in them, which render the outstanding rating meaningless. These include reorganisation or liquidation of the issuer, and the obligation being under dispute in a court of law or before a statutory authority.

'+' (plus) or '-' (minus) signs for ratings from FAA to FC to indicate the relative position within the rating category

Credit Ratings - Corporate Credit Scale

1) CCR AAA ("CCR Triple A") : A 'CCR AAA' rating indicates Highest degree of strength with regard to honoring debt obligations.

2) CCR AA("CCR Double A") : A 'CCR AA' rating indicates High degree of strength with regard to honoring debt obligations.

3) CCR A: A 'CCR A' rating indicates Adequate degree of strength with regard to honoring debt obligations.

4) CCR BBB: A 'CCR BBB' rating indicates Moderate degree of strength with regard to honoring debt obligations

5) CCR BB: A 'CCR BB' rating indicates Inadequate degree of strength with regard to honoring debt obligations.

6) CCR B: A 'CCR B' rating indicates High Risk and greater susceptibility with regard to honoring debt obligations.

7) CCR C : A 'CCR C' rating indicates Substantial Risk with regard to honoring debt obligations.

8) CCR D: A 'CCR D' rating indicates that the entity is in Default of some or all of its debt obligations.

9) CCR SD: A 'CCR SD' rating indicates that the entity has Selectively Defaulted on a specific issue or class of debt obligations, but will continue to meet its payment obligations on other issues or classes of debt obligations.

'+' (plus) or '-' (minus) modifiers for ratings from 'CCR AA' to 'CCR C' to reflect comparative standing within the category.

113.8 Credit Rating Agencies in India

1. Credit Rating Information Services of India Limited (CRISIL)

CRISIL is one of India's oldest credit rating firms. It was first introduced in the country in 1987, and the company went public in 1993. CRISIL, headquartered in Mumbai, began grading infrastructure in 2016 and celebrated its 30th anniversary in 2017. In 2017, CRISIL purchased an 8.9 percent share in the CARE credit rating agency. In 2018, it created India's first index to benchmark the performance of foreign portfolio investors' (FPI) fixed-income assets in the rupee and dollar markets. The portfolio of the organisation comprises mutual fund rankings, ULIP rankings, CRISIL coalition index, and so on.

2. ICRA Limited

ICRA Limited is a public limited corporation based in Gurugram that was founded in 1991. Previously, the organisation was known as Investment Information and Credit Rating Agency of India Limited. ICRA was a joint venture between Moody's and many Indian financial and banking service organisations before going public in April 2007. Currently, the ICRA Group includes four subsidiaries: Consulting and Analytics, Data Services and KPO, ICRA Lanka, and ICRA Nepal. Moody's Investors Service, the multinational credit rating agency, is currently ICRA's largest stakeholder. Corporate debt, financial rating, structured finance, infrastructure, insurance, mutual funds, project and public finance, SME, market linked debentures, and other products are all part of ICRA's product offering.

3. Credit Analysis and Research limited (CARE)

CARE, which was founded in 1993, provides credit ratings in areas such as corporate governance, debt ratings, financial sector, bank loan ratings, issuer ratings, recovery ratings, and infrastructure ratings. CARE, headquartered in Mumbai, provides two types of bank loan ratings: long-term debt instruments and short-term debt instruments. The organisation also provides ratings for Initial Public Offerings (IPOs), real estate, renewable energy service companies (RESCO), financial assessments of shipyards, Energy service companies (ESCO), and numerous educational institution courses. CARE Ratings has recently expanded its services to

include valuation of stock, debt instruments, and market related debentures. Furthermore, the company has formed a new worldwide credit rating agency called ARC Ratings in collaboration with four partners from South Africa, Brazil, Portugal, and Malaysia. ARC Ratings has begun operations and has completed sovereign ratings of countries such as India.

4. Brickwork Ratings (BWR):

Canara Bank promotes Brickwork Rating, which was founded in 2007. It provides ratings for bank loans, small and medium-sized enterprises (SMEs), corporate governance ratings, municipal corporations, capital market instruments, and financial institutions. It also evaluates NGOs, tourism, IPOs, real estate investments, hospitals, IREDA, educational institutions, MFI, and MNRE. Brickwork Ratings has been designated by the Reserve Bank of India (RBI) as an external credit assessment agency (ECAI) to conduct credit ratings in India.

5. India Rating and Research Pvt. Ltd:

Fitch Group's wholly owned subsidiary in India is India Ratings. It provides credit ratings to insurance companies, banks, corporate issuers, project finance, financial institutions, finance and leasing firms, managed funds, and municipal governments. The company is also recognised by the Reserve Bank of India and the National Housing Bank, in addition to SEBI.

6. Acuite Ratings & Research Limited:

Acuité Ratings & Research Limited is a full-service credit rating firm that is registered with the Securities and Exchange Board of India (SEBI). In 2012, the company was accredited by the RBI as an External Credit Assessment Institution (ECAI) for Bank Loan Ratings under BASEL-II guidelines. Since then, it has assigned over 8,300 credit ratings to various securities, debt instruments, and bank facilities of companies from all over the country and across all industries. It is registered and has its headquarters in BKC, Mumbai.

7. Infomerics Valuation and Rating Private Limited:

Infomerics Valuation and Rating Private Limited, an RBI-accredited and SEBI-registered credit agency, was founded by top financial professionals and is now led by Mr. Vipin Mallik. The credit bureau attempts to provide unbiased and extensive credit worthiness analysis and evaluation to NBFCs, banks, corporations, and small and medium-sized businesses. They determine an organization's creditworthiness through their rating and grading system. Infomerics aids in the reduction of information asymmetry between investors and lenders. Keeping transparency as a core objective, the credit bureau ensures that all of their clients receive full and accurate reports and data.

11.3.9 Limitations of Credit Rating:

1) Biased rating and misrepresentation:

Credit rating is a burden for the capital market business in the absence of quality rating. To avoid a biased rating, a rating agency expert doing a detailed analysis of a firm should have no ties to the company or any of its stakeholders, so that their assessment is impartial and prudent in its recommendation to the rating committee.

2) Static study:

The rating is based on the company's current and historical data, and it is a static analysis. Predicting the health of a firm through rating is imprecise, and anything can happen after the assignment of rating symbols to the company. Reliance on the rating for future results defeats the many purposes of the risk indicator of the rating.

3) Concealment of material information:

Rating companies may withhold key facts from the credit rating company's investigation team; in such circumstances, the rating's quality suffers and the rating becomes unreliable.

4) Rating is no guarantee for soundness of the company:

Ratings are done for a specific instrument to measure credit risk, but they should not be viewed as a certification of the company's or management's matching quality.

5) Human bias:

The findings of the investigation team may be influenced by human prejudice due to unavoidable personal weaknesses on the part of the employees, which could affect the rating.

6) Down grade:

Once a firm has been rated, if it fails to maintain its working results and performance, the credit rating agency will evaluate the grade or decrease the rating, harming the company's reputation.

7) Validity of rating:

The rating's validity expires when a debt instrument matures, and it no longer benefits the issuing company because the rating is only valid for the duration of the debt instrument being rated.

8) Difference in rating of two agencies:

In many circumstances, the ratings assigned by two different credit rating agencies to the same instrument by the same issuing company will not be equal. Such discrepancies are likely to arise as a result of value judgement disparities in the qualitative element of the analysis between two rating

agencies, despite the fact that the quantitative analysis may be the same and identical.

Q1 Fill in the blanks

- 1) _____ is a type of lending that provides credit to a customer for personal or domestic use.
- 2) The interest rate on a fixed rate loan does not _____
- 3) A _____ is a numerical representation of a consumer's creditworthiness based on the consumer's credit record, and it measures the likelihood of the consumer defaulting on a credit obligation.
- 4) Edward Bellamy proposed the concept of utilising _____ to make purchases in 1887.
- 5) In the absence of cash in the market, _____ such as Paytm are growing

Q2 Answer briefly

- 1) What are the sources of consumer finance?
- 2) What are the benefits of credit card and danger of credit card?
- 3) What is the prevention of fraud and misuse of Plastic money?
- 4) Explain briefly Consumer Finance Practice in India?
- 5) What are the types of consumer finance?

Q3 Short note

- 1) Explain consumer credit scoring
- 2) What are the types of plastic cards?
- 3) Explain credit rating agencies?
- 4) Explain Growth of Plastic Money Services in India?
- 5) Explain Credit Rating Symbol?

