FINANCIAL SERVICES

B.B.A. SECOND YEAR

Semester – 4

Lesson Writers

Dr. V.K. Bhaskar Rao,
M.Com., Ph.D.
Dept. of Commerce (PG),
VRS & YRN College,
Chirala.

Dr. C. Anil Kumar
M.Com., DFM, Ph.D.
Dept. of Commerce (PG),
TJPS College,
Guntur.

Dr. V. Naga Nirmala,
MBA, M.Com., MIB, M.Phil., Ph.D.
Faculty,
Dept. of HRM,
Acharya Nagarjuna University,
Nagarjuna Nagar, Guntur.

Editor

Prof. Noorbasha Abdul,
M.Com., MBA, Ph.D.
Dept. of Commerce & Business Administration,
Acharya Nagarjuna University.

Director

Dr. NAGARAJU BATTU
MBA, MHRM, LLM, M.Sc.(Psy), M.A.(Soc), M.Ed., M.Phil., Ph.D.
Centre for Distance Education,
Acharya Nagarjuna University,
Nagarjuna Nagar 522 510, GUNTUR.

Ph : 0863 - 2346208, 2346222, 2346259 (Study Material)
Website : www.anucde.info
e-mail : anucdedirector@gmail.com

B.B.A. SECOND YEAR Semester - 4

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FOREWORD

Since its establishment in 1976, Acharya Nagarjuna University has been forging ahead in the path of progress and dynamism, offering a variety of courses and research contributions. I am extremely happy that by gaining a 'A' Grade from the NAAC in the year 2014, the Acharya Nagarjuna University is offering educational opportunities at the UG, PG levels apart from research degrees to students from over 285 affiliated colleges spread over the two districts of Guntur and Prakasam.

The University has also started the Centre for Distance Education with the aim to bring higher education within reach of all. The centre will be a great help to those who cannot join in colleges, those who cannot afford the exorbitant fees as regular students, and even housewives desirous of pursuing higher studies. With the goal of bringing education in the door step of all such people. Acharya Nagarjuna University has started offering B.A, and B, Com courses at the Degree level and M.A, M.Com., L.L.M., courses at the PG level from the academic year 2021-22 on the basis of Semester system.

To facilitate easier understanding by students studying through the distance mode, these self-instruction materials have been prepared by eminent and experienced teachers. The lessons have been drafted with great care and expertise in the stipulated time by these teachers. Constructive ideas and scholarly suggestions are welcome from students and teachers invited respectively. Such ideas will be incorporated for the greater efficacy of this distance mode of education. For clarification of doubts and feedback, weekly classes and contact classes will be arranged at the UG and PG levels respectively.

It is aim that students getting higher education through the Centre for Distance Education should improve their qualification, have better employment opportunities and in turn facilitate the country's progress. It is my fond desire that in the years to come, the Centre for Distance Education will go from strength to strength in the form of new courses and by catering to larger number of people. My congratulations to all the Directors, Coordinators, Editors and Lesson -writers of the Centre who have helped in these endeavours.

Prof. P.Rajasekhar
Vice –Chancellor,
Acharya Nagarjuna University

B.B.A -SEMESTER – IV
406BBA21-FINANCIAL SERVICES

Unit-I:

Financial Services: Public Issue –Prospectus-Pricing of New issues - SEBI Guidelines, Functions of Merchant Bankers and Under Writers, Issue Managers, Registrar to Issue –Credit Rating Agencies - Mutual Funds –Determination of NAV.

Unit-II:

Factoring and Forfaiting: Meaning, Role in financial services - Theoretical Framework, Factoring services in India.

Unit-III:

Leasing: Lease Evaluation, Types of Lease, Structuring and Funding of Leases, Import Leasing and Cross Border Leasing, Hire Purchase Agreements- Evaluation of Hire purchase Agreements.

Unit-IV:

Credit Cards-Consumer Finance – Financing Schemes for Consumer durables– Process and Instruments and Venture capital financing.

Unit-V:

Housing Finance: National Housing Bank (NHB), NHB's Housing Finance Companies - Guidelines for extending equity support to housing finance companies - Guidelines for extending Refinance support to Housing Finance, Mortgage.

References:

1.Khan M.Y., Financial Services, Tata McGraw Hill Education Private Limited, New Delhi.

2.Vasant Desai, Financial Markets and Financial Services, Himalaya Publishing House, Mumabi.

3.Siddiah, T., Financial Services, Pearson

4.TripatyNaliniPrava, Financial Services, Prentice Hall of India, New Delhi.

5.Guruswamy.S, Financial Services, Tata McGraw Hill Education Pvt. Ltd., New Delhi.

6.V. Avadhani, Financial Services in India, Himalaya Publishing House, Mumbai, 2009.

7.Rajesh Kothari, "Financial Services in India", SAGE.

MODEL QUESTION PAPER (406BBA21)

B. B. A. Degree Examination

Second Year – Fourth Semester

Paper – IV : FINANCIAL SERVICES

Time : Three hours **Maximum Marks : 70**

Section – A

Answer any FIVE of the following questions. (5 × 4 = 20 Marks)

1. Public Issue.
2. Issue Managers.
3. Forfeiting.
4. Lease.
5. Hire Purchase Agreements.
6. Credit Cards.
7. Mortgage.
8. NHB.

Section – B (5 x 10 = 50 Marks)

Answer ALL the following questions.

9. (a) Explain the functions of Merchant Bankers and under writers.

Or

(b) Explain Service Guidelines.

10. (a) Explain the role in Financial Services.

Or

(b) Explain Factoring Services in India.

11. (a) Explain various types of Lease.

Or

(b) Explain the evaluation of Hire Purchase Agreement.

12. (a) Discuss about venture capital financing.

Or

(b) What is Consumer Finance? Explain Financing schemes for consumer durables.

13. (a) Explain the Guidelines for extending equity support to housing finance companies.

Or

(b) Discuss the guidelines for extending refinance support to having finance.

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CONTENTS

LESSON – 1

INTRODUCTION TO FINANCIAL SERVICES

Learning objectives :

- To study the Classification of Financial Services in Industry.
- To understand the Nature and Characteristics of Financial Services in India.
- To learn the Financial Services institutions.
- To discuss the Factors Affecting Access to Financial Services.

Structure of the lesson :

1.1 INTRODUCTION :

The development of a sophisticated and matured financial system in India, especially in the era of Liberalization, Privatization and Globalization (LPG), led to the emergence of a new sector known as Financial Services Sector. Financial services sector plays a significant role in any modern economy. Its objective is to act as intermediary and facilitate financial transactions of individuals and institutional investors.

The bundle of institutions that make up an economy's financial system can be seen as "the brain of the economy", providing the bulk of the economy's need for many functions.

1.2 MEANING OF FINANCIAL SERVICES :

The term financial service in its broader sense refers to "mobilizing and allocation of savings". It is identified as all those activities involved in the process of converting savings into investments. Financial services also include Financial Intermediaries such as, Merchant Bankers, Venture capitalists, Commercial banks, Insurance Companies etc.

1.3 DEFINITION OF FINANCIAL SERVICES INDUSTRY :

It may be defined as "the collection of organizations which intermediate and facilitate financial transaction of individual and institutional investors resulting from their resources allocation activities through time."

The financial services include all activities connected with the transformation of savings into investment.

1.4 CLASSIFICATION OF FINANCIAL SERVICES INDUSTRY :

The financial services industry can be traditionally classified into two categories :

i) Capital market intermediaries, consisting of term lending institutions and investing institutions providing long-term funds.

ii) Money market intermediaries, including commercial banks, cooperative banks and other agencies, which supply funds for shortterm requirements.

Therefore, the term financial services include all kinds of organizations, which act as intermediary and facilitate financial transactions of both individuals and corporate customers.

The entities that provide these services are classified into the following categories :

- Non – Banking Finance companies (NBFCS)
- Commercial banks and
- Investment bank

1.5 EMERGENCE AND DEVELOPMENT OF FINANCIAL SERVICES IN INDIA :

Financial services sector is blooming in India and it has passed through various phases as mentioned below :

i) Initial phase (1960-80) – Merchant Banking Era

ii) Second phase (1980-90) – Investment Companies Era

iii) Third phase (1990-2002) – Modern Services Era

1.5.1 Initial Phase :

Innovative services like Merchant banking, Insurance and Lease

Finance are introduced at the initial phase. The functions of Merchant bankers start from project appraisal and end at mobilization of funds. It includes underwriting of shares for public issues and listing of shares in the stock exchange. These functions are initiated by LIC, GIC, and UTI. In addition to this, leasing service is also initiated in the year 1970. Leasing service was started with equipment lease financing. Slowly, the leasing companies engaged in other types of lease such as, financial lease and operating lease

1.5.2 Second Phase :

Value added services like, over the counter share transfers, pledgingof shares, mutual funds, factoring, discounting, venture capital and credit rating are introduced in the second phase. The major contribution to the industry is from mutual fund in the developed countries. Capital market malpractices have come down due to the introduction of credit rating services. Initially the rating was applied only to debt instruments andnow-a-days, it is mandatory for the instruments, commercial papers and fixed deposits.

1.5.3 Third Phase :

In the era of post liberalization, financial services sector introduced new financial instruments and set up new institutions. During this phase, the contemporary issues like depositories, online trading, paperless trading, dematerialization, stock lending schemes and book building method of stock issues are initiated. Book building method of stock issues has become popularized because it helps both investors and issuingcompanies. Foreign Institutional investors (FIIs) are allowed to enter into the Indian capital market.

Present Scenario :

i) Conservatism to Dynamism :

The liberalization of financial sector has built the revolutionary changes in the Indian financial system. This reform is made to bring an efficient, competitive and diversified financial system in the country.

Present trend of Indian financial services sector is moving towards dynamism.

ii) Emergence of Primary Equity Market :

Raising finance through capital market is the major phenomena. Indian primary markets have become very active since the entrance of the private sectors in the financial services industry.

iii) Concept of Credit Rating :

The debt instruments are rated by Credit rating agencies. It helps the investors in finding a profitable and safe debt investment. The rating symbols indicate safety and risk of the instruments. Now-a-days, rating service is extended to equity securities also, which helps the investors to cautiously invest their savings.

iv) Process of Globalization :

The entry of innovative and sophisticated financial products is possible in our country due to globalization. The obstacles in Indian financial sector are slowly eliminated by the Government of India. It paves the way for introducing innovative financial products.

v) Process of liberalization :

The financial services reform is initiated by Government of India. Reformation is made in the mode of liberalization activities like deregulation of interest rate, privatization of banking and mutual fund sectors and amendment of companies act, MRTP act, Income tax act etc.

1.6 NATURE AND CHARACTERISTICS OF FINANCIAL SERVICES :

- Service provider and user (individual or firm) are involved in the process of financial services.
- Financial institutions are acting as intermediaries in the flow of funds.
- Corporate sector procure public funds smoothly and within the required time with the help of financial services sector.
- Services are based on customers' needs.
- They are consistently dynamic and convincing services.

1.7 FUNCTIONS OF FINANCIAL SERVICES INSTITUTIONS :

They help the firm or corporate not only to raise fund but also forefficient deployment of funds.

They help to construct the capital structure of the company

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1.8 CHARACTERISTICS OF FINANCIAL SERVICES INSTITUTIONS :

They help the firm or corporate not only to raise fund but also for efficient deployment of funds.

They help to construct the capital structure of the company

1.8.1 Capital Market instruments :

The instruments which deal in Capital market are of long-term nature. There are various types of securities such as :

- Equity shares
- Preference shares
- Debentures
- Gilt-edged securities
- Zero coupon bonds
- Deep discount bonds
- Option bonds
- Derivative securities – options, futures etc.,

1.8.2 Market players :

The players in the market include :

- Commercial banks
- Finance companies
- Stock brokers
- Consultants
- Underwriters
- Market makers

1.8.2.1 Commercial Banks :

In the developed countries, commercial banks are not only providing loans but also participating in the debt and equity finance of the corporate sector. Now – a – days all commercial banks in developing countries are also engaged in merchant banking services, hire purchasing finance, leasing, factoring, mutual funds, insurance and other services.

1.8.2.2 Finance companies :

The role of Finance companies is vital in the economic growth. It is also called as Non –

banking finance company whose business is receiving deposits besides engaging in any of the following activities

- o Financing by way of loans, advances etc.,
- o Acquisition of shares/stocks/bonds/debentures / securities
- o Hire – Purchase
- o Any class of insurance, stock broking etc.
- o Chit funds and
- o Collection of money by way of subscription/sale of units or other instruments/any other manner and their disbursement.

1.8.2.3 Stock Brokers :

The role of stock brokers is very important in stock market. They act as an agent and bridge between buyer and seller of securities in a recognized stock exchange. They should have obtained certificate of registration from SEBI after satisfying all the terms and conditions. The certificate from SEBI is mandatory to act as stock brokers. They may get an individual membership or corporate (firm) membership.

1.8.2.4 Consultants :

Corporate sector may get expert advice or opinion for their decision making. Those experts are specialized in the field of finance and they are called as Finance experts or professionals. They give only consultancyservice in all areas of functional management such as production, finance, marketing and human resources management.

1.8.2.5 Underwriters :

Underwrites are important intermediaries in the new issue/primary market to issues of capital who agree to take up securities which are not fully subscribed. They make a commitment to get the issue subscribed either by themselves or others. They are appointed by the issuing companies in consultation with the lead managers/merchant bankers to the issues. They get commission from issuing company for the assurance of subscribing to the stocks of issuing company.

1.8.2.6 Market makers :

The system of market making is popular in stock exchanges like London, New York and Chicago. A market maker is a bank or brokerage company that stands ready every second of the trading day with a firm ‘ask and bid price’. They actually purchase the stock from the seller even without any offer from the buyers’ side. The market maker maintains a spread on each stock to prevent the risk of fall in price of stock. The temporary disparity between the supply and demand for scrip is eliminated by them.

1.8.3 Specialized Institutions :

Specialized institutions are providing financial services in various forms such as Acceptance Houses, Discount houses, Factors, Depositories, Credit rating agencies, Venture capital etc. Financial market is dynamic and solves the contemporary issues of corporate sectors through these specialized service providers.

1.8.4 Regulatory Bodies :

Regulatory body is controlling authority of financial system. Reserve Bank of India (RBI) and Securities Exchange Board of India (SEBI) are the regulatory body of Indian monetary system. They are statutory bodies who have power of monitoring and regulating the entire financial system of India. Financial market must be closely monitored and regulated because it is highly volatile. RBI is central bank of India and it is the prime authority to monitor and control the affairs of entire banking system of our country. SEBI is the sole authority of monitoring, directing, regulating and controlling Financial Market (stock market). There are other regulatory bodies to regulate the corporate affairs such as company law board, Industrial board etc.

1.9 FACTORS AFFECTING ACCESS TO FINANCIAL SERVICES :

A number of factors affecting the access to financial services have been identified. These are

1. Gender Issues
2. Age Factor
3. Legal Identity
4. Limited literacy
5. Place of Living
6. Psychological Barriers
7. Cultural Barriers
8. Social Barriers
9. Social Security Payments
10. Level of Income
11. Bank Charges
12. Terms and Conditions
13. Types of Occupations

14. Caste and Religion
15. Attractiveness of the product
16. Cumbersome Procedures
17. Bias of Financial Institutions
18. Prides and Prejudices of the white caller
19. Wrongful Assessment
20. Willingness to spread service
21. Employment Barriers
22. Lack of Opportunities
23. Owning assets
24. Difficulty in smoothening income to cope with shocks
25. Exclusion from mainstream society

1.10 SCOPE OF FINANCIAL SERVICES :

Financial services cover a wide range of activities. They can be broadly categorized into two parts, namely :

(a) Traditional activities

(b) Modern activities

1.10.1 Traditional Activities :

Conventionally the financial services are identified under two heads :

1. Fund based activities and
2. Non-fund based activities

The traditional services which come under Fund Based Activities are the following :

- Underwriting of shares, debentures etc
- Dealing in foreign exchange market activities
- Lease Financing, hire purchase, venture capital, Factoring and Forfaiting,
- Housing Finance, Insurance Services, Venture Capital financing etc.
- Dealing in secondary market activities

- Participating in money market instruments like treasury bills, discounting bills, commercialpapers etc.

Non – Fund Based Activities Include :

- ★ The management of capital issues (pre and post issue management).
- ★ Arrangement for the placement of capital and debt instruments with investment institutions.
- ★ Arrangement of funds from financial institutions.
- ★ Arrangement of working capital for clients.
- ★ Assisting in the process of obtaining government Clearance.

1.10.2 Modern Activities :

It includes rendering project advisory services, right from the preparation of the project report till the raising of funds for starting the project

Planning for mergers and acquisitions and assisting for their smooth carry out.

Directing corporate customers in capital restructuring.

Acting as trustees to the debenture holders.

Recommending suitable changes in the management structure and management style envisaging achieving better results.

Portfolio management of large public sector undertakings.

Capital market services such as, Clearing services, Registration and transfers, collection of income on securities etc.

a) Leasing :

A Lease is a contract between owner of the asset and beneficiary. Owner of the asset is called lessor and the beneficiary is called lessee. The lessee has the right to posses and to use the asset on payment of the specified rentals over a predetermined period of time.

Steps involved in Leasing

- A contract of lease provides a person an opportunity to use an asset which belongs to another person. The following steps are involved in a leasing transaction:
- The lessee identifies the need for the equipment and selects the supplier.
- The lessee approaches a leasing company or Lessor to lease the equipment needed.

The lessee has to furnish the following information :

- ♦ Name and address of lessee
- ♦ Details about his business
- ♦ Name and address of guarantor, if any
- ♦ Description of the equipment
- ♦ Name and address of the supplier and the quoted price
- ♦ Place of installation
- ♦ Duration of the lease.

The Lesser examines the proposal after receiving the particulars from lessee and evaluates the credit – worthiness and rent paying capacity of the lessee.

The Lessor and Lessee enter into lease agreement. It contains the terms and conditions of the lease such as, lease period, rental payments, details regarding renewal of lease period, cost of repair and maintenance, insurance and any other expenses etc.,.

After the lease agreement is signed, the Lessor requests themanufacturer to supply the asset to lessee.

Types of Leasing :

Financial Lease :

Financial lease is an alternative to borrowing money and buying the equipment. The features of financial lease are :

1. The machinery is selected from the supplier by lessee based on his requirement.
2. The lessee negotiates the terms of the purchase i.e., price, delivery, installation, warranties, maintenance and payments.
3. The payment for purchases is made by Lessor and he is the legal owner of the machinery.
4. The risk of obsolescence and responsibility for maintenance are to be borne by lessee.
5. Lessee has to pay rent regularly.

Operating Lease :

Operating lease is a rental agreement and its features are as follows :

The period of the operating lease is generally shorter than the economic life of the leased asset.

The 'lessor' bears the risk of obsolescence and responsibility of maintenance of asset.

Sale and Lease Back :

It is an agreement between owner of the asset and leasing company. First, the firm (ownerthe asset to the Leasing Company and leases it back simultaneously. The ownership of the asset transfers to the leasing company, the company in turn leases it to the seller and the seller becomes lessee.

Public Issue by Listed Companies :

All listed companies can issue shares/convertible securities nprovided the issue size in a financial year does not exceed 5 times their pre issue net worth as per the audited balance sheet of the last financial year.

If the name of the issuer company is changed within the last one year, the revenue from the activity suggested by the new name should not be less than 50% of the total revenue in the preceding one full year.

If the above two conditions are not satisfied, a listed company can make a public issue through the book building process with the same conditions as applicable to unlisted companies.

Listed companies can also raise funds through Qualified Institutional placement.

Exemptions

The above norms for listed and unlisted companies are not applicable in the following cases.

Private / Public sector banks :

Infrastructure companies whose project has been appraised by a PFI / IDFC / ILFS or a bank which was earlier a PFI and also not less than 5% of the project cost has been financed by any of the appraising institutions jointly / severally.

Rights issue by a listed company.

Issues both public and rights of a convertible debt instruments – Conditions

Conditions for issue of a Debt Instrument :

The following conditions should be satisfied on the date of filing the draft offer document with SEBI and also on the date of filing the final offer document with the ROCs / designated stock exchange:

i. The offer document should disclose credit rating obtained from at least two SEBI registered credit rating agency.

ii. The issuer company should not be in the RBI's defaulters list.

iii. In case of debentures, the issuer company should not be in default for more than six months in the payment of interest and repayment of principal.

iv. The issuing company should disclose in the offer document all credit ratings obtained during the 3 years preceding the public/ rights issue for any listed security.

II. Pricing of Public Issues :

The Initial Public Offering Price is the price at which the stock is going to be offered to the public. The determination of initial public offering price depends on several things, like market condition, growth rate of the company, profitability etc.

Pricing

1) An issuer may determine the price of specified securities in consultation with the lead merchant banker or through the book building process.

2) An issuer may determine the coupon rate and conversion price of convertible debt instruments in consultation with the lead merchant banker or through the book building process.

3) The issuer shall undertake the book building process.

The determination of pricing of issues through book building process as follows :

a) Firstly, the company and its underwriters determine a price range (price band) within which they are going to set their stock's price.

b) Then the underwriter puts together a prospectus which comprises the price range. That prospectus is submitted to the Securities and Exchange Commission (SEC).

c) The next phase of pricing starts just before the day of offering. In this phase the company and its underwriter fix the final price at which the public can buy the issue.

d) Finally the phase of observation. That is, the company will observe its value assessment by the market after the issue starts trading.

1.11 SUMMARY :

The Financial services the world over has undergone a profound transformation since the early 1990s. The changed operating environment for the financial intermediaries, underpinned by globalization,deregulation, advancement in information technology, introduction of innovative instruments and management practices has resulted in intense competition pressures to provide financial services. This has exposed the financial system / financial intermediaries to newer risks and posed serious regulatory and supervisory challenges.

1.12 KEY WORDS :

Financing Services – The term financial service in its broader sense refers to "mobilizing and allocation of savings''.

Credit Rating - The debt instruments are rated by Credit rating agencies. It helps the investors in finding a profitable and safe debt investment. The rating symbols indicate safety and risk of the instruments.

Stock Brokers – The role of stock brokers is very important in stock market. They act as an agent and bridge between buyer and seller of securities in a recognized stock exchange.

Underwriters – Underwrites are important intermediaries in the new issue/primary market to issues of capital who agree to take up securities which are not fully subscribed

Regulatory Bodies – Regulatory body is controlling authority of financial system. Reserve Bank of India (RBI) and Securities Exchange Board of India (SEBI) are the regulatory body of Indian monetary system.

1.13 SELF ASSESSMENT QUESTIONS :

1. Briefly Explain Classification of financial services in Industry .
2. Discuss the Nature and characteristics of Financial Services in India.
3. Explain the Financial Services institutions.
4. Discuss the Factors Affecting Access to Financial Services.

1.14 SUGGESTED READINGS :

1. Frank J. Fabozzi CFA, Pamela P. PetersonFinancial Management and Analysis (Frank J. Fabozzi Series) Wiley Publicaitons 2003.
2. Eugene F. Brigham, Michael C. EhrhardtFinancial Management Theory and Practice, 13th EditionCenage Learning 2010.
3. C. Paramasivan, T. Subramanian Financial ManagementNew Age International Pvt Ltd Publishers, 2022.
4. Peter AtrillFinancial Management for Decision Makers, 5th Edition Edition : Financial Times Management City: Harlow 2022.
5. Raymond BrooksFinancial Management: Core Concepts, Global Edition Edition : 3 Pearson Publications, 2022.

Dr. V. Naga Nirmala

LESSON – 2

MERCHANT BANKERS

Learning Objectives :

- To know the functions of merchant bankers
- To understand the role of intermediaries in the issue management activities
- To familiarize with the SEBI norms for intermediaries in relation to the issue activities
- To get knowledge of the issue procedures of issue management

Structure of the lesson :

2.1 INTRODUCTION :

The origin of Merchant Banking is Italy. The Italian grain merchants provided funds for commodity traders and cargo owners. Their other activities were buying, selling and shipping of goods. The merchant Bankers were either individuals or Banking houses. Later on, the center of merchant banking operations was shifted from Italy to Amsterdam and thereafter to London.

2.2 MERCHANT BANKING IS ONE OF THE MAJOR FEE BASED / ADVISORY SERVICES :

In 1969, the Greenlays Bank commenced merchant Banking division in India. Formal Merchant Banking service was originated. The bank started the activities relating to public issue of securities. They also undertook financial consultancy services. In the year 1973 the State Bank of India started Merchant Banking services. In 1974, the ICICI started research service. After 1975 many Merchant Banking organizations came into existence. The sponsors for these organizations were by Banks, Financial Institutions, Non-Banking Financial Institutions (NBFCs), Brokers and so on. Consequently, the scope of merchant banking activities was widened.

Initially, the new issue market was regulated under the provisions of the Capital issues (Control) Act 1947 and rules made under it. In 1992, the act was repealed. The protection of the interest of the investors was transferred to the Securities and Exchange Board of India (SEBI). Various regulatory measures covering both the intermediaries as well as the activities were introduced by SEBI for strengthening the operations of the new issues in the country. Many intermediaries who play an important role in the process of selling new issues emerged.

2.3 ISSUES OF MARKET INTERMEDIARIES :

1. Merchant Bankers
2. Lead Managers
3. Underwriters
4. Bankers to issue
5. Brokers to an issue
6. Registrars to issue and Share transfer agent
7. Debenture trustees
8. Portfolio Managers

The legal framework prescribed by SEBI controlled the operations of these intermediaries. Rules and regulations were framed by SEBI for prohibition of fraudulent and unfair trading practices relating to the Securities Market and Prohibition on dealing / communicating / counseling on matters relating to insider trading.

The role of these intermediaries and SEBI regulations on their activities as well as issue procedure relating to issues of capital / securities are elaborately dealt in this unit.

2.3.1 Merchant Bankers :

Definition :

"A Merchant Banker means any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities or acting as manager/consultant / advisors or rendering corporate advisory service in relation to such issue".

The word 'issues' in the definition refers to an offer for sale/ purchase of securities by any Body-Corporate/other person or group of persons on its / his / their behalf to, or from the public or, from the holders of the securities through a Merchant Banker.

Categories of Merchant Bankers :

Merchant Bankers fall under four categories :

Category I – Merchant Bankers of this category can carry on any activity relating to issue management. The activities are as follows :

Preparation of Prospectus and other information relating to issue,

Determining the financial structure,

Tie-up of financiers,

Final allotment of securities

Refund of subscribes etc.,

They could also act as Advisors, Consultants, Co-Managers,

Underwriters or Portfolio Managers.

Category II – Merchant Bankers of this category can act as Advisors, Consultants, Co-Managers, Underwriters and Portfolio Manager.

Category III – Merchant Bankers of this category can act as Underwriters, Advisors and Consultants to an issue.

Category IV – Merchant Bankers of this category can act only as Advisors or consultant to an issue.

All the categories below Category – 1 were abolished by SEBI on 5th September 1997. Those operating below category-1 have to apply for Category-1 status.

2.3.2 Lead Managers :

"In a syndicate, an underwriting firm immediately subordinate to the managing underwriter. A syndicate is a group of underwriters responsible for placing a new issue of a security with investors. Every syndicate is a temporary arrangement. The lead manager is assigned the second-largest part of the new issue for placement. A lead manager is also called an arranger".

As per the SEBI regulations all issues should be managed by at least one authorized Merchant Banker functioning as Sole manager or Lead manager. As such only Category1 Merchant Bankers could act as Lead Managers to an issue.

Number of Lead Managers

The SEBI guidelines stipulate the following :

1. For an issue of size less than ` 50 crores, the number of Lead Managers should not exceed
2. For an issue of size ` 50 crores but less than 100 crores, the maximum number of Lead Managers should not exceed 3.
3. For an issue of size ` 100 crores but less than 200 crores, the maximum number of Lead Managers should not exceed .
4. For an issue of size 200 crores but less than 400 crores, the maximum number of Lead Managers should not exceed 5.
5. For an issue of size above ` 400 crore the number of Lead Managers may be 5 or more as may be agreed by SEBI.

Conditions of Registration / Renewal Certificate of a Merchant Banker

The Registration / Renewal certificate of a Merchant Banker is subject to the following conditions :

1. Prior approval of SEBI is necessary to continue to act as a
   Merchant Banker after change of its status/constitution – such as amalgamation, merger, and consolidation and any other kind of corporate restructuring / change in its managing/whole time directors, change in control etc.
2. A Merchant Banker should enter into a legally binding contract with the issuer specifying their mutual duties and responsibilities.
3. A Merchant Banker should pay the Registration/Renewal in the prescribed manner.
4. He should take adequate steps for redressal of grievances of investors within one month of the complaint. He should inform the SEBI the details of complains and the manner of redressal.
5. He should abide by the relevant regulations under the SEBI act.

Restriction on Business :

The Merchant Banker other than a bank/public finance institution is not permitted to carry on business other than in the securities market i.e., he is prohibited from carrying on fund/asset based business such as leasing.

Responsibilities of Lead Managers :

Every Lead Manager must sign an agreement with the issuing companies. The agreement must contain the matters regarding mutual rights, liabilities and obligations relating to issues which must necessarily include disclosures, allotment and refund.

Merchant banker should furnish a statement specifying the details in the agreement to SEBI. Such statement should be sent at least one month before the opening of the issue for subscription. The statements should also contain the details about all lead managers and their respective responsibilities if there were more than one.

Lead Manager / Merchant Banker :

There should be no association between the lead manager and the issuing company.

There should be no association with other merchant bankers who do not hold a certificate of registration with SEBI.

The minimum undertaking obligation to be accepted by a lead manager is 5% of the total underwriting commitment or ` 25 lakhs whichever is less.

Due diligence certificate: The lead manager should furnish a certificate to SEBI 2 weeks before the opening of the issue for subscription stating the following:

The prospectus/letter of offer is in conformity with the documents/materials and papers relevant to the issue.

All legal requirements in connection with the issue have been complied with.

The disclosures are true fair and adequate to enable the investors to make a decision regarding investment.

The merchant banker must submit to the SEBI two weeks before the date of filing with the registrar of companies / regional stock exchanges or both, the following particulars of the issue:

Draft prospectus/letter of offer,

Other literature to be circulated to the investors / shareholders

	Issue Size	Fees
a. Public issue	upto ₹ 10 crore	Flat rate of ₹ 25,000/-
	₹ 10 to 5000 crore	0.025% of the issue size
	₹ 5000 crore to 25,000 crore	₹ 1.25 crore plus 0.00625% of the issue size in excess of 5000 crore
	More than ₹ 25,000 crore	Flat charge of ₹ 3 crore
b. Right issue	upto ₹ 10 crore	Flat rate of ₹ 25,000/-
	₹ 10 to 500crore	0.005% of the issue size
	More than ₹ 500 crore	Flat charge of ₹ 5 lakh

2.3.3 Underwriters :

Underwriters to issue of capital are one of the important intermediaries in the new issue / primary market. They agree to take up securities which are not fully subscribed. They make a commitment to get the issue subscribed either by others or themselves. After 1995, underwriting is not mandatory.

Appointment of Underwriters :

The issuing companies, in consultation with the lead managers/ merchant bankers to the issues appoint underwriters. The underwriters' assets must be adequate to meet their obligations. A statement to this effect should be incorporated in the prospectus.

Registration

To act as underwriters, a certificate of registration should be obtained from the SEBI. No separate registration to act as underwriter is required in the case of merchant banker registered with SEBI.

Matters considered by SEBI in granting certificate of Registration :
Infrastructure adequacy (office space, equipment and manpower) to discharge the activities relating to underwriting.

The applicant must have experience in underwriting or he must appoint at least two persons with experience in it.

The applicant or any person directly or indirectly connected with the applicant has not been granted registration with the SEBI as underwriter (Previous application for registration should not have been rejected).

The applicant for underwriting should not have any disciplinary action taken against him under the SEBI Act/Rules/Regulations.

The applicant for underwriting should have net worth (capital plus free reserve) of not less than ` 20 lakh.

The applicant for underwriting should not have been found guilty of any economic offence and should not have been convicted of offence involving moral turpitude.

Fees :

The application fee for underwriter is ` 25,000/- the fee payable for registration at the time of grant of certificate is ` 10 lakh.

A renewal fee of ` 5 lakh every two years from the fourth year from the date of initial registration is payable.

Failure to pay the fee would result in suspension of certificate of registration.

Conditions for Registration

Conditions for registration applicable to merchant bankers are also applicable to underwriters.

Obligations and Responsibilities :

The underwriters have

a) To protect the interests of its clients.

b) To maintain high standards of integrity, dignity and fairness in the conduct of business.

c) To render high standards of service and maintain professional ethics.

d) To exercise due diligence.

e) To ensure proper care and professional judgment.

f) To avoid conflict of interest

g) To make adequate disclosure of his interest.

h) To treat equally all its clients without discrimination.

i) To maintain appropriate level of knowledge and competence.

j) To abide by the provisions of the SEBI Act, regulations, circulars and guidelines issued by the SEBI.

k) To furnish true and complete statement, material fact in any documents reports papers without suppressing any fact or making untrue statement.

l) Should not have insider trading activity.

m) Should not engage in unfair competition harmful to the interest of other underwriters

2.3.4 Bankers to an Issue :

Bankers to an issue are engaged in the following activities:-

a) Acceptance of applications from the investors in respect of issues of capital,

b) Acceptance of application money and

c) Refund of application money.

d) Issue means an offer of sale/purchase of security by anybody corporate / person / group of persons on his / its / their behalf to or from the public/holders of securities of the body corporate/person / group of persons.

Registration :

A person for acting as a banker to an issue must obtain a certificate of registration from the SEBI.

Requirements :

The applicants must have necessary infrastructure, communication and data processing facilities and manpower to effectively discharge his functions as a banker to an issue.

The applicant/any of the directors of the applicant should not have been involved in any litigation connected with the securities market.

The applicant should not have been convicted of any economic offence.

The applicant must be a scheduled bank.

The grant of certificate should be in the interest of the investors.

The applicant should be a fit and proper person as per the criteria specified in the SEBI Intermediaries Regulation 2008 Obligations and Responsibilities of Bankers to an Issue

Furnishing information to SEBI: The bankers to an issue must furnish the following information if required by SEBI

a. No. of issues for which he is a banker

b. No. of applications received

c. Details of application money received

d. Date of forwarding the applications to the issuing company / Registrar to the issue.

e. Date and amount of refund to the investors

Maintenance of accounts and Documents: The banker must maintain records / documents / accounts for furnishing information to SEBI when they require. He must keep the records for 3 years.

Entering agreement with issuing companies: The agreement entered into by the bankers with the issuing company must provide for the following :

a. No. of collection centers at which applications/application money received is forwarded to registrar.

b. Submission of daily statement stating the no. of applications and amount of money received by the investors.

Any disciplinary action taken by RBI against a banker to an issue regarding issue payment must be informed to the SEBI.

2.3.5 Brokers to the Issue :

Meaning :

Brokers are the persons mainly concerned with procurement of subscription to the issue from the prospective investors.

Appointment of Brokers :

The appointment of brokers is not obligatory. There is no restriction to the number of brokers to be appointed. The leading merchant bankers acting as managers to the issue have particulars of the performance of brokers. The company consults with the stock exchange and writes to all active brokers of all exchanges. It obtains their consent to act as brokers to the issue. The prospectus should disclose the names and addresses of the brokers to the issue and the same along with the copy of the consent letter of the broker is to be filed with the Registrar of companies.

Who cannot be appointed?

The stock exchange bye laws prohibit the members from acting as

Managers or brokers to the issue and

Making preliminary arrangement in connection with new issue

If the stock exchange of which they are members does not give its approval. Also it would prohibit the members to act as brokers if the company does not confirm to the prescribed listing requirements and undertakes to have its securities listed on a recognized stock exchange.

The permission granted by stock exchange is further subject to other stipulations which are set out in the letter of consent.

Brokerage Rate :

The brokerage rate is 1.5% for all types of public issue industrial securities. It is immaterial whether the issue is underwritten or not. The stock brokers have to meet mailing cost and other out of pocket expenses for canvassing of public issues. The company will not pay these expenses. The agreement with broker and company should include a clause to this effect. The brokerage on private placement of capital payable by the listed companies is a maximum of 0.5%. Brokerage is not allowed in respect of Promoters quota

Amount taken up by the directors/their friends and employees

Rights issue taken by or renounced by the existing shareholders

Brokerage is not allowed when the application are made by institutions/bankers against their underwriting commitments.

The brokerage should be paid by the company within two months from the date of allotment. The particulars of the allotment made against applications bearing their stamps should be furnished to the broker. The cheques for brokerage amount on new issues should be made payable at par at all centers where the recognized stock exchanges are situated. The prospectus should disclose the rate of brokerage.

2.3.6 Registrar to an Issue and Share Transfer Agents :

Functions of Registrar to an issue

The Registrar to an issue, in the capacity of an intermediary in the primary market carryon the following activities :

Collecting applications from the investors

Keeping a proper record of applications and money received from investors.

Keeping a proper record of amount paid to seller of securities

Assisting company in determining the basis of allotment of securities in consultation with stock exchanges.

Finalizing the allotment of securities

Processing / dispatching allotment letters, refund orders, certificates and other related documents in respect of issue of capital.

Functions of Share Transfer Agent :

Maintaining records of holders of securities or on behalf of companies.

Dealing with all matters connected with the transfer/redemption of securities.

Registration :

The Registrars to an issue and the share transfer agents for carrying out their function must be registered with the SEBI.

A. The Registrar and Share Transfer Agent fall into two categories

To carry on the functions of both Registrars to an issue and share transfer agent

To carry on the functions of either the Registrar or share transfer agent

B. Conditions for Registrations

SEBI grants Registration considering besides all relevant matters, the following :

Necessary infrastructure

Past experience

Capital adequacy

Should not have been convicted for any offence involving moral turpitude, or should not have been found guilty of any economic offence.

The applicant must be a fit and proper person in terms of the SEBI Intermediary Regulation 2008

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The applicant must be a fit and proper person in terms of the SEBI Intermediary Regulation 2008

C. Capital Adequacy

Category	Net worth (capital & free reserve)
Category – I	₹ 6,00,000/-
Category – II	₹ 3,00,000/-

D. Fees

Category	Registration Fees	Renewal Fees
Category - I	₹ 3,00,000/-	₹ 1,00,000/- every 3 years
Category – II	₹ 1,00,000/-	₹ 50,000/- every 3 years

The application Fee for Registration is ₹ 10,000/-

E. Conditions of Registration :

The conditions of Registration are as applicable to merchant bankers / underwriters / Bankers

F. Maintenance of Records:

Records relating to

To all applications received from investors.

To rejected application together with reasons.

To basis of allotment

To terms and conditions of purchase of security.

To allotment of securities.

To list of allottees and non-allottees.

To refund orders

To list of holders of securities of corporate.

To names of transferors and transferees

To Dates of transfer of security are to be maintained and preserved for a period of 3 years.

G. Appointment of Compliance Officer :

They should appoint a compliance officer for Investors Grievances Redressal and for monitoring SEBI Act rules and regulations.

H. Inspection :

SEBI is empowered to inspect books of accounts and other records of Registrar to an issue and Share Transfer Agent. SEBI is also empowered to investigate into compliance from investors and others. SEBI can also investigate on its own in the interest of investors into the affairs of Registrar to an issue and Share Transfer Agent. Based on inspection report SEBI can instruct the concerned parties to take remedial measures. It may appoint an auditor to investigate the accounts of Registrar to an issue and Share Transfer Agent. Any Registrar to an issue and Share Transfer Agent, any of the provisions of SEBI act, rules and regulations would be dealt with in accordance with the SEBI Intermediary Regulation 2008.

Factors considered for Registration by SEBI :

Infrastructure facilities like office space, equipment and manpower to discharge duties effectively.

Past experience as a debenture trustees (or) employment of two experienced persons in the matters relating to debenture trustee.

Should not have direct / indirect connection with the applicant.

Engagement of minimum of one person with professional qualification in law.

Any of its directors / principal officers should not have been convicted for any offence involving more turpitude or should not have been found guilty of any economic offence.

Must be fit and a proper person as per the criteria specified in SEBI intermediary regulation 2008.

Period of Registration & Registration Fee :

The Registration is valid for 3 years and can be renewed before 3 months following the expiry of the period of the certificate.

Registration fee is ` 10 lakh.

Renewal fee is ` 5 lakh

Conditions of Registration are the same as those applicable to merchant bankers.

2.3.7 Debentures trustees :

Responsibilities and duties of a debenture trustee of obligation before appointment.

Must enter into a written agreement with the body corporate before the opening of the subscription list for issue of debentures.

Agreement should contain the following :

a) Agreeing to act as the trustee under the trust deed for securing an issue of debentures for the body corporate.

b) The time limit of the security for the debenture holders.

Obligations : The Debenture Trustee should accept the trust deed.

The deed should contain the following matter.

Rights of the Debenture holders and manner in which they are vested in the trustee.

Purpose of raising funds through debenture issue.

Description of debenture like, amount, tenure, interest, periodicity of payment, period for redemption, options available terms of conversion/redemption of the debentures.

Nature of charge, rank of charge of assets.

Creation of future security for the issue of debentures – time limit within which is to be created.

Events under which security becomes enforceable.

Creation of obligation of company not to create future security.

Minimum security cover require

A clause for subsequent valuation

Circumstances necessitating the enforceability of the security.

Preservation methods of assets charged as security circumstances under which security may be disposed or leased out with the approval of the trustee.

Inspection of charged.

Steps which would be taken by the Debenture Trustee in the event of default.

The companies' duties should be specified in the agreement.

Other Miscellaneous provisions such as

Procedure for appointment

Removal of trustee,

Appointment of new trustee

Non-relinquishment from the assignment

Procedure for removal of debenture trustee by a resolution passed by at which 75% of debenture holders.

Provision for redressal of grievance of the debenture holders

Inspection by SEBI

a. SEBI is authorized to inspect books of account and other records of debenture trustees.

b. The purpose of inspection is

To ensure proper maintenance and compliance with companies Act.

To ensure that they are maintained in the manner prescribed by SEBI.

To grant continuance of Registration

Investigation of compliance against the trustees' activities.

In the interest of securities / Business/investors.

c. As an alternative the SEBI may appoint a qualified auditor for investigation into the accounts / affairs of the trustee.

d. Based on the inspection report SEBI can direct the trustee to take measures in the interest of the security market and for due compliance with the provisions of SEBI Act

2.3.8 Portfolio Managers :

The SEBI takes into account the following matters while considering the application :

Matters relevant to portfolio management activities

Employment of two persons experienced in portfolio management, stock broking, investment management.

Persons connected with the applicant should not have been refused registration.

Capital adequacy requirement of not less than net worth of 2 crore.

The applicant/partner/director/principal officer should not have been convicted for any offence involving moral turpitude/guilty of any economic offence. The applicant should not have been involved in any litigation connected with the securities market.

The principal officer of the applicant to have professional qualification in finance / law / accounting / business management or at least 10 years experience in related activities in the securities market.

The issue of certificate should be in the interest of investors.

The applicant should be a body corporate

There should not have been any disciplinary action taken by SEBI against any person directly or indirectly connected with the applicant.

The applicant must be a fit and proper person as per the criteria specified in the SEBI Intermediaries Regulation 2008.

2.4 SUMMARY :

Merchant banking essentially involves selling an issue for a company and handling related work. In the wake of liberalization of the financial sector, we are witnessing certain merchant banking prospects emerging be it an Indian company or foreign or a multinational, playing in the primary and secondary markets competitively. The mushroom growth of merchant banks has given rise to unethical means to sell shares. For a healthy growth of the market operation, the SEBI should enforce strict control on merchant banks and remove the weeds of manipulation and corruption in the market. Stipulation of proper checks and regulation will raise the confidence of investing public in the dynamic and vibrant market mechanism which will be in the larger interests of the society as well as of the economy.

The growth of the capital market in India in the 90s is mainly due to the key role played by the merchant banking divisions of leading development banks as well as commercial banks. In a way, the merchant banks have come to occupy an important place in the Indian financial scene with seven of the top ten merchant banking coming from the development banks and other financial institutions. They dominate the market in providing professional service to the corporate sector. The future growth of the capital market depends, to a large extent on the financial services made available by them

In fact, merchant banks should replace brokers in trading, in course of time, so that the market operations will be beneficial both to the industrial sector and investors as well as other operators in the primary and secondary markets. And the merchant bankers should also pass on the profits to investors, depositors and shareholders equitably. By its unique features, it is playing key role in accelerating the economic growth.

2.5 KEY WORDS :

Merchant Banker – A Merchant Banker means any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities or acting as manager/consultant/ advisors or rendering corporate advisory service in relation to such issue".

Lead Managers – In a syndicate, an underwriting firm immediately subordinate to the managing underwriter. A syndicate is a group of underwriters responsible for placing a new issue of a security with investors. Every syndicate is a temporary arrangement. The lead manager is assigned the second-largest part of the new issue for placement. A lead manager is also called an arranger".

Underwriters – Underwriters to issue of capital are one of the important intermediaries in the new issue/primary market. They agree to take up securities which are not fully subscribed. They make a commitment to get the issue subscribed either by others or themselves.

Brokerage Rate – The brokerage rate is 1.5% for all types of public issue industrial securities. It is immaterial whether the issue is underwritten or not. The stock brokers have to meet mailing cost and other out of pocket expenses for canvassing of public issues.

2.6 SELF ASSESSMENT QUESTIONS :

1. Briefly Discuss the functions of merchant bankers
2. Describe the role of intermediaries in the issue management activities
3. Briefly Analyze the SEBI norms for intermediaries in relation to the issue activities
4. Explain the issue procedures of issue management

2.7 SUGGESTED READINGS :

1. Frank J. Fabozzi CFA, Pamela P. Peterson Financial Management and Analysis (Frank J. Fabozzi Series) Wiley Publicaitons 2003.
2. Eugene F. Brigham, Michael C. Ehrhardt Financial Management Theory and Practice, 13th Edition Cenage Learning 2010.
3. C. Paramasivan, T. Subramanian Financial Management New Age International Pvt Ltd Publishers, 2022.
4. Peter Atrill Financial Management for Decision Makers, 5th Edition Edition: Financial Times Management City: Harlow 2022.
5. Raymond Brooks Financial Management: Core Concepts, Global Edition Edition: 3 Pearson Publications, 2022.

Dr. V. Naga Nirmala

LESSON – 3

CREDIT RATING AGENCIES

Learning objectives :

- To know the Factors influencing Assigned Rating.
- To understand the SEBI code of conduct.
- To discuss the Credit Rating Process.
- To learn the Credit Rating agencies in India.

Structure of the lesson :

3.1 INTRODUCTION :

Credit rating is an opinion of rating agency about a debt instrument. The opinion is expressed through symbols which indicate the degree of riskassociated with repayment of principal and payment of interest on debt instrument. Credit rating agency gets fee for their services from corporate entities which approach for rating of their instruments. Credit rating is not mandatory to all corporate sectors except for certain instruments.

The financial position of the corporations is reviewed frequently and the ratings are revised by the credit rating agency.

3.2 ORIGIN :

In 1841, the first mercantile credit agency was set up in New Yorkto rate the ability of merchants to pay their financial obligations. Later on, it was taken over by Robert Dun. This agency published its first rating guide in 1859. The second agency was established by John Bradstreet in 1849 which was later merged with first agency to form Dun & Bradstreet in 1933. It became the owner of Moody's Investor's Service in 1962. Since 1970's, a number of credit rating agencies have been set up all over the world including countries like Malaysia, Thailand, Korea, Australia, Pakistan, Philippines etc. In India, CRISIL (Credit Rating and Information Services of India Ltd.) was setup in 1987 as the first rating agency.

3.3 RATING INDICATIONS :

Rating symbols assigned to a security issue is an indicator of the following :

- The nature and terms of the particular security being issued;
- The ability and the creditworthiness of the issuer of a security to make payments in time;
- The probability that the issuer will make a default in payments

3.4 FACTORS INFLUENCING ASSIGNED RATINGS :

1. The ratings are assigned by the credit rating agency based on the following factors:
2. The issuer's ability to meet the obligations of debt.
3. The volume and composition of outstanding debt.
4. The earning capacity of the company and its stability of 'future cash flows'.
5. The interest coverage ratio i.e. it is the relationship between fixed interest and profit of the company (EBIT) whose ability to meet its fixed interest obligations.
6. Current Ratio which is calculated to assess the liquidity position of the issuing firm.
7. The value of assets pledged as collateral security
8. Market demand for the products, competitors' market share, and distribution channels etc.
9. Operational efficiency is judged by capacity utilization, prospects of expansion, modernisation and diversification, availability of raw material etc.
10. Track record of promoters, directors and expertise of staff.

3.5 BENEFITS OF CREDIT RATING :

The beneficiaries of Credit rating are investors, companies and intermediaries benefited in the following ways :

Investors get an idea about the degree of financial strength of the issuer company through credit rating.

Risk and Returns :

Credit rating indicates the degree of risk and possibility of returns on debt instruments. The indication (symbol) helps the investor to take decision for making investment on such instruments.

Investment Decisions :

Credit rating symbol expresses the creditworthiness of the instruments as a layman can easily understand about the risk & return status of such instruments. Hence, he can take his own decision instead of seeking any advice from the stock brokers.

Investment Choice :

Commonly, there are two different types of investors i.e., risk taker and risk averter. The level of risk taking is different for different investors.

Hence, the investor can choose the securities for his investment based on his risk bearing capacity.

Easy Perception :

All debt instruments are rated mandatorily. No analytical knowledge is required to make investment on debt instruments. Therefore, investors can make investment easily and quickly.

No Need of Issuing Company Details :

Credit rating agencies conduct detailed investigation about the issuing companies' details like nature of business, financial position, liquidity and profitability position before evaluating the instruments issued by them. Therefore, investors need not bother about the company.

Monitoring System :

The constant monitory system is followed by credit rating agencies after grading the instruments.

3.6 BENEFITS TO THE COMPANY :

Quick Mobility of Fund :

Highly rated instruments indicate the ability of the yield of the instruments. Normally, investors are interested to invest in this kind of instruments. Hence, the issuing company can mobilize fund quicklythrough the issue of such type of securities.

Lower Cost of Debt :

The highly rated instruments are quoted with lower rate of interest. So, the company can get cheaper source of debt fund.

Reducing Issue Expenses :

The rating itself is an advertisement for highly rated instruments. Hence, the issuing company has no need to spend for publicity of such instruments. Therefore, the issuing cost can be reduced to the issuingcompany.

Increasing Goodwill :

The goodwill of the company would increase when their instruments get high rate. The high rated instruments build good image of the company in the eyes of stakeholders.

Motivation for Growth :

The promoters of the company with highly rated instruments are motivated to expand their operations and move towards the growth path of the company.

Recognition :

Credit rating is a way for getting opportunity to recognize the new companies or unknown companies.

3.7 BENEFITS TO INTERMEDIARIES :

The less effort is sufficient to approach the investors for the selection of instruments by the intermediaries in case of highly rated instruments.

Limitations of Credit Rating :

Credit rating suffers from the following limitations :

Hidden Information :

Investors can get loss when the company does not disclose the important information to the investigation team of credit rating agency

Non – Consideration of External Factors :

The external factors like economic, political, environment and government policies which may affect the creditworthiness of the firm are not considered while evaluating the instruments. Generally, the rating is based on historic data which may mislead the investors.

No Guarantee :

Rating is simply an opinion about the capability of the company but it is not a certificate or guarantee of the credit rating agency.

Biased :

The quality of the rating may be affected due to the personal bias of the investigating team.

Difference in Rating Grades Investors get confused due to different rating scale for the same instrument given by different rating agencies.

The Regulatory Framework for Credit Rating Agencies

SEBI Regulations :

The Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999 empower SEBI to regulate CRAs operating in India. In fact, SEBI was one of the first few regulators, globally, to put in place an effective and comprehensive regulation for CRAs.

SEBI regulation for CRAs has been designed to ensure the following :

Credible players enter this business (through stringent entry normsand eligibility criteria)

CRAs operate in a manner that enables them to issue objective and fair opinions (through well-defined general obligations for CRAs)

There is widespread investor access to ratings (through a clearly articulated rating dissemination process).

The applicant should be registered as a company under the Companies Act, 1956 and possess a minimum network of ` 5 crore.

The following are some of the General Obligations specified in the CRA regulations. CRAs are amongst the very few market intermediaries for which such detailed operating guidelines have been prescribed under the regulations.

Code of Conduct stipulated by SEBI

- Agreement with the client
- Monitoring of ratings
- Procedure for review of rating
- Internal procedures to be framed by the CRA
- Disclosure of Rating Definitions and Rationale by the CRA
- Submission of information to the Board
- Compliance with circulars etc., issued by the Board
- Appointment of Compliance Officer
- Maintenance of Books of Accounts records, etc.
- Confidentiality
- Rating process

These regulations cover issues with respect to confidentiality of information and disclosure with respect to the rationale of the rating being assigned. Several other provisions exist, like the regulator‘s right to inspect a CRA. An important feature of the regulation is that CRAs are prohibited from rating their promoters and associates.

3.8 SEBI CODE OF CONDUCT :

SEBI‘s code of conduct for CRAs addresses some of the basic issues relating to conflicts of interest. The Code of Conduct is designed to ensure transparent and independent functioning of CRAs. Some of the salient provisions of the Code of Conduct are :

A CRA shall make all efforts to protect the interests of investors.

A CRA shall at all times exercise due diligence, ensure proper careand exercise independent professional judgment in order to achieveand maintain objectivity and independence in the rating processand international rating standards.

A CRA shall keep track of all important changes relating to the client companies and shall develop efficient and responsive systems to yield timely and accurate ratings.

A CRA shall disclose its rating methodology to clients, users and the public.

Regulating Authority :

In India, the regulating authority of Credit Rating Agencies and Financial instruments are SEBI, RBI and IRDA. The list of various financialinstruments, and the relevant regulators, are given below :

Products / Instruments requiring mandatory rating before issuance

Sl. No	Instrument	Regulator
1	Public / Rights/ Listed issue of bonds	SEBI
2	IPO Grading	SEBI
3	Capital protection oriented funds	SEBI
4	Collective Investment Schemes of plantation companies	SEBI
5	Commercial Paper	RBI
6	Bank loans	RBI (Basel II capital computation for banks)
7	Security Receipts	RBI (For NAV declaration)
8	Securitised instruments (Pass Through Certificates)	RBI ((Basel II capital computation for banks)
9	Fixed Deposits by NBFCs & HFCs	RBI
10	LPG/SKO Rating	Ministry of Petroleum and Natural Gas
11	Maritime Grading	Directorate General of Shipping (for some courses)

Regulatory prescription of use of ratings for investment purposes

S. No	Product	Regulator
1	Banks' investments in unrated non-SLR portfolio	RBI
2	Investments by Insurance companies	IRDA
3	Provident Fund investments	Government of India

International Regulations :

The International Organization of Securities Commission (IOSCO) has formulated a Code of Conduct Fundamentals for the working of CRAs.

The IOSCO Code of Conduct broadly covers the following areas : Quality and integrity of the rating process – This includes the measures to ensure quality of the rating process and monitoring and updating by the CRAs.

CRA‘s independence and avoidance of conflicts of interest – The procedures and policies to ensure the same.

CRA‘s responsibilities to the investing public and issuers – These address issues such as transparency and timeliness of ratings disclosure and the treatment of confidential information.

Disclosure of the code of conduct and communication with market participants – This requires CRAs to disclose to the public in accordance with the IOSCO Principles regarding the activities of Credit Rating Agencies

3.9 CREDIT RATING AGENCIES IN INDIA :

The Indian credit rating agency has evolved over a period of time.

Indian credit rating agencies include mainly CRISIL, ICRA, CARE, FITCH and Brickworks. CRISIL is the largest credit rating agency in India, with a market share of greater than 60%

CRAs registered with SEBI

Name of the CRAs	Year of commencement of Operations
CRISIL	1988
ICRA	1991
CARE	1993
Fitch India	1996
Brickworks	2008

3.9.1 Credit Rating Information Services of India (CRISIL Ltd.) :

CRISIL is the first rating agency in India. It was set-up in 1987 jointly by the erstwhile ICICI Ltd. and UTI. The other shareholders are

Asian Development Bank (ADB), LIC, State Bank of India, HDFC etc. The head office of the company is located at Mumbai and it has established offices outside India also. The

CRISIL Ltd. is the world's fourth largest rating agency. 'CRISIL' has rated over 4700 debt instruments issued by 2200 companies.

The activities of CRISIL Ltd. are as under

To provide credit rating service in respect of Ratings of corporate debt issuances, Ratings of banks, non-banking finance companies,

Ratings of borrowing programmes of governments and government bodies, Ratings of structured finance instruments and Ratings of micro-finance institutions

To provide analytical tools for management of risk such as market risk, credit and operational risk and valuation services

To undertake research on economy, industry and company performance and publish such reports

To provide corporate as well as market advisory services to corporate and non-corporate clients.

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

ICRA was established in the year 1991 by the collaboration of financial institutions, investment companies, and banks. The company has formed the ICRA group together with its subsidiaries. The company offers products like short-term debt schemes, Issue – specific long – term rating and offers fund based as well as non-fund based facilities to its clients.

The objectives of the ICRA Ltd. are as follows :

a. To rate rupee denominated debt instruments issued inter alia, by manufacturing companies, commercial banks, non-banking finance companies, financial institutions, public sector undertakings and local bodies, etc.

b. To take – up assignments for credit assessment of companies/undertakings intending to use the same for obtaining specific line of assistance from commercial banks, financial institutions, nonbank financial services companies.

c. It provides services of general assessment. At the request of banks or any other potential users, it prepares, as per their requirements, general assessment reports. It does not assign any specific symbols in respect of such general assessments. It provides a report on various aspects of the functioning of companies such as operations, quality of management etc.

d. To undertake research based study reports to address the unique needs and requirements of an individual client. The assignments include due diligence studies, equity assessment/valuation, industry analysis, and market study etc.

e. To offer advisory services to banks, finance companies, manufacturing companies, government, regulatory authorities and local bodies in the following areas of strategic consulting, risk management and inputs for policy formulation

3.9.3 Credit Analysis and Research Limited (CARE) :

CARE was incorporated in 1993. It was promoted by IndustrialDevelopment Bank of India (IDBI), Canara Bank, Unit Trust of India (UTI) and other financial and lending institutions. CARE has completed over 7,564 rating assignments since its inception in 1993.

The functions of CAREL are as under

To undertake credit rating of all types of debt instruments, both short term and long term.

To make available information on any company, industry or sector required by a business enterprise.

To undertake equity research study of listed or to be listed companies on the major stock exchanges.

3.9.4 FITCH Ratings :

Fitch Ratings is a global rating agency committed to provide the world's credit markets with independent and prospective credit opinions, research, and data. The headquarters of Fitch Ratings is in New York and London and it is a part of the Fitch Group.

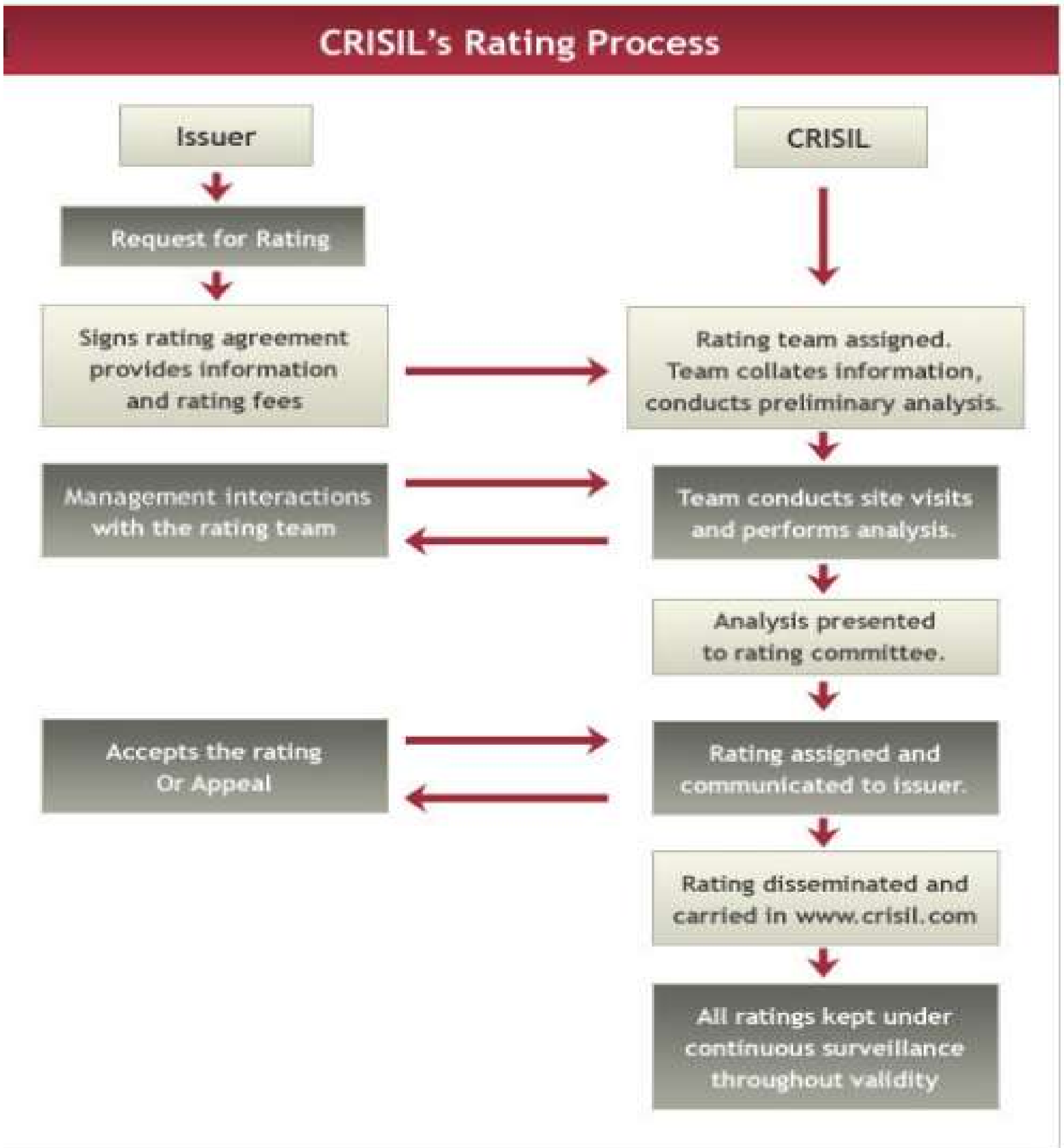
3.9.5 BRICKWORK Ratings :

Brickwork Ratings is a private credit rating agency. It was registered under SEBI in the year 2008. It was founded by bankers, credit ratingprofessionals, former regulators as well as professors, was committed to promoting Financial Literacy.

3.10 CREDIT RATING PROCESS :

The rating process is designed to ensure that all ratings are based on the highest standards of independence and analytical rigour. From the initial meeting with the management to the assignment of the rating, the rating process normally takes three to four weeks. However, the rating agency has sometimes arrived at rating decisions in shorter time frames, to meet urgent requirements. The process of rating starts with a rating request from the issuer, and the signing of a rating agreement. Credit rating agency employs a multi-layered, decision – making process in assigning a rating.

The process / procedure followed by all the major credit rating agencies in the country are almost similar and usually comprises of the following steps.



3.10.1 Receipt of the Request :

The issuing company approaches the credit rating agency to rate their instruments which are issued to the public. It is the starting point in the process of rating. The rating agency and Issuer Company enter intoan agreement. The general terms and conditions of the agreement are as follows :

To Keep confidential information about the issuing company

Acceptance of the rating is in the hands of issuing company

Providing all information is essential on the part of issuing company

3.10.2 Assignment to Analytical Team :

Credit rating agency entrusts the job to its expertise team for investigating the issuing company after entering into the agreement with them. Normally, the team consists of two members and it may vary depending upon jobs.

3.10.3 Obtaining Information :

The issuing company must provide all the requisite information to the analytical team. The analytical team analyses the information relating to its financial statements, cash flow projections and other relevant information.

3.10.4 Team Visits and Interacts with Management :

The analytical team must visit the issuing company for better understanding of the client's operations and interact with the company's executives.

3.10.5 Presentation of Findings :

The analytical team presents the report on the issuing company to the internal committee of the credit rating agency.

3.10.6 Rating Committee Meeting :

The rating committee conducts meeting with the analytical team to discuss about the assessment of all factors concerned to the issuer. After a deep discussion, the rating committee evaluates the issuing company and rates their instruments. The decision of the rating committee is final. The issuing company cannot be involved directly in the process of rating.

3.10.7 Communication of Decision :

The issuing company gets the information from CRA about the rating grade assigned by them. The supported documents or explanations would be furnished to the issuing company. The issuing company may accept or reject the ratings. The rejected ratings are not disclosed by the Credit rating agency.

3.10.8 Broadcasting to the Public :

The credit rating agency can broadcast the rating information through printed reports to the public after the acceptance of the issuer.

3.10.9 Continuous Surveillance :

The Credit Rating Agency is continuously monitoring the issuing company till the validity period of the ratings.

The rating methodology is a detailed analysis of all the factors affecting the creditworthiness of an issuer company. The important factors are business, financial and industry characteristics, operational efficiency, management quality, competitive position of the issue, commitment to new projects etc.

The credit rating agency analyses the following factors for evaluating the instruments such as:

I. Business Risk Analysis

II. Financial Analysis

III. Management Risk Analysis

IV. Project Risk Analysis

V. External support

I. Business Risk Analysis :

Business risk analysis involves the analysis of the industry risk, market position and operating efficiency of the company which has various factors that depicts in the following char

Business Risk Analysis		
Industry Risk	**Market Position**	**Operating Efficiency**
➢ Macro Economic Factor ➢ Industry Structure ➢ Industry Demand Supply Scenario ➢ Industry Growth Prospectus ➢ Industry Profitability ➢ Market Size ➢ Extent of Competition ➢ Extent of Cyclicality ➢ Regulatory Environment	➢ Key Competitive Advantages ➢ Market Share Movements ➢ SWOT Analysis ➢ Brand Strength ➢ Product Profile ➢ Trend Analysis ➢ Pricing Power ➢ Distribution Network	➢ Cost Structure ➢ Technological Factors ➢ Access to Resource ➢ Labour Relations ➢ Capacity Utilisation ➢ Integration (forward & Backward) ➢ Flexible Production Capacities ➢ R & D Capabilities

A. Industry risk :

The rating agency evaluates the industry risk by considering the following factors:

a. Strength of the industry prospect,

b. Nature and basis of competition,

c. Demand and supply position,

d. Structure of industry,

e. Pattern of business cycle etc.

B. Market Position :

The credit rating agency determines the market position of the issuing company with reference to the following parameters :

i. Revenue Generation Addressed

a. Market Size and Segments

b. Market Share and Trends

c. Entry Barriers and Capacity

d. Product Range and Customer Diversity

ii. Competitive Advantages

a. Brands, Product Quality

b. Strength of Distribution network and geographical Reach

c. Long Term contracts for Product off take / marketing arrangement

d. Ability to pass on Input Cost Increase

C. Operating Efficiency :

Operating Efficiency can be measured by using the following aspects:

i. Cost Structure

a. Technology used

b. Capacity Utilization

c. Regular up keep / modernization of facilities

ii. Input Structure

a. Access to resource, cost of key inputs

b. Level of Integration

c. Assured, Quality supply of Critical Utilises

d. Labour Relations – Union

II. Financial Analysis :

Financial risk analysis aims at determining the financial strength of the issuer company. The credit rating agency can use some accounting tools& techniques to analyze the financial risk which are depicted in the following picture.

Financial Risk Analysis			
Accounting Quality	**Financial Position**	**Cash Flow Adequacy**	**Financial Flexibility**
➢ Accounting Polices ➢ Reporting Disclosures ➢ Analytical adjustments	➢ Capital Structure ➢ Profitability Analysis ➢ Debt Protection Ratios ➢ Off-Balance Sheet Obligations ➢ Sensitivity Analysis ➢ Liquidity Short Term Factors ➢ Working Capital Management	➢ Sources of uses of Funds ➢ Cash accruals in relation to debt repayments ➢ Capital Expenditure Plans, funding profile	➢ Bank Limits ➢ Cash and marketable securities ➢ Access to Capital markets ➢ Relationship with bankers ➢ Contingency Plans ➢ Ability to Defer Capital Expenditure

A. Accounting Quality :

- Qualification of Auditors
- Inventory Valuation Policies.
- Income recognition method
- Off Balance Sheet Items

B. Past and Future Financial Record :

- Past performance
- Capital Structure (Debt – Equity)
- Debt Protection measure (Interest Coverage & Cash DSCR) &Liquidity
- Profitability Trends in Operating / Net Margins (indicating asset side Performance) – provide a tool to measure cash generation.
- Trends in Company's Funding mix Philosophy – Phasing of Capex Programmes.
- Future Performance Based on Industry Trends, Company's own operations and future plans.

C. Cash Flow Adequacy and Financial Flexibility :

- Assess the adequacy and stability of cash Flow in relation to debt, working capital needs and capital expenditure requirement.
- Comparison of sources and uses of funds
- Ability to raise alternative financing eg. Equity, Quasi Equity, Loans from Promoters
- Financial support from group / promoters and its past track record
- Availability of un encumbered liquid assets

III. Management Risk Analysis :

Rating of a debt instrument requires evaluation of the management strengths and weaknesses because company's performance is highly influenced by the management goals, plans, strategies etc., which can be analyzed through the following aspects :

Management Risk Analysis			
Integrity	**Risk Appetite**	**Competence**	**Governance Practices**
➢ Adherence to Laws & Regulations	➢ Financial Policy	➢ Track Record	➢ Equitable treatment of Shareholders

3.11 SUMMARY :

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

Evaluating the creditworthiness of an instrument comprises of both qualitative and quantitative assessments, making credit rating far from a straightforward mathematical calculation.

A credit rating agency (CRA) is a company that rates debtors on the basis of their ability to pay back their interests and loan amount on time and the probability of them defaulting. CRAs were set up to provide independent evidence and research-based opinion on the ability and willingness of the issuer to meet debt service obligations, quintessentially attaching a probability of default to a specific instrument.

3.12 KEY WORDS :

FITCH Ratings – Fitch Ratings is a global rating agency committed to provide the world's credit markets with independent and prospective credit opinions, research, and data.

BRICKWORK Ratings – Brickwork Ratings is a private credit rating agency. It was registered under SEBI in the year 2008. It was founded by bankers, credit rating professionals, former regulators as well as professors, was committed to promoting Financial Literacy

Business Risk Analysis – Business risk analysis involves the analysis of the industry risk, market position and operating efficiency of the company

Management Risk Analysis – Rating of a debt instrument requires evaluation of the management strengths and weaknesses because company's performance is highly influenced by the management goals, plans, strategies etc.

3.13 SELF ASSESSMENT QUESTIONS :

1. Briefly Explain the Factors influencing Assigned Rating.
2. Discuss the SEBI code of conduct.
3. Discuss the Credit Rating Process.
4. Briefly Explain the Credit Rating agencies in India.

3.14 SUGGESTED READINGS :

1. Frank J. Fabozzi CFA, Pamela P. PetersonFinancial Management and Analysis (Frank J. Fabozzi Series) Wiley Publicaitons 2003.
2. Eugene F. Brigham, Michael C. EhrhardtFinancial Management Theory and Practice, 13th EditionCenage Learning 2010,

3. C. Paramasivan, T. Subramanian Financial ManagementNew Age International Pvt Ltd Publishers, 2022.

4. Peter Atrill Financial Management for Decision Makers, 5th Edition Edition : Financial Times Management City : Harlow 2022.

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Dr. V. Naga Nirmala

Lesson - 4

FINANCIAL SERVICES AND FINANCIAL MARKETS

4.0 Objective:

After studying this lesson, you shall be able:

* to understand the concept of Financial System.
* to know about the objectives of Financial System.
* to understand about Financial Market and its participants.
* to know about the concept of Financial Services and examine various types of Financial Services.

Structure:

4.1 Financial System:

The financial system is the most important institutional and functional vehicle for economic transformation. It is a set of interrelated activities and services working together to achieve some predetermined purpose or goal. It includes different markets, the institutions, instruments, services and mechanisms which influence the generation of savings, investment of capital and growth. Van Horne defines the financial system as the purpose of financial markets to allocate savings efficiently in an economy to ultimate users either for investment in real assets or for consumption. Robinson defines financial system as “a link between savings and investment for the creation of new wealth and to permit portfolio adjustment in the composition of the issuing wealth’. From the above definitions, it may be said that the primary function of the financial system is the mobilisation of savings, their distribution for industrial investment and stimulating capital formation to accelerate the process of economic growth.

A financial system provides services that are essential in a modern economy. Financial assets with attractive held, liquidity and risk characteristics encourage savings. By evaluating alternative investments and monitoring the activities of borrowers, financial intermediaries increase the efficiency of resource use. Access to a variety of financial instruments enables an economic agent to pool, price and exchange risks in the markets. Trade, the efficient use of resources, saving and risk taking are the cornerstones of a growing economy. The financial system has been identified as the most catalysing agent for growth of the economy, making it one of the key inputs of development.

Structure of the Finance System: The Indian Financial System is broadly classified into two broad groups i.e., (1) Organised sector, (2) Unorganised Sector. The financial system is also divided into users of financial services and providers. Financial institutions sell their services to households, businesses and government. They are users of the financial services. The providers of financial services are central bank, commercial banks, financial institutions, Money and capital markets, non-banking institutions etc.,

Organised Financial System: The organised financial system comprises of an impressive network of banks, other financial and investment institutions and a range of financial instruments which together function in fairly developed capital and money markets. Short term funds are mainly provided by the commercial and cooperative banking structure. About 85 percent of such banking business is managed by twenty seven public sector banks. In addition to commercial banks, there is the network of comparative banks and land development banks at state, district and block levels. With around two third share in the total assets in the financial system, banks play an important role. Of late, Indian banks have also diversified into areas of such as merchant banking, mutual funds, leasing factoring and insurance etc.,

The organised financial system consists of the following sub systems:

* Banking System
* Cooperative System
* Development Banking
    (i) Public Sector
    (ii) Private Sector
* Money Markets
* Financial Companies/Institutions

Over the years, the structure of financial institutions in India has developed and become broad based with diversification.

Unorganised Financial System: The unorganised financial system comprises money lenders, indigenous bankers, lending pawn brokers, landlords, traders etc., This part of the financial system is not directly under the control of the Reserve Bank of India. There are a host of financial companies, investment companies, chit funds etc., which are not regulated by the RBI or the government in a systematic manner.

Organised Financial System:

Banking System: The structure the banking system is determined by two basic factors - economic and legal. The development of the economy and the spread of banking habit calls for increasing banking services. The RBI, the central bank of the country is at the top of the financial system. The commercial banking system can be divided into four as given hereunder.

I. Public Sector Banks:

* State Bank of India, Associate Banks } State Bank group 1 + 7
* 14 Nationalised Banks (1969)
* 6 Nationalised Banks (1980) 6-1 = 5

  1 Bank merged with another bank.
* Regional Rural Banks (196) (Sponsored by Public Sector Banks)

II. Private Sector Banks:

* Old Private Banks
* Newly set up Private Banks

III. Foreign Banks & their Representative Offices:

IV. Cooperative Banks:

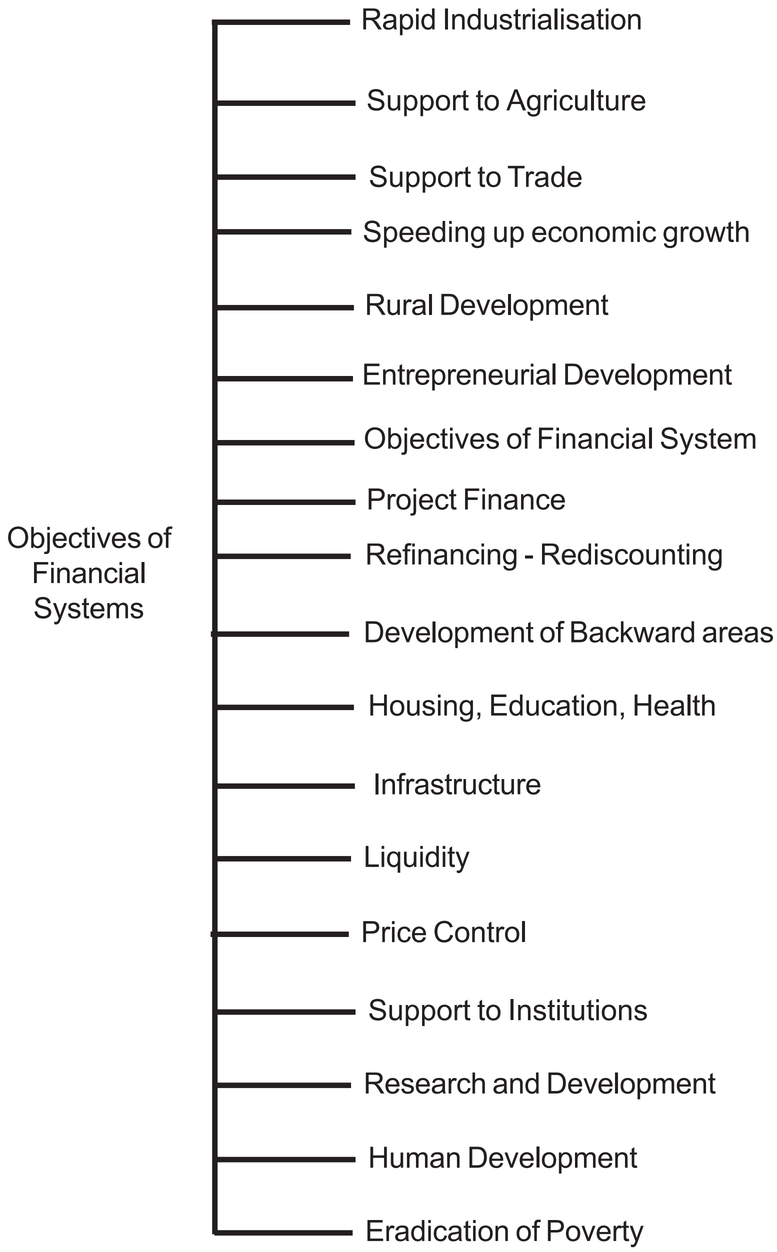
* State Cooperative Banks
* Central Cooperative Banks
* Primary Agricultural Credit Societies
* Urban Cooperative Banks
* Land Development Banks

Financial Systems and Development:

A financial system provides services that are essential in a modern economy. The Indian financial system comprises of an impressive network of banks, other financial and investment institutions offering wide range of products and services which together function in fairly developed capital and money markets. As such, financial system has come to occupy an important role in the process of economic development. The economic development of a country depends on its financial structure. Investment is a precondition of economic growth. This is essential to sustain growth of the economy. The more efficient composition of real wealth is obtained by the provision of financial assets which provide incentives to savers to hold a large part of their wealth in financial form. The increasing rate of savings is correlated with the increase in the proportion of savings held in the form of financial assets relative to tangible assets.

4.2 Objectives of Financial System:

The Indian financial system has been undergoing rapid changes particularly in relation to the emerging financial liberalisation. In the process, it has undergone a radical transformation in its structure and organisation. The main objectives of the financial system is to serve as an agent of socio-economic development in various sectors viz., industry, agriculture and international trade.



The foremost task of any financial system is to accelerate the growth of the economy. Rapid industrialisation even in the private sector has been referred to as providing additional employment opportunity as well as higher production. Liquidity and Price Control motivate people to save and invest in development and thereby develop various segments of the economy and create vast employment opportunities, generate income, improve standard of living, eradicate poverty, ill health, illiteracy and sustain economic development.

Role of the Financial System:

Financial systems provide payment services. They mobilise, savings and allocate credit. The diverse services used in the financial system are by households, business and government through an array of instruments like cheques, DDs, credit cards, bonds, stock, certificates, commercial papers, Billing Exchange etc;. A financial system's contribution to the economy depends on the quantity and quality of its services and the efficiency with which it provides them. Financial services make it cheaper and less risky to trade goods and services and to borrow and lend.

Finance is the key to investment and growth. Providing saved resources to others with more productive uses for them raises the income of saver and borrower alike. Without an efficient financial system, lending can be both costly and risky. Self financed investment is one way to overcome these difficulties but profitable investment opportunities may exceed the resources of the individual enterprise. Investment by the public sector is another answer and the government mobilises additional savings through tax system. When the economy is growing, financial arrangements need to be augmented by commercial banks, financial institutions. In a diversified market based system, the government retains a key role as prudential regulator to ensure sound development of financial system through effective, functioning of financial institutions.

Financial Intermediaries:

Financial intermediaries are the institutions which collect savings from others, issuing in return claims against themselves and use the funds thus acquired to purchase ownership or debt claims. They play a very important role in the saving investment process by raising the level of saving and investment and allocating more efficiently scare savings among most productive investments. Financial institutions are grouped under five different categories as given hereunder.

(1) Banking System (Central Bank, Commercial Banks, Cooperative Banks, Regional Rural Ranks)

(2) Depository Organisations (Mutual funds, Credit Unions etc.)

(3) Insurance Organisations (LIC, GIC, Postal Insurance, Pension Funds, Provident Funds etc.)

(4) Development Banks and

(5) Other Institutions (Investment and Finance Companies, Stock Exchanges etc.)

The financial system in India has undergone rapid changes. The financial system should facilitate the speedy growth of the economy. In recent years, the financial institutions are concentrating more on the management of fund based resources as an effective means of development. The changing environment of competition amongst different segments of the financial system should call for more professionalism and good performance levels.

4.3 Financial Markets:

Money, debt instruments and equities are called financial assets and they are claims against present and future income. These claims are traded in financial markets. Although some securities are traded directly between buyers and sellers after private negotiation, the major places for trading securities are called financial markets. Financial markets perform a vital function of allocating the wealth of the economy. Financial markets are the centres or arrangements that provide facilities for buying and selling of financial claims and services. The participants on the demand and supply sides of these markets are financial institutions, agents, brokers, dealers, borrowers, lenders, savers and others who are interlinked by the laws, contracts and communication network.

Classification of Financial Markets:

The financial market comprises all banking and non banking financial institutions, procedures, practices followed in these markets and financial instruments for facilitating the flow of funds. The financial markets in an economy can be classified into:

(a) Primary and Secondary Markets and

(b) Money and Capital Markets.

a) Primary and Secondary Markets:

Primary market deals with the new issues of securities, while the market for existing claims (financial assets) is known secondary market. In other/words, primary market deals with new securities issued for the first time to the public and the secondary market deals in those securities which have already been issued to the public. In the primary market, the brokers act as under writers, managers, registrars and even merchant bankers to the new issues. In the secondary market, the claims of long term nature of one year and above are traded both on spot and forward basis. This trading imparts liquidity to investments and thus promotes saving and investment. These claims can be converted into money at any time although at a loss of capital in various degrees.

In the primary market, the government and corporate sector issue securities and raise additional funds for investment purposes. In the secondary market, the existing securities change hands from one owner to another owner and there is no additional flow of funds for further investment. An active secondary market stimulates activity in the primary market. Thus, the level of development in the secondary market determines the efficiency and growth of the primary market.

b) Money and Capital Markets:

Money Market is the place where short term claims (with a maturity period of one year or less) are traded. The money market facilitates short term financing and assures liquidity of short term financial assets. The money market is the central place for banking activities and is significant in indicating changes in short term interest rates, monetary policy and availability of short term credit. Money market assures borrowers that they can obtain short term funds quickly and it also assures the lenders that they can convert their short term financial assets into cash. A well developed money market is the basis for an effective monetary policy.

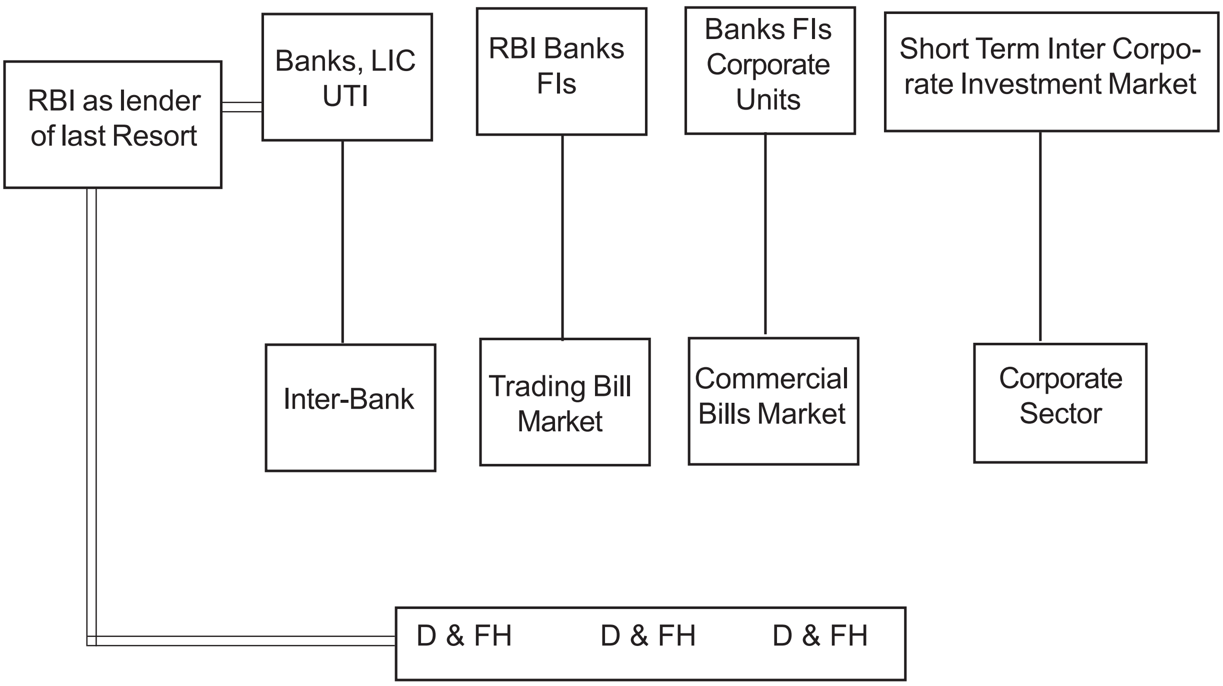
Capital market is a wider term and includes all operations in the new issues market (NIM) and stock market. It is the market in which lenders and investors provide long term funds in exchange for financial assets offered by borrowers or holders. The primary purpose of capital market is to direct the flow of savings into long term investments by development banks and other financial institutions. There are two important aspects of capital market, namely, the raising of new capital in the form of shares and debentures and trading in the securities already issued by companies. While the first aspect is much more important from the point of view of economic growth, the second aspect is also of considerable significance. However, the financial deregulation, development of new instruments of money market and setting up of new subsidiaries of banks for undertaking financial services have all aided in the deepening and widening of the capital market in India.

4.4 Participants in Financial Markets:

Financial Markets include money and capital markets. Money market an important segment of the financial market has no geographical constraints and relates to all dealings in money and monetary assets. The Indian money market is divided into organised and unorganised markets. The unorganised money market consists of indigenous bankers and money lenders. The organised money market in India consists of Reserve Bank of India, State Bank of India and its subsidiaries, commercial banks, foreign banks, cooperative banks, regional rural banks, financial corporations, bill market etc; The banking system is the most dominant force in the Indian money market and the RBI being the central bank occupies the pivotal position in the money market as it has wide powers to control money and credit through various credit instruments.

Participants in Money Market:

The participants and interconnecting participants in money market are presented in the charts given hereunder.

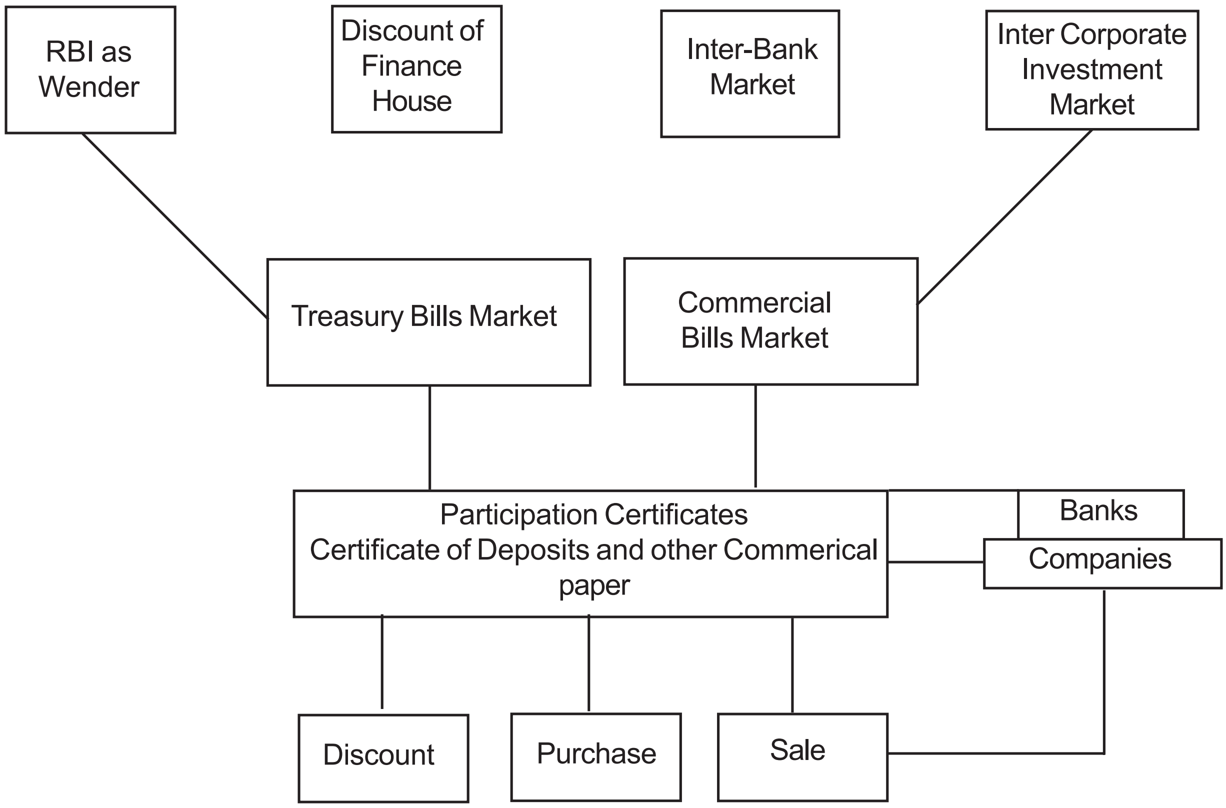


D & FH - Discount and Finance Houses

Source: VA Avadhani, Marketing of Financial Services, Himalaya Publishing House, New Delhi, 2004, P-42.

Inter Connecting

Participants in Money market



Source: V,.A, Avadhani, Marketing of Financial Services, Himalaya Publishing House, New Delhi, 2004, P- 42

The money market consists of a number of interrelated sub markets such as call marker, bill market, treasury bill market, commercial paper market, certificates of deposit market etc.

Participants in the Capital Market:

Following are the participants in the capital market.

* Industrial Development Bank of India (IDBI) as Apex body

* Industrial Finance Corporation of India (IFCI)

* Industrial Credit & Instrument Corporation of India (ICICI)

* Small Industries Development Bank of India (SIDBI)

* Industrial Reconstruction Bank of India

* State Financial Corporations.

* State Industrial Development Corporations

* Life Insurance Corporation of India (LIC)
* General Insurance Corporation (GIC)
* Unit Trust of India (UTI)
* Discount and Finance House of India (DFHI)
* Securities and Exchange Board of India (SEBI)
* Stock Holding Corporation of India (SHCI)
* National Stock Exchange of India (NSE)
* Over the counter Exchange of India (OTCEI)
* Credit Rating Institutions.

The Indian capital market has developed to a large extent due to various measures taken over the years. Various institutions like SEBI, Stock Holding Corporation of India, over the Counter Exchange of India and credit rating agencies have been set up to strengthen and expand the securities market in the country and to provide various services to the investors and companies and also to regulate stock exchanges so as to promote a healthy and orderly securities market. A depository system has been introduced and dematerialised trading is picking up and computerised one line trading between different markets is gathering momentum. All these steps are aimed to achieve greater autonomy to corporates and better transparency for investors.

Financial Services:

Concept: Financial Services Sector refers to that sector which provides are facilities for the people to put their money in various investment portfolios. There has been phenomenal growth in the financial services sector during the last one decade. The growth of capital and money markets and the fast pace of industrialisation have contributed to the development of financial services sector to a greater extent. Financial services sector comprises financial institutions, commercial banks, merchant bankers, brokerage houses and stock advisers. The expansion of financial services at a very fast pace has left its impact on the financial services scenario in the country. In the last fifteen years, coordinated efforts were being made to reorganise and restructure the financial services industry. Such efforts were made by various committees set up by the government to look into specific area of the financial sector. Prominent among these have been the Narasimham Committee on financial sector reforms, the Pherwani Committee on reorganisation of stock exchanges, the Dave Committee on mutual funds etc.

Elements of Financial Services Sector:

The financial services sector consists of three major elements:

(a) Instruments: which include issue of company shares, debentures, fixed deposit certificates, Commercial papers etc.

(b) Market Players: Which include Banks, financial institutions, mutual funds, stock brokers etc.

(c) Regulatory Bodies and Specialised agencies : Which include the SEBI, Stock exchanges, credit rating services, DFHI, SHCI, OTCE of India, Venture Capital companies etc;

Constituents of Financial Services Sector: Following are the various constituents of financial services sector in India.

1) Government: The central government is one of the most important constituents of the financial services sector because of its regulating powers. It has extensive powers under the companies Act 1956, Capital Issues (control) Act and securities contract (Regulation) Act 1956.

2) Regulatory Agencies:

* SEBI - Securities Exchange Board of India
* CCI - Controller of Capital Issues
* RBI - Reserve Bank of India.

3) Financial Institutions:

* Commercial Banks
* Mutual Funds
* Stock Exchanges
* Merchant Bankers
* Portfolio Managers
* Stock Brokers
* Non Banking Financial Institutions (NBFI)
* Financial Consultants

4) Specialised Institutions:

* Discount and Finance House of India (DFHI)
* Stock Holding Corporation of India (SHCI)
* Over the Counter Exchange of India (OTCEI)
* Credit Rating Information Services of India Ltd. (CRISIL)
* Information and Investment Credit Rating Associates (IICRA)

4.5 Nature and Scope of Financial Services:

The nature and scope of financial services are very broad which cover not only the fund based activities are: Mutual funds, Merchant Banking etc; Financial Services industry includes all kinds of organisations which intermediate and facilitate financial transactions of both individuals and corporate customers. In view of the development of industry and trade in the country, the financial services sector had to introduce numerous services in recent years to cater to the requirements of the industry. Following are different types of financial activities/services provided by various financial agencies to suit different financial needs of the country.

4.5.1 Mutual Funds:

Mutual Fund is an institution which pools the savings of the community and invests in various types of securities. Mutual fund units are investment vehicles that provide a means of participation in the stock market for people who have neither the time, nor the money, nor perhaps the expertise to undertake direct investment in equities successfully. It offers the individual saver the advantages of reasonable dividend and capital appreciation coupled with safety and liquidity. The first mutual fund institution i.e., Unit Trust of India was set up in 1964. Later in nineties, many public sector banks like SBI, Indian Bank, Bank of India, PNB, Canara Bank etc; and LIC GIC have launched mutual funds. Subsequently, foreign mutual funds like ANG Grindlays, Standard chartered and Private Sector mutual funds like Reliance, HDFC, ING Vysya, Tata Birla, Escorts etc; companies have started their mutual fund agencies to mobilise resources in the country.

4.5.2 Merchant Banking:

Merchant Bank is defined as a kind of financial institution that provides variety of services including investments, portfolio management, Corporate Counselling, under writing of the issue etc;. Merchant banking in India is of recent origin. It has its beginning in India in 1967 when Grindlays Bank established a division followed by Citi Bank in 1970. State bank of India started its Merchant Banking Division in 1972. Later on ICICI set up their merchant banking division followed by many nationalised banks and financial institutions. Some private companies have also launched Merchant banking Consultancy Services in a big way. For example, J.M. Financial Consultants Champaklal Investments and Financial consultancy, V.B. Desai Consultancy etc;. Following are the merchant banking services.

* Project Counselling or Reinvestment Studies for investors
* Syndication of Loans and Project Finance.
* Issue Management
* Provision of Working Capital
* Foreign Currency Loans
* Portfolio Management for Non Residents

4.5.3 Hire Purchase Financing:

Hire purchase is a form of credit where goods are supplied after payment of a deposit with an agreement to pay regular installments over a period of time. At the end of the hiring period, legal title passes to the hirer on payment of a nominal sum. The hire purchase Act was enacted in 1972 which provides for regulating various, rights and obligations of the owner (financier) and the hirer under a hire purchase transaction. Commercial banks entered in the field of hire purchase later than the private hire purchase financiers. Ever since nationalisation of bank, commercial banks have been playing a dominant role in providing finance to road transport sector, which is a priority sector for the purpose of their advances, while at the same time, hire purchase companies in the private sector continued to grow because of the fast efficient and personalised services.

4.5.4 Housing Finance:

Housing in India has been one of the important economic activities which serves to fulfil many of the plan objectives, providing shelter to the needy, raising the quality of life, creating additional employment. Further, housing could lead to the generation of additional savings at all levels. Easy access to institutional finance at affordable rates is an essential pre-requisite for accelerating the tempo of housing activity. In the recent past, several private housing finance companies were set up. The national Housing Bank (NHB) has been set up by the government of India as an apex housing finance body to make funds available to provide refinance the commercial banks, housing finance companies, cooperative housing housing finance companies etc; The NHB has recognised 10 housing finance companies as being eligible for refinance facilities. The Housing and Urban Development Corporation (HUDCO), Housing Development Finance Corporation (HDFC), LIC and GIC have been very active in providing finance for housing facilities.

4.5.5 Venture Capital:

Venture capital is a new financial service, the emergence of which went towards developing strategies to help a new class of new entrepreneurs to translate their business ideas into realities. The capital provided to start a venture is known as venture capital. In particular, for a small entrepreneur with zeal and dynamism but inadequate or lack of finance, venture capital of seed capital is a boom making it a launching pad for financial growth. Venture capital is “equity support to fund new concepts that involve a higher risk and at the same time have high growth and profit potential”. Venture capital carries a high degree of risk, but the potential to generate a substantial rate of return is high, if the project is viable.

The venture capital was originated in USA during the nineteenth and early twentieth centuries. In 1987, the government of India announced guidelines for venture capital companies. In 1988, the first venture capital Company Technology Development and Information Company of India (TDICI) was jointly set up by UTI and ICICI. The Technology Development Fund (TDF) set up by IDBI, the Equity Development Scheme (EDS) set up by SBI Capital Markets Ltd and Canfina which have been joined by India Investment Fund (IIF) Promoted by Grindlays Bank are some of the venture capital institutions set up in India. In the Private Sector, Credit Capital Corporation (CCC) started a venture capital company. Andhra Pradesh Industrial Development Corporation (APIDC) and Gujarat Industrial Development Corporation (GIDC) too have started venture capital subsidiaries.

4.5.6 Portfolio Services:

A new area in which financial services are rendered is portfolio services i.e., managing the portfolios of individuals clients. SBI Personal Banking centres and Vysya Bank’s investors clubs are the two good examples. These are also a few private investment advisers, who guide and help individual investors and manage their portfolios. Portfolio Management service include:

* Guidance on purchase and sale of securities
* Handling of such transactions
* Advise on market conditions
* Safe custody of Documents
* Collection of earnings and dividends etc;

4.6 Leasing Finance:

A Lease is defined as a contract between lessor and a lessee for the hire of a specific asset for a specified period of payment and for a specified rentals. It is an arrangement between two parties, the leasing company and the user, whereby the former arranges to buy capital equipment for the use of latter in accordance with the latter’s requirements and specifications. The consideration for the transaction is in the form of rentals paid by the lesser to the lessor, who, however, remains the owner of the equipment over the agreed period. The rentals are predetermined and payable at fixed intervals of time, according to the mutual convenience of both the parties. A lese is a finance lease if it transfers substantially all the risks and rewards incident to ownership. Lease rentals refer the payments in the form of interest on the lessor's investment, charges born by the lessor - repairs, insurance, maintenance etc; depreciation and servicing charges.

Types of Leases: Following are the different types of leases:

* Financial Lease
* Operating Lease
* Sale and Lease Back Leasing
* Cross Border Lease
* Leveraged Lease
* Specialised Service Lease
* Foreign to Foreign Lease

Leasing finance business was grown in countries like South Korea, Malaysia and Indonesia and leasing is successful in these countries in mobilising and allocating scare financial resources, while fulfilling the medium term and long term needs of their rapidly growing industry. In India, the first leasing company was promoted by chidambaram group in 1973 at Madras. This was followed by the 20th century leasing company in 1980 at Mumbai. Four other finance companies ie; Shetly Investment and Finance, Motor and General Finance, Jayabharati Credit and Finance and Sundaram Finance joined the stream in 1982. The number of leasing firms in India is about 4000, Equipment leasing was being carried out by ICICI and IFCI which provide leasing for computerisation, exports, expansion etc.

Leasing finance being helpful for the small and medium sized units has gained importance with the increasing number of entrepreneurs. Leasing is accepted as an alternative source of finance. The new industrial policy and other economic measures of the government, withdrawal of investment allowance etc, have made leasing as a financing option. It plays an important role in the financing of machinery, plant and equipment. Thus, alot of optimism has been brought about in the leasing industry due to liberalisation. The need of the hour is to regulate it properly to maximise its benefits to the stake holders. Development banks' participation would bring respectability and stability in the lease market as a result of which lease finance will be widely accepted as an innovative instrument for the growth of entrepreneurship.

4.6.1 Factoring:

Factoring is defined as an out right purchase of credit approved accounts receivable with the factor assuming bad debt losses. With the increase in the volume of production and sales, timely collection and efficient management of receivables has assumed greater importance. Factoring Companies specialise in financing inventories and receivables. Factoring offers a clear solution to the problems created by working capital setting locked up in trade debts. It basically means purchase of book debts of clients. In order to be an economically viable proposition, a factoring agency has to build up a suitable infrastructure so as to ensure optimum efficiency in the working of credit and collection departments so that the fixed costs are absorbed at low unit costs.

Factoring is thus an asset based method of financing as well as a specialised service being the purchase of book debts of a company by the factor, thus releasing the capital tied up in accounts receivables and providing financial accommodation to the company. The factor is an intermediary between the supplier and customers who performs financing and debt collection services. Factoring in one form or other is extended on a large scale in USA, UK and many European countries. The varied services provided by the factors could benefit the large number of suppliers in India. The need for factoring in India arises due to the limitations of the banking industry in the provision of finance, credit protection or collection services. Moreover, an efficient system of receivables management for the manufacturers is the need of the hour.

The RBI has already accepted the recommendations of Kalyana Sundaram Committee and initiated on working out the details. SBI has floated its subsidiary to look after factoring service in five zones of the country. Canara Bank has also floated a subsidiary in the southern region. Private sector is being presently kept out of the factoring services. The establishment of SBI factors and Commercial Services (P) Ltd. is a boom to Indian industries. It was set up by SBI in collaboration with Small Industries Development Bank of India (SIDBI), Union Bank of India and State Bank of Saurashtra in Feb 1991 to service the industry. Since the establishment of SBI Factors and Commercial Services (P) Ltd, the sellers of the industrial products, particularly the manufacturers have improved their cash flows through prepayment facilities, leading to increased sales, continuity of suppliers and reduction in the cost of maintenance.

4.6.2 Forfaiting:

Forfaiting is a financial tool to exporters enabling them to convert their credit sales into cash sales by discounting their receivables with an agency called A Forfaiter. It is also to work as Risk Management tool to exporters because by selling the export receivables to the forfaiter, the exporter is relieved of the political and commercial risks involved in international trade. Forfaiting is a source of finance which enables exporters to get funds from the institution called forfaiter on transferring the right to recover the debts from the importer. The exporter surrenders his right to receive payments in future for immediate cash payments.

Forfaiting is a mechanism of financing exports carried as below:

* by discounting export receivables
* evidenced by bills of exchange or Promissory notes
* without recourse to the seller
* carrying medium to long term maturities
* on a fixed rate basis

Forfaiting is the non recourse discounting of export receivables. The most outstanding benefit of forfaiting is its flexibility and it is gaining popularity because of limitations of the traditional sources of export finance. Finance for exports needs to be fast, cheap and flexible and on all these counts, forfaiting meets the bill. Over a period of time, forfaiting is likely to emerge as an alternative source of trade finance especially for deferred exports.

4.7 Credit Rating Services:

Credit Rating is essentially giving an expert opinion by a rating agency on the relative willingness and ability of the issuer of a debt instrument to meet the debt servicing obligation in time and in full. It is important to note that the company is not rated but the instrument, issued by the company is rated for its capacity to service that instrument. Credit rating is an assessment of the capacity of an issuer of debt security by an independent agency. A rating agency collects the qualitative as well as quantitative data from a company which has to be rated and it assesses the relative strength and capacity of company to honour its obligations contained in the debt instrument through out the duration of the instrument. The methodology involved is the analysis of past performance of the company and assessment of its prospects. If debt securities are rated professionally and if such ratings enjoy widespread investor acceptance and confidence, a more rational risk return trade off would be established in the capital market.

The ratings are expressed in code numbers which can easily be comprehended even by the lay investors. The ratings are the quickest way of understanding a company's financial standing without going into the complicated financial reports. Credit rating is only a guidance to the investors and not a recommendation to a particular debt instrument. Credit rating is a source of cost information to investors. The collection, processing and analysis of relevant information is done by a specialised agency which a group of investors can trust. A highly rated firm can enter the market with great confidence. It also forewarns the management of the perception of risk in the market. Ratings also encourage discipline among corporate borrowers to improve their financial structure and performance to obtain better rating for their instruments.

The credit rating concept was started in USA in 1860. Subsequently, many countries have evolved the credit rating of corporate firms. The Indian capital market has witnessed a tremendous growth in late 80s and the member of companies borrowings directly from capital market has increased and this has forced the industry for credit rating mechanism of the debt instruments issued. Now, there are four credit rating agencies working in India: (1) Credit Rating Information Services Ltd. (CRISIL-1988), (2) Investment Information and Credit Rating Agency of India (ICRA - 1991), (3) Credit Analysis and Research (CARE - 1993), (4) Duff Phelps Credit Rating Pvt. Ltd. (DCR - India). Credit Rating agencies conduct a rating exercise at the request of a company. In accordance with industry prace allover the world, the methodology involves an analysis of the past performance of the company and assessment of its prospects. Already, more instruments and bonds of banks and corporate companies have been covered under credit rating. The outlook for the credit rating industry is said to be positive.

4.8 Summary:

The financial services sector in India is in a process of rapid transformation particularly after the introduction of reforms in the financial sector. The main objective of the financial sector reforms is to promote an efficient, competitive and diversified financial system in the country. At present, numerous new financial intermediaries have started functioning with a view to extending multifashions services to the investing public in the area of financial services. The emergence of various financial institutions and regulatory bodies have transformed the financial services sector from being a conservative industry to a very dynamic one. Further, the process of globalisation has paved the way for the entry of innovative and sophisticated financial products into our country. Keeping in view of the changed environment, the financial services industry in India has to play a very positive and dynamic role in the years to come by offering many innovative products to suit the varied requirements of the millions of the prospective investors spread throughout the country.

4.9 Self Assessment Questions:

1. What is financial system and explain its structure.
2. Discuss the objectives and role of Financial System.
3. Examine the concept of Financial Markets and explain their participants.
4. What are financial services and describe on the elements of Financial Service Sector.
5. Outline the Nature and Scope of Financial Services and discuss Mutual Funds and Housing Finance.
6. Write short notes on:
   a. Leasing Finance
   b. Factoring
   c. Credit Rating Services.

4.10 Reference Books:

1. *Financial Markets And Services* : Gordon E & Natarajan K, Himalaya Publishing House, Mumbai, 2000.
2. *Marketing of Financial Services* : V.A. Avadhani, Himalaya Publishing House, Mumbai, 2004.
3. *The Indian Financial System* : Vasant Desai, Himalaya Publishing House, Mumbai, 1999.

- Dr. V.K. BHASKARA RAO

LESSON : 5

LEASING AND HIRE PURCHASE

5.0 Objective:

After reading this lesson, you will be able to understand

- Concepts of leasing and hire purchase
- Differences between leasing and hire purchase
- Types of leasing
- Evaluation of leasing

Structure:

5.1 Introduction :

Business enterprises mobilise funds from various sources for the purpose of financing assets. A company issues equity shares and debentures for mobilising equity and debt capital. It borrows funds from financial institutions. Alternative forms of financing assets are also used by availing Asset Finance Services. Asset finance facilitates the acquisition of asset without the financial burden and the use of asset without capital expenditure.

Asset finance provides another line of credit without disturbing debt-equity composition of the company. It provides finance for the entire cost of asset with generally minimum initial cash outlay. Asset can be obtained and paid for from cash flows generated by the asset. Separate capital need not be allocated.

Various asset finance services such as leasing, hire purchase, debt securitisation etc are in vogue. In this lesson leasing and hire purchase methods are discussed.

5.2 Meaning :

5.2.1 Leasing :

The Transfer of Property Act defines a lease as “a transaction in which a party owning the asset provides the asset for use over a certain period of time to another for consideration either in the form of periodic rent and / or in the form of down payment”.

According to the Institute of Chartered Accountants of India (ICAI), “ a lease is an agreement whereby the lessor conveys to the lessee, in return for rent, the right to use an asset for an agreed period of time”.

The following are the characteristics of a lease.

(a) Two parties are involved, the lessor being the owner of an asset who transfers the right to use the asset for a consideration (lease rentals) and the leasee being the user of the asset with a right to use the asset.

(b) The consideration is in the form of lease rentals.

(c) The period of lease is agreed upon by both the parties.

5.2.2 Hire Purchase :

Hire purchase is purchasing of an asset where in the purchaser (the hirer) pays the value of consideration in equal periodic installments over a period of time.

According to the Hire Purchase Act, 1972, hire-purchase is defined as “an agreement under which goods are let on hire and under which the hirer has an option to purchase them in accordance with the terms of agreement, and includes an agreement under which:

(i) Possession of goods is delivered by the owner there of to a person on the condition that such person pays the agreed amount in periodic payments.

(ii) The property of the goods is to pass to such a person on the payment of the last of such installments.

(iii) Such person has a right to terminate the agreement any time before the property so passes.

5.3 Leasing V. Hire Purchase :

Following section presents the differences between both types of asset finance services.

	LEASING	HIRE PURCHASE
1	Ownership of the asset lies with the lessor	Ownership is transferred to the hirer on the payment of last installment

2	Lessor is entitled to depreciation	Hirer is entitled to claim depreciation
3	After the lease period the asset is returned to lessor	After the expiry of the period the ownership transfers to the hirer
4	Lessor capitalises the asset	Hirer capitalises the asset
5	Lessee has to maintain the leased asset in case of financial lease and lessor has to maintain the leased asset in case of operating lease	Hirer has to maintain the hired asset
6	Leasing is used as a source of finance for acquiring high cost assets such as airplanes, ships, heavy machinery	Hire purchase is used as a source of finance for a acquiring selectivity low cost assets such as office equipment, automobile.
7	Down payment is required in case of financial lease	Down payment (margin money) is required
8	Lease rentals are treated as revenue expenditure and taken into account for tax purpose.	Hire interest is considered as revenue expenditure and taken into account for tax purpose
9	Lease assets are not shown in the Balance Sheet of the lessee.	Assets acquired through hire purchase are shown as assets in the Balance Sheet of the hirer and outstanding installments amount is treated as a liability.
10	Lease is preferred for long periods	Hire purchases are under taken for short periods of time

5.4 Types Of Lease :

Leasing takes different forms. Most important forms are

1. Financial lease
2. Operating lease
3. Sale and lease back

5.4.1 Financial Lease:

Financial lease is a lease where in the user can acquire the use of the asset for most of its useful life and pay rentals to the lessee. The wear will be responsible for maintenance of the equipment and the payment of taxes and insurance.

The International Accounting Standard (IAS) No: 17 defines a financial lease as “a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or many not eventually be transferred”.

In the case of financial lease, the lessee selects the equipment it wants and the supplier of that equipment. Lessee negotiates terms with a leasing company. When the terms are set the leasing company buys the equipment. The supplier delivers the equipment to the lessee. The supplier is paid by the lessor (Leasing Company) plant, Machinery and equipment are acquired through financial lease arrangements.

Financial lease is some times called capital lease. A lease should be treated as **'Capital Lease'** if it meets any one of the following four conditions, as per the Financial Accounting Standards Board.

- If the lease life exceeds 75% of the life of the asset
- If there is a transfer of ownership to the lessee at the end of the lease term.
- If there is an option to purchase the asset at a "bargain price" at the end of the lease term
- If the present value of the lease payments, discounted at an appropriate discount rate exceeds 90% of the fair market value of the asset.

5.4.2 Operating Lease :

Operating lease is a contract between the lessor and lessee such that the cost of the asset is not fully recovered from a single lessee. The period of the lease will be shorter since the lessor will recover the cost of the asset from multiple lessees. Repair and maintenance of the asset is the lessor's responsibility.

Operating lease is also known as service lease, which provides for financing and maintenance. Computers, office equipment, automobiles and trucks are acquired through operating lease.

5.4.3 Sale And Lease Back :

Sale and lease back is a transaction where the lessee already owns the asset he wants to lease. The lessee sells the asset to the lessor who pays for the asset and immediately leases it back to the lessee. This type of lease is an alternative to a mortgage. This method is similar to financial lease. The only difference is that the leased equipment is not new and lessor buys it from the user-lessee. It provides non-fund based finance to the selling company and brings down debt-equity ratio.

5.4.4 Structure Lease :

In the case of structure lease, lease rentals are not flat or equated over the lease term. Rentals vary over the lease term. The rental structure is scheduled in such a way that it typically fits the lessee's inflows from the asset. Main types of structured lease are

1. Stepped up rentals where rentals are structured so that the lessee will pay smaller rental amounts at the beginning of the lease period and larger rental amounts towards the end of the lease period.
2. Stepped - down rentals are structural so that the lessee will pay larger rental amounts at the beginning of the lease period and lower rental amounts towards the end of the lease period.

5.4.5 Other Types

5.4.5.a Secondary Lease :

A second lease period during which the lessee will pay nominal peppercorn rentals in order to ensure that the lease period is long enough for the lessee to gain maximum benefit from the lease.

5.4.5.b Sub – Lease :

A transaction in which the lease property is re-leased by the original lessee to another party and the lease agreement between the two original porties remains the same.

5.5 Essential Features Of Leasing :

The essential features of leasing are as follows:

1. Leasing is a contract between the lessor and lessee and hence should satisfy the requirements of a valid contract as per the Indian Contract Act 1872.
2. The parties to the lease contract are lessor and lessee. Lessor must be competent and must have a clear title to the equipment leased, leasee must be competent to contract.
3. Equipments are bought by lessor at the request or lessee.
4. Lease contract specifies the period of contract.
5. The leasee uses the equipment.
6. The lessee in consideration pays the lease rentals to the lessor.
7. The lessor is the owner of the assets and is entitled to the benefit of depreciation and other benefits under the Income Tax Act 1966a.
8. The lessee can claim the lease rentals as expenses chargeable.

- Lessee selects the supplier and the equipment required
- Lessor enters into a contract with the lessee
- Lessor acquires the title to the equipment to be leased by paying the value of the equipment
- Supplier delivers the equipment to the lessee
- Lease rentals are paid by the lessee to the lessor
- The equipment is returned to the lessor at the end of the lease period

or

- The lessee continues to use it on small annual secondary rental payment

5.6 Advantages of Leasing :

The following are the important advantages of leasing from the lessee's point of view:

(i) It is an easy method of financing capital assets requiring huge capital outlays
(ii) No margin money is required as in the case of borrowing
(iii) It helps for read the capital cost over a period
(iv) For business with shortage of capital or which cannot access capital market for funds leasing is an ideal source.
(v) Lease rentals are deductible for tax purpose
(vi) It helps conserve scarce capital resources
(vii) Lessee is protected from technological obsolescence when it is under operating lease agreement
(viii) It is an 'off Balance sheet ' method of financing
(ix) It gives the facility to possess and operate the asset without owning the asset

The advantages to the lessor are:
(i) It is a safe method of asset based financing
(ii) Lessor enjoys tax benefit arising out of depreciation on leased asset
(iii) Lease rentals provide better liquidity through regular cash inflows.

5.7 Disadvantages of Leasing :

The following are the disadvantages of leasing from the lessee's point of view:

(i) When compared other methods, lease financing is costly
(ii) Lessee will have no flexibility once the contract terms are agreed upon

(iii) Lessee can not claim depreciation on leased asset

5.8 Evaluation of Lease :

Both lessor and lessee should evaluate a prospective lease. Lessee must determine whether (a) taking an asset on lease is beneficial or (b) buying an asset is beneficial. As lease is comparable to borrowing lessee must compare between the following options

(i) buying an assets by borrowing the funds required
(ii) leasing the asset

Lease evaluation from the viewpoint of lessee involves the following steps:

✡ Find after tax cash out flows for each year under the leasing after native. Lease rental payments are deductible for income tax purpose.

After – Tax Cash out flows = Lease rental Payment (1 – Tax rate)

✡ Find after tax cash out flows for each year under the buying alternative. When an asset is bought by borrowing, annual installment payable by the borrower will have two components (i) loan (capital) repayment (ii) interest on borrowed amount (deductible for income tax purpose).

Annual cash outflow = Loan repayment + Interest
After tax cash outflow = Loan repayment + Interest (1 – tax rate)

✡ Find the tax benefit when annual depreciation is charged under buying alternative.
When asset is purchase by borrowing the lessee will be the owner and eligible for depreciation claim which is deductible for income tax purpose. Lessee gets the tax benefit.

Tax benefit = Annual Depreciation **x** Tax rate
✡ Find net after tax cash outflows for each year under buying alternative

Net after tax cash outflows = Loan repayment + Interest (1 - tax rate)
– tax benefit due to depreciation.

✡ Find the present value of the cash outflows under both the alternatives at a discount rate i.e., after-tax cost of capital (K) of the company.
✡ Select the alternative with the lowest present value of cash outflows.

<u>Example:</u>

A company is proposing to acquire a machine for a period of ten Years. The company is evaluating two alternatives.
The cost of the machine is Rs. 1,00,000.

<u>Alternative 1 :</u>

If the asset is taken on lease the company would be required to pay lease rentals at the rate of Rs. 34,000 per annum for the first five years and Rs. 600 per annum for the next five years.

Alternative 2 :

If the asset is to be owned / purchased by the company to finance the asset a loan of Rs. 75,000 can be raised at 9% per annum interest. Interest is payable annually and principal is repayable in year ten.

Rate of depreciation is to be charged at 15% per annum under written down value method. Tax rate is 33%.
Advise the company as to which alternative it should adopt.

Solution :

6a. After tax cash outflows under leasing alternative

Year	(Lease Rental X 1 – Tax rate)
1 – 5	(34,000 X (1 – 33%) = 22,780
1 – 6	(600 X (1 – 33%) X 5 = 402

2. After tax cash outflows under buying alternative

			Rs.	Rs.
Year	0	Own Investment	-	25,000
	1 – 10	Interest	6,750	4,523
	10	Repayment of Loan	-	75,000

3. Tax benefit due to depreciation

Year	Depreciation	Tax Benefit
1	15,000	4,950
2	12,750	4,208
3	10,838	3,577
4	9,212	3,040
5	7,830	2,584
6	6,656	2,196
7	5,657	1,867
8	4,809	1,587
9	4,087	1,349
10	3,474	1,146

4. Net after tax cash outflows under buying alternative

Year	After Tax Cash outflow	Tax Benefit	Net after Tax Cash flow
	25,000	-	25,000
1	4,523	4,950	- 427
2	4,523	4,208	315
3	4,523	3,577	946
4	4,523	3,040	1,483
5	4,523	2,584	1,939
6	4,523	2,196	2,327
7	4,523	1,867	2,656
8	4,523	1,587	2,936
9	4,523	1,349	3,174
10	4,523 + 75,000	1,146	3,377 + 75,000

5. PV of Cash on flows

Year	PV factor at 10%	After Tax cash out flows		PV of cash out flow	
		Leasing	**Buying**	**Leasing**	**Buying**
0	6a.0	----	25000	----	25000
1	0.909	20780	-427	20707	-388
2	0.826	22786	315	18816	260
3	0.751	22780	946	17108	710
4	683	22780	1483	15559	1013
5	0.621	22780	1939	14146	1204
6	0.564	402	2327	227	1312
7	0.513	402	2656	206	1363
8	0.467	402	2936	188	1371
9	0.424	402	3174	170	1346
10	0.386	402	78377	155	30254
				87282	**63833**

Conclusion :

Purchase of plant out of borrowed funds is the best alternative rather than taking it on lease.
From the lessor's point of view leasing agreement would be beneficial if the asset earns return that exceeds the cost of capital (K). The cash inflows (lease rentals) must be adjusted to the tax payable and the tax savings accruing due to the claim of depreciation. The lessor is entitled to depreciation, as he is the owner of the asset. Following are the steps in the lease evaluation from the lessor's point of view.

1. **Find the Cash Outflows:** Cost of the asset proposed to be leased is the cash outflow (Co)

2. **<u>Find out Cash Inflows after Tax (CIAT)</u>:**

	Rs.	
Annual Lease Rentals	xxxx	[Cash Flows Before Depreciation and Tax]
<u>Less:</u> Annual Depreciation	xxx	
Earnings Before Tax	xxxx	
<u>Less:</u> Tax	xxx	
Earnings After Tax	xxxx	
<u>Add</u>: Annual Depreciation	xxx	
Annual Cash flows After Tax	xxx	

3. Find the present value of the Annual CFAT:

PV of annual CFAT = CFAT x PV of annuity of Rs. 1 at Cost of Capital(K) for n Years.

4. Net Cash flow = PV of ACFAT - Cost of the asset
= PV of ACFAT - Co

5. The lessor should go for leasing the asset if the net cash flow is positive i.e., PV of ACFAT exceeds cost of the asset (Co).

5.9 Hire Purchase:

The features of hire purchase and the differences between hire purchase and leasing have been discussed in 6.2.2 and 6.3 respectively. In this part of the lessor let us see how the hire purchase installments can be split in to interest and principal repayment.

Hire Purchase instalments cover interest as well as principal repayment. The hiree charges interest on a flat basis. This means that a certain rate of interest is charged on the initial investment made by the hiree and not on the diminishing balance.

Assume that the cost of equipment is Rs. 1 crore, the flat interest rate is 15% and hire purchase period is 36 months.

Total Interest = Rs. 1,00,00,000 x 15% x 3 Years
= Rs. 45,00,000

Hire Purchase Installment per annum = $\frac{\text{Rs. 1,00,00,000 + Rs. 45,00,000}}{\text{3 years}}$
= Rs. 48,33,333

Hire purchase Installment per month = $\frac{\text{Rs. 48,33,333}}{\text{12 months}}$
= Rs. 4,02,777.

As per the sum of the years digit method the proportions of interest allocated to the three years are as follows:

$$\text{Year 1} = \frac{36+35+34+\ldots\ldots\ldots\ldots\ldots..+25}{36+35+34+\ldots\ldots\ldots\ldots\ldots..+1} = \frac{366}{666}$$

$$\text{Year 2} = \frac{24+23+22+\ldots\ldots\ldots\ldots\ldots..+13}{36+35+34+\ldots\ldots\ldots\ldots\ldots..+1} = \frac{222}{666}$$

$$\text{Year 3} = \frac{12+11+10+\ldots\ldots\ldots\ldots\ldots..+11}{36+35+34+\ldots\ldots\ldots\ldots\ldots..+1} = \frac{78}{666}$$

Based on these proportions, the interest allocations are:

$$\text{Year 1} = \frac{366}{666} \times \text{Rs. } 45{,}00{,}000 = \text{Rs. } 24{,}72{,}972$$

$$\text{Year 2} = \frac{222}{666} \times \text{Rs. } 45{,}00{,}000 = \text{Rs. } 15{,}00{,}000$$

$$\text{Year 2} = \frac{78}{666} \times \text{Rs. } 45{,}00{,}000 = \text{Rs. } 5{,}27{,}027$$

Year	Hire Purchase Installment Rs.	Interest Component Rs.	Principal Component Rs.
1	48,33,334	24,72,972	23,60,361
2	48,33,333	15,00,000	33,33,333
3	48,33,333	15,27,027	43,06,306
Total	**1,45,00,000**	**45,00,000**	**1,00,00,000**

5.10 Summary:

In this unit major types of asset financing services are discussed. Lease is an agreement whereby the lessor conveys to the lessee, in return for rent, the right to use an asset for an agreed period of time. Hire purchase is purchasing of an asset where is the hirer pays the value of consideration in equal periodical installments over a period of time. Under leasing the lessor will be the owner of the asset while in hire purchase the hirer will be considered as the owner Hire purchase is extended for transport vehicles where as leasing is granted for industrial equipments.

5.11 Self Examination Questions:

1. Discuss the meaning and features of leasing.
2. Distinguish between leasing and hire purchase.
3. What are the various types of leasing? Discuss.
4. Explain advantages and disadvantages of leasing.
5. What steps are involved in the evaluation of leasing V. Purchase.

5.12 Further Readings:

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Dr.C.ANIL KUMAR

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LESSON : 6

CREDIT CARDS

6.0 Objective:

After reading this lesson, you will be able to understand .

- Concept of credit cards
- Types of credit cards
- Benefits, limitations of credit cards

Structure:

6.1 Introduction: -

Economic, social, cultural and technological development of society led to the growth of the service industry. Society exhibited increasing affluence combined with growing complexity of life. All these factors have contributed to the phenomenon of credit cards. Credit cards enable the individuals to purchase certain products / services without paying immediately. The buyer only needs to present the credit card at the cash counter and to sign on the bill. Credit cards can therefore be considered as a good substitute for cash and cheques. However these credit cards are accepted only by those establishments, which have consented to entertain them, these establishments are known as merchant establishments.

During the past decade, plastic cards have become increasing popular in India. The reason for their popularity has now shifted focus from being a status symbol to offering convenience and security with worldwide acceptance of late, banker have been permitted into the credit card business with out every the prior approval of the RBI. Banks have been given the freedom to start the card division either by them selves or in association with other card issuing banks. As a result, many Indian banks including state Bank of India have entered the credit card business in a big way during the last few years.

6.2 Origin and History:-

Credit cards were introduced as viable means of selling goods on credit with maximum of expanding sales and building a strong customer base.

6.2.1 Non Bank Cards:-

The use of credit cards originated in USA in the 1920's, when individual firms, such as oil companies, hotel chains, began issuing them to customers for purchase made at their outlets.

Mobil oil issued the world's first credit card in the year 1940. Initially, the company in order to give specialised services to its regular customers issued the card. This helped boost sales and increase customer base following the success of the Mobil card, various organizations such as the Diners club, American Express and carte blanche standard issuing cards, for different purposes like travel, leisure, etc.

6.2.2 Visa and Master Card:-

Fraklin National Bank, USA issued the first ever-general purpose credit card in the year 1952, and it was widely accepted by local merchants. The sales ship which was generated using the card, was presented to the bank, which would then credit the merchants account. The limitation of these cards was the card-holders could shop only in their geographical area and only with those merchants who had agreements with their banks.

In 1960, Bank of America developed the present credit card operating system. This system was subsequently licensed to some other banks, which led to the establishment of an international bankcard system called Visa international. Competition amongst the U.S. banks resulted in mother international bankcard system being introduced, known by Master card.

6.2.3 Electronic Cards:-

Most banks became members of the two organizations and started to issue both super of cards. The seventies witnessed the evolution of electronic card authorization systems, electronic clearing and settlement systems and electronic data capture (EDC) at the point of sale (POS) terminals. This virtue6 eliminated paper work and significantly speeded up the process. The card industry is presently witnessing a technological, revolution and is fast moving towards the introduction of "Smart" cards, which user computer ships, biometrics etc.

6.3 Features of Modern Credit Card:-

Any card that is used as a payment device to access customers financial resources is referred to as a credit card. The card. The card may be used during travel, at home, for purchaser or at the Automatic Teller Machines (ATM's) for credit or debit transactions. It is also known as plastic money and it can be used for the purchase of all kinds of goods and services. Following all the salient features of the modern credit card.

6.3.1 Owner identification:-

A Credit card identifies its owners at one who is entitled to purchase goods and services with out physical money and is eligible for credit from establishments. For this purpose, the card issuer enters into tie-up with various merchant establishments.

6.3.2 Wide usage:-

Bank credit is the most widely used payment device issued by bank of. It is based on the system of revolving credit where by a credit limit if sectioned to the customer and can be availed impart or in full. The credit card holders can use the credit cards at merchant locations to buy goods and services.

6.3.3 Credit Limit:-

The issues for the purpose of convenience and scrutinising set up a credit card limit for its card holders and a floor limit for its merchant establishments. The convenience and safety factors add value to these cards.

The credit card business is typically a high volume low value business, with the potential to break-even only beyond a certain volume of cards issued. The dependence on technology is inevitable to keep the operating costs to the minimum.

6.4 Types of Credit Cards (or) Classification of Credit Cards:-

The credit cards system can provide a wide range of products and services to the user. Depending on the necessity of the customer and trade competition, banks issue different types of credit cards.

Classification of Credit Cards

Based on Mode of Credit recovery	Based on Status of Credit Card	Based on geographical validity tie-up	Based on Franchise / category	Based on the issuer
(1)	(2)	(3)	(4)	(5)

6.4.1 Based on mode of credit recovery:-

This classification includes two types.

6.4.1.1 Revolving Credit Card:-

This type of credit card follows revolving credit principle. A limit is set on the amount of money one can spend on the card for a particular period. The card holder has to pay a minimum percentage of outstanding credit which may vary from 5 to 10 percent at the end of a particular period. Interest varying from 30 to 36 percent per annum is changed on the outstanding amount.

6.4.1.2 Charge Card:-

A change card is not a credit instrument. This facility given a consolidated bill for a specific period and bills are payable in full on presentation. There is no interest liability and no pre-set spending limits either.

6.4.2 Based on the status of Credit Card:-

Based on the status of credit card the credit cards can be classified into three types as under.

6.4.2.1 Standard Card:-

Credit cards that are regularly issued by all card-issuing banks an called standard cards, with these cards it is possible for a card holder to make purchases with out having to pay cash immediately. Some banks issue standard cards under the fraud name “Classic” cards.

6.4.2.2 Business Card:-

It is also known as “Executive” cards are issued to small partnership firms, firms of chartered accountants, tax consultants and others for use by executives on their business trips.

6.4.2.3 Gold Card:-

The gold card offers high value credit for the elite. It offers many additional benefits and facilities such as higher credit limits more cash advance limits etc., that are not available with standard or executive cards.

6.4.3 Based on Geographical Validity:-

Based on geographical validity the cards can be classified into two categories.

6.4.3.1 Domestic Card:-

Cards that are valid only in India and Nepal are called “Domestic Cards”. All transactions will be in rupees. These cards are issued by most of the banks in India.

6.4.3.2 International Card:-

Credit cards that have international validity are called “international cards”. These cards are honored in every part of the world except India and Nepal. The card holder can make purchaser in foreign currencies subject to RBI sanction and FEMA rules and regulations.

6.4.4 Based on Franchise Tie-up:-

According to this category, the cards can be classified into four categories. Those are.

6.4.4.1 Proprietary Card:-

Cards that are issued by banks themselves, with out any tie-up are called proprietary cards. A bank issuer such cards under its own fraud.

6.4.4.2 Master Card:-

This is a type of credit card issued under the umbrella of “Master Card International”. The issuing bank has to obtain a franchise from the Mater Card Corporation of USA.

6.4.4.3 Visa Card:-

This is a type of credit card, which can be issued by bank having tie-up with VISA international corporation, USA. The banks that issue VISA cards are said to have a franchise of VISA international.

6.4.4.4 Domestic tie-up card:-

These are cards issued by a bank having tie-up with domestic credit card brands such as Can-card and Ind-card etc.

6.4.5 Based on the issuer category:-

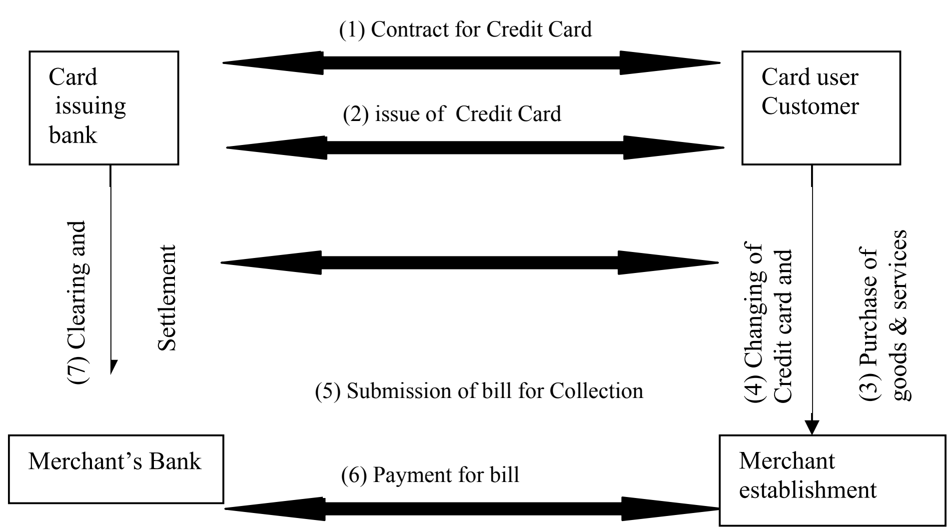
According to this category the credit cards can be divided into 2 types.

6.4.5.1 Individual Cards:-

These are the non-corporate credit cards that are issued to individuals.

6.4.5.2 Corporate Cards:-

These are the credit cards that are issued to corporate and business firms. The executives and top officials of the firms use these cards. The card bears the name of the firm and the bills are paid by them.
Mechanics Of Credit Card Operation (or Process of Credit Card):-



6.5 Benefits of Credit Cards:-

The benefits of credit cards can be classified into three types as under.
(a) Benefits to card holders
(b) Benefits to Merchants and

(c) Benefits to issuer banks.

6.5.1 Benefits to card holders:-

6.5.1.1 Shopping convenience:

Credit cards are convenient to use. Shopping is made more comfortable and joy us and purchasing poses no difficulty, since cards have wide acceptance.

6.5.1.2 Credit facility:-

The credit card enables the card holders avail the credit facility sanctioned by the card issuing company. The customer can either repay the amount of credit in full, or can up to for repaying it in flexible monthly installments. Card holders usually get a period of 30 to 45 days to clear the dues.

6.5.1.3 Safety:-

Credit cards allow for a safe means of conducting transactions. Credit card holders need not carry large amount of cash, they avoiding the risk of theft.

6.5.1.4 Acceptability:-

Merchant establishments widely accept VISA and Master card. This makes it vary convenient for holding a credit card.

6.5.1.5 Cash withdrawals:-

In times of need, card holders are also given the facility of withdrawing cash up to the sanctioned limits, from the banks or other tie-up ATMs.

6.5.1.6 Offers:-

Card issuing institutions, service organizations like Railways and Airlines, Merchant establishments are giving attractive bargains and offers to encourage purchase transactions by credit cards.

6.5.2 Benefits to Merchants: -

6.5.2.1 Guaranteed Payment: -

The merchant has guarantee of payment and in his account if created immediately on the submitting the charge slip into his bank. No bad debt arises in credit card transaction.

6.5.2.2 Proper Cash Flows: -

A good cash flow is established because of the speedy settlement of bills by banks.

(i) Reduction in Security Risk: -

The acceptance of credit card in lieu of cash reduces security risk.

(ii) Availability Credit Facility: -

The member establishments are able to offer credit facility to their customers without setting up their own credit arrangement.

(iii) Increase in volume of business: -

More and more people accept the practical advantage of credit cards and turn to suppliers who accept the cards in settlement. This helps in increasing the volume of business to member establishments.

6.5.3 Benefits to issuer banks: -

(i) High Profit: -

Credit card holders offer high profit for the banks. They commission or discount usually @ 2.5% on sale through credit cards. As more and more take advantage of credit facility the credit card service becomes more profitable.

(ii) New Customers: -

If the card is issued to non-account holders it may help to generation of new customers.

(iii) Cost control: -

The credit card system helps to control the bank cost as it reduces the number of cheques issued by the cumtomers

Credit Card limitations: -

The rapid growth of the payment card industry has lead to a dramatic rise in credit card frauds. A significant amount of money is lost because of frauds. The credit card is not risk free and all payers associated with it have to face an element of risk associated with it.

1. The card holders are burdened with service charge, annual fee, membership fee, etc. A high rate interest is charged for delayed payment. Credit card tempt the holders for more purchases beyond their repayment capacity.
2. The cost involved in the credit card business is high which includes the cost of plastic card to be imported, cost of information and the cost on staff to monitor processing of applications, etc. Unless the number of cards are high and the volume of business is more, the credit card business will not be profitable one.
3. The frauds perpetuated by the holders of bogus cards and some times in collusion with the member establishments is the major problem for the issuers.
4. The average utilisation of credit card is only 20% to 30% in India. The under utilisation this facility erodes the profitability of the banks.
5. More commission is to be paid to the issuing bank or credit card organisation. Due to the lack of effective system and prominent personnel some banks make delay in payment, which affect the cash flow of the member establishment.

Drawbacks of Credit Cards:-

Credit have many drawbacks for the user, issuer and the merchant establishments alike. Some of these are.

1. **Waste of Money:-**

It would be a waste of money to subscribe to a credit card if the card was not utilised.

2. **Thought less buying:-**

Credit cards invariably encourage impulsive purchases. Since the user need not pay instantly it may tempt the purchase of product / services that are not genuinely required.

3. **Financial problem:-**

Use of credit cards may drag the user into financial problems including overdraft. This happen where repayment on the credit card account is not done promptly.

4. **Mental agony:-**

The pressure tactics used by recovery agents appointed by some card issuers to collect outstanding dues may cause mental agony to the user.

6.6 Conclusion: -

According to top banking professionals the credit card business will grow over 100% every year for the next 5 years. To realise the potential in the credit card market the following suggestions are made.

- Reduce the membership and annual subscription fees.
- Encourage member establishments to accept credit cards for routine items also.
- Make the features of cards convenient to middle class people.
- Enhance the cash withdrawal limits.
- Workout the strategies to popularise the credit card among people in semi urban and rural areas.

6.7 Self Examination Questions: -

1. Explain the features of credit cards issued by various banks?
2. Explain various types of credit cards?
3. Describe the facilities offered to the credit card holders?
4. Discuss the advantages and disadvantages of credit cards?

6.8 Reference Books: -

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LESSON – 7

FINANCIAL SCHEMES FOR CONSUMER DURABLES

Learning Objectives :

- To Understand the features and Benefits of consumer durable loan
- To learn the factors affecting the consumer durables
- To discuss the consumer financing in the different sectors

Structure of the lesson :

7.1 INTRODUCTION :

The Indian financial services industry has undergone a metamorphosis since1990. Before its emergence the commercial banks and other financial institutions dominated the field and they met the financial needs of the Indian industry. It was only after the economic liberalisation that the financial service sector gained some prominence. Now this sector has developed into an industry. In fact, one of the world's largest industries today is the financial services industry. Financial service is an essential segment of financial system. Financial services are the foundation of a modern economy. The financial service sector is indispensable for the prosperity of a nation.

Meaning of Financial Services :

In general, all types of activities which are of financial nature may be regarded as financial services. In a broad sense, the term financial services means mobilisation and allocation of savings. Thus, it includes all activities involved in the transformation of savings into investment. Financial services refer to services provided by the finance industry. The finance industry consists of a broad range of organisations that deal with the management of money. These organisations include banks, credit card companies, insurance companies, consumer finance companies, stock brokers, investment funds and some government sponsored enterprises. Financial services may be defined as the products and services offered by financial institutions for the facilitation of various financial transactions and other related activities. Financial services can also be called financial intermediation.

Financial intermediation is a process by which funds are mobilised from a large number of savers and make them available to all those who are in need of it and particularly to corporate customers. There are various institutions which render financial services. Some of the institutions are banks, investment companies, accounting firms, financial institutions, merchant banks, leasing companies, venture capital companies, factoring companies, mutual funds etc. These institutions provide variety of services to corporate enterprises. Such services are called financial services. Thus, services rendered by financial service organisations to industrial enterprises and to ultimate consumer markets are called financial services. These are the services and facilities required for the smooth operation of the financial markets. In short, services provided by financial intermediaries are called financial services.

Consumer durables like refrigerators, microwaves, washing machines, etc. have become necessities in today's age. However, buying one or more durables for the home incurs a considerable amount of money. If the consumer don't have sufficient savings at disposal, the consumer can apply for a consumer durable loan.

This post discusses the uses, benefits, eligibility, documents and steps to apply for a consumer durable loan easily. Read on!

7.2 WHAT IS A CONSUMER DURABLE LOAN ? :

A consumer durable loan is a type of personal loan or line of credit that banks offer to customers to buy consumer goods like phones, cameras, refrigerators, laptops, and home theatre systems, among other things.

Consumer durable loans usually have a shorter repayment tenure – 24 to 36 months. Though most lenders provide 100% financing of consumer durables, the interest rate and the loan amount could vary depending on certain factors, like the credit score, monthly income, etc. Generally, the interest rates vary from lender to lender and depend on various parameters including credit score, monthly income and the likes.

7.3 FEATURES AND BENEFITS OF A CONSUMER DURABLE LOAN :

1. Up to 100% financing of the preferred consumer durables
2. Flexible EMI options up to 36 months or more
3. No collateral or guarantor required
4. Minimal documents required
5. Less stringent eligibility criteria

7.4 TYPES OF CONSUMER DURABLE LOANS :

A consumer durable loan is a form of credit that can be used to purchase consumer durable goods, such as household appliances, electronic gadgets, etc. The most common type of consumer durable loan is termed as an Installment Loan. This type of personal loan differs from an EMI conversion using a credit card/debit card as no card is used to complete the purchase and or set up an installment-based payment plan.

Details of an installment loan and its various subtypes are as follows :

7.4.1 Installment Loans :

These are the most common form of consumer durable loans and are paid back in weekly, fortnightly, monthly or bi-monthly installments according to a preset timetable. The interest rate charged on these installments may be fixed or vary with time. Additionally, these consumer loans may or may not require security or collateral. Based on these unique features, installment loans may be further divided into the following types :

7.4.2 Fixed – rate consumer durable loan :

Most consumer loans offered to borrowers are fixed-rate loans similar to the mechanism using which other personal loan interest rates are applicable. As the name suggests, these consumer loans have the same interest rate throughout the loan tenure.

7.4.3 Variable-rate consumer durable loan :

In a variable rate consumer loan, the interest rate charged on the outstanding balance varies with the change in market interest rates. As a result, the consumer paid the interest payouts will vary as well. However, these loans usually have limits on how high or low the interest rate can be.

7.4.4 Secured consumer durable loans :

Secured loans are those which are secured against assets as collateral. Secured consumer loans in India usually involve hypothecation of the item being purchased. Some banks also provide consumer durable loans secured using other instruments such as fixed deposits, RBI Bonds, gold jewelry, LIC policy, etc. Thus, interest rates are usually lower for secured consumer durable loans. If the consumer are unable to repay the loan for any reason, the lender is entitled to claim the security to make up for their loss.

7.4.5 Unsecured consumer durable loans :

Unsecured consumer durable loans are the most common. The borrower does not have to provide any kind of. Interest rates for unsecured loans can be higher than the secured variant. However, most banks and financial institutions that offer consumer durable loans do so at competitive rates that are at par with personal loan interest rates. In some cases such as during festivals, you might even qualify for special offers with nil or zero processing fees and an effective interest rate of 0%.

7.5 FEES & CHARGES :

Besides interest charges, there may be other additional fees and charges that may be applicable on a consumer durable loan. Some of these are discussed in detail below:

7.6 PROCESSING FEES :

The administrative fee/charges involved in the disbursement of a personal loan are covered under processing fees. The processing fee generally varies between 0% and 6% of the loan amount sanctioned.

7.7 LATE PAYMENT CHARGES :

In case the consumer are late in paying the EMIs, the consumer have to pay these charges (generally a fixed charge) along with the due EMI amount.

7.8 CHEQUE BOUNCE CHARGES :

Cheque bounce charges are payable in case the consumer miss an EMI payment because the account linked to the post-dated cheque is either low on funds or has been closed. It is generally a fixed charge of around Rs. 500.

7.9 FORECLOSURE/PREPAYMENT CHARGES :

Prepayment involves paying an amount in excess of the actual EMI amount. However, when the consumer pay off a loan completely before the end of the repayment tenure it is known as foreclosure. This complete prepayment usually involves some charges known as fore – closure / prepayment charges. These generally range between 0% and 6% of the principal amount prepaid plus taxes as applicable.

7.10 FACTORS AFFECTING CONSUMER DURABLE LOAN INTEREST RATE :

Though some lenders offer consumer durable loans at a 0% interest rate, there are some that do charge interest on these loans. The interest charged by a lender not only varies with the financial institution but also with the individual applicant's profile. Given below are a few key factors that affect the interest rate charged to an individual :

7.10.1 Credit Score :

Credit score is a 3-digit numeric summary of the credit report/ credit history and ranges from 300 to 900. A score closer to 900 (such as 750 or above in case of CIBIL score) helps to secure a consumer durable loan more easily as it indicates higher creditworthiness. It also helps the consumer to avail it on better terms such as a lower rate of interest.

7.10.2 Loan Amount :

Higher loan amounts generally result in the applicant being at a higher rate of interest. This is because higher loan amounts generally lead to higher EMI payouts which increase the risk of default for the lender.

7.10.3 Loan Tenure :

Longer repayment tenures usually come with higher rates of interest and vice versa.

7.10.4 Current Outstanding Debt :

A higher rate of interest may be charged on consumer loans in the case of applicants with high existing debt as this is perceived to increase the risk of default for the lender.

7.11 CONSUMER FINANCING – PICKING MOMENTUM :

Consumer lending in India has zoomed from Rs20,000 crore in 2000- 2001 to Rs55,000 crore in 2001-2002. Finance is available for anything under the sun from TVs, washing machines, refrigerators, air-conditioners, PCs, two-wheelers, cars, to branded furniture, software, books and teaching aids. Consumer financing is now available even for air travel, holidaying and higher education. Cheaper and easily available finance is infact fuelling the growth in demand for white goods.

The National Council of Applied Economic Research reckons that the impact of consumer finance first began to be felt in 1999-00. In that year, demand for financed white goods rose 23.9 per cent while the overall market grew just 18.9 per cent. In the rural markets the availability of cheap finance was an even bigger factor in growth. While rural demand for white goods grew 22.4 per cent in 1999-00, the growth of financed white goods rose a phenomenal 39.6 per cent. Southern states accounted for 45 percent of consumer finance market and western states, 30 percent.

Retail loans have grown at 27 percent per annum between 2000-2001 and 2002-2003 and commercial credit, at 13.6 percent. Growth in purchases with consumer financing in 1999-2000 was 134 percent overall in urban areas and 103 percent in southern states.

7.11.1 Auto Finance :

There are several private finance companies in India specializing in auto finance, both at the regional and national level. Apart from these companies, automobile loans are offered by most private and public sector banks. ICICI Bank disburses over Rs300 crore per month in the car financing business. It is also the largest financer in the 2 – wheeler industry.

Auto loan industry is growing at 30 percent per annum. Also, consumers are upgrading their cars by borrowing from auto financing companies. Automobile finance companies tend to focus on personal automobiles, while banks cater more to commercial vehicles. Availability of financing for used vehicles is presently limited but expected to be a major driver of growth in the near future.

Leasing options for new vehicles are also limited. Recently, car manufacturers have begun offering one-year interest-free loans to buyers of their cars. Like other lending institutions in India, auto finance companies face a high percentage of delinquencies. Some of the problems facing auto finance companies in India are :

- Lending decisions are taken at the local level, and lack consistency. As local offices have to meet performance targets, they tend to lend approve marginal cases.
- Credit checks are inaccurate due to lack of information.
- Recovery from defaulters is difficult. Even repossession of automobiles limits recovery as borrowers often replace new components with used ones.
- Interest rates are high because of low recovery. This makes finance options less attractive to consumers.
- Used automobile finance and leasing of new vehicles is limited due to the difficulties in assessing consumer credibility and lack of effective recovery options.
- Automobile finance companies do not share consumer data. Consumers are often able to obtain automobile finance even after defaulting with previous such loans.
- ICICI Bank has been facing a similar scenario, with many of its auto loan borrowers defaulting on the payments. It has now started repossessing the vehicles but disposing of them is a big issue.
- Many of these vehicles are finally getting channeled to online auctioneers like Bazee.com for sale at discounted prices.

7.11.2 Housing Finance :

India has several housing finance companies offering loans for construction, renovation, and purchase of residential accommodation. Recently, banks have also started offering housing finance, and are seen as significant competition to housing finance companies. ICICI Bank and State Bank of India leads in home loan segment among banks while Housing Development Finance Corporation and LIC Housing Finance leads the HFCs. Maximum number of housing loans is of the size less than Rs5 lakh with a repayment period of 10-15 years. Total loan disbursement by banks and HFCs increased by 76 percent in 2002-03 to Rs51,673 crore against a 31 percent increase witnessed in 2001-2002.

India currently faces a large shortage of adequate housing in the country. Overall, there is a shortfall of 19.4 million dwelling units in the country, of which 16 million are in rural areas.

The government is initiating various programs and policies to bridge this shortage. The availability of adequate housing finance will remain a key factor in their success.

A survey conducted by the FICCI on 47 banks and housing finance companies has revealed that banks have overtaken house finance companies (HFCs) in the home loan market. Banks have netted a 65.5 percent share of the total home loan disbursements in 2002- 2003 (43.6 percent in 2001-2002). In light of this increased competition, untapped markets such as rural housing, or low income housing can no longer be ignored.

Some of the common issues facing housing finance companies in India are :

- Lending decisions are conservative and restricted to the high income group consumers due to the lack of facilities to establish credibility, and foreclosure regulations.
- Rural and semi-urban markets have remained largely untapped due to high down payment requirement and non availability of title deeds in the absence of land records in the rural areas.
- For new construction, finance is generally offered for construction only, and not for purchase of land. This makes new housing less affordable.
- Recovery of defaults is difficult due to the lack of an effective legal framework.
- Processing of loan applications is time-consuming and expensive.
- Interest rates are high because of poor recovery.
- Pricing of property and construction are inflated by consumers to get additional financing.
- Banks are able to make better lending decisions than housing finance companies as they favor their existing clients and are aware of their financial standing.

The default rate in the housing finance sector is about 1.47 percent. Recently, National Housing Bank has decided to extend the provisions of Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 to housing finance companies, which are registered with it. These stipulations would bring 23 housing finance companies under the purview of the Act, including HDFC Ltd, LIC Housing Finance, ICICI Home Finance, Can Fin Home Finance, and Birla Home Finance among others. These firms can repossess houses of defaulting housing loan customers by just lodging a complaint with the police. This would thus facilitate the recovery process.

7.11.3 Retail Credit / Durable goods financing :

India has a large consumer goods manufacturing base. It has several major players in the luxury and semi – luxury segments that boast of nationwide retail and distribution networks. A number of consumer goods manufacturers have started offering loans to consumers for purchase of their products. These loans are normally processed at the retail location level. Color televisions (CTVs), refrigerators and air conditioners, generate 80 percent of business for consumer durable financiers.

There are several finance companies that offer consumer durable finance. Countrywide Personal Finance and The Associates are two companies that have percolated to a very large number of consumer durables dealers. Apart from this, housing finance companies also offer consumer durable finance at attractive interest rates to existing home loan customers. Since repayment capacity has already been appraised by the concerned HFC, getting a consumer finance loan through this channel could be fast and easy. Some banks (both public sector and private), also offer consumer loans. These are generally offered to existing account holders of the bank.

Personal loans offered by some banks and finance companies (like Citibank and Kotak Mahindra) may also be used for financing your consumer durable purchase. The eligibility criteria for these loans, however, tend to be more stringent, since no security for the loan is asked for. Also, interest rates tend to be a little higher than those for consumer finance schemes. Some of the important players in the field include Countrywide - Classic Scheme, Countrywide - Express Channel, Countrywide - Instant ATM Loans, HDFC, The Associates, ICICI, Allahabad Bank, Corporation Bank, Bank of Baroda, Central Bank, and HDFC Bank.

Issues that need to be resolved in order to boost consumer finance in this area include :

- Manufacturer or dealer promoted finance schemes for consumer goods are an effective tool for business development, but come with a heavy price due to poor recovery. It is also difficult to refinance such loans as the credit decisions are mostly made at the retail location level and application procedures are inadequate.
- Credit decisions normally take a few days. This makes such finance schemes less marketable.
- Large corporations find it difficult to implement such finance schemes nationally and seek maximum benefit.
- Retailers are also weary of promoting such schemes locally due to the lack of means of gauging consumer credibility.

Currently, percentage of total sales accounted for by the rural buyers is 26 percent for color televisions and 22 percent for refrigerators. The rural market for consumer durables is projected to grow by 15-20 percent in 2003-2004. A recent study conducted by Francis Kanoi, a market research company based in Chennai, shows that growth of the consumer durables industry in the rural market could be affected by unavailability of consumer finance options.

7.11.4 Innovations in lending – Avenues for Growth :

Banks and finance companies have came up with various innovative products and services to lure the consumer- from 0% interest schemes, to 100% finance schemes to instantaneous loan approvals, all leading to a spurt in the Consumer Finance market in India. Banks are offering customized financing solutions by offering schemes which have 'step up' and 'step down' repayment options (monthly installment increases or decreases each year) or repayments which are Front Ended (Higher Repayments at the beginning) or Back Ended (Higher Repayments towards the end).

To cite a specific example of innovative new offerings, Dewan Housing Finance Ltd (DHFL) has recently launched a scheme, DHFL Sampoorna Rakshak (SR), that provides risk cover for three equated monthly installments (EMIs) of the home loan in case the borrower of the loan loses the job or in case of medical emergency. SR also covers the house to the extent of its construction value. The insurance covers against unforeseen disaster such as earthquake, gas cylinder explosion or fire.

7.11.5 Rural Financing :

The rural demand for financial services can roughly be divided into two segments, based on different orientation and perspectives:

The "agricultural segment" :

Composed of farmers who make most of their living from agricultural activities) Agricultural loans finance purchase of tractors and other farm machinery, production, processing and marketing of enterprises specialized in agriculture. To deal with the price risk, lenders can make use of the available futures/Options contracts to gain information about the probable evolution of prices in the shot term. Plantation of tree crops, land leveling, heavy farm machinery etc are some examples of long term loans for investments which can also be financed taking into account value of the collateral, present value of additional income generated by the investment etc.

The "transitional segment" :

Significant portion of their income comes from non-agricultural sources like wages, rearing livestock, remittances, commerce, etc.) Rural loans generally have a variety of repayment schedules which include bullet payments (i.e. a single payment of interest and principal at maturity), loans with monthly payments of interest and repayment of principal at maturity, or even loans in which the timing and size of payments are not constant but irregular, based on the borrower's projected seasonal income pattern. Tailoring payment plans to the expected cash flows of individual households is essential for rural lending since rural clients usually have substantial income from agriculture and more diversified income sources than urban clients. SafeSave has recently launched a new rural lending product in Bangladesh which allows the clients to specify the desired maturity (which may not exceed 12 months) and pay the interest up front. Once disbursed, clients are free to pay whatever amounts they wish to SafeSave's collectors, who visit clients at regular intervals (daily, weekly or monthly).

Another subset of Multi-Purpose rural credit products are loans which are granted or rescheduled in emergency situations. Emergency loans can be used for individual emergencies such as accidents, illnesses or other individual events and disasters caused by natural catastrophes like earthquakes, draught or flooding. These include rescheduling of existing loans, grant of small and standardized loans during this critical phase to help clients cover basic needs and loans for financing repair or replacement of damaged or destroyed farm property (real and chattel) and supplies lost or damaged as a direct result of a natural disaster.

State / Central Governments have also realized the need for rural financing and have been taking steps to make it more attractive for a risk averse lender. Banks/HFCs on the other hand have been cautious of lending to farmers without sufficient security to enforce in case of defaults in repayment of dues. Many states in India propose to amend their respective legislations to enable borrowers to mortgage their farms for purposes other than agriculture. This, in turn, will give a fillip to rural housing finance as the existing legislation does not allow agricultural land as collateral for housing mortgages.

Innovations in Educational finance :

Educational finance in India is restricted to higher education loans by banks. These loans are typically given by banks for higher technical education at the graduate and post graduate level.

However, there exists a huge demand for loans for school education. There has been a large improvement in the standard of primary education in India which has led to an increase in the basic fee of medium rung schools in urban and semi urban India. With the increasing emphasis on education, even the low income families strive to educate their children in good, expensive schools even if it is too expensive for them. Many companies like insurance companies hav identified the importance of good primary education to parents and have come up with investment products which take care of the schooling years of the children of the savers. Thus clearly there exists a huge market for school fees financing in India. For example, a finance company can finance the school fees of a child for six years from class six to class twelve and receive it in EMI's over fifteen/twenty years. This would provide parents access to schools, fees of which they otherwise cannot afford. This need has not been addressed by finance companies so far and a huge untapped market lies ahead.

7.12 CUSTOMER FINANCING BY LARGE RETAIL OUTLETS :

Large retail stores and multi brand outlets are becoming increasingly popular in urban and semi urban India. Retails chain store like Westside, Pantaloons, Music world, Lifestyle, Food world are getting increasingly popular. These stores have an increasing customer base and are growing at a fast rate. Most of these stores have a huge electronic database of customers.

Most of these stores also have membership programs for their customers and issue them cards to track their purchase and reward them. As more and more people from lower middle class families migrate to these stores, the demand for credit purchases have been increasing. S, there exists a huge market for financing the purchases from these big stores. Lets illustrate this with the help of an example. Lets say, on the basis of a credit check and study, Pantaloons grant their customers a credit facility on purchase on a single bill over Rs 5000. Now this Rs 5000 can be returned in 3,6,9 or twelve months , depending upon the credit needs of the customers. Now Pantaloons will get this arranged through a financing company.

This is extremely beneficial to Pantaloons as well as to the consumers. The sales of retail outlets like Pantaloons, will experience a substantial growth through this programme. This will prove to be a better source of financing than credit cards to the consumers because of convenience and lower interest payments. Thus, there exists a huge demand for financing in this segment, which will turn out to be a major growth driver for finance companies.

7.12.1 Expanding Gamut of Credit Cards :

Aided by technology and innovation fuelled by the market needs and underlying growth propositions, a wide range of credit card offerings are now possible that are structured to meet the requirements / demands/life style of consumers. Innovations in the Cards market have resulted in the evolution of the card from being a "convenient alternative to Cash" to becoming the "financial window" for lenders to offer bundled services to consumers. Some of the offerings that have become possible are :

- Co-branded Cards aimed at maximizing benefits to the Card Holder by both the issuing and Co-branding partners.
- Co-issuing for and on behalf of a partner.
- Affinity Cards representing a close user group with the benefits realized on the spend by the Affinity Group
- Installment Loans with EMI linked to Card outside the Credit Limit.
- Personal Loan linked to a Card
- Consumer Loan disbursed through a Card with a credit line equivalent to the Loan amount. The paid up installments adding to Open To Buy (OTB)
- Secondary Limits on the Cards during high spend seasons
- Hybrid products covering the features of the Card and the Loan
- Virtual Card (e-card for exclusive use on the net)
- A Card as part of the Mobile Phone SIM card for making Payments etc.

7.13 RISK MITIGATION STRATEGIES - USE OF CREDIT REPORTING :

The significant decrease in lending costs achieved in developed countries with the use of credit bureaus and credit scores has induced regulators and financial institutions to assess and promote the use of such instruments to enhance credit processes. Credit scoring can be provided by the credit bureaus or with information provided by these.

7.13.1 Credit bureaus :

Credit bureaus are public or private firms using large databases containing the history of financial transactions of individuals and firms of all economic activities. These histories are used by lenders and insurances in order to assess applications of potential clients in different ways, depending on the lender's or the insurance's criteria which are usually reflected in scores. Credit bureaus fulfill for lenders two important functions: They allow appreciating the risk which is incurred when lending to a specific individual or firm and they help enforce the repayment of the loans. The more complete the information in a credit bureau with respect to its scope and the number of information sources, the more comprehensive the analysis which can be performed by a lender. Repayment of loans is enforced by credit bureaus by making an even temporary breach of a lending contract become public. When such information becomes public about a client, other lenders may restrict lending to him or her or they may increase the interest rate charged for loans to this individual, who is now perceived as a higher risk. The higher costs of lending or the exclusion from further lending sets for clients a strong incentive to repay loans in time.

7.13.2 Credit scoring :

Scoring is widely used in developed countries to assess repayment risk. It is based on the assumption, that the past performance of the different client segments is a valuable tool to predict the future repayment patterns and even loyalty to a given institution. As such, credit scoring analyses the past performance of different client segments and tries to predict future repayment based on this information. In the United States, credit scoring, based on the extensive databases and is used as the sole tool to select potential clients and to determine whom to lend and whom to reject. Scoring and additional information on the applicant's income is also used to determine loan size and to determine the interest rate charged to each client. Credit scoring is a management tool which entails assigning weights or points to bits of information and the total score of the customer is arrived at. The model facilitates a more rational approach to credit decisions and is based on portfolio behavior - it has proved to help reduce delinquencies. Setting up a scoring scheme to predict future repayment conduct or loyalty can only be undertaken if accurate information exists for large numbers of clients over several years. Setting up a scoring scheme requires specialized expertise as the existing information has to be assessed using statistical models and mathematical forecast models have to be set up. Given the shocks and deep changes, which affect the economies in developing countries and especially their rural economies, scoring in such countries can only be used to determine the general trends in repayment behavior. It may not be used, as in developed countries, to give a forecast of the probability of default. Also, if the databases are not extensive and repayment is not being reinforced by efficient credit bureaus, the potential of scoring is more limited.

In India, Currently, banks are prohibited from sharing positive data by secrecy provisions governing their operations. Reserve Bank of India (RBI) has recommended enacting umbrella legislation, Credit Information Bureau Regulation Act, to pave the way for setting up of credit information bureaus and easing the process of sharing information on individuals and corporate companies. A database of customer accounts is also being drawn up by the Credit Information Bureau of India (CIBIL), which can be used to spot serial defaulters. Potential users of these credit reports are:

- Banks & financial institutions
- Consumer & mortgage finance companies
- Credit card companies & other service providers e.g. mobile phones etc.

CIBIL aims to provide complete and reliable credit information to its members. It has 75 members, consisting of 53 commercial banks, 7 housing finance companies and six FIs and 7 non-banking finance companies. Member institutions have been asked to submit returns of all existing nonsuit-filed accounts by the end of Dec 2004. CIBIL will obtain and share data on borrowers, both consumer and commercial, in a systematic manner for sound credit decisions, thereby helping to avoid adverse selection. This would also facilitate reduction in NPAs.

7.14 SUMMARY :

We have shown that consumer financing business in India has been on an uptrend recently and is expected to remain so in the future fuelled by the sweeping changes in the consumption habits of the Indian middle class. Till now most of the growth has come from traditional channels of financing like auto finance, housing finance, consumer durable financing etc. But going forward, banks and NBFC alike need to search for other avenues for sustaining the momentum. This growth can come from areas like developments in rural finance, widened gamut of credit card offerings, education, partnerships with Multi Brand Outlets etc. While targeting growth, financial institutions also need to be equally weary of how to mitigate the extra risk involved in exploring untapped market. This involves setting up of credit bureaus and development of credit scoring models to gauze the credit worthiness. If credit scoring coupled with credit bureaus providing in-depth databases is employed, promising results may be achieved in reducing transaction and risk costs, as lending decisions can be automated and as repayment is reinforced.

7.15 KEY WORDS :

Installment Loans :

These are the most common form of consumer durable loans and are paid back in weekly, fortnightly, monthly or bi-monthly installments according to a preset timetable. The interest rate charged on these installments may be fixed or vary with time

Variable-rate consumer durable loan :

In a variable rate consumer loan, the interest rate charged on the outstanding balance varies with the change in market interest rates. As a result, the consumer paid the interest payouts will vary as well

Secured consumer durable loans :

Secured loans are those which are secured against assets as collateral. Secured consumer loans in India usually involve hypothecation of the item being purchased. Some banks also provide consumer durable loans secured using other instruments such as fixed deposits, RBI Bonds, gold jewelry, LIC policy, e

Unsecured consumer durable loans :

Unsecured consumer durable loans are the most common. The borrower does not have to provide any kind of. Interest rates for unsecured loans can be higher than the secured variant. However, most banks and financial institutions that offer consumer durable loans do so at competitive rates that are at par with personal loan interest rates. In some cases such as during festivals, you might even qualify for special offers with nil or zero processing fees and an effective interest rate of 0%.

Credit Score :

Credit score is a 3-digit numeric summary of the credit report/ credit history and ranges from 300 to 900. A score closer to 900 (such as 750 or above in case of CIBIL score) helps to secure a consumer durable loan more easily as it indicates higher creditworthiness. It also helps the consumer to avail it on better terms such as a lower rate of interest

7.16 SELF ASSESSMENT QUESTIONS :

1. Briefly discuss the features and benefits of consumer durable loan(s).
2. Explain the factors affecting the consumer durables.
3. Discuss the consumer financing in the different sectors.
4. Describe the Risk Mitigation Strategies to use credit reporting?
5. Explain the Customer Financing by large retail outlets?

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Dr. V. Naga Nirmala

Lesson – 8

VENTURE CAPITAL

Objective :

After reading this lesson you will be able to understand

- Concept of Venture Capital
- Features
- Stages in Venture Capital Financing & Importances of Venture Capital.

Structure of the lesson :

8.1 Introduction :

Venture Capital is risk money, which is used in risky enterprises either as equity or debt capital. It may be in new sunshine industries or older risk enterprises. The funds, which finance such risky ventures, are called venture capital funds.

8.2 Origin of Venture Capital :

Venture Capital was originated and popularised in the USA in the sixties. American Research and Development Corporation, founded by Gen. Doriot soon after the Second World War. The real development of VC took place in 1958 when the business administration was passed by US congress.

UK occupies a second place after US in terms of investment in VC. The concept became popular in the late sixties in UK.

8.3 Initiative in India :

Indian tradition of VC for industry goes back more than 150 years when many of the managing agency houses acted as venture capitalists providing both finance and management skill to risky projects. The Tatas also initiated a managing agency system, named investment corporation of India in 1937 which by acting as venture capitalist. Venture capital's growth in India passed through various stages. In 1973, R.S. Bhatt committee recommended formation of Rs 100 crore venture capital fund. United Nations Development Programme in 1987 on behalf of Government examined the possibility of developing venture capital in private sector.

8.4 Meaning of Venture capital :

Venture Capital is long-term risk capital to finance high technology projects, which involve risk, but at the same time has strong potential for growth. Venture capitalist pools their resources including managerial abilities to assist new enterprises in the early years of project. Once the project reaches the stage of profitability they back their equity holdings at high premium.

8.5 Features of Venture Capital :

Some of the features of venture capital financing are as under.

1. Venture Capital is usually in the form of equity participation. It may also take the form of convertible debtor long-term loan.
2. Investment is made not only in high risk but also in high growth potential projects. 3. Venture capital is available only for commercialisation of new ideas or new technologies and not for enterprises, which are engaged in trading, booking, financial services, agency liaison work or research and development.
4. There is continuous investment in business after making an investment by the investor.
5. Investment is usually made in small and medium scale enterprises.

6. Venture Capital is not just injection of money but also an input needed to setup the firm, design its marketing strategy and organise and manage it.

8.6 Venture Capital Financing – Stages :

The various stages in the financing of venture capital are described below.

8.6.1 Development of an Idea – seed finance :

In the initial stages venture capitalists provide seed capital for translating an idea into business preposition. At this stage investigation is made indepth, which normally takes a year or more.

8.6.2 Implementation stage – startup finance :

When the firm is setup to manufacture product or provide a service, startup finance is provided by venture capitalists. The first and second stage capital is used for full manufacturing and further business growth.

8.6.3 Fledging stage – Additional finance :

In the third stage the firm has made some headway and entered the stage of manufacturing a product but faces farthing problems. It may not be able to generate adequate funds and so additional round of financing is provided to develop the marketing infrastructure.

8.6.4 Establishment stage-Establishment Finance :

At this stage, the firm is established in the market and expected to expand at a rapid pace. It needs further financing for expansion and diversification so that it can reap economics of scale and attain stability. At the end of the establishment stage the firm is listed on the stock exchange and at this point the nature capitalist disinvests their share holdings through available exit routes.

8.7 Importance of Venture Capital :

8.7.1 Advantages to investing public :

Venture capital is of great practical value to every corporate enterprise in modern times.

(a) The investing public will be able to reduce risk significantly against unscrupulous management, if the public invests in venture fund that in turn will invest in equity of new business.

(b) The venture funds equipped with necessary skills will be able to analyse the prospects of the business. So the investor has no means to vouch for the profitability of the business.

8.7.2 Advantages to the promoters :

1. Public issue of equity shares has to be preceded by lot efforts, viz., necessary statutory sanctions, under writing and brokerage arrangement the new entrepreneurs find it very difficult to meet all these arrangements and requires a great deal of effort. Venture fund assistance would eliminate those efforts by leaving the entrepreneur to concentrate upon bread and butter activities of business.
2. For the success of public issue the entrepreneur is required to convince the under writers, brothers and number of investors but to obtain venture capital assistance he will be required to sell his ideas to justify the officials of the venture fund.

8.7.3 General advantages :

1. A developed venture capital institutional setup reduces the time lag between a technological innovation and its commercial exploitation.
2. It helps in developing new processes / products in conceder atmosphere, free from the dead weight of corporate bureaucracy, which helps in exploiting full potential.
3. Venture capital acts as a cushion to support business borrowings as bankers and investors will not lend money with inadequate managing of equity capital.
4. A venture capital firm serves as an intermediary between investors looking for high return for their money and entrepreneurs in search of needed capital for their startups.
5. It also pares the way for private sector to share the responsibility with public sector.

8.8 Methods of venture financing (the Indian scenario) :

8.8.1 Equity participation :

Venture capital firms participate in equity through direct purchase of shares but their stake does not a need 49%. These shares are sold either to the promoter at negotiated price under by back agreement or to the public in the secondary market at a profit.

8.8.2 Conventional loan :

Under this form of assistance, a lower fixed rate of interest is changed till the assisted units become commercially operational after which the lean carrier normal or higher rate of interests.

8.8.3 Conditional loan :

Under this form of finance an interest free loan is provided during the implementation period but it has to pay royalty on sales. The loan has to be repaid according to a predetermined schedule as soon as the company is able to generate sales and income.

8.8.4 Income Notes :

It is a combination of conventional and royalty are payable at much lower rates than in case of conditional loans.

8.9 Conclusion :

At present there are several venture capital firms incorporated in India and they are promoted by all India FIs like IDBI, ICICI, IFCI, State level FIs, Public sector banks or promoted by foreign banks.

8.10 Self Assessment Questions :

1. Define the term Venture Capital and write the features of Venture Capital Financing?
2. Discuss the various types of Venture Capital Financing.
3. Discuss the various stages involved in Venture Capital Financing.
4. Trace the origin and growth of Venture Capital Financing.

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LESSON – 9

HOUSING FINANCE

9.0 Objective:

After going through this lesson, you will be able to understand

- Emergence of housing finance
- Role being played by institutional players

Structure:

9.1 Introduction :

From the time immoral shelter is considered to be the basic necessity of a Humans being To the Homoc Sepian no other problem is as worrying and mind boggling as the housing problem. To construct a house is a distant dream in the lives of many people. Conservatively in our country most of the people used to dependent on their Provident Fund and gratuity amounts received after retirement for the purchase or construction of a house. Loan is considered to be the last resort for many a people in yesteryears. Employees who are in transferable Jobs also give importance to construct a house at the fag end of their career or they will decide where to settle just before the retirement. Hence this is a major burning problem for many people.

In a populated country like India many people are below the poverty line and to construct a house is a big dream for them. People below the poverty line have been living in slum areas. Even after attainment of Independence there is no considerable momentum in this sector.

However with the emergence of housing finance as a major business in the country an increasingly large member of people are going for housing loans. As a result the housing and real estate sector in our country is undergoing unprecedented change. There is another reason for this also. In search of Employment villagers are migrating to towns and cities. Due to this phenomenon there is a need to develop urban infrastructure. Consequent to the introduction of economic reforms internationally reputes industrial houses are feeling that Indian market is very attractive and they are of the opinion that "IF YOU ARE NOT IN INDIA TODAY, YOU MAY AS WELL NOT BE IN BUSINESS".

The sustained demand from the international Technology Sector certainly changed the Urban Land Scape of our country. Bangalore has positioned it self as the IT Capital of India and there is intensive competition in the area among Bangalore, Hyderabad and Chennai. Several multinational companies are evincing keen interest to start their operations in India to take advantage of low costs. Since human resource being the chief element in the Industry, the hiring and houses of people both at their work place and home assume great-importance and hence the need to create space for people to work and live, which is turn triggers the development of other related Infrastructure. Young I.T employees are being paid good salaries and on an average before attainment of 30 years they are planning to acquire a house property. Just married I.T couples are also preferring to possess the house in order to avail the Income Tax Concessions. Indians are migrating to other countries and their savings at work places are being sent to their parents and the parents are purchasing / constructing beautiful homes, apartments etc.

The predominant trend has been to setup world class business centers often camups style establishments. Some of these locations are being formed as the "TEMPLES OF MODERN INDIA". Just an indication of the extent of Real Estate Development taking place. The Housing Industry today has been transformed into a Buyer's market with service standards having to keep pace with the ever rising customers expectations.

The emergence of Housing finance as a major Business in the country, an increasingly large number of people are going for Housing Loans. Incomes of families are rising and their purchasing capacity as well as loan re-paying capacities are also going up. At present both public sector banks, private sector banks and foreign banks are liberally coming forward to extend loan facilities to prospective buyers. The Government of India has been giving substantial encouragement to the Housing Sector. The social structure of the Indian families is going through a sea change as the joint family is fast giving way to the nuclear family concept. The pressure to have one's Home is high among these families.

9.2 Role of Institutional Players:

Many Institutions such as State Bank of India, Canara Bank, Indian Overseas Bank, Syndicate Bank, in fact all Public Sector Banks are Proving Housing finance at attractive and affordable rates. A part from these banks, HDFC, LIC, PNBHF, ICICI, are very active in this area. All these institutions offer number of Home Loan Products to its clientele that include plot purchase loan, house construction loans, home / flat purchase loan, house improvement loan and extension loan. Royal Sundaram Home Loans is very Popular in southern India.

9.3 Tenure of Loan:

The tenure of loan depends upon age, need of the customer, purpose of loan, pepayment capacity, tenure of service etc. On an average house owners are taking the loan for 15 years on Equated Monthly Installments (EMI) Cost of Loan: All the housing finance Institutions charge processing and administration fee which is linked to the amount of loan from customers. The quantum of charges affects the cost of loan to be borne by the customer.

9.4 Repayment Schedule of Loan:

The Loan is repaid in the form of installments. Mostly the installments are to be paid monthly. The repayment of loan in the case of most of the Housing finance Institution are in the form of Equated Monthly (EMI). Some Institutions permit the customers to repay the amount at any time but normally it is paid in Equated Monthly Installments and has a provision of Bi-annual system of repayment in case of agriculturists. Some other loan options available are Front Loaded, Ballon Type or Back Loaded. In case of Front Loaded system the Installments will be very high. In case of Ballon type the total loan period will be divided into Three parts and in the initial years the installment will be low and in the middle period the installment will be high and again at the fag end period the installment amount will bellow. Some Private Housing finance Companies are charging at 'FLAT RATE'. The interest will be spread for the entire loan period. For prompt payment there will be some concession of 1 or 2 percent keeping in mind the competition level among Housing finance Institutions. Almost all the Institutions are offering fixed or floating rate of Interest to their customers.

9.5 Role of National Housing Bank (NHB):

This Institution was established as a fully owned subsidiary of the Reserve Bank of India (RBI) in the year 1988 under the NHB Act 1987 to operate as a Principal Agency to promote Housing finance Institution (HFIs) at both local and Regional Levels and to Provide financial and other support to the. The NHB is a body corporate. It can establish offices / agencies at any place with the prior approval of the Reserve Bank of India. It was incepted with an authorised paid up capital of Rs. 350 crores and it is fully subscribed by the RBI. The authorised capital can be increased up to Rs. 2000 crores by the Union Government in consultation with the Reserve Bank of India. The Board of Directors of the National Housing Bank may issue the increased authorised capital on terms and conditions determined from time to time. At the minimum 51% of its issued capital would be held by the RBI / Government / Public Sector Banks and other Institutions owned / controlled by the Government.

The supervision, direction and management of the affairs and business of the NHB is vested in its Board of Directors which exercises all powers and executes all acts and things on its behalf. Subject to the provisions of the NHB Act, the Board while discharging its functions has to act on Business Principles with due regard to Public Interest. The NHB is allowed to the following kinds of Business.

a) Promoting, establishing, supporting / Aiding in the promotion establishment / support of Housing Financing Institutions.

b) Making of loans and Advances or rendering any other form of financial assistance, what so ever for housing activities to HFI's, Banks, State Co-operative, Agricultural and Rural Development Banks or any other Institutions / class of Institutions notified by the Government.

c) Subscribing to / purchasing stocks, shares, bonds, debentures and securities of every other description.

d) Guaranteeing the Financial Obligations of HFI's and Under writing the issue of stocks / shares / Bonds / Debentures / Other Securities of HFI's.

e) Drawing, accepting, discounting / rediscounting, buying / selling and dealing in Bills of Exchange / Promissory Notes, bonds / debentures, hundies, coupons / other instruments.

ea) Buying / selling or otherwise dealing in any loans / advances secured by mortgage / charge of immovable property relating to banks / HFI's.

eb) Creating Trust (s) and Transferring loans / advances together with / without securities to HFIs for a consideration.

ec) Setting aside loans / advances held by NHB and issuing / selling securities based upon them in the form of debt obligations / trust certificates of beneficial interest / other instruments and to act as trustee for the holders of such securities.

ed) setting up of Mutual Funds for undertaking housing finance activities.

ee) Undertaking / participating in housing mortgage insurance.

f) Promoting / forming / conduction or associating in promotion / formation conduct of companion / mortgage banks / subsidiaries societies / Trusts / other associations of persons it may deem fit for carrying out all / any of its functions under NHB Act.

g) Undertaking research and surveys on construction techniques and other studies relating to shelter / Housing and Human settlement.

h) Formulating schemes for purposes of mobilization of resources and extension of credit for Housing.

i) Formulating scheme (s) for purposes of mobilization of resources and extension of credit for Housing for the economically weaker sections of society, which may be subsidised by the Government or any other source.

j) Organising Training Programmes / Seminars / Symposia on matters relating to Housing.

k) Providing guidelines to HFIs to ensure their growth on sound lines.

l) Providing Technical / Administrative assistance to HFIs.

m) Co-ordinating with Life Insurance Corporation of India the unit trusts of India. The General Insurance Corporation of India and other Financial Institutions in the discharge of its overall functions.

n) Exercising all powers and functions in the performance of duties entrusted to it under the NHB Act or under any other law in force for the time being.

o) Acting as a Agent of the Central / State Government / RBI or of any authority as may be authorised by the RBI.

p) Any other kind of Business which the Government may on the recommendations of the RBI authorize.

q) Generally, doing of all such matters and things as may be incidental to or consequential upon the exercise of its powers or the discharge of its duties under the NHB Act.

9.6 Borrowing and Acceptance of Deposits:

For purposes of carrying out its functions the NHB may

a) Issue and sell Bonds and Debentures with or without the guarantee of the Central Government in such manner and on such terms on may be prescribed.

b) Borrow money from the Central Government, Banks, Financial Institutions, Mutual Funds and from any other authority or organization or Institution approved by the Government on such terms and conditions as may be agreed upon.

c) Accepting Deposits repayable after such period and on such forms as may generally or specially be approved by the RBI.

d) Borrow money from the RBI (i) By way of loans and advances and generally obtain financial assistance in a manner specified by the RBI (ii) out of the National Housing Credit (Long Term operation) Fund established under sec. 46 – D of the RBI Act.

e) Receive for services rendered, remuneration, commission, commitment charges, consultancy charges, service charges royalties, premium, license fee and other considerations of any description.

f) Receive gifts, grants, donations or benefactions from the Government or any other source.

9.7 Housing finance System:

The implementation of Housing finance Policies presupposes efficient institutional arrangements. Although there were a large number of agencies providing direct finance to individuals for house construction, there was no well established finance system till the mid eighties in as much as it had not been integrated with the main financial system of the country. The establishment of the National Housing Bank (NHB), a fully owned subsidiary of the Reserve Bank of India as an apex Institution was the end of the fulfillment of a long overdue need of the Housing finance Industry in India. The system has also been characterised by the emergence of several specialised financial institutions that have considerably strengthened the organization of the Housing finance system in the country. At present, there are about 320 Housing finance companies of which 26 are registered with the NHB and which account 98 percent of the Total Housing Loan disbursed. Following are the main agencies operating in our country.

a) **Central and State Governments:** Till the mid eighties the responsibility to provide Housing finance rested by and large with the Government. The Central and State Governments indirectly support the housing building effort. The Union Government has introduced from time to time various social housing schemes. The role of the Central Government against these schemes is confined to laying down broad principles providing necessary advice and rendering financial assistance in the shape of loans and subsidies to the State Governments and Union Territories. The Central Government has set up the Housing and Urban Development Corporation (HUDCO) to finance and undertake housing and Urban development Programmes Development of land for satellite towns besides setting up of a building materials industry.

The Central Government provides necessary fulcrum to the HUDCO and guarantees the Bonds issued by it. Apart from this the Central Government and respective State Governments provide house building advances to their employees. The responsibility of the Central Government is to evolve the policies and the respective State Governments are the real implementers.

9.8 Housing and Urban Development Corporation (HUDCO):

HUDCO was established on 25th April 1970 as a fully owned Government of India enterprise with the following objectives.

a) To provide long-term finance for construction of houses for the residential purposes or finance or undertake housing and urban development programmes in the country.

b) To finance or undertake the establishment of New Satellite Towns.

c) To finance or undertake the establishment of the building materials industries.

d) Administer the monies received from the government of India and other such grants for purposes of financing or undertaking housing and urban development programmes.

e) To subscribe to the debentures and bonds to be issued by the State Housing Boards, Improvement Trusts, Development Authorities and so on specially for the purpose of financing housing and urban development programmes.

9.9 Insurance Organizations / Corporations:

The Life Insurance Corporation of India and General Insurance Corporation support housing activity both directly and indirectly. Besides subscribing to bonds of the HUDCO and State Housing Boards, LIC grants loans to the states for their Rural Housing Programmes and to Public Sector Companies for construction of Staff Quarters. Though LIC has been granting loans directly to individuals the impetus to housing finance was provided In June 1989, the LIC promoted a subsidiary for the purpose namely LIC Home Finance Ltd.

9.10 Commercial Banks:

The trend of commercial banks lending to individuals for housing emerged in the wake of the report of the working group on the role of banking system in providing finance to housing schemes. (R.C SHAH Working Group the RBI 1978). They have been lending to the Housing sector based on Annual Credit allocations made by the RBI. In terms of the RBI guidelines, scheduled commercial banks are required to allocate 1.5 percent of their incremental deposits for disbursing on housing finance every year. Of this allocation 20 per cent has to be by way of direct housing loans which again at least half, that is 10 per cent of the allocation, has to be rural and semi – urban areas. Another 30 per cent could be for indirect lending by way of term loans to housing institutions, housing finance companies and public housing agencies for the acquisition and development of land and to private builders for construction. The balance 50 per cent is for subscription to the HUDCO and the NHB Bonds.

9.11 Co-operative Banks:

The Co-operative Banking Sector consists of state co-operative banks (SCBS). District control co-operative banks (DCBs) and primary urban co-oerative Banks (PUCBs). The First set of comprehensive guidelines for these co-operative banks were issued in 1984 by the RBI. Co-operative Banks, Finance Individuals, Co-operative group Housing Societies, Housing Boards and others who under take housing projects for the Economically weaker sections, Low Income groups and Middle Income groups.

9.12 Specialised Housing finance Institutions (HFIS):

There are some Institutions termed as “Specialised HFIs that cater only to the needs of the housing sector. They can be further classified as housing finance companies (HFIs) promoted in the Public / Joint / Private Sectors and Co-operative Housing finance Societies. A major and leading company is Housing Development Finance Corporation (HDFC). It lends mainly for new residential housing to individuals, group of individuals and individual members of co-operative societies. Apart from the HDFC a member of Housing finance Corporations have been sponsored by banks such as the SBI Home Finance Ltd., Canfin Homes Ltd., Ind Bank Housing finance Ltd. And Citi Bank Ltd.,

SECURITISATION: This is a process of Pooling and repackaging of homogeneous illiquid financial assets into marketable securities that can be sold to investors. The process leads to the creation of financial instruments that represent ownership interest in or one secured by segregated income producing asset or pool of Assets. The pool of assets collateralises securities. These assets are generally secured by personal or real property such as automobiles, real estate or equipment loans but in some cases are unsecured credit card debt and consumer loans.

9.13 Securitisation Process:

1. Assets are originated through receivables, leases, housing loans or any other form of debt by a company and funded on its balance sheet. The company is normally referred to as the 'Originator'.
2. Once a large portfolio of assets has been originated, the assets are analysed as a portfolio and then sold or assigned to a third party, which is normally a special purpose vehicle company (SPV) formed for the specific purpose of funding the assets. It issues debt and purchases receivables from the originator. The SPV is owned by a trust the originator.
3. The administration of the asset is then subcontracted back to the originator by the SPV. It is responsible for collecting interest and principal payments on the loans in the underlying pool of assets and transfer to the SPV.
4. The SPV issues tradable securities to fund the purchase of assets. The performance of these securities is directly linked to the performance of the assets and there is no recourse back to the originator.
5. The investors purchase securities because they are satisfied that securities would be paid in full and on time from the cash flows available in the asset pool. The proceeds from the sale of securities are used to pay the originator.
6. The special purpose vehicle (SPV) agrees to pay any surplus which may arise during its funding of the assets back to the originator. Thus the originator for all practical purposes retains its existing relationships with the borrowers and all of the economies of funding the assets.
7. As cash flow arise on the assets, these are used by the SPV to repay funds to the investors in the securities.

9.14 Competition in Housing finance:

Towards the end of 1990s against the back drop of lower interest rates, Industrial slow down, sluggish credit off-take and ample liquidity, commercial banks reorganised that if they had to maintain profit margin they need to shift their focus from the wholesale segment and build up their retail portfolios. Some commercial banks devised aggressive marketing campaign to increase the size of their housing segment. This includes intensive advertising campaigns. Waivers of processing and administrative fee, gift offers and other incentives on the spot loan approvals without margin money i.e. cent per cent. Due to these reasons Housing finance Industry to-day has been transformed into 'Buyers Market. Service standards keep pace with ever rising customers satisfaction.

9.15 Future Scenario:

As such there is great demand for housing finance in India. In order to give impetus to this sector there is a need to completely change the legal system governing various aspects of real estate. There are several procedures to be followed in different states due to the reason that land is a state subject. Every year Government is increasing Stamp Duty which is a State Subject. This aspect is to be rationalised. Similarly more avenues have to be opened up facilitating long-term finance for the Housing sector. The noteworthy feature is that Securities Exchange Board of India has permitted the mutual fund asset management companies to enter into real estate Arena. At the same time, the introduction of mortgage guarantee or insurance will help a large segment of the society to access Housing finance.

9.16 Summary:

Housing finance has grown into a major business. Several private and public institutions have entered this field of business. National Housing Bank established as a subsidiary of Reserve

Bank of India is operating as a principal agency to promote Housing finance Institutions. HUDCO established as a fully owned Government of India enterprise provide long term finance for construction of houses for residential purpose.

9.17 Self Assessment Questions:

1. Discuss the role of National Housing Bank.
2. Explain the role of HUDCO
3. Explain the system of housing finance prevailing in India.

9.18 Further Readings:

1. VK Bhalla, *Management of Financial Services* Armed Publications Pvt. Ltd, New Delhi.
2. S. Gurusamy, *Financial Services and Systems* Vijay Niole imprints Pvt. Ltd, Chennai.
3. M Y Khan, *Financial Services*, Tata McGraw Hill, Publishing Co. Ltd., New Delhi.
4. V A Avadhani, *Financial Services*, Himalaya Publishing House, New Delhi.

Dr. C.ANIL KUMAR

MORTGAGE :

A mortgage is a type of loan secured by real property. Most people think of a mortgage as being drawn to purchase a property, but mortgage loans are also used to refinance properties that are already owned by the borrower.

A mortgage drawn to support the acquisition or the refinancing of a home is typically called a residential mortgage. A mortgage drawn to support the acquisition or the refinancing of a commercially zoned property (like a warehouse, mall, or office facility) is usually called a commercial mortgage.

A mortgage lender (creditor) is compensated for extending the credit by charging the borrower (debtor) interest.

Features :

- A mortgage is a type of loan secured by real property.
- There are both residential and commercial mortgages, with risk characteristics that are unique to each.
- Mortgages tend to have more favorable terms (longer amortization, higher LTV, and lower interest rates) than other types of borrowing.
- Mortgage loans are made by traditional banks, as well as other financial services firms like insurance companies, asset managers, and other investment funds.

1. Money Market :

It is a market for short-term funds normally up to one year. Itrefers to the institutional arrangement which deals with the short term borrowingand lending of funds. It is a short-term credit market.

2. Capital Markets :

It is a market for issue and trading of long-term securities.Theterm to maturity should be longer than 3 years. The securities traded in capitalmarket are informally classified into short-term, medium-term, and long-termsecurities depending on their term to maturity.It is market for long termborrowing and lending of funds.

3. Financial Mortgages Market :

It is a market through which mortgage loans aregranted to individual customers. Mortgage loans are granted against immovableproperty like real estate. Mortgage is the transfer of an interest in the specificimmovable property for the purpose of securing loans.The transferor is calledmortgager and transferee is called mortgagee. The common type of mortgageloan, which are seen in India is residential mortgages, housing DevelopmentCorporation, National Housing

Bank, Housing Finance Companies and LifeInsurance Corporation are prominent players in financing residential projects.

4. Financial Guarantees Market :

The financial guarantee market is an independentmarket. It is a financial service market. It is the centre where finance is providedagainst the guarantee of a reputed person in the financial circle. There are manytypes of guarantees.The common forms are

Performance guarantee :

It covers the payment of earnest money, retention money, advance payments etc. these guarantees are given by the banks to government or public bodies on behalf of contractors undertaking to pay the penalty in the event of the non – fulfillment o the contract.

Financial guarantees :

It covers only financial contracts. The mainsources of guarantee in India are.

1. Personal guarantee :

It is the guarantee given by the individual toobtain loans from cooperative banks or stands as a surety for chitfunds etc.

2. Government guarantee :

The centre and state governments areproviding guarantees in a number of instances. The governmentstands as a guarantor for public sector enterprises to obtainfinance from the financial institutions.

3. Institutional guarantee :

It is the guarantee provided by theinstitutions like LIC, statutory financial institutions, specializedfinancial institutions like credit Guarantee Corporation, DepositInsurance and Credit Guarantee Corporation etc.

5. Foreign Exchange Market :

Foreign exchange refers to the process ofconversion of home currencies into foreign currencies and vice versa. According to

Kindle Berger :

Foreign exchange market is a place where foreign moneys are boughtand sold. This market deals with exchange of foreign currency, notes, coins and bankdeposits denominated in foreign currency units and liquid claims like drafts, traveler'scheques, letters of credit and bills of exchange expressed in Indian rupee but payable inforeign currency.In India foreign exchange market is the privilege of the Reserve Bankof India.Foreign Exchange Regulation Act (FERA) was passed by the Government ofIndia in 1947, which was later modified in 1973 to regulate foreign exchange market.